COMMITTEE ON COMMERCE,
SCIENCE, AND TRANSPORTATION

OFFICE OF OVERSIGHT AND INVESTIGATIONS
MAJORITY STAFF

Update on the Financial State of the Class I Freight Rail Industry

STAFF REPORT FOR CHAIRMAN ROCKEFELLER
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Table of Contents

EXECUTIVE SUMMARY

In September 2010, Chairman Rockefeller issued a Senate Commerce Committee Majority Staff Report on the financial condition of the freight railroad industry. Relying on financial information that the dominant Class I freight railroads regularly report to their investors, the Staff Report concluded that the freight railroad industry had recovered from the serious financial problems that prompted Congress to pass the Staggers Rail Act of 1980. The report found that, three decades after the Staggers Act, the Class I freight railroads were financially sustainable and highly profitable companies.

Understanding the financial condition of the railroads is integral to assessing whether the current regulatory system effectively balances the interests of railroads, shippers, and consumers. Because railroads were struggling financially when the Staggers Act was enacted, the regulatory system that was built on that law places heavy focus on helping railroads earn higher revenues. For example, under the Staggers Act, shippers that do not have access to other transportation modes ("captive shippers") subsidize the freight railroads' revenues by paying transportation rates that far exceed the railroads' costs. If the railroad industry is now proving to be financially viable for the near and long term, policymakers will need to consider whether regulatory changes are in order to make sure the industry does not enjoy unfair advantages.

Because the debate over freight railroad policy continues both in Congress and at the Surface Transportation Board (STB), Commerce Committee staff recently reviewed the railroad industry's latest financial reports to update the findings of the September 2010 Staff Report. These financial reports, as well as the public statements the companies' executives have recently made to their investors and Wall Street analysts, show that the financial performance of these companies is at its strongest since the passage of the Staggers Act. The positive financial trends identified in the 2010 Staff Report have continued in the most recent years, and the railroads appear confident they will continue for the foreseeable future.

Specifically, this Committee staff report finds:

- In every reporting period since the last quarter of 2009, at least one of the three largest publicly traded Class I freight railroads set an all-time company quarterly record for operating ratio, operating income, or earnings per stockholder share (EPS);

- In the past four years, these companies broke records for operating ratios in 29 of the 48 quarters, with Union Pacific having a streak of 8 consecutive quarters in the most recent reporting periods. A decrease in operating ratio means a company is keeping more income after operating expenses are removed from revenue;

- In 30 of the past 48 quarters, the companies set new records for operating income – or the amount of income left over after subtracting a company's operating expenses from its gross profit. It is a measure of the profitability of a company's basic business activities;

- The railroads have also achieved record results in earnings per share (EPS) for stockholders, with Union Pacific breaking its EPS record in 15 of the last 16 quarters, and Norfolk Southern setting records for 6 straight quarters in 2011 and 2012;

- In the last few years the STB routinely has been finding these companies to be "revenue adequate" under an analysis that examines a company's return on investment in relation to the industry's cost of capital. This trend stands in stark contrast to the decades following enactment of the Staggers Act, where railroads in the vast majority of years were found not to be "revenue adequate;"

- The companies' publicly traded stock shares have performed significantly better in recent years than the Standard and Poors stock market index; and

- Increasing free cash flow of the companies in the past few years has enabled them to increase capital expenditures at the same time they boost dividend payments and stock buyback programs. For example, between 2006 and 2010, CSX increased its dividend per share payments by 445% and the cumulative value of its share buyback grew from $500 million in 2006 to $5.6 billion in 2010.

While much of the rest of the American economy has been struggling to recover from a deep recession, the freight railroads have been achieving new financial performance milestones. These financial results are especially remarkable as they were accomplished even while overall rail volumes were still below prerecession levels, and while the two dominant railroads operating east of the Mississippi River, CSX and Norfolk Southern, experienced significant drops in the volume of their coal shipments. Each new quarter brings further evidence that the large freight railroad companies are highly profitable enterprises that have confidence that their financial success will continue.

I. Background on Freight Railroad Financial Performance

In September 2010, the Senate Commerce Committee Majority Staff issued a report examining the financial state of the Class I freight railroad industry.[1] This report presented evidence showing that, 30 years after the passage of the Staggers Rail Act of 1980, the freight rail industry had reached the law's goal of financial stability and profitability. It found that the large U.S.-based Class I railroads that dominate the industry today were generating significant profits for their owners, investing substantial capital in their networks, and competing successfully against other transportation modes.

The current financial condition of the freight railroads is an important issue for policymakers because the laws regulating the railroad industry were written at a time when the industry was experiencing serious financial problems. Two of the important goals of the Staggers Act were "to assist the rail system to remain viable in the private sector of the economy" and "to assist in the rehabilitation and financing of the rail system."[2] If these goals have been achieved, policymakers should take a fresh look at whether the current U.S. freight rail system is meeting another important goal of the Staggers Act, "to provide a regulatory process that balances the needs of carriers, shippers, and the public."[3]

In early 2011, recognizing the changing landscape of the freight railroad industry, the Surface Transportation Board (STB) initiated a new public hearing process to examine competition issues. Among the factors the Board cited as its reasons for opening the proceeding were, "the improving economic health of the railroad industry" and "increased consolidation in the Class I railroad sector."[4] In this proceeding, *Ex Parte 705*, the STB heard from a variety of interested parties on competitive access issues including whether to mandate "reciprocal switching" and "terminal use" policies that require railroads to carry cars of a competitor or allow a competitor access to terminals for a fee.[5] The proceeding also reviewed policy options

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[1] Senate Committee on Commerce, Science, and Transportation, *Majority Staff Report on the Current Financial State of the Class I Freight Rail Industry* (hereinafter "September 2010 Staff Report") (Sept. 15, 2010) (online at http://commerce.senate.gov/public/?a=Files.Serve&File_ id=76823478-a901-4b4d-869b-9301bb43343b).

[2] The Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (1980). In order to increase the railroads' ability to earn "adequate revenues," the Staggers Act allowed railroads to charge higher rates to shippers over which they had "market dominance." U.S. House of Representatives, *Staggers Rail Act of 1980 Conference Report*, 96th Cong. (H.R. Rep. No. 96-1430), at 90-91; 49 U.S.C. § 10707. According to the Staggers Act conference report, regulators would have greater authority to review this so-called "differential pricing" when the railroads were once again financially stable businesses. *Staggers Rail Act of 1980 Conference Report*, at 91 ("The Conferees have adopted the concept of a jurisdictional level that varies according to the performance of the railroad industry. When the industry is earning revenues which are adequate, it is appropriate for the Commission to have the authority to review rate increases more carefully").

[3] *Id.*

[4] *Competition in the Rail Industry*, S.T.B. Ex Parte No. 705, 2011 WL 93782, *3 (Jan. 11, 2011).

[5] *Competition in the Rail Industry*, S.T.B. Ex Parte No. 705, 2011 WL 93782, *1-4 (Jan. 11, 2011).

concerning "rail bottlenecks," where the origin or destination of an otherwise competitive route is served by only one carrier, and contractual provisions known as "interchange commitments" that limit the incentive or ability of a rail line purchaser or tenant carrier to interchange traffic with competitors of the seller or lessor railroad.[6]

Following the July 2011 closure of the record on *Ex Parte 705*,[7] the STB initiated a proceeding regarding certain rules on rail rate cases and ultimately adopted a number of rule modifications.[8] In a separate ongoing proceeding, *Ex Parte 711*, the STB is considering a petition for a rule to modify reciprocal switching and terminal use policies.[9]

II. Railroads Have Been Setting New Financial Performance Records

A. Overview

A detailed review of the freight railroads' financial results over the past four years shows that the companies have been establishing record-low operating ratios, experiencing record growth in operating income, and posting record earnings-per-share figures.[10] As detailed in this report, 35 of the past 48 individual quarters of publicly available financial information were described by the three largest publicly traded Class I railroads as "record" or "record-breaking" quarters.[11] In each of the most recent 16 quarters, at least one freight railroad set new records for operating ratio, operating income, or earnings per share.

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6 *Competition in the Rail Industry*, S.T.B. Ex Parte No. 705, 2011 WL 93782, *2-4 (Jan. 11, 2011).

7 *See Petition for Rulemaking to Adopt Revised Competitive Switching Rule*, S.T.B. Ex Parte No. 711, 2011 WL 5257467, *1 (Nov. 3, 2011); *see also Competition in the Railroad Industry*, S.T.B. Ex Parte No. 705, 2011 WL 2596922, *1-2 (June 30, 2011).

