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RAIL RATES FOR COAL TRANSPORTATION: AN ICC DECISION COSTLY TO SHIPPERS

Ben David Shiriak*

I. INTRODUCTION

The standards which govern regulatory commissions in the conduct of their ratemaking functions are set by the Supreme Court. In Federal Power Comm. v. Hope Natural Gas Co.,¹ the Court stated that the “ratemaking process involves a balancing of the investor and consumer interests.”² Elaborating upon Hope the Court in Permian Basin Area Rate Cases,³ stated that a reviewing court must: (a) determine whether the Commission’s order abused or exceeded its authority; (b) examine “the manner in which the Commission has employed the methods of regulation which it has itself selected . . . ;” (c) decide whether “each of the order’s essential elements is supported by substantial evidence;” and (d) determine:

[Whether the order may reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risks they have assumed, and yet provide appropriate protection to the relevant public interests, both existing and foreseeable. The Court’s responsibility is not to supplant the Commission’s balance of these interests with one more nearly to its liking, but instead to assure itself that the Commission has given reasoned consideration to each of the pertinent factors. [Emphasis added.]⁴

Both Hope and Permian Basin require regulatory bodies to balance the interests of investors and consumers.

The standards articulated in these cases are applicable to the Interstate Commerce Commission, the agency which regulates railroad rates through both rulemaking and ratemaking proceedings.⁵ In its rulemaking function, the Commission may establish industry-wide standards for the prescription of rates.⁶ In ratemaking, the Commission, after finding that it has jurisdiction,⁷ focuses on

* BA, Rutgers University, 1961; MBA, Columbia University, 1967; JD, Rutgers University, 1973; Mr. Shiriak participated in Ex parte No. 393, Standards for Railroad Revenue Adequacy. The views expressed in this article are those of Mr. Shiriak and do not reflect those of his current or past associates.

1 320 U.S. 591 (1944).
2 Id. at 603.
4 Id. at 790-92.
6 Rulemaking proceedings are governed by the Administrative Procedure Act, Pub. L. 89-554, § 1, 80 Stat. 383, codified as 5 U.S.C. § 553.
7 The Railroad Revitalization and Regulatory Reform Act (4-R Act) limited the Commission’s jurisdiction to railroad rates over which a carrier has “market dominance.” Pub. L. 94-210, § 202(b), 90 Stat. 31 (codified at various portions of Titles 46 and 49 U.S.C.). See 49 U.S.C. § 10701a(b)(1) (Supp. IV 1980). Market dominance was defined as “an absence of effective competition from other carriers or modes of transportation for the traffic or movement to which a rate
specific traffic (such as movement from point A to point B) determines its costs, and prescribes a tariff.

*Ex parte No. 393, Standards for Railroad Revenue Adequacy*⁸ was a rulemaking proceeding in which the Commission sought to implement 49 U.S.C. § 10704a(2). Section 10704(a)(2) provides:

(2) The Commission shall maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers providing transportation subject to its jurisdiction under that subchapter that are adequate, under honest, economical, and efficient management, to cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit applies.” Pub. L. 94-210, § 202(c)(1). See 49 U.S.C. § 10709(a) (Supp. IV 1980). The Staggers Rail Act of 1980 amended the market dominance provisions of the 4-R Act. Pub. L. 96-448, § 202, 94 Stat. 1885, codified at various portions of Title 49 U.S.C. See 49 U.S.C. § 10709(d)(2) (1980 Supp. IV). It established the “jurisdictional threshold,” which meant that a rail carrier could not have market dominance if the ratio of revenues to variable cost for the challenged movement was less than a certain percentage. *Id.* For the year beginning October 1, 1982 and ending September 30, 1983, the revenue to variable cost ratio is 170 percent. The term “revenue” means the price charged to transport a movement. The term “variable costs” resembles, but is not necessarily the same as, variable costs as they might be defined by generally accepted accounting principles. Variable costs are those costs which vary with the volume of traffic. They include operating expenses, certain taxes (but not Federal income taxes), and an allowance at the embedded debt level for a return on road property and equipment. Variable costs are less than fully-allocated costs which include variable costs plus fixed costs (those expenses which do not vary with traffic, e.g., management salaries) plus an allowance for the current cost of capital.

The jurisdictional threshold ratio of 170 represents a return of approximately 20.0% after-tax on investment and 27.0% on equity. In *Ex parte No. 394, Cost Ratio for Recyclables—1980 Determination* (1981), the I.C.C. found that a ratio of 146.3% of variable cost would cover total costs (fully allocated costs) including the current cost of capital. A ratio of revenue to variable costs greater than the jurisdictional threshold did not, however, create a presumption of market dominance. 49 U.S.C. § 10709(d)(4). After passage of the Staggers Act, the I.C.C. revised the criteria with which it would evaluate market dominance. *Ex parte No. 320 (Sub-No. 2), Market Dominance Determinations, 365 I.C.C. 118, 120-21 (1981).* The Commission had formerly presumed that a carrier held market dominance if it (1) had a 70% market share of the commodity involved; (2) had a rate to cost ratio of 160 or greater; or (3) the shipper had made a substantial investment in rail-related plant or equipment. The Commission rejected these presumptions, and adopted guidelines which focused on various forms of competition (intramodal; intermodal; geographic; and product). The revised guidelines made it much more difficult for shippers to show market dominance. The guidelines were appealed. The United States Court of Appeals for the Fifth Circuit found them invalid and remanded for further proceedings which have not as yet been undertaken. Western Coal Traffic League v. United States, 694 F.2d 378 (5th Cir. 1982). The Court found that the geographic and product competition standards were not authorized by Congress. It approved, however, the Commission's elimination of the presumptions.

