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At recent hearings about the Uniform Railroad Costing System (URCS), STB has hinted that there might be pressure very soon to mandate or force the Board to adopt replacement accounting. Although the concept of using replacement costs flies in the face of common accounting principles, it appears that the railroads are also are attempting to include it in legislation now being considered by Congress regarding the reauthorization of the STB. **FACT: If replacement cost accounting is mandated for system-wide railroad valuation, the railroads' investment base will increase which would allow railroads to significantly increase rates to its customers.**

ARC leadership and Meyers & Associates are working with Congress to disprove the myth about replacements costs. The following analysis was provided to members and staff working on railroad issues.

IMPACT OF USING REPLACEMENT COST

The STB and other agencies have determined that there are serious problems associated with replacement cost for system-wide railroad revenue adequacy determinations.[1] It is also inconsistent with what other industries are using according to General Accounting Practices (GAP).

The U.S. General Accounting Office (GAO) has expressed concerns that that the replacement cost approach could overstate the value of the railroads' investment base.[2] And then, if railroads were allowed to use replacement costs, the next step would be to have other industries use replacements costs. For example, electric utilities could then use the concept. This would significantly increase rates to customers.

The following analysis gives an indication of the degree of the increase.

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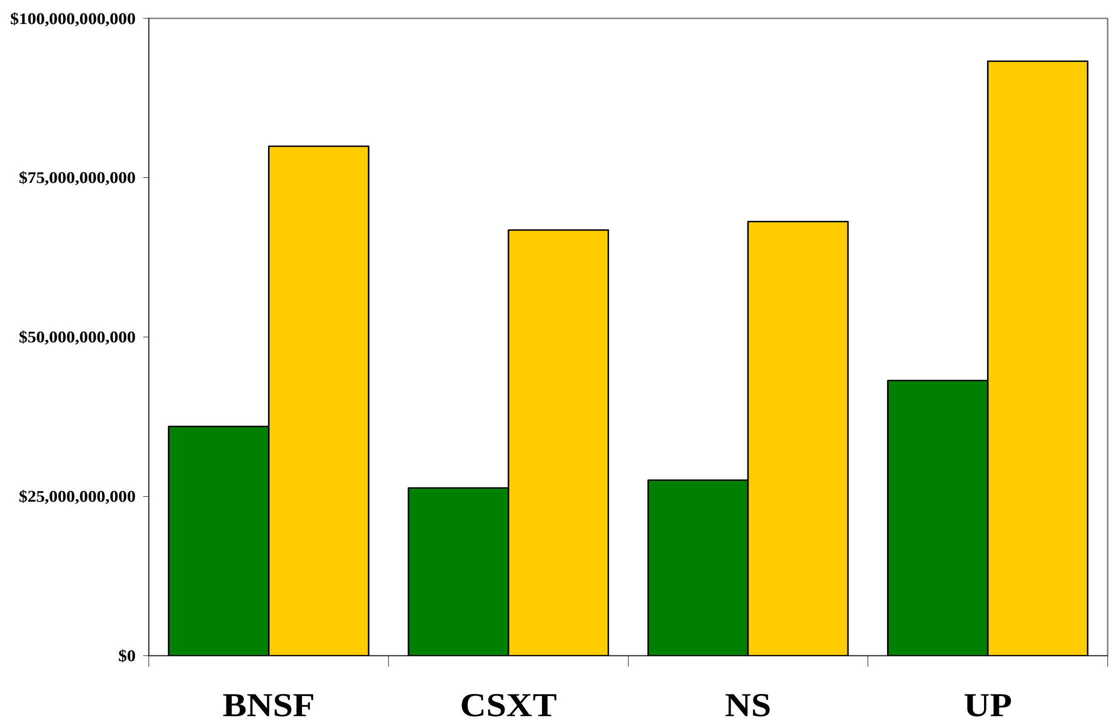
1 Replacement cost accounting is used by the STB in railroad rate reasonableness proceedings involving specific individual railroad movements. (See, e.g, Ex Parte No. 6346 (Sub-No. 1), Simplified Standards For Rail Rate Cases, served September 5, 2007).