8 Association of Corporate Counsel, *Ex Parte No. 715, Rate Regulations Reforms* (July 19, 2013) (online at http://www.lexology.com/library/detail.aspx?g=9ef9f5b5-b8e7-4ec8-997d-ba4bc395a6b9). For example, STB removed the $5 million relief cap previously imposed on pursuit of certain simplified relief cases. *Id.* It is unclear at this point whether these reforms will have a significant impact on rate regulation cases.

9 *Petition For Rulemaking to Adopt Revised Competitive Switching Rules*, S.T.B. Ex Parte No. 711, 2012 WL 3059230, *1-2 (July 25, 2012). The rule would allow shippers located in terminal areas without competitive alternative carriers to be granted access to a competing carrier if there was an interchange within a reasonable distance. *Id.*

10 To conduct this update, Committee staff reviewed the last sixteen quarters of financial information reported by CSX, Norfolk Southern, and Union Pacific. Committee Staff reviewed 10-Q Financial Reports filed by the companies with the Securities and Exchange Commission (SEC), company earnings press releases, transcripts of the companies' quarterly earnings calls, as well as transcripts of rail industry investor conferences. Any subsequent revisions companies may have made to these reports were not part of this review. The September 2010 Staff Report included BNSF quarterly financial results, while this update does not. Since Berkshire Hathaway acquired BNSF in early 2010, the company ceased conducting quarterly earnings calls, and it no longer reports earnings in the same manner as when it was a standalone company.

11 For the purposes of this report, a "record quarter" occurs when the management of the railroad described its quarterly performance as a new quarterly or all-time financial record with respect to any of

These impressive operating and earnings accomplishments occurred at a time when overall rail volumes were below their record 2006 peaks. Importantly for the purposes of this report, the freight railroads were able to continue improving their operating and earnings results even as the shipment of coal, which makes up a significant share of rail volume, decreased significantly as the U.S. utilities began a transition to natural gas as primary fuel for electrical generation.[12]

The companies' public statements about their financial performance have been replete with superlatives, highlighting the companies' record-shattering results.[13] For example, at an investor conference in June 2011, Union Pacific's CFO, Rob Knight, summarized his company's record-breaking 2010 performance:

> A little more than a year ago, we started to see a rebound from the severe economic downturn of 2009. As 2010 progressed, we continued to gain momentum, and ended up recording the most profitable year in the history of our Company. Topline growth and efficiency gains in 2010 resulted in an all-time record operating ratio of 70.6. We achieved best-ever earnings per share, free cash flow, and return on invested capital.

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the following financial metrics: operating ratio, operating income, or earnings per share. In determining a quarterly record, the point of comparison is the same quarter in the previous year; *e.g.* first quarters are compared to first quarters in previous years, not to the immediately preceding or succeeding quarter.

[12] Between 2008 and 2013, the price of natural gas in the United States fell from $13 to less than $4 per British thermal unit. This decline in the price of natural gas contributed to a drop in coal consumption by the nation's electrical power plants from 264.3 million to 212.4 million short tons of coal between Q1 2008 and Q1 2013. This five-year drop was part of a larger trend of power plants in the United States turning to alternative energy sources. While in 1990, American power plants generated 53% of their electric power from coal, by 2015, power plants are estimated to generate an estimated 39% of their electric power from coal. *Railroads Struggle at the Coal Face,* The Wall Street Journal (Mar. 16, 2012); *A Declining Source of Energy,* The New York Times (May 29, 2012); Investment Mine, *5 Year Natural Gas Prices and Natural Gas Price Charts* (Nov. 13, 2013) (online at http://www.infomine.com/investment/metal-prices/natural-gas/5-year/); U.S. Energy Information Administration, *Quarterly Coal Report* (Oct. 2, 2013) (online at http://www.eia.gov/coal/production/quarterly/); U.S. Energy Information Administration, *Electricity Net Generation: Total (All Sectors)* (Oct. 2013) (online at http://www.eia.gov/totalenergy/data/monthly/pdf/sec7_5.pdf).

[13] When the Committee in 2010 issued its initial staff report on the financial state of the railroad industry, the Association of American Railroads (AAR) took issue with the report's use of "accounting measures" such as operating revenue and operating ratio, arguing for a focus on the railroads' return on investment instead. *See* Joint Verified Statement of Robert S. Hamada and Rajiv B. Gokhale, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (May 27, 2011) (report commissioned by AAR discussing the 2010 Committee Staff Report). This criticism ignores the fact that when top rail industry executives themselves describe their companies' financial performance to investors and analysts, they repeatedly focus on the very same "accounting" metrics used in the Committee staff report.

> These were impressive results, considering our volume levels were still 10% below peak levels of 2006.[14]

Since that conference, Union Pacific's operating results continued to follow a record-breaking course. On the company's most recent quarterly investor teleconference, Mr. Knight asserted:

> Let's start with a recap of our third-quarter results. Operating revenue grew 4% to an all-time quarterly record of nearly $5.6 billion, driven mainly by solid core pricing gains. Operating expense totaled $3.6 billion, increasing 1.5%. Operating income grew 10% to $1.96 billion, also hitting a best-ever quarterly mark. … These results combined to produce a best-ever quarterly earnings of $2.48 per share, up 13% versus 2012.[15]

In CSX's investor teleconference call announcing the company's results for the second quarter of 2011, CEO Michael Ward commented:

> Last evening CSX was pleased to report another record quarter of financial results. ... From a financial perspective, it was an excellent quarter. Operating income was up 21% to a record $926 million, and the operating ratio improved 190 basis points to 69.3%. That represents real progress against our target of achieving a high 60s operating ratio for the year and a 65% operating ratio by no later than 2015. Looking at the full year, we expect the upward trends in markets we serve to continue going forward and for CSX to produce another record year in 2011 for our shareholders.[16]

CSX went on to have a record year in 2011 regarding performance in operating income, operating ratio, and earnings per share. Describing CSX's overall 2012 results, Mr. Ward predicted that even with a drop in its coal shipping volumes it was well positioned to reward shareholders:

> At this time last year, we had just completed eight straight years of operating ratio improvement with earnings growth in seven of those years. Both occurred in a period that included one of the most severe economic periods in our nation's history. In 2012, we again grew earnings while facing a major drop in a key market, one of the slowest economic recoveries on record and a political environment that has added even more uncertainty to the mix. Through all of this we have remained a vibrant, healthy company with a compelling long-term value proposition for investors.[17]

On January 24, 2012, Norfolk Southern CFO Jim Squires announced to Wall Street analysts that his company had set new records concerning several key financial metrics for 2011:

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[14] Union Pacific Presentation at Deutsche Bank Securities, Inc. Global Industrials and Basic Materials Conference (June 15, 2011).

[15] Union Pacific 3rd Quarter 2013 Earnings Conference Call (Oct. 17, 2013).

[16] CSX 2nd Quarter 2011 Earnings Conference Call (July 20, 2011).

[17] CSX 4th Quarter 2012 Earnings Conference Call (Jan. 23, 2013).

> Record revenues of $11.2 billion, up 17% versus 2010, contributed to record income from railway operations of $3.2 billion, up 20% compared to $2.7 billion in 2010. These results generated a 70 basis point improvement in our operating ratio, which was 71.2% for the year, a close second to our 71.1% post Conrail records set in 2008. Net income for the year reached $1.9 billion compared to $1.5 billion in 2010 and diluted earnings per share increased from $4 to $5.45 per share. These results reflect a 28% increase in net income and a 36% increase in diluted earnings per share. Both measures set new records.[18]

A drop in its coal volumes would also impact Norfolk Southern in 2012. However, when discussing the company's second quarter of 2013 financial results, Norfolk's Chief Marketing Officer Don Seale argued that with potential decreasing coal shipments, the company remained well-positioned for continued growth:

> Wrapping up in summary, we expect that our diverse market base will generate volume growth ahead, despite continuing challenges in the coal market and a slow growth economy. We also remain committed to market based pricing at levels that equal or exceed the rate of rail inflation. Obviously, with current conditions in our coal business, this is a short-term challenge. But that doesn't alter the value of our strong service product across a very diverse set of markets, where our pricing remains solid.[19]

B. <u>Freight Railroads' Operating Ratios Continue to Improve</u>

One of the financial indicators that reflect the railroad industry's strong financial performance is its steadily improving operating ratio. This metric expresses as a percentage the relationship between operating expenses and revenues. A company that lowers its operating ratio is improving the productivity of its operations by keeping more income after operating expenses have been removed from revenues. As Union Pacific CFO Rob Knight explained to investors, the operating ratio measures "UP's progress on improving total returns and profitability."[20]

As the September 2010 Staff Report documented, between 2000 and 2009, the largest U.S. Class I freight railroads lowered their operating ratios by approximately nine percentage points, from ratios in the mid-80s to ratios in the mid-70s.[21] The data the companies have reported during the last 16 quarters shows that they are continuing to drive their operating ratios even lower. While operating ratios vary from quarter to quarter for various reasons, Table I

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[18] Norfolk Southern 4th Quarter 2011 Earnings Conference Call (Jan. 24, 2012).