Market dominance is simply another label for monopoly power. Most coal shippers have no transportation alternative. These shippers are faced with the same situation as the ordinary retail user of electricity, natural gas, local telephone, and water: there is only one supplier of an essential service. It would therefore appear that the regulatory standards which are consistently applied to the latter industries by federal and state commissions should also be applied to market dominant rail traffic.


or return (or both) on capital employed in the business. The Commission shall make an adequate and continuing effort to assist those carriers in attaining revenue levels prescribed under this paragraph. However, a rate, classification, rule, or practice of a rail carrier may be maintained at a particular level to protect the traffic of another carrier or mode of transportation only if the Commission finds that the rate or classification, or rule or practice related to it, reduces or would reduce the going concern value of the carrier charging the rate. 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.¹⁰

This section, which originated in section 205 of the 4-R Act, was, with the exception of the addition of the words “and revise as necessary,” substantially unchanged by the Staggers Act.

In Ex parte No. 393, the Commission found that:

(a) a single standard—rate of return on net investment in plant—should be used to determine revenue adequacy;

(b) the current cost of debt should be used in calculating the cost of capital; and

(c) deferred taxes should not be deducted from net investment (rate base) or treated as zero-cost capital.

Numerous coal shippers appealed.¹¹ Ex parte No. 393 raises the rates captive shippers pay in two ways. First, it makes it easier for railroads to be declared “revenue inadequate” and thereby entitled to differential pricing.¹² Second, it increases the cost of the capital component of an individual rate.

The concept of revenue adequacy is derived from section 10704a(2) which refers to “revenue levels . . . that are adequate . . . to cover total operating expenses . . . plus a reasonable and economic profit or return. . . .”¹³ The Commission chose rate of return on investment as its standard of revenue adequacy. A railroad earning more than its prescribed rate of return will generally

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¹¹ Coal shippers spend about $6 billion annually to move coal by rail. Dunbar, The (Uncertain) Route to Railroad Deregulation and What It Will Cost Utilities, Electric Perspectives, Winter 1983 at 3. Ex parte No. 393 would appear to raise rail rates unnecessarily by about $1.2 to $2.4 billion in the first year of its implementation.
¹² When determining the share a particular class of customers must bear of the total revenue requirement, the principles of Payne v. Washington Met. Area Transit Comm’n, 415 F.2d 901 (D.C. Cir. 1969) and National Assoc’n of Greeting Card Pub. v. United States Postal Service, 569 F.2d 670 (D.C. Cir. 1976) come into play. These cases state that differential pricing—charging certain customers more in relation to costs than others—may be utilized if it can be demonstrated that all customers as a whole are better off. These cases require a showing that the traffic which receives favorable rates would not move in the absence of those rates, and that the contribution from that traffic is sufficient to reduce rates to the unfavored traffic below what they would be if the unfavored traffic were the only traffic moving.
be considered revenue adequate. If the railroad is revenue inadequate, it is eligible for differential pricing. Differential pricing is an increment above fully-allocated costs designed to make a railroad revenue adequate. Those customers which have the most inelastic demand for a service will pay the highest price. Included in that price is a subsidy so that the railroad may charge the lowest possible price to customers whose demand is highly elastic, that is, those which have other transportation alternatives.14

In Ex parte No. 347 (Sub-No. 1), Coal Rate Guidelines-Nationwide, decided February 8, 1983,15 the Commission proposed a differential pricing scheme permitting the railroads to raise their captive coal shipper rates by 15% per year until the railroad has achieved revenue adequacy.16 The Commission projected that 19 of 21 coal carrying railroads would become revenue adequate within eight years.17 However, the Commission did not project the impact of the 15% annual increase on the rates paid by shippers. It is estimated the result would be a 206% increase.18 For example, a rate of $10.00 per ton in 1983 would be $30.06 per ton in 1991. Coal shippers would pay $18 billion per year in 1991, $12 billion more than today.

The criteria of Ex parte No. 393 are also used to calculate the cost of capital component of an individual rate.19 The Commission determines the appropriate cost of capital for an individual railroad, and multiplies it against the net investment in railroad plant associated with the specific movement when prescribing the individual rate. For example, if 12.5% were the appropriate after-tax cost of capital, and the net investment allocable to the specific movement was $1,000,000, then $125,000 would be the return on investment required. The Commission would prescribe a rate incorporating the cost of capital component. When the Commission-determined cost of capital is greater than it actually is, shippers pay an unnecessary extra expense.

The United States Court of Appeals for the Third Circuit in Bessemer &
Lake Erie RR v. ICC\textsuperscript{20} affirmed the Commission's decision in Ex parte No. 393.

This Comment will discuss the Commission's and the third circuit's positions on: (1) the use of the current cost of debt instead of the actual historical cost in calculating the rate of return; (2) the inclusion of deferred taxes in the rate base; and (3) the rate of return as the sole standard of revenue adequacy.

