RAILROAD ACQUISITION PREMIUMS

In 2010 Berkshire Hathaway, Inc. acquired BNSF (Burlington Northern Santa Fe) Railway and paid an estimated $7 billion premium above the book value of BNSF. This overpayment, typically calculated as the difference between the value of a company[1] and the price that the buyer actually has to pay to obtain control, is called the "acquisition premium."

Acquisition premiums can mean higher rates for shippers. The Surface Transportation Board (STB), the federal body regulating railroads, allows railroads to treat acquisition premiums as a capital cost on their balance sheets; this differs from the practice of other federal regulatory agencies, such as the Federal Electric Regulatory Commission. This practice has two significant implications. First, the STB allows acquisition premiums to be included in the evaluation of a railroad's "revenue adequacy," a measure of a railroad's financial health. Second, the STB also permits an acquisition premium to be included when determining whether a captive shipper can challenge a railroad's shipping rates. The combined effect is that an investment company like Berkshire Hathaway can pay an inflated price for a railroad, and then simply pass that cost on to its customers.

Including acquisition premiums can skew revenue adequacy determinations and undermine rate regulation for shippers. The STB is required to determine whether each major (Class I) railroad is "revenue adequate," meaning it has earned an appropriate return on its capital investment. Under its current methodology, the STB has never found that the railroads, on an industry-wide basis, are revenue adequate. Shippers assert that by including an acquisition premium in a railroad's capital costs, the calculated return on investment will decrease and move it further from a determination of revenue adequacy. Perceiving railroads to be less financially healthy than they actually are could lead to inadequate regulatory scrutiny from Congress and the STB. A finding of revenue-inadequacy also provides justification for railroads to raise rates.

Including acquisition premiums make it harder for captive shippers to challenge rates. Congress has given the STB regulatory authority over the rates charged to captive shippers because they are only served by a single Class I railroad that has no competition. In these situations, the Board has authority to determine whether a rail rate is unreasonably high only when: (1) the railroad has market dominance over that particular traffic; and (2) the rate leads to revenues exceeding 180 percent of a railroad's "variable costs."[2] If revenues don't meet the 180 percent threshold, the railroad is presumed to be non-market dominant and therefore not subject to STB's jurisdiction. Unfortunately, railroads can currently include acquisition premiums in their "variable costs," thereby making it harder for captive shippers to dispute rates in these uncompetitive markets. For the small number of shippers that meet these criteria, the STB's dispute process is notoriously time-consuming, cumbersome, and expensive.

The STB has the authority to reassess its policy on acquisition premiums. The STB is directed by statute to conform to generally accepted accounting principles (which permits the use of acquisition premiums) to the "maximum extent practicable." However, Congress also made its intent clear that the STB should protect captive shippers from unreasonable rates where there is no market competition. Further, the STB is required to "periodically review its cost accounting rules" and make changes in its rules to conform with its regulatory purposes. 49 U.S.C § 11161. Pursuant to this directive, the STB should reassess its current accounting rules to exclude the use of acquisition premiums.

For more information about this issue, please contact Bidisha Bhattacharyya (4-5641) or Susan Rohol (4-9623) in Senator Franken's DC office.

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[1] The company's value can be based on its book value or the price of a single share of stock before a tender offer.
[2] Under the formula used by the STB, "variable cost" includes a portion of the capital asset of the railroad.