[19] Norfolk Southern 2nd Quarter 2013 Earnings Conference Call (July 23, 2013).

[20] Union Pacific 4th Quarter 2009 Earnings Conference Call (Jan. 21, 2010).

[21] September 2010 Staff Report, at 6. *See* note 10 *supra* for a discussion of why BNSF financial results were used in the September 2010 Staff Report, but were not available for this report.

shows that the companies have regularly achieved quarterly operating ratios in the low 70s to high 60s, occasionally dropping into the mid-60s, over the past four years.[22]

TABLE I - Operating Ratios Reported by the Three Largest Publicly Reported Class I Freight Railroads (green highlight = company record)[23]

Year	2009	2010				2011				2012				2013		
Operating Ratio	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	74.9	74.5	71.2	69.1	70.0	72.5	69.3	70.4	71.5	71.1	68.7	70.5	72.1	70.4	68.6	71.5
NSC	73.9	75.2	69.8	69.6	73.2	77.1	69.5	67.5	71.4	73.3	67.5	72.9	73.4	74.8	70.2	69.9
UNP	73.3	75.1	69.4	68.2	70.2	74.7	71.3	69.1	68.3	70.5	67.0	66.6	67.1	69.1	65.7	64.8

As the green highlighting in Table I[24] indicates, the three largest publicly traded Class I railroads broke quarterly operating ratio records in 29 of the 48 quarters Committee staff reviewed. CSX and Union Pacific set new operating ratio records for six straight quarters in 2010 and 2011. Union Pacific exceeded this streak recently with its eight most recent record-breaking quarters.

C. <u>Operating Income Continues to Grow</u>

Another investment measure the railroads tout in their quarterly earnings calls and press releases is their growing operating income. Operating income is the amount of income left over after subtracting a company's operating expenses from its gross profit. It is a measure of the profitability of a company's basic business activities.[25] The railroads have set new operating income records in 30 of the 48 quarters Committee Staff reviewed, as shown in Table II.

TABLE II - Operating Income ($ Millions) Reported by the Three Largest Publicly Reported Class I Freight Railroads (green highlight = company record)

Year	2009	2010				2011				2012				2013		
Operating Income	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	583	634	768	825	846	773	926	878	841	856	943	854	804	875	963	854
NSC	549	555	733	746	642	600	875	938	800	745	934	731	714	691	836	849
UNP	1,002	988	1,279	1,401	1,313	1,137	1,392	1,578	1,617	1,510	1,724	1,786	1,725	1,633	1,878	1,962

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22 *See also* the CSX Power Point slide included at Appendix XI. Presented as part of CSX's fourth quarter 2010 earnings call, this chart shows the dramatic improvements the company made in operating ratios over the previous several years, dropping from 78.6% in the fourth quarter of 2006 to 70% in the comparable 2010 quarter. CSX 4th Quarter 2010 Earnings Presentation, at 22 (Jan. 25, 2011) (online at http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Nzg0Mzd8Q2hpbGRJRD0t MXxUeXB1PTM=&t=1). CSX continued to set new operating ratio records in 2013, posting a first quarter record of 70.4% and a second quarter record of 68.6%.

23 *See* note 11 *supra* for a discussion of the use of the term "record quarter" in this report.

24 All tables and figures depicted in this report are included in the appendices section in the order in which they appear in the text.

25 Jan R. Williams, Susan F. Haka, Mark S. Bettner, and Joseph V. Carcello, *Financial & Managerial Accounting The Basis for Business Decisions,* at 622 (2008).

D. Freight Railroads Are Breaking Earnings Per Share Records

The healthy financial performance of the companies is also driving record results in earnings per share (EPS) for shareholders, a metric that the financial markets monitor closely. Comparing a company's EPS to a previous period's EPS (adjusted for any stock splits) is one of the most common ways for investors to see how fast a company's profits are growing.[26] As shown in Table III, Union Pacific has broken its EPS record for 15 of the last 16 quarters. Norfolk Southern set new record EPS marks for six straight quarters in 2011 and 2012. And CSX broke its quarterly EPS records in two of the last three quarters before its 3:1 stock split in May of 2011, as well as in two quarters in 2011 and one of the last three quarters in 2013.[27]

TABLE III - Earnings per Share Reported by the Three Largest Publicly-Reported Class I Freight Railroads (green highlight = company record)

Year	2009	2010				2011				2012				2013		
Earning Per Share	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	0.77	0.78	1.07	1.08	1.14	1.06	0.46	0.43	0.43	0.43	0.49	0.44	0.43	0.45	0.52	0.46
NSC	0.82	0.68	1.04	1.19	1.09	0.90	1.56	1.59	1.42	1.23	1.60	1.24	1.30	1.41	1.46	1.53
UNP	1.08	1.01	1.40	1.56	1.56	1.29	1.59	1.85	1.99	1.79	2.10	2.19	2.19	2.03	2.37	2.48

E. STB Now Is Routinely Finding Class I Freight Railroads "Revenue Adequate"

As the top Class I freight railroads report quarter-after-quarter of record results with respect to operating ratios and revenues, they also have been performing well in the "revenue adequacy" evaluation of rail companies that the Surface Transportation Board is required to conduct annually under the 1980 Staggers Act. "Revenue adequacy" is defined under law as revenues sufficient 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."[28] While for many years following enactment of the Staggers Act, the top Class I freight railroads were found to be "revenue inadequate," that trend has been changing in recent years.

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[26] Morningstar, *Morningstar Investing Glossary* (Nov. 16, 2013) (online at http://www.morningstar.com/InvGlossary/earnings_per_share.aspx).

[27] On May 4, 2011, CSX announced that its board of directors approved a 3-1 stock split, meaning that all shareholders of record would receive three shares for every one share owned at the close of business on May 31, 2011. CSX Corporation, *CSX Announces Stock Split, Dividend Increase, Share Buyback* (May 4, 2011) (online at http://www.csx.com/index.cfm/media/press-releases/csx-announces-stock-split-dividend-increase-share-buyback/). CSX appears to have set an EPS record in an additional recent quarter, Q2 of 2013, as the company press release on this quarter said that CSX saw "record results" in "all key financial measures." Because the company statement did not specifically address whether EPS was one of these measures, however, the Committee staff report does not count the CSX EPS results in that quarter as a "record."

[28] 49 U.S.C. § 10704(a)(2).

The 1976 Railroad Revitalization and Regulatory Reform Act (known as the "4R Act") instructed the then-Interstate Commerce Commission (ICC) to help freight railroads regain their ability to earn "adequate" revenues.[29] Four years later, the 1980 Staggers Rail Act ordered the ICC to begin calculating annually "which rail carriers are earning adequate revenues."[30] When it implemented this annual reporting requirement in 1981, the ICC decided that to be revenue adequate, a railroad must be "earning a rate of return equal to the current cost of capital."[31]

The theory behind this formula was that freight railroads could not be financially viable over the long term if their operating revenues were not strong enough to attract investors, either through selling equity shares or issuing debt. A railroad producing a return on investment high enough to attract investment (i.e., at the cost of capital level):

> [S]hould be able to generate sufficient revenue to cover all of its operating expenses, including depreciation and taxes; generate sufficient cash flow to fund needed capital expenditures; retire maturing debt; pay interest on existing and new debt; and earn for the shareholders a fair and reasonable return on their investment commensurate with the risk involved.[32]

In its 1986 *Coal Rate Guidelines* decision, the ICC offered more helpful guidance about the regulatory significance of the revenue adequacy evaluation. "Adequate" revenue meant the level "necessary for a railroad to compete equally with other firms for available financing in order to maintain, replace, modernize, and, where appropriate, expand its facilities and services."[33] The revenue adequacy standard represented "a reasonable level of profitability for a healthy carrier" that "assures shippers that the carrier will be able to meet their service needs for the long term." But once the freight railroads reach the revenue adequacy standard, the decision explained, shippers should no longer be asked to subsidize carrier operations:

> Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues. Therefore, the logical first constraint on a carrier's pricing is that its rates not be designed to earn greater revenues than needed to achieve and maintain this "revenue adequacy" level. In other words, captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier capable of meeting its current and future service needs.[34]

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[29] Railroad Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (1976) § 205. The STB's current statutory authority continues to recognize the broad policy goal that "rail carriers shall earn adequate revenues." 49 U.S.C. § 10701(d)(2).

[30] Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895, § 205.