2 See, for example, STB Decision in Ex Parte No. 679, Association of American Railroads – Petition Regarding Methodology For Determining Railroad Revenue Adequacy, served October 23, 2008 and related filings.

Analysis

Gerald Fauth III, of G. W. Fauth and Associates produced the following chart based on AAR's estimated increase investment cost with replacement cost:[3]

AAR'S ESTIMATED INCREASES IN HISTORICAL INVESTMENT COSTS BASED ON REPLACEMENT COST ACCOUNTING



As can be seen from this chart, AAR's estimates that railroad investment cost will more than double for the four major Class I railroads (BNSF-2.22; CSXT-2.54; NS-2.47; and UP-2.16). Although AAR's estimated increases in investment valuation under replacement cost accounting is significant, it is also significantly understated. As Gerald Fauth points out – the AAR's replacement cost estimates used historical book values for land values. The historical land values used by the AAR for the four Class I railroads total approximately $10 billion. Under replacement cost accounting, land would also be valued at its replacement cost. If land values were included at a replacement cost value, it is very likely that the railroads' investment costs would more than *triple* and there are some indications that such a proposal has been made by the railroad.

According to Gerald Fauth III, the AAR also estimated the impact of replacement cost on the STB's 2006 return on investment calculations, which are shown in the following chart:[4]

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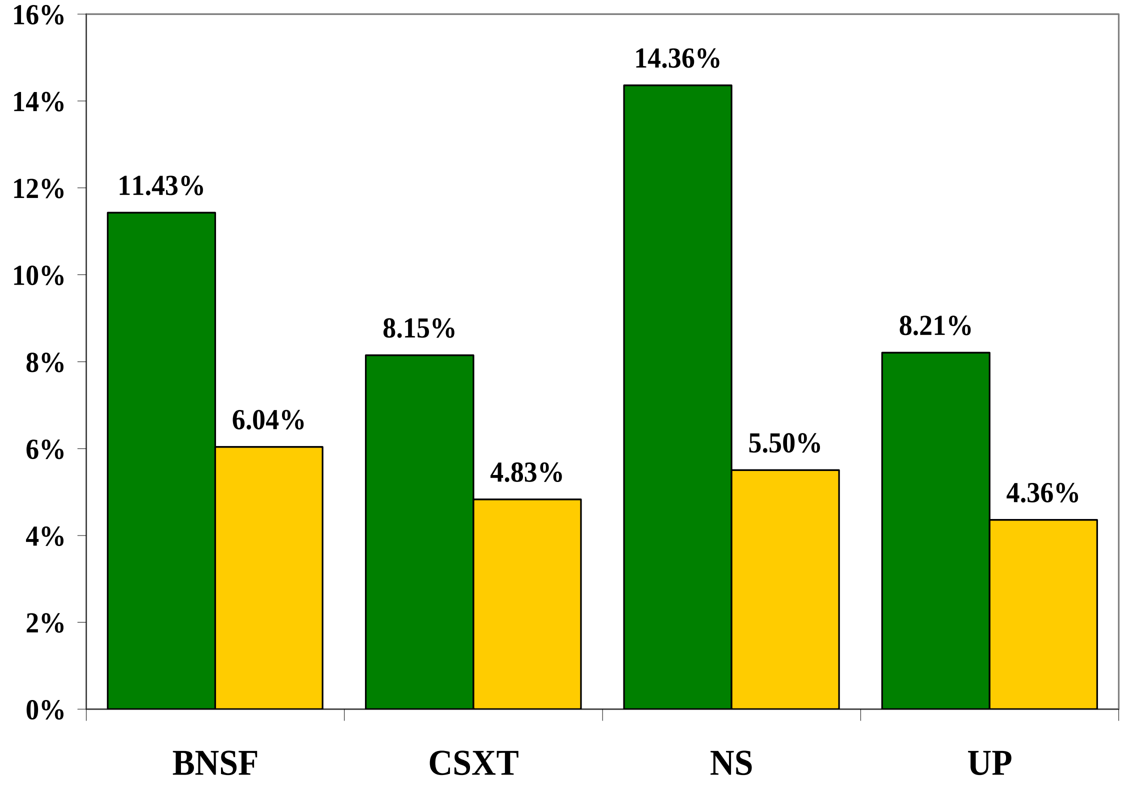
[3] Based on historical investment data included in 2006 R-1 Annual Reports to the STB, Sch. 352B and AAR's filing dated May 1, 2008 in Ex Parte No. 679.

