Revenue Adequacy:
A Calculation to Inform Regulators of Railroads' Financial Health, Not to Cap Rail Rates

Freight Railroads: Capital Intensive & Cost-Effective

Almost entirely privately owned and operated, today's U.S. freight railroads invest an average of $25 billion annually to maintain and modernize their 140,000-mile network. With demand for freight expected to grow 35% by 2040, railroads must be able to earn the revenue necessary to ensure safe and reliable service.

U.S. freight railroads offer the most competitive rail rates in the world, with average U.S. freight rail rates (based on revenue per ton-mile and adjusted for inflation) 44% lower in 2018 than in 1981. In fact, the average rail shipper today can move nearly double the freight for about the same price it paid nearly 40 years ago.

At the same time, multiple forces place competitive constraints on railroads. The intensity of the competition railroads face means they are not guaranteed any piece of the freight transportation market; they must earn it by providing their customers better value than competitors. Competition and demand for services are ultimately the best way to govern rail rates.

Key Point

Rather than a measure of the minimum amount of revenue needed for a healthy rail system, the STB is now considering turning revenue adequacy into a finding that a railroad is earning excessive revenue and then using that as a rate regulation tool for individual rail customers. This would mean that if the railroad is revenue adequate and a rail customer challenges a railroad's rate as too high, the STB could potentially cap the railroad's rate, regardless of actual market conditions.

The STB Determines if a Railroad is "Revenue Adequate" to Help Ensure a Healthy Rail System

Current statute directs the Surface Transportation Board (STB) to enact policies that enable railroads to earn adequate revenues to operate and maintain their network and attract investment in capital markets like all other private businesses in the economy. The STB and its predecessor, the Interstate Commerce Commission, have made "revenue adequacy" determinations annually for nearly 40 years.

A railroad is deemed "revenue adequate" when its rate of return on net investment (ROI) equals or exceeds the industry's cost of capital (COC). The idea is that a revenue adequate railroad is earning enough to cover the costs of efficient operation, including a competitive return on invested capital. Only in recent years has ROI collectively exceeded the COC for the industry, as individual railroads vary in terms of when and how often they have been deemed revenue adequate.

The STB Is Considering Using Revenue Adequacy to Cap Rail Rates

Railroads' financial performance has improved in recent years, enabling them to keep their infrastructure and equipment in top condition, improve service, respond to changing markets and add new capacity as needed. Congress charged the STB with regulating rail rates when there is **not** effective competition and the potential for market abuse. Using revenue adequacy to constrain an individual railroad's rates is disconnected from the system and would:

- Violate the statute that governs the STB.
- Threaten railroads' ability to adapt to operational, regulatory, and structural change over time.
- Push away capital from the industry, hindering railroads' ability to reinvest in their networks, potentially harming safety and ultimately harming rail shippers and the overall economy.
- Undermine long-term planning as railroads invest in infrastructure that will be in place for a long time. They must be able to expect to generate an adequate return over a long period.

Better Approach: Look to What Railroads Need to Earn in the Future to Maintain a Vibrant Network

Instead of using the current revenue adequacy calculation to look backwards to what railroads have earned in a year, the STB should focus on what railroads need to earn in the future to continue to attract capital and pay for the capacity upkeep and expansion needed to meet our nation's growing future freight transportation needs.

- Rather than constituting a ceiling for earnings, revenue adequacy is better thought of as a floor, a necessary but not sufficient precondition to long-term financial health.
- Revenue adequacy can only be meaningful if it is measured over many years. One good financial year means little in terms of a railroad's long-term prospects.