[31] Interstate Commerce Commission, *Standards for Revenue Adequacy,* Ex Parte No. 393, 364 I.C.C. 803, 807 (1981).

[32] Interstate Commerce Commission, *Standards for Railroad Revenue Adequacy*, Ex Parte No. 393, 3 I.C.C. 2d 261, 268 (1986).

[33] Interstate Commerce Commission, *Coal Rate Guidelines, Nationwide*, Ex Parte No. 347, 1 I.C.C. 2d 520, 535 (1985).

[34] *Id.*, at 535-36.

Since the original 1981 ruling, the ICC, and from 1996 onwards, the STB, have made a number of adjustments to the formulas used to calculate each freight railroad's return on investment (ROI) and the cost of capital (COC) against which it is annually compared. Many of these changes have been responses to concerns raised by freight railroads, shippers, or other interested parties about elements of the STB's methodology for calculating revenue adequacy.[35]

While the freight rail community continues to debate whether the STB is properly calculating revenue adequacy,[36] in recent annual evaluations the agency has routinely found that the large Class I freight railroads have been earning rates of return that meet or surpass their cost of capital.

As Table IV below shows:

- With the exception of 2009, Norfolk Southern's ROI has either exceeded, met, or come close to meeting the cost of capital in every year for the last decade.

- While CSX was reporting ROIs in the 4-6% range in the 2003-05 period, the company has come within a few basis points of meeting, or has exceeded, COC in the 2010-12 time frame.

- In 2012, UP's ROI surged to 14.69%, exceeding the COC by more than three full percentage points.

[35] For example, in 2008, in response to concerns raised by the shipper community, the STB replaced the "Single-Stage Discount Cash Flow" model for estimating the rate of return investors require to buy shares of freight railroads, with a different accounting method known as the "Capital Asset Pricing Model." A year later, the STB modified its method for determining this so-called "cost of equity" by adding the Morningstar/Ibbotson "Multi-Stage Discount Cash Flow" method to the calculation. Surface Transportation Board, *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*, S.T.B. Ex Parte No. 664, 2009 WL 197991, *11 (Jan. 23, 2009).

[36] *See, e.g., Statement of Professor Alfred E. Kahn and Report of Professor Jerome E. Hass on Revenue Adequacy Standards* (Feb. 1997) ("The STB's measure of return on investment for each Class I railroad is fraught with short-comings and severely short-sighted; and the cost of capital estimate it uses as a benchmark against which to judge adequacy is severely flawed as well. Simple measures, such as market-to-book ratios, retention rates and debt ratings indicate that the railroads have a high degree of financial integrity and are expected to earn returns on the book value of equity well in excess of their cost of capital. They clearly have no difficulty in raising capital without causing any dilution for existing shareholders").

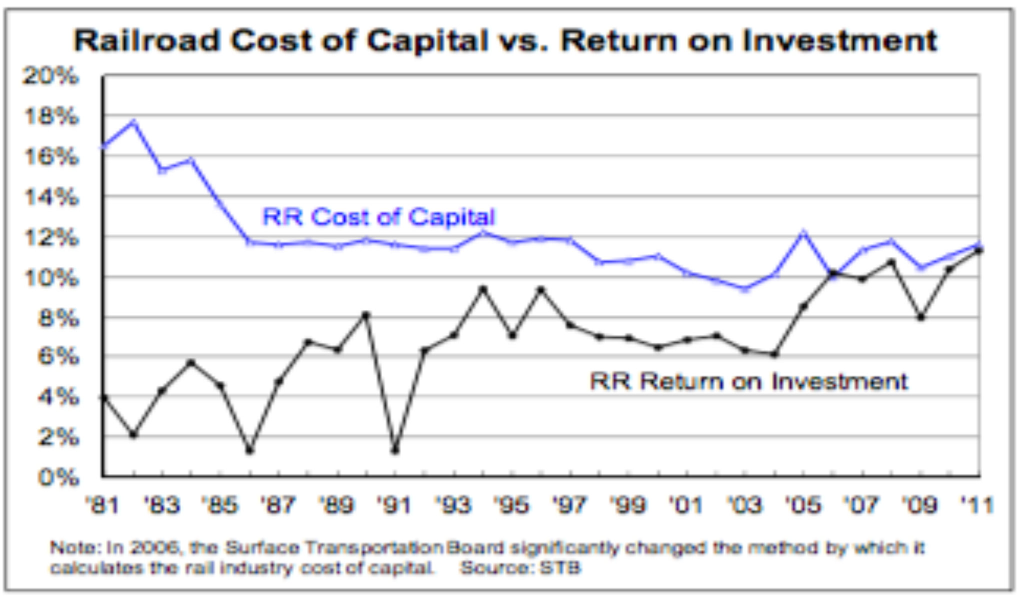
TABLE IV – STB's Railroad Cost of Capital and Revenue Adequacy Determinations
(* Indicates Pending STB Review)

Year	Cost of Capital	BNSF	CSX	NSC	UNP
2003	9.40%	6.20%	4.00%	9.10%	7.30%
2004	10.10%	5.84%	4.43%	11.64%	4.54%
2005	12.20%	10.32%	6.23%	13.21%	6.34%
2006	9.94%	11.43%	8.15%	14.36%	8.21%
2007	11.33%	9.97%	7.61%	13.55%	8.90%
2008	11.75%	10.51%	9.34%	13.75%	10.46%
2009	10.43%	8.67%	7.30%	7.69%	8.62%
2010	11.03%	*	10.85%	10.96%	11.54%
2011	11.57%	*	11.54%	12.87%	13.11%
2012	11.12%	*	10.81%	11.48%	14.69%

Source: STB Revenue Adequacy Filings

This pattern contrasts starkly with the two decades following the passage of the Staggers Act, during which the STB determined that most railroads in most years were not revenue adequate.[37] As the graph below prepared by the Association of American Railroads (AAR) shows, in the most recent years, the freight railroads' ROI has been converging with the STB-calculated COC.

Figure I – Railroad Cost of Capital vs. Return on Investment
Since the Passage of the Staggers Act



Source: Association of American Railroads

[37] Between 1980 and 2005, the ICC and STB made 445 individual determinations of revenue adequacy for railroad companies. It found railroads to be revenue adequate in just 32 instances. Congressional Research Service, *Rail Transportation of Coal to Power Plants: Reliability Issues*, at 78 (Sept. 26, 2007).

Furthermore, while the ROI numbers reported by BNSF in the years following its 2010 purchase by Berkshire Hathaway were below the cost of capital, the recalculation of BNSF ROIs required by a recent STB ruling is expected to boost the revenue adequacy results for BNSF for the years 2010, 2011, and 2012.[38]

These recent revenue adequacy findings suggest that the long-term policy goals of the Staggers Act have been reached with respect to the major Class I freight railroads. These companies are now reliably producing enough income to fund their operations, make appropriate capital expenditures, and attract and reward their investors. If the companies are now profitable and, as a regulatory matter, revenue adequate, policymakers need to take a new look at the competitive advantages Congress gave the railroads 30 years ago.

III. Companies Project Continuing Financial Improvement

In their conversations with Wall Street analysts, railroad executives have repeatedly stated that they expect to continue delivering strong financial performance by "pricing above inflation" in future quarters and by continuing to drive operating ratios lower. These projections reflect a business environment starkly different from the one that existed at the time of the passage of the Staggers Act of 1980.

A. Freight Railroads Continue to Enjoy Strong Pricing Power

One of the key drivers behind the railroads' improving financial performance is their ability to charge their customers increasingly higher rates to move their goods. The September 2010 Staff Report reviewed the growing evidence that after many years of declines in the rates they could charge their non-captive shippers, the freight railroads started raising their prices beginning in about 2004 and 2005.

According to outside experts and the railroads themselves, this "pricing renaissance" occurred because the railroads had steadily improved their productivity and were reaching the end of long-term "legacy" contracts they had entered when they had less pricing power.[39] In testimony before the STB on June 22, 2011, J.P. Morgan transportation analyst Tom Wadewitz commented: "Since 2004 we believe that a favorable pricing trend has been an important factor that has attracted investors to the railroads."[40]

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[38] In July 2013, the STB ruled that BNSF needed to calculate its ROIs for 2010, 2011, and 2012, to exclude the $8.1 billion "acquisition premium" it had previously included when calculating its investment base. *Western Coal Traffic League – Petition for Declaratory Order*, S.T.B. FD 35506, 2013 WL 3834052, *25-26 (July 24, 2013). Because the investment base represents the denominator of the ROI ratio, the $8.1 billion acquisition premium makes the company's net operating income look smaller in comparison and reduces the return on investment percentage.

[39] September 2010 Staff Report, at 8-10.