II. CURRENT COST OF DEBT

Section 10704a(2) of the Staggers Act specifies that railroads are entitled to rates which provide "a reasonable and economic profit or return (or both) on capital employed in the business" and which "assure the repayment of a reasonable level of debt [and] permit the raising of needed equity capital . . . ." Rates "should . . . attract and retain capital in amounts adequate to provide a sound transportation system in the United States."\textsuperscript{21} The Commission had previously implemented this language by computing a cost of capital ("capital employed in the business") which was the weighted average of the embedded cost of debt and the current cost of equity.\textsuperscript{22} In so doing, the Commission used the rate of return formula common to virtually every regulatory body in this country: 1) the historical cost of debt is calculated; 2) the current cost of equity is determined; 3) an appropriate capital structure is selected; and 4) the components are then weighted together to produce an overall cost of capital.\textsuperscript{23} For example, a 10% cost of debt, a 15% cost of equity, and a 50/50 debt-equity ratio would produce a 12.5% overall cost of capital:

<table>
<thead>
<tr>
<th>Component of Capital Structure</th>
<th>Share of Capital Structure</th>
<th>Weighted Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>50%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Equity</td>
<td>50%</td>
<td>7.5</td>
</tr>
<tr>
<td>Total:</td>
<td>100%</td>
<td>12.5%</td>
</tr>
</tbody>
</table>

In Ex parte No. 393, the Commission substituted the current cost of debt for the historical. Since current costs are substantially higher than historical, the result is to raise the overall cost of capital. If a 15% cost of debt is substituted in the formula above, then the revised cost of capital is 15%, as opposed to the 12.5% produced when historical debt costs are used. Thus, railroads whose actual earned rates of return were above 12.5%, but below 15%, would be deemed revenue inadequate, even though they earned greater than their actual costs. The use of current cost of debt is also important in individual rate

\textsuperscript{20} 691 F.2d 1104 (3d Cir. 1982).
\textsuperscript{21} 49 C.F.R. § 10704a(2) (Supp. IV 1980).
\textsuperscript{22} This was the Commission's general practice as set forth in Ex parte No. 338.
\textsuperscript{23} This formula is commonly accepted by financial theorists and regulatory bodies. See R. Johnson, supra note 9 at 254. The Interstate Commerce Commission has consistently utilized a weighted cost of capital formula.
cases because it adds to the overall return component of a particular rate.\textsuperscript{24}

The Commission based its position on two theories. The first might be termed the "marginal cost, incremental investment" rationale. The Commission, quoting its Notice of Proposed Rulemaking, stated, "If the flexibility granted revenue inadequate carriers is restricted in periods of high debt rates to carriers earning less than the cost of capital calculated using the embedded debt rate, some economically efficient investments (those earning at least the current cost of capital) may be foregone."\textsuperscript{25} This statement appears to ignore the phrasing of section 10704a(2), "capital employed in the business," which refers to investments already made in the business. The Commission's approach is strictly forward-looking and ignores past costs. By focusing on incremental investments, the Commission did not adequately consider the purpose of \textit{Ex parte} No. 393, i.e., to set a standard for all investments. The Commission did not recognize that the cost of capital formula commonly used by regulatory agencies is sufficiently flexible so that the cost of capital of a new or proposed investment may be reflected in that formula.

The Commission's second theory considers debt cost in the future debts. It may be summarized:

Let us assume further, however, that the railroads are today issuing debt instruments at much higher rates. Five years from today, rates will be premised on coverage of such debt instruments [under the shippers' approach], even though debt might then be available at far lower rates. Shippers dependent on rail service would then be forced to pay rates at levels higher than would be necessary if current debt costs were used.\textsuperscript{26}

But, this position conflicts with the statute which requires rates that "assure the repayment of a reasonable level of debt . . . ."\textsuperscript{27} This goal may only be achieved if future rates provide for all historical interest costs. In addition, it is contrary to the principles of \textit{Hope} and \textit{Permian Basin}. The interests of investors would not have been protected because they would not have been fairly compensated "for the risks they have assumed."\textsuperscript{28}

The Third Circuit's principle reason for approving the current cost of debt was the "leverage" argument. This position was not advocated by any party or the Commission. The court reasoned: "In an unregulated industry it would be the object of management, by judicious resort to borrowed funds, to make capital investments which properly utilized would earn in excess of the cost of borrowed funds, thereby providing leverage for stockholder investors."\textsuperscript{29} The

\textsuperscript{24} The total impact of the change from the historical to the current cost of debt is difficult to estimate. It will: (a) render some railroads revenue inadequate and, therefore, eligible for the differential pricing subsidy; and (b) raise the return permitted on the railroad rate base. A one percent increase in the return on a rail rate base of $10 billion would produce a $100 million rate increase.

\textsuperscript{25} 364 I.C.C. at 815.

\textsuperscript{26} Id. at 816.

\textsuperscript{27} 49 C.F.R. § 10704a(2) (1976).

\textsuperscript{28} \textit{Permian Basin}, 390 U.S. at 792.

