Revenue Adequacy: A Calculation to Inform Regulators of Railroads' Financial Health

Freight railroads are capital intensive and cost-effective.

> **Key Takeaway**
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> Railroads must be able to earn the revenue necessary to provide safe and reliable service. Revenue adequacy calculates the minimum amount of revenue needed for a healthy rail system,

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 30% 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) 43% lower today than in 1981, which means the average shipper can move significantly more 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.

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. These polices should also allow railroads to 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.

Thanks to improved financial performance in recent years, railroads have kept their infrastructure and equipment in top condition; improved service; responded to changing markets; and added 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.