[40] Testimony of Tom Wadewitz, J.P. Morgan, *Competition in the Railroad Industry*, Surface Transportation Board, Ex Parte No. 705 (June 22, 2011).

A review of the company's recent filings and investor calls shows that the railroad companies continue to expect they will be able to raise rates faster than the rate of rail inflation for the foreseeable future. For example, on a third quarter 2012 earnings call, Don Seale, Norfolk Southern's Chief Marketing Officer, stated:

> With respect to pricing, our commitment remains to price at levels above the rate of rail inflation over the long run. Export coal markets made this a difficult task in the third quarter, and we expect those same headwinds over the next few quarters. But based on our internal analysis, and excluding that negative effect of export coal, we met our objective of pricing above rail inflation in the third quarter, and we expect that positive trend to continue as we provide excellent service and value to our customers across our network.[41]

Similarly, CSX CEO Clarence Gooden highlighted the company's expectations to price above rail inflation, in the following exchange with an analyst:

> Analyst: It doesn't seem, at least from your results, that there is any aggressive pricing between you and the NS going on right now. I just wanted to make sure that that is the case.
>
> Gooden: What do you mean by aggressive pricing between us and the NS?
>
> Analyst: I'm saying aggressive – are you guys getting more aggressive with trying to steal freight from one another? I think that was the crux of Bill's question.
>
> Gooden: Absolutely not. As we've told you earlier, we are going to price to above rail inflation. We're going to price above it because, one, we think we've got a product that offers a significant value. And, secondly, because it's necessary for us to invest in our infrastructure. We've had a solid plan over the last 10 years now, nearly, in which we've wanted to work on our pricing. And that's what we're going to continue to do.[42]

B. <u>Projected Improvements in Operating Ratios and Operating Income</u>

Executives from CSX have told investors and Wall Street analysts that the company's operating ratios will continue to improve, publicly announcing the company's goal of a 65% operating ratio by 2015. In the company's third Quarter 2011 earnings call, CEO Michael Ward told analysts, "We remain highly committed to a 65% operating ratio by no later than 2015, and we fully expect that this will be achieved."[43] CSX CFO Fredrick Eliasson, in a recent conference call with investors, noted that, even considering the "coal headwinds" that impacted CSX's financial results throughout 2012 and 2013, the company "remains on track to sustain a high-60s operating ratio by 2015, and a mid-60s operating ratio longer term."[44]

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[41] Norfolk Southern 3rd Quarter 2012 Earnings Conference Call (Oct. 23, 2012).

[42] CSX 1st Quarter 2013 Earnings Conference Call (Apr. 17, 2013).

[43] CSX 3rd Quarter 2011 Earnings Conference Call (Oct. 19, 2011).

[44] CSX 2nd Quarter 2013 Earnings Conference Call (July 17, 2013).

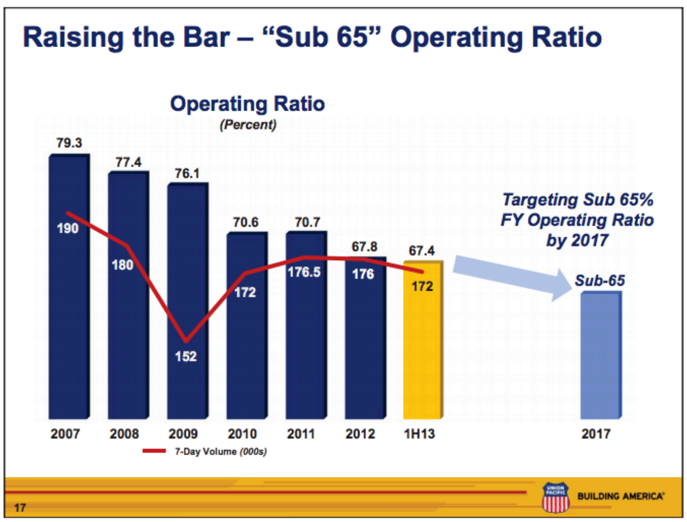
Union Pacific has set a similarly ambitious operating ratio goal. In 2007, the company initiated "Project Operating Ratio" with a goal of achieving a "low 70's operating ratio by 2012."[45] Union Pacific CFO Rob Knight recently explained that his company had already achieved the goals of "Project Operating Ratio," and had set a new, even lower goal:

> While it's evident that the math of today's higher fuel prices can inflate the operating ratio, as we just saw in the fourth quarter, we are focused on achieving our new target of 65% to 67% full-year operating ratio by 2015.[46]

According to Committee staff's analysis, Union Pacific has set a new, lower operating ratio record for 14 of the last 16 quarters including the last eight consecutive quarters.

Union Pacific has used the slide below at investor conferences over the past year to discuss progress made since initiating Project Operating Ratio and targets going forward:

Figure II – Union Pacific Analysis of Improvements to its Operating Ratio Since the Beginning of Project Operating Ratio



Source: Union Pacific Investor Presentation

On the company's most recent conference call, Mr. Knight updated investors and Wall Street analysts on Union Pacific's record-breaking operating ratio of 64.8%, noting "We are not going to stop. So the sub-65% is not an end game, it's just the next rung on the ladder."[47]

In this same call, Union Pacfic CEO Jack Koraleski reaffirmed his confidence in the company's future financial performance in the following exchange with an analyst:

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[45] Union Pacific, Project Operating Ratio Presentation (May 2008) (online at http://www.up.com/investors/attachments/presentations/2008/analyst_conf/rmk_slides.pdf).

[46] Union Pacific 4th Quarter 2010 Earnings Conference Call (Jan. 20, 2011).

[47] Union Pacific 3rd Quarter 2013 Earnings Conference Call (Oct. 17, 2013).

> Analyst: When you look at the Union Pacific network and you see what you have been able to achieve over the last five to seven years, which in margin terms are kind of breathtaking, is there anything about the network that makes you say, yes, it is going to be hard for us to ever achieve record profitability relative to our peers in the industry? Is there anything about your network structure that limits how good you can be?
>
> Koraleski: Man, I can't think of anything.[48]

IV. The Railroads' Strong Financial Performance is Benefiting Shareholders

The publicly traded shares of the freight railroads have performed significantly better in recent years than the widely followed stock market indexes. This strong performance is tied to the companies' excellent financial results. In June 2011 testimony before the STB, J.P. Morgan analyst Tom Wadewitz explained that "[f]avorable EPS [earnings per share] growth performance and a broader trend of improving financial returns have been key factors that have attracted equity investors to the railroad stocks over the past seven years."[49]

In testimony delivered during the same hearing, Scott Group from the Wolfe Trahan transportation industry analysis firm presented a graph showing that "Rail Stocks Have Materially Outperformed Other Transports and the S&P Since 2005." According to this graph, "Large-Cap Rails" have provided investors annualized returns of 15% since 2000, and trucking stocks had returns of 6.1%, while at the same time the S&P index return was -1.2%.[50]

The September 2010 Staff Report presented a graph showing that the performance of freight rail stocks between 1999 and 2009 – the first decade after the rail industry had consolidated into four dominant U.S. based carriers – far exceeded the performance of companies that are part of the S&P 500 Index.[51] A Fortune magazine story on the freight railroad industry showed the same graph updated through July 29, 2011. This graph was captioned, "The total return of the Big Four railroads' stocks has left the S&P 500 far behind."[52]

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[48] Union Pacific 3rd Quarter 2013 Earnings Conference Call (Oct. 17, 2013).

[49] Testimony of Tom Wadewitz, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (June 22, 2011).

[50] Testimony of Scott Group, Wolfe Trahan & Co., *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (June 22-23, 2011).

[51] September 2010 Staff Report, at 6-7.

[52] *Showdown on the Railroad*, Fortune (Sept. 26, 2011) (online at http://features.blogs.fortune.cnn.com/2011/09/13/showdown-on-the-railroad/).

While AAR critiqued the September 2010 Staff Report's analysis of stock performance,[53] the railroads themselves have presented similar information to their investors to illustrate the strong recent performance of their shares.