AAR'S ESTIMATED DECREASES IN IN RETURN ON INVESTMENT (ROI) <u>BASED ON REPLACEMENT COST ACCOUNTING</u>



Under replacement cost, none of the railroad would even be close to becoming revenue adequate. In addition, if AAR had included land at a replacement cost value, the calculated ROI levels would be even lower.

If Congress approves changing railroad accounting from original to replacement cost accounting, however, the impact would not be limited to the ROI calculations for revenue adequacy determinations. The increases in investment costs would directly flow-through to the STB's Uniform Railroad Costing System (URCS). Sources are now suggesting that that the bill includes <u>fully-allocated</u> replacement cost, which would be even higher than the estimates above - actually more than doubling URCS costs!

URCS is primarily used to calculate the variable cost associated with specific railroad movements and service. URCS costs are used to establish and determine STB jurisdiction. Specifically, as established by Congress, a rate must generate a revenue-to-variable cost or R/VC ratio of ***180 percent*** based on unadjusted URCS costing.

The adoption of replacement cost accounting would have a significant impact on URCS costing. URCS depreciation and return on investment expenses could triple under replacement cost accounting. The impact of replacement cost accounting would be

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[4] AAR's filing dated May 1, 2008 in Ex Parte No. 679 and STB's Decision in Ex Parte No. 552 (Sub-No. 11), <u>Railroad Revenue Adequacy – 2006 Determination</u>, served May 6, 2008.

different for each movement and can only be accurately determined based on URCS costs developed using replacement accounting. Shippers, such as grain producers and farmers, using railroad equipment (such as railroad-owned covered hoppers used in grain service) would be especially adversely impacted.

Virtually all of the current rates being charged by the railroads in this country would become deregulated (not subject to regulatory challenge) if the current URCS models were utilized with replacement cost as a base.

URCS depreciation and ROI costs would significantly increase which would increase the total variable cost, but URCS variable expense portion would remain the same. <u>This demonstrates one of the major problems and unfairness associated with the use of replacement costs on a system-wide basis</u>. As Gerald Fauth points out, when looking at URCS variable expenses include locomotive fuel and maintenance costs. "If replacement costs are included, shippers would effectively have to pay for the cost of a new locomotive, but, at the same time, have to pay the fuel and maintenance costs associated with the current locomotive fleet, which would be older, less efficient and have higher maintenance costs.

The result, a substantial amount of railroad traffic, which is currently subject to STB jurisdiction, would be effectively deregulated under replacement cost accounting since many R/VC's would fall below 180%.

If Congress adopts replacement cost accounting, this jurisdictional ratio would obviously need to be revised and substantially reduced. In order to properly do so, a detailed *before and after* study would need to developed based on URCS data developed using both original and replacement cost accounting, which would be difficult, time-consuming and controversial. "

Because of the many known problems that will come from utilizing replacement cost on a system-wide basis coupled with the fact that 180% R/VC was based on historical accounting, the Commerce Committee should reject a change to railroad replacement cost accounting and retain the historical cost accounting approach and URCS which the STB is starting to modernize. Otherwise the replacement cost utilization will effectively deregulate the nation's railroads and the captive rail customers will be left with NO protection or avenues for redress.