\textsuperscript{29} 691 F.2d at 1113.
failed to recognize that, with regard to this process, there is no distinction between regulated and unregulated industries. The cost-of-capital formula illustrates leverage. In that illustration, the equity investor earns 15%, the firm earns 12.5%, and debt covers its costs at 10%. Equity investors thereby reap the benefits of lower cost debt. Since the traditional cost of capital formula employing historical debt costs already achieves leverage, the court’s justification for the current cost of debt is without basis.

Because it is unreasonable to require coal shippers to pay rates significantly higher than actual costs, the Commission and the court are in conflict with 49 U.S.C. § 10101a(6) which requires “reasonable rates where there is an absence of effective competition.” Furthermore, it does not appear that there has been a proper balancing of consumer and investor interests.

III. Deferred Taxes

A. A Brief Explanation

Deferred taxes are a contingent liability, representing future obligations to the Federal government. They arise primarily, but not exclusively, from taxbook timing differences associated with the usage of accelerated depreciation for tax purposes and straight-line depreciation for book purposes. Each year’s tax deferrals represent an interest-free source of funds which have been contributed by ratepayers.

There are two common ratemaking treatments for tax deferrals: flow-through and normalization. Under the flow-through method, rates reflect actual taxes paid. Flow-through is generally considered appropriate when there is a permanent tax saving. Under normalization, rates reflect total taxes, that is, the sum of actual taxes plus deferred taxes. But, since deferred taxes are cost-free capital, either a deduction is made from rate base of the total amount of accumulated deferred taxes or this account is treated as zero-cost capital in the calculation of the cost of capital.

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See E. Brigham, Financial Management Theory and Practice 195 (2d Ed.).

Neither the Third Circuit nor the Commission cited any cases supporting their positions.

Alfred E. Kahn described the problem:

So regulatory commissions have had to decide whether the taxes to be incorporated in price should be only those actually paid—in which event the benefits of accelerated depreciation are passed on entirely to customers in the years of tax saving—or “normalized” over the life of the investment (higher than actual taxes in the early years, lower in the later)—in which event the interest-free loan is retained by the company. If the latter is chosen, commissions have had to decide also what treatment should be given to the revenues recouped from consumers in excess of the taxes actually paid in the earlier years. These “phantom taxes” are typically segregated in a special reserve for deferred taxes, in recognition of the fact that taxes will in later years exceed these “normalized” recoupments from customers. But the controversial question is whether the amount of
taxes when treated as zero-cost capital on the rate of return.

Cost of Capital Calculation
Adjusted for Deferred Taxes at Zero Cost

<table>
<thead>
<tr>
<th>Component</th>
<th>Share of Capital</th>
<th>Cost</th>
<th>Weighted Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structure</td>
<td>Structure</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td>40%</td>
<td>10%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Equity</td>
<td>40</td>
<td>15</td>
<td>6.0</td>
</tr>
<tr>
<td>Deferred Taxes</td>
<td>20</td>
<td>0</td>
<td>0.0</td>
</tr>
<tr>
<td>Total:</td>
<td>100%</td>
<td></td>
<td>10.0%</td>
</tr>
</tbody>
</table>

In *Ex parte* No. 393, the Commission did not adopt either flow-through or normalization. The Commission's approach could be called "normalization plus." Under normalization plus, the railroads are twice compensated for taxes they do not pay. First ratepayers pay a fictitious current tax expense. Then they pay a return on the deferred taxes included in rate base. Shareholders receive a bonus return since they did not provide the deferred taxes.

The difference between normalization plus and true normalization is substantial. Under normalization, if the statutory tax is $10.00 and the actual tax paid is $5.00, then the shipper pays a rate reflecting $10.00 in taxes. But under normalization plus, the shipper pays a rate which reflects $10.00 in taxes plus an additional $1.00 in return on rate base (assuming a 20% pre-tax rate of return times the $5.00 of deferred taxes remaining in the rate base). Each year that the $5.00 remains in rate base, the shipper will pay the $1.00 again.

The following table demonstrates the impact of paying a return on deferred taxes assuming, as in the first example, a 12.5% cost of capital:

Cost of Capital Calculation
Adjusted for Deferred Taxes at 12.5% Cost of Capital

<table>
<thead>
<tr>
<th>Component</th>
<th>Share of Capital</th>
<th>Actual Return</th>
<th>Weighted Cost</th>
<th>Earned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Structure</td>
<td>Structure</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Debt</td>
<td>40%</td>
<td>10.0%</td>
<td>4.0%</td>
<td>10.00%</td>
</tr>
<tr>
<td>Equity</td>
<td>40</td>
<td>15.0</td>
<td>6.0</td>
<td>21.25</td>
</tr>
<tr>
<td>Deferred Taxes</td>
<td>20</td>
<td>12.5</td>
<td>2.5</td>
<td>—</td>
</tr>
<tr>
<td>Total:</td>
<td>100%</td>
<td>12.5%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The actual return earned on equity will be 21.25%. Only shareholders would benefit by permitting the return on deferred taxes. Therefore, the earned re-

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1 A. Kahn, *The Economics of Regulation: Principles and Institutions* 33.
turn on deferred taxes (at a rate of 12.5%) must be combined with the earned return on equity (at a rate of 15.0%) to form the numerator of the ratio, return on equity. The Commission's approach permits equity holders to earn in excess of their cost of capital.