For example, during an investor conference in 2011, a Norfolk Southern executive presented the graph below showing that over the past five and a half years, her company's stock "has returned a compound annual growth of 11.4% versus 2.4% for the S&P 500."[54] It is worth noting that, as of mid-November 2013, Norfolk Southern shares were trading at or near their 52-week highs.[55]

Figure III – Norfolk Southern Shareholder Return

Source: Norfolk Southern Investor Presentation

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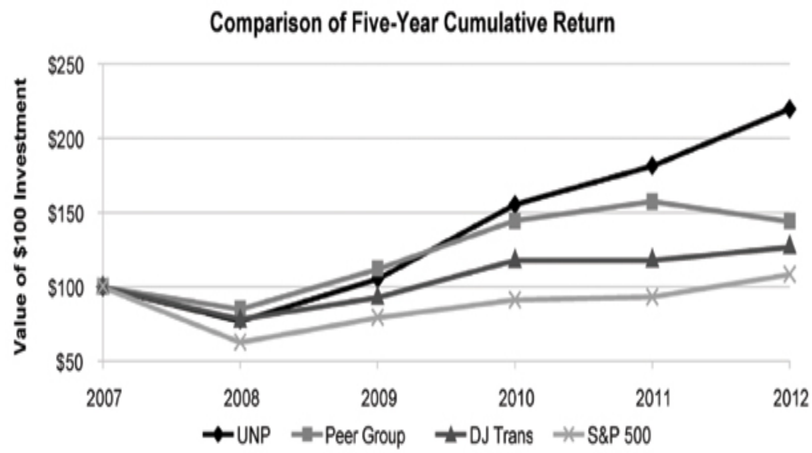
[53] Joint Verified Statement of Robert S. Hamada and Rajiv B. Gokhale, at 4-6, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (May 27, 2011) (statement commissioned by AAR). AAR takes the position that there is "nothing extraordinary about railroad stock performance," arguing that the appropriate point of comparison is industries with similar capital intensities. *See* Reply Comments of the Association of American Railroads, *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705, at 15 (May 27, 2011).

[54] Norfolk Southern Presentation at Morgan Keenan Industrial/Transportation Conference (Sept. 14, 2011).

[55] Stock price graph for NSC, January 6, 2006 to November 19, 2013, via Google Finance (accessed Nov. 19, 2013).

Similarly, as part of its 2012 10-K financial filing to the Securities and Exchange Commission, Union Pacific (UNP) published the graph below showing that the company and its peers have substantially outperformed stocks in the Dow Jones and S&P indexes over the past five years. According to this graph, a $100 investment in UNP stock on December 31, 2007, with subsequent dividends reinvested, was worth approximately $230 at the end of 2012, while $100 invested in the major stock indexes would have only been worth marginally more at $110.[56]

Figure IV – Union Pacific Shareholder Return



Source: Union Pacific SEC Filings

The owners of freight railroad stocks are not just benefiting from the increasing value of their shares. They are also benefiting from the railroads' aggressive use of their free cash flows to expand their dividends and buy back outstanding shares. As noted in the September 2010 Staff Report, the freight railroads have been using the growing income left over from operations to increase their capital expenditures.[57] At the same time, they were also using significant portions of their free cash flows to boost the short-term value of their shares through stock buyback programs.

The CSX Power Point slide below illustrates what the company calls its "balanced approach" to managing its growing free cash flows. Free cash flows represent the cash a company has remaining after investing for the growth of its business operations.[58] These funds can be used to pursue opportunities to enhance shareholder value. As depicted in the chart, at the same time the company continued its strong commitment to capital expenditures between 2006

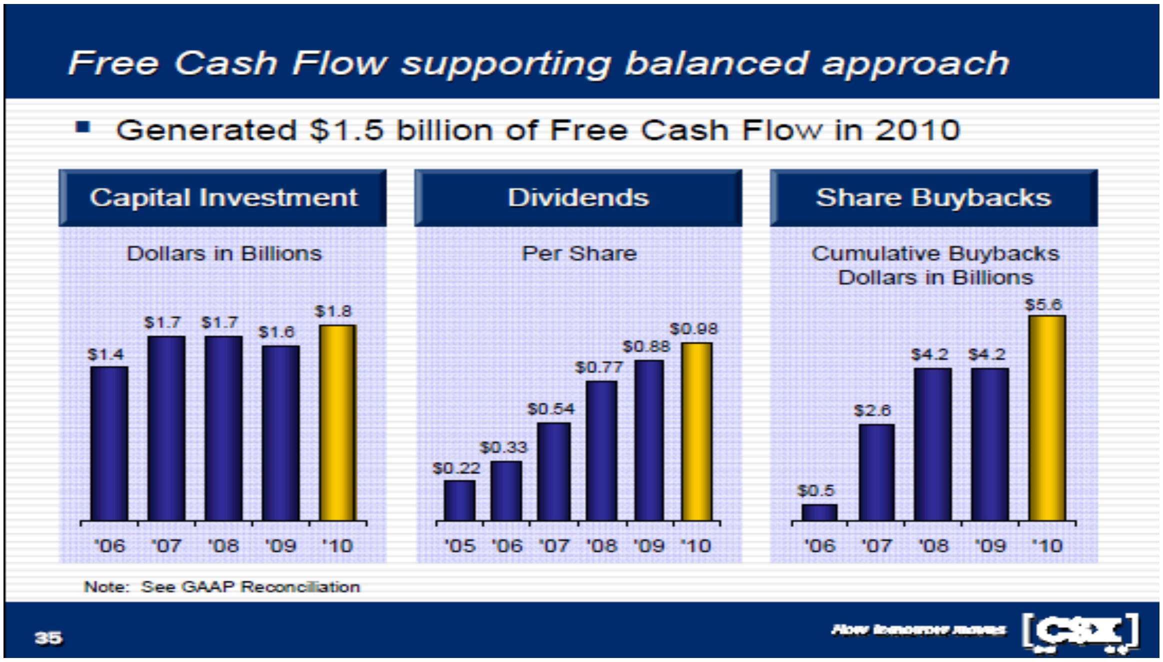
[56] Union Pacific 2012 Form10-K Securities and Exchange Commission Financial Filing, at 20 (Feb. 8, 2013). With respect to this chart, Union Pacific in its 10-K filing defines "peer group" as CSX and Norfolk Southern, and "DJ Trans" as the Dow Jones Transportation Index.

[57] While the dollar value of the freight railroads' capital expenditures has generally been growing in recent years, the portion of operating revenues they dedicate to capital expenditures has remained at a steady 16-18%. Testimony of Scott Group, Wolfe Trahan & Co., *Competition in the Railroad Industry*, Surface Transportation Board Ex Parte No. 705 (June 22-23, 2011).

[58] Morningstar, *Morningstar Investing Glossary* (Nov. 16, 2013) (online at http://www.morningstar.com/InvGlossary/free_cash_flow_definition_what_is.aspx).

and 2010, it also increased its dividend per share payments by 445% between 2005 and 2010, and the cumulative value of its share buyback grew from $500 million in 2006 to $5.6 billion in 2010.[59]

Figure V – CSX Free Cash Flow



Source: CSX Investor Presentation

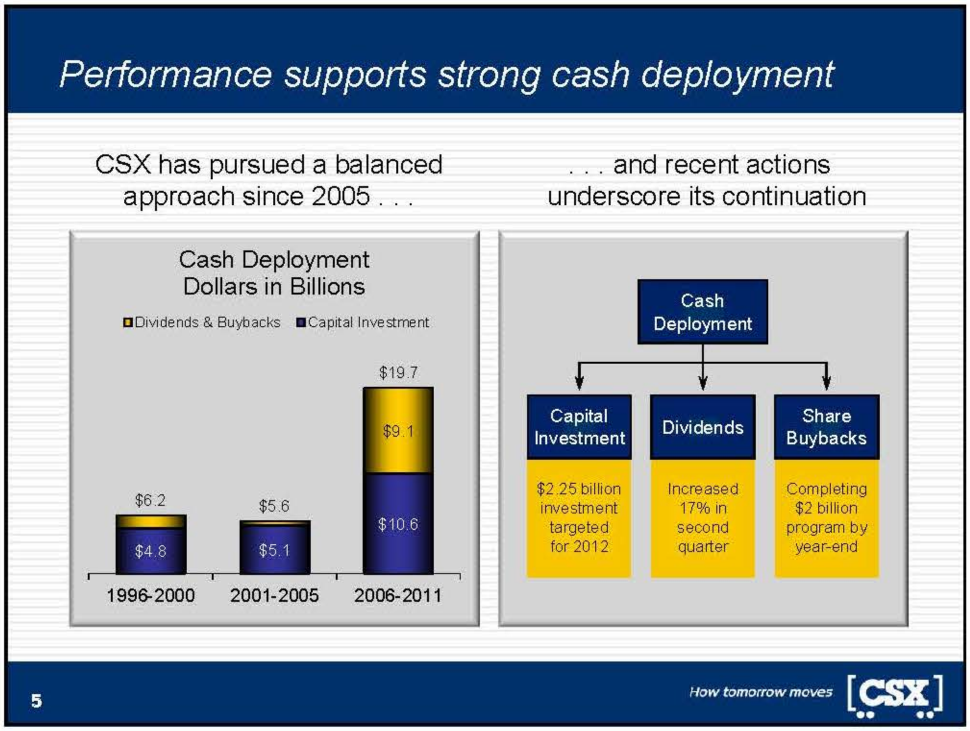
At a 2012 investor conference, CSX CFO Frederick Eliasson also highlighted CSX's ability to support a balanced approach to its cash deployment. Presenting the slide below, he commented:

> Our cash deployment, really since 2005, has been very, very balanced, both between reinvesting in our business, but also in regards to returning cash to our shareholders. Prior to 2006, we weren't really in the position to either fully reinvest in our business, nor to return significant amounts of cash to our shareholders because of where we were in regards to our margins in our business. But since then, we have improved that significantly, and also as a result of that, been able to reinvest and return cash to our shareholders in a way we hadn't done previously.[60]

[59] CSX 4th Quarter 2010 Earnings Presentation, at 35 (Jan. 25, 2011) (online at http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Nzg0Mzd8 Q2hpbGRJRD0t MXxUeXBlPTM=&t=1).

[60] CSX Presentation at UBS Best of Americas Health Care Conference, at 5 (Sept. 6, 2012).

Figure VI – CSX Strong Cash Deployment

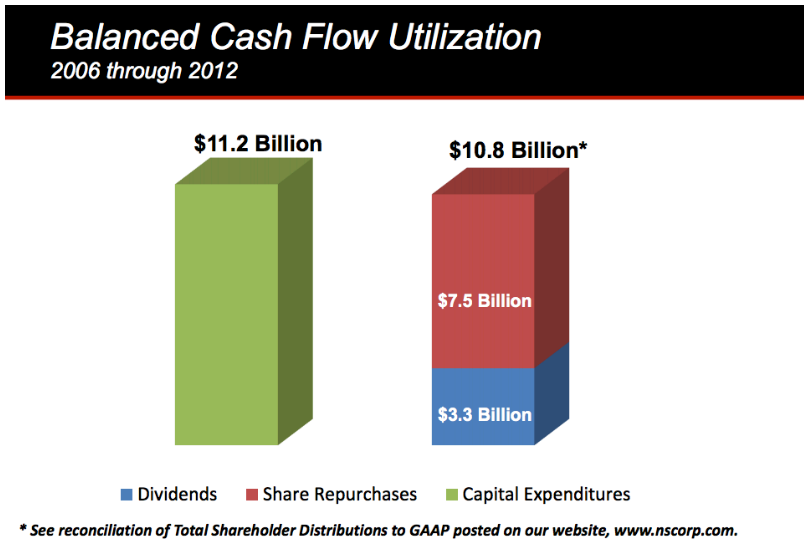


Source: CSX Investor Presentation

Norfolk Southern also has deployed its increasing cash flows to both increase capital investments in their networks and deliver short-term rewards to company shareholders. The slide below, recently presented by Norfolk Southern at an investor conference hosted by Citi, shows the scale and split of the cash distribution the company has managed since 2006 through the end of 2012. Norfolk Southern split its $22 billion in cash flow roughly evenly between long-term capital investment and shorter-term shareholder gains. The company spent 34% of cash flow on share repurchases, 15% on dividends to shareholders, and 51% on capital expenditures.[61]

[61] Norfolk Southern, Cowen Securities Global Transportation Conference, at 24 (June 11, 2013). (online at http://www.nscorp.com/content/dam/nscorp/get-to-know-ns/investor-relations/Slides/cowen_presentation_2013.pdf).

Figure VII – Norfolk Southern Balanced Cash Flow Utilization



Source: Norfolk Southern Investor Presentation

Union Pacific as well has been using cash flows to pay dividends as well as buy back shares. In comments to investors and analysts in 2011, Union Pacific CFO Rob Knight asserted that since 2007, his company had "distributed more than $6.3 billion to shareholders through a combination of dividends and share repurchase," and that the company anticipated even larger shareholder payments in the future.[62] At another investment conference in 2011, he explained:

> In 2010, we achieved a record return on invested capital of 10.8% and free cash flow of $1.4 billion. Looking ahead, we are confident our returns and cash flows will be even higher, as we stay dedicated to growing our business, improving pricing, and driving efficiency gains. Beyond investing back into the business, we will reward our shareholders directly through both dividends and share repurchases. And as our cash grows, so does our ability to return even more to the shareholders through these programs.[63]

More recently, at an investor conference earlier this year, Mr. Knight discussed how Union Pacific was "delivering value to shareholders." Referencing the slide below, he explained:

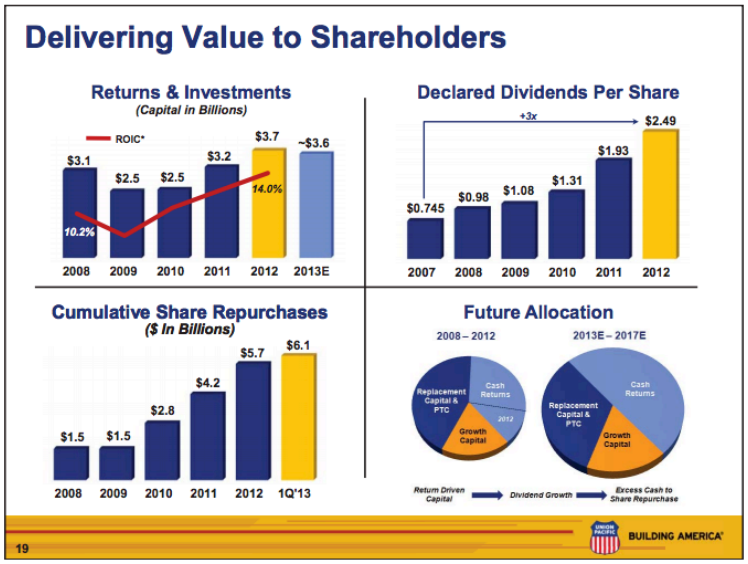
> Beyond funding our capital programs, our record profitability has enabled us to grow shareholder returns. In the past five years we have increased our declared dividend per share over three-fold and bought back almost $6 billion worth of stock. Cash returns in 2012 alone totaled over $2.6 billion, driven by a 30% dividend payout ratio and opportunistic share repurchases. Looking ahead, we expect to generate even more cash

[62] Union Pacific, J.P. Morgan Aviation, Transportation & Defense Conference (Mar. 24, 2011).

[63] Union Pacific Presentation at Deutsche Bank Securities, Inc. Global Industrials and Basic Materials Conference (June 15, 2011).

to allocate over the next five years. Even with a larger capital budget, we expect shareholders will receive a bigger piece of the cash pie going forward.[64]

Figure VIII – Union Pacific Analysis of Benefits to Shareholders Since 2007



Source: Union Pacific Investor Presentation

Conclusion

In 1980, at the signing ceremony for the Staggers Act, President Jimmy Carter heralded the Act's regulatory reforms with the following description:

> [S]tripping away needless and costly regulation in favor of marketplace forces wherever possible, this act will help assure a strong and healthy future for our Nation's railroads and the men and women who work for them. It will benefit shippers throughout the country by encouraging railroads to improve their equipment and better tailor their service to shipper needs. America's consumers will benefit, for rather than face the prospect of continuing deterioration of rail freight service, consumers can be assured of improved railroads delivering their goods with dispatch.[65]

There is a broad consensus that the Staggers Act enabled the successful restructuring of the American freight rail industry. Three decades after President Carter signed the Staggers Act into law, the large U.S. Class I freight railroads in the United States see a "strong and healthy future" for their businesses. In recent public statements, the railroads have confidently predicted that their record-setting financial performance will continue for the foreseeable future.

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[64] Union Pacific Presentation at Cowen Global Transportation Conference (June 11, 2013).

[65] Statement on Signing S.1946 into Law, 3 Published Papers of the President, Jimmy Carter 1980-1981 1949, at 2229 (Oct. 14, 1980).

While the railroads are prospering under the regulatory system established by the Staggers Act, it is less clear that today's shippers and consumers are enjoying the benefits President Carter envisioned in his 1980 statement. The goal of the Staggers Acts was not to enrich railroad companies, but to "provide a regulatory process that balances the needs of carriers, shippers, and the public." As policymakers continue to discuss the future of America's rail transportation network, they will need to carefully consider whether changes are needed to reach this goal.