B. The Positions of the Commission and the Third Circuit

In Ex parte No. 338, Standards and Procedures for the Establishment of Adequate R.R. Revenue Levels the Commission deducted deferred taxes from the investment base, stating:

We are cognizant of the fact that this treatment confers a benefit on the carriers, in that they are receiving and retaining revenue which is not accounted as income. As indicated by some of the parties, the capital funds arising from deferred taxes have been contributed by the ratepayers rather than by investors in the company. Thus it is appropriate to deduct the deferred tax account from the net investment rate base prior to any calculation of rate or return.3

But relying upon its position as set forth in a Notice of Proposed Guidelines in Ex parte No. 347 (Sub-No. 1), Coal Rate Guidelines-Nationwide, the Commission reversed itself.4

In our notice of proposed guidelines in Ex parte No. 347 (Sub-No. 1), we said:

The deferred tax account can be considered a source of funds freed up for reinvestment. These funds constituted a substantial part—up to 20 percent in some cases—of the total capital available to individual railroads for this purpose. To the extent that the railroads are not allowed to earn a return on investments made with these funds, the incentive to undertake railroad investments with such funds is substantially reduced. Instead, an environment is created in which there is an incentive to take funds generated within the railroad industry and invest them elsewhere, where market-determined rates of return are available. We are concerned that this may thwart the intent of Congress in passing the Revenue Acts of 1954 and 1962, to provide business enterprise with tax benefits as a means of spurring capital spending.

While we are not considering ratemaking per se here, the economic principle is the same. If we exclude internally generated funds, whether stemming from accelerated depreciation or any other railroad activity, from the investment base, the effect will be to establish a rate of return below the cost of capital. This, in turn, will result in incentives to railroads to invest these funds in nonrail operations. In short, we are concerned that exclusion of the deferred tax account from the investment base would conflict with our duty under section 10704(a)(2)(A) of the Interstate Commerce Act as amended by the Rail Act to set revenue adequacy figures at levels that would 'provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure

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No state regulatory commission fails to deduct accumulated deferred taxes from rate base or treat them as zero-cost capital in the cost of capital calculation. NATIONAL ASSOCIATION OF REGULATORY UTILITY COMMISSIONERS, 1980 ANNUAL REPORT ON UTILITY AND CARRIER REGULATION, at 562-64. The Federal Energy and Regulatory Commission and the Federal Communications Commission also make the rate base deduction.
the repayment of a reasonable level of debt, permit the raising of needed eq-
ui ty capital, and cover the effects of inflation.37

The Third Circuit agreed with the Commission.

The simple fact remains, however, that for all businesses accelerated de-
preciation is a source of funds which may be reinvested. If the railroad indus-
try were to be put in the position that unlike unregulated industries it could
not earn a rate of return on investment of such funds it would be a competitive
disadvantage in seeking equity capital, and it would be encouraged to invest
the funds generated from accelerated depreciation elsewhere than in the rail-
road business. Perhaps in balancing the competing interests for shippers and
rail carriers a commission decision excluding reserves for deferred taxes from
the rate base would be a defensible interpretation of section 205. Indeed that
was the ICC's earlier position. . . . It would, moreover, produce a rate of re-
turn below the cost of capital, since capital markets act with knowledge of the
availability of accelerated depreciation as a source of funds.38

C. Precedent

While some regulatory jurisdictions flow through tax deferrals, the major-
ity normalize. Virtually every normalizing jurisdiction makes either a rate base
deduction or the zero cost of capital adjustment.39 This procedure is based on
Hope which holds that the interests of investors and consumers must be bal-
canced.40 Under normalization, investors benefit because the firm receives ade-
quate revenues to cover operating expenses. Consumers benefit because a con-
stant income tax rate tends to stabilize rates. But under normalization plus,
investors benefit excessively since the firm receives revenues greater than any
income tax expense.41 Rates will be perpetually excessive for the consumer.

The United States Court of Appeals for the District of Columbia Circuit
was fully aware of the applicable legal principles when it instructed the Com-
misson to deduct deferred taxes from the rate base in San Antonio Tex. v.
United States.

As this Court has recognized on more than one occasion, the principle of ex-
cluding a deferred tax reserve from the rate base, as such reserve comes into
existence, is an essential component of the agency's election to normalize taxes
for ratemaking purposes. Otherwise, the ratepayer who has paid higher rates
reflecting normalization accounting would be paying the carriers for earnings
on the tax differential even though it was the ratepayer who contributed the
differential in the first place. [Footnote omitted.]42

The Third Circuit apparently did not recognize that its decision was in conflict

37 364 I.C.C. at 813.
38 691 F.2d at 1116.
39 Normalization plus means that the railroads more than cover "operating expenses." This
40 320 U.S. 591 (1944).
41 The Sixth Circuit Court of Appeals concurred with the D.C. Circuit, See, Cleveland-Cliffs
Iron Co. v. I.C.C., 664 F.2d 568, 586 (6th Cir. 1981). See also, Iowa Public Service Co. v. I.C.C., 643
42 631 F.2d at 847.
with the D.C. Circuit, and ignored its implications.\textsuperscript{43}

The failure of the court and the Commission to conform to accepted regulatory practice could cost consumers several hundred million dollars per year by raising the rate of return standard above actual costs and permitting a return on the approximate $4 billion of deferred taxes on railroad books.

\section*{IV. The Single Standard Of Revenue Adequacy}

As discussed above, a firm's cost of capital is not accurately measured when the current cost of debt is substituted for the historical and deferred taxes not reflected at zero-cost. The cost of capital produced is far greater than the actual cost. Application of this standard to determine revenue adequacy under section 10704a(2) therefore would not be valid. Yet, the Commission in \textit{Ex parte} No. 393 decided to break with precedent and apply this standard.

The Commission first implemented section 10704a(2) in \textit{Ex parte} No. 338, \textit{Standards and Procedures for the Establishment of Adequate Railroad Revenue Levels}.\textsuperscript{44} It specifically found that consideration was necessary of "all pertinent financial indicators" to determine revenue adequacy.\textsuperscript{45} In \textit{Ex parte} No. 393, the Commission reversed itself and selected the cost of capital as the sole standard, stating: "The standard we will use to measure the adequacy of the rate of return is the current cost of capital."\textsuperscript{46} In rejecting the use of financial ratios, the Commission held:

\begin{quote}
We further proposed to base this determination on specific financial ratios. Specifically, as additional necessary standards for a finding of revenue adequacy, we proposed an operating ratio of 0.85 or less, a fixed charge coverage ratio of 3.5 or greater, and a throwoff to debt ratio of 3.5 or greater. We stated that the operating ratio (operating expenses as a percentage of operating revenue) would show whether a carrier's operations were covering its current expenses, while the fixed charge coverage ratio (income before fixed charges as a percentage of fixed charges) and the throwoff-to-debt ratio (cash flow as a percentage of long-term debt due within 1 year) would give indications of a firm's ability to meet its existing financial obligations. We asked for comments on whether the use of these ratios is appropriate, whether the figures proposed are the most suitable, and whether these three financial ratios are the best ones to show the soundness of a carrier's financial condition.

After considering these comments we now believe that using these financial ratios as conditions to a finding of revenue adequacy would be misleading. Financial ratios are intended to provide summary information that, if not interpreted within the proper context, could suggest incorrect conclusions. For example, a firm's fixed charged ratio might be low because of its ability to raise long-term debt. That ability could, in turn, be a reflection of its strong financial outlook. Yet the low fixed charge ratio would lead us to conclude the carrier was revenue inadequate. Because of the possible ambiguity, we have
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\textsuperscript{43} 691 F.2d at 1116 n.8.
\textsuperscript{44} 358 I.C.C. 844 (1978).
\textsuperscript{45} 49 C.F.R. § 1109.25 (1978). These indicators included financial ratios, and a funds-flow model.
\textsuperscript{46} 364 I.C.C. at 809.
decided that these financial ratios should not be used in revenue adequacy determinations. We believe firmly that the rate of return standard is correct, and will base our determinations on it.  

The Third Circuit did not discuss this issue. After reviewing the contentions of shippers and the position of the Commission, it concluded:

Given the highly deferential scope of review by which this court is confined, we cannot hold that the adoption of a single standard encompassing the objectives listed in section 205 must be set aside. The overall policy pursued by the agency is entirely consistent with Congressional directives. Reasons for departure from the ICC’s prior position with respect to use of financial ratios and flow of funds analysis, and for refraining from incorporating productivity standards under section 205, have been carefully explained.  

There are several objections to using a sole standard for revenue adequacy. First, to determine the overall cost of capital, a weighted average of the costs of debt and equity must be computed. But the Commission has rejected using the cost of equity as a standard. The cost of equity is merely a step in the calculation of cost of capital. Therefore, it is possible for a railroad to have a return on equity in excess of its cost of equity (which means that shareholders earn excess profits). This means that, while shareholders are more than fully compensated, revenue may still be inadequate because its total return on investment did not meet the Commission standard. The Commission’s approach is contrary to the usual regulatory practice in which return on equity is also a standard. If investors are earning more than their cost of equity, it is immaterial whether the company is earning more than its cost of capital, since it is the investors to whom protection is owed. It should be remembered that Hope stressed return to the investor:

From the investor or company point of view it is important that there be enough revenue not only for operating expenses but also for the capital costs of the business. These include service on the debt and dividends on the stock... By that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.

By ignoring the cost of equity, the Commission would appear inconsistent with the requirements of Hope.

Second, to measure the rate of return actually earned, net operating profits must be divided by net investment. If neither figure is trustworthy, then the result is dubious. This is the case under Commission accounting practices. The Commission currently utilizes retirement-replacement-betterment accounting while other industries use ratable depreciation accounting. The General Ac-
counting Office described the differences:

Depreciation accounting systematically and rationally allocates the cost of capital assets, such as buildings and machines, over their estimated useful lives. As a result, the cost of an asset is not charged entirely to the period when the item is purchased.

Betterment accounting is the method railroads are required to use to account for the track structure in reports to the Interstate Commerce Commission (ICC) and is generally used in reports to the Securities and Exchange Commission (SEC) and stockholders. Under betterment accounting, no systematic depreciation expense is taken. The cost of track structure replacements is charged to expense in the periods when the replacements occur. If a higher quality replacement is made, the portion of cost representing an improvement (betterment) is not charged to expense but is considered an asset. As a result, income reported under betterment accounting is significantly lower than income reported under depreciation accounting. The GAO found that a switch to depreciation accounting would have produced a thirty-five percent increase in average net income after taxes for ten railroads in 1978.

Although the Commission recognized that betterment accounting understates profits, it did not believe that betterment accounting overstates the rate base. It concluded:

In continuing to think about this issue, we have grown more convinced that betterment accounting may underestimate—not overestimate—the value of the investment base. Track structure is valued at the original cost of the track at the time the original investment was made, plus betterments (valued at their original cost). Under depreciation accounting, track structure would be continually revalued. Due to inflation, track structure would, therefore, likely be valued at a higher level under depreciation accounting because its value is set at a later date.

But then, in Docket No. 36988, Alternative Methods of Accounting for Railroad Track Structures, the Commission revised its accounting regulations and adopted depreciation accounting beginning with the 1983 railroad annual report (due March 31, 1984). The Commission recognized that a railroad’s return on investment would be higher under depreciation accounting. But, while annual reports will utilize depreciation accounting, ratemaking will not. The Commission plans to adopt “procedures to account for inflation” which will increase both operating expenses and investment. As a result, “the reduction in income (through increased expenses) will be greater than the expansion of the investment base and . . . ROI figures for railroads would be

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61 Comptroller General, Report to the Congress of the United States, Accounting Changes Needed in the Railroad Industry, at ii.
62 Id. at 21.
63 "Since all maintenance other than betterments is considered to be an expense, a railroad’s profits are understated in periods of high maintenance." 364 I.C.C. at 812.
64 364 I.C.C. at 813.
66 Id. at 165. “We believe that ROI would usually increase under DA.” Id.
67 Id. at 172.
reduced." To determine revenue adequacy, the Commission would examine the return on investment derived from its inflation adjustments, not the return shown in the annual reports. The Commission's approach might be charitably termed manipulative.

Recognizing the problems with return on investment, shippers argued in *Ex parte* No. 393 that the Commission should adopt the financial ratios suggested in its Notice of Proposed Guidelines. Financial ratios show the relationships between various accounts appearing on balance sheets and statements of income. Return on investment and return on equity are two such ratios. Other ratios include: return on total capitalization (net operating profits as a percentage of total debt and equity), dividend payout (dividends as a percentage of net operating profits), operating (operating expenses as a percentage of operating revenue), fixed charge coverage (income before fixed charges as a percentage of fixed charges), and throw-off to debt (cash flow as a percentage of long-term debt due within one year). These ratios are commonly used in financial statement analysis,\(^5\) and can provide a picture of the health of a firm, its position relative to other firms in the same industry, and trends in profitability. If, for example, an industry has an average operating ratio of ninety percent, and Firm X has a ratio of ninety-eight percent, then Firm X would appear unhealthy relative to the rest of the industry.

Furthermore, there are interrelationships among financial ratios. The Commission's prescription of a 16.50% return on investment for 1981 implies a fixed charge coverage ratio of 4.69%.\(^6\) If this ratio is exceeded, then revenue adequacy would have been implicitly shown. In 1981, the Union Pacific showed a fixed and contingent charge coverage of 4.81, more than covering the implied prescription. Yet this railroad was found revenue inadequate under the sole standard approach.\(^7\)

The Commission staff itself recommended that ratios should be used. In a Memorandum, the Acting Chief of the Section of Financial Analysis related the requirements of 49 U.S.C. § 10704a(2) to various ratios:

\(^5\) See J. SUELFLOW, PUBLIC UTILITY ACCOUNTING: THEORY AND APPLICATION 6-10; E. BRIGHAM, FINANCIAL MANAGEMENT THEORY AND PRACTICE 191-205.

\(^6\) See Verified Statement of Dr. George H. Borts on behalf of Nevada Power Company in *Ex parte* No. 436, *Railroad Cost of Capital—1982* at 9. Dr. Borts demonstrated the calculation of the implicit fixed charge coverage ratio:

Recall that the fixed charge coverage ratio has a numerator equal to income (before taxes) available for fixed charges, and a denominator equal to the level of fixed charges.

The fixed charge coverage ratio may therefore be written as follows:

\[
\text{Numerator} = \text{Pre-tax cost of equity} \times \frac{\text{equity}}{\text{total capital}} + \text{cost of debt} \\
\text{Denominator} = \text{cost of debt} \times \frac{\text{debt}}{\text{total capital}}.
\]

\(^7\) The Commission has always ignored as evidence of financial health the high wages of railroad employees. For example, a Union Pacific crew member may make about $53,000 per year, and a top executive over $1,000,000. Such high wages would hardly seem the hallmark of an impoverished company or industry.
Requirements of Title 49 Section 10704(a)(2) of U.S. Code

1. Cover total operating expenses, including depreciation and obsolescence.

2. Provide a reasonable and economic profit or return (or both) on capital employed in the business.

3. Provide a flow of net income plus depreciation adequate to support prudent capital outlays.

4. Assure repayment of a reasonable level of debt.

5. Permit raising of needed equity capital.

6. Cover effects of inflation.

7. Attract and retain capital in amounts adequate to provide a sound transportation system.

Appropriate Financial Ratio

Operating Ratio

Return on Investment (ROI)
Return on shareholders' equity (ROE)
Return on total capitalization (ROTC)

Percentage of increase in net transportation investment

Throw-off to debt ratio (TOTD)
Fixed charges coverage ratio (FCC)

Return on shareholders' equity

Comparison of ROI to cost of capital

ROI, ROE, ROTC and dividend payout ratio.