APPENDICES

The Largest Publicly Traded Class I Freight Railroads Are Breaking Records in Several Key Financial Measures

(Green Highlighting Indicates Record Breaking Quarter)

TABLE I - Operating Ratio

Year	2009	2010				2011				2012				2013		
Operating Ratio	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	74.9	74.5	71.2	69.1	70.0	72.5	69.3	70.4	71.5	71.1	68.7	70.5	72.1	70.4	68.6	71.5
NSC	73.9	75.2	69.8	69.6	73.2	77.1	69.5	67.5	71.4	73.3	67.5	72.9	73.4	74.8	70.2	69.9
UNP	73.3	75.1	69.4	68.2	70.2	74.7	71.3	69.1	68.3	70.5	67.0	66.6	67.1	69.1	65.7	64.8

TABLE II – Operating Income

(In Millions)

Year	2009	2010				2011				2012				2013		
Operating Income	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	583	634	768	825	846	773	926	878	841	856	943	854	804	875	963	854
NSC	549	555	733	746	642	600	875	938	800	745	934	731	714	691	836	849
UNP	1,002	988	1,279	1,401	1,313	1,137	1,392	1,578	1,617	1,510	1,724	1,786	1,725	1,633	1,878	1,962

TABLE III – Earnings Per a Share

Year	2009	2010				2011				2012				2013		
Earning Per Share	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
CSX	0.77	0.78	1.07	1.08	1.14	1.06	0.46	0.43	0.43	0.43	0.49	0.44	0.43	0.45	0.52	0.46
NSC	0.82	0.68	1.04	1.19	1.09	0.90	1.56	1.59	1.42	1.23	1.60	1.24	1.30	1.41	1.46	1.53
UNP	1.08	1.01	1.40	1.56	1.56	1.29	1.59	1.85	1.99	1.79	2.10	2.19	2.19	2.03	2.37	2.48

Appendix I

STB's Railroad Cost of Capital and Revenue Adequacy Determinations

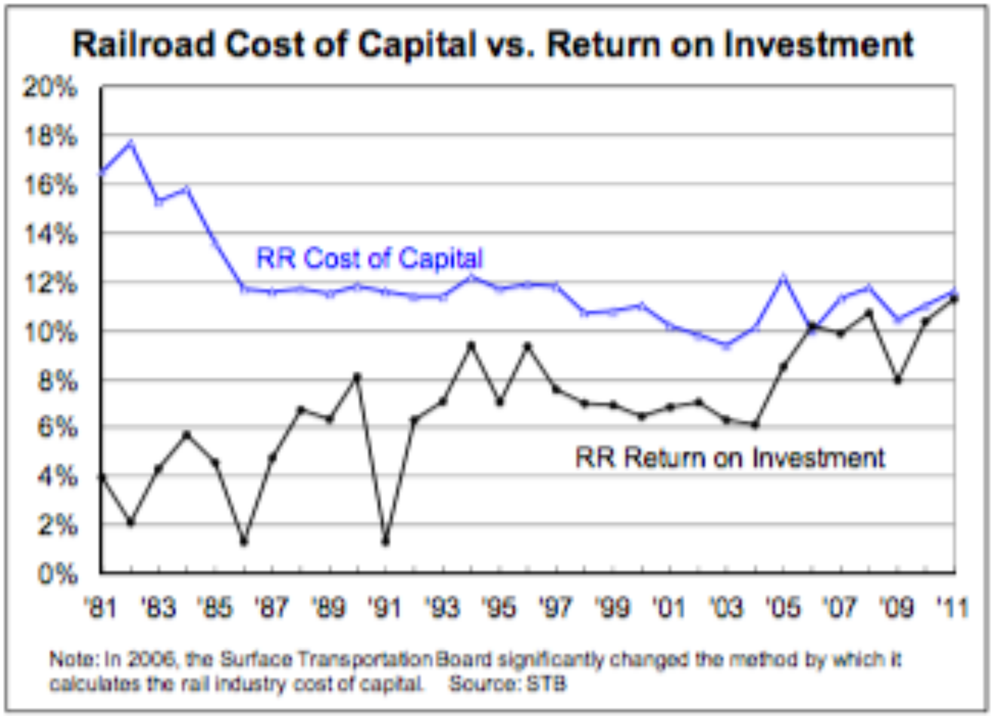
(* Indicates Pending STB Review)

Year	Cost of Capital	BNSF	CSX	NSC	UNP
2003	9.40%	6.20%	4.00%	9.10%	7.30%
2004	10.10%	5.84%	4.43%	11.64%	4.54%
2005	12.20%	10.32%	6.23%	13.21%	6.34%
2006	9.94%	11.43%	8.15%	14.36%	8.21%
2007	11.33%	9.97%	7.61%	13.55%	8.90%
2008	11.75%	10.51%	9.34%	13.75%	10.46%
2009	10.43%	8.67%	7.30%	7.69%	8.62%
2010	11.03%	*	10.85%	10.96%	11.54%
2011	11.57%	*	11.54%	12.87%	13.11%
2012	11.12%	*	10.81%	11.48%	14.69%

Source: STB Revenue Adequacy Filings

Appendix II

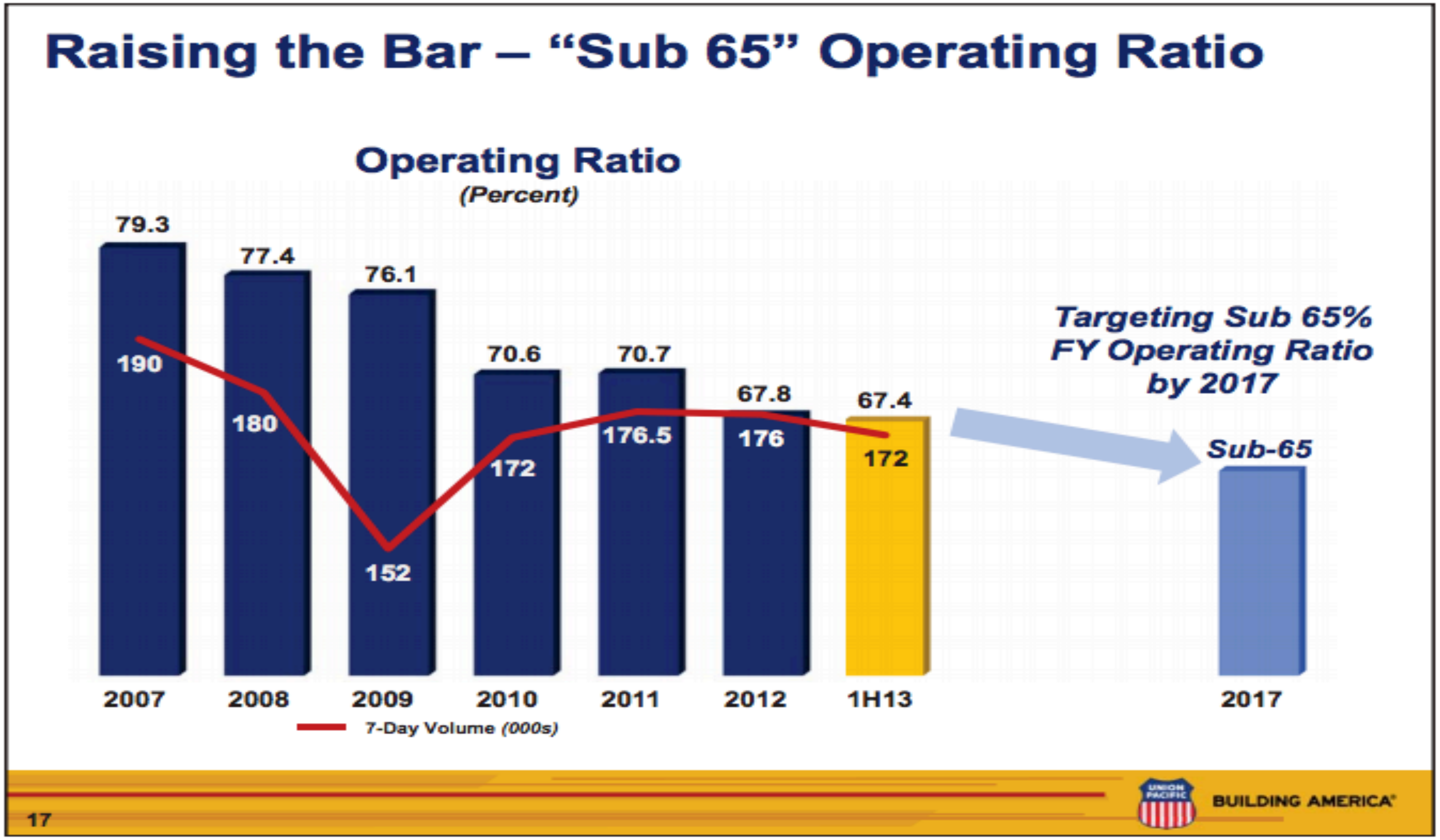
Railroad Cost of Capital vs. Return on Investment Since the Passage of the Staggers Act



Source: Association of American Railroads

Appendix III

Union Pacific Analysis of Improvements to its Operating Ratio Since the Beginning of "Project Operating Ratio"



Source: Union Pacific Investor Presentation