The Commission, however, disregarded the advice of its own staff. It felt that "using these financial ratios . . . would be misleading. Financial ratios are intended to provide summary information that, if not interpreted within the proper context, could suggest incorrect conclusions. . . ."

It is correct to state that financial ratios can be misleading. "[F]irms can employ 'window dressing techniques' to make their financial statements look better to analysts. Recently, [for example,] a firm sold its corporate aircraft for cash just prior to issuing a quarterly statement. This substantially improved its cash balance in time for the quarterly report." A firm which leases substantial portions of its equipment will also show a higher return on net investment than a firm which does not because leases are generally not included as a part of investment. Furthermore, ratios do not usually show the quality of earnings, that is, whether revenues are recurring and dependable, or non-recurring, seasonal, cyclical, or otherwise unusual.

While it is true that financial ratios can be misleading, the Commission has nonetheless chosen one ratio, return on investment, as its sole standard of revenue adequacy. The Commission has not shown that this ratio is less mis-

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63 364 I.C.C. at 817.
64 BRIGHAM, supra note 24 at 204.
65 "A high current ratio may show a strong liquidity position, which is good, or excessive cash, which is bad because excess cash in the bank is a nonearning asset." Id.
leading than any of the other ratios originally proposed for adoption as standards. Indeed, given the Commission's position that it will require depreciation accounting for the preparation of the financial statements which appear in annual reports, but will use inflation adjustments in ratemaking, thereby producing a lower return on investment, it would seem that it is the Commission itself which is the source of the misleading ratios. Consequently, a railroad could be healthy according to numerous financial ratios, including return on equity, but nonetheless be termed revenue inadequate, because the railroad has failed one, perhaps impossible, test.

If financial ratios, including return on investment, can be misleading and manipulated, the solution to the problem of determining revenue adequacy is the close scrutiny of the data which underlies those ratios. This scrutiny could be achieved through the adoption of the public utility ratemaking model. Utility commissions generally prescribe rates after conducting a company-wide examination of revenues, costs, plant in service, and cost of capital. Included in this examination are considerations such as whether the revenues and costs may reasonably be expected to continue at the levels shown on the financial statements, whether there are known changes—such as an increase in rates—which will affect operating results, and whether there are seasonal or cyclical peculiarities. I.C.C. ratemaking does not closely examine company-wide financial status in this manner. For example, if a railroad serving one customer and charging $10.00 per ton for moving coal during the first eleven months of the year, had a rate increase to $15.00 during the last month, the Commission would take no notice of the increase in its determination of revenue adequacy. Yet it is obvious that in the succeeding year the railroad's revenues would be almost fifty percent greater. In contrast, public utility ratemaking would recognize the impact of the increase on earnings.

Both 49 U.S.C. § 10704(a)(2) and § 10707a(e)(2)(C) provide statutory support for the company-wide rate case. Section 10704(a)(2) requires the Commission to devise standards "for establishing revenue levels . . . 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." Section 10707a(e)(2)(C) requires that, in determining the reasonableness of a rate, the Commission consider the amount of traffic priced below going concern value, the amount of marginally contributory traffic, and whether one commodity is

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66 Alfred Kahn describes this process. Kahn, The Economics of Regulation, at 26-58.

67 Interstate Commerce Commission ratemaking differs from public utility ratemaking in another important aspect. The Commission does not scrutinize or regulate rate base; the public utility commissions do. The consequence is that a railroad has great freedom with regard to what is included in net investment; it may engage in unnecessary construction projects that unduly inflate the rate base. The railroad does not have to worry that its new investments will be disallowed as not used and useful. Numerous economists have pointed out that such excessive expenditures would not be in the public interest. See, Kahn, The Economics of Regulation, at 49-52, discussing the "A-J-W Effect."

paying an unreasonable share of a carrier's overall revenues. The logical implementation of these sections is a company-wide rate case. This would provide the public with the information necessary to determine whether a railroad is operating honestly, economically, and efficiently as well as whether some traffic is unprofitably priced.

V. CONCLUSION

Because Bessemer and Lake Erie permits the I.C.C. to determine a railroad cost of capital higher than that actually experienced, railroads may earn their actual cost of capital and, nonetheless, be found revenue inadequate. Under the fifteen percent per year guidelines of Ex parte No. 347, these revenue inadequate railroads will be permitted to price differentially. Shippers can therefore expect to spend additional, largely unnecessary, billions to subsidize other rail traffic.

Bessemer & Lake Erie was wrongly decided. It splits with the D.C. and Sixth Circuits on the issue of deferred taxes and encourages the Commission to continue its less than even-handed implementation of the Staggers Act. Coal shippers will be forced to pay unnecessarily higher rates which will be passed on to end users. A higher delivered price of coal can only result in the loss of sales, and a setback to coal and coal-related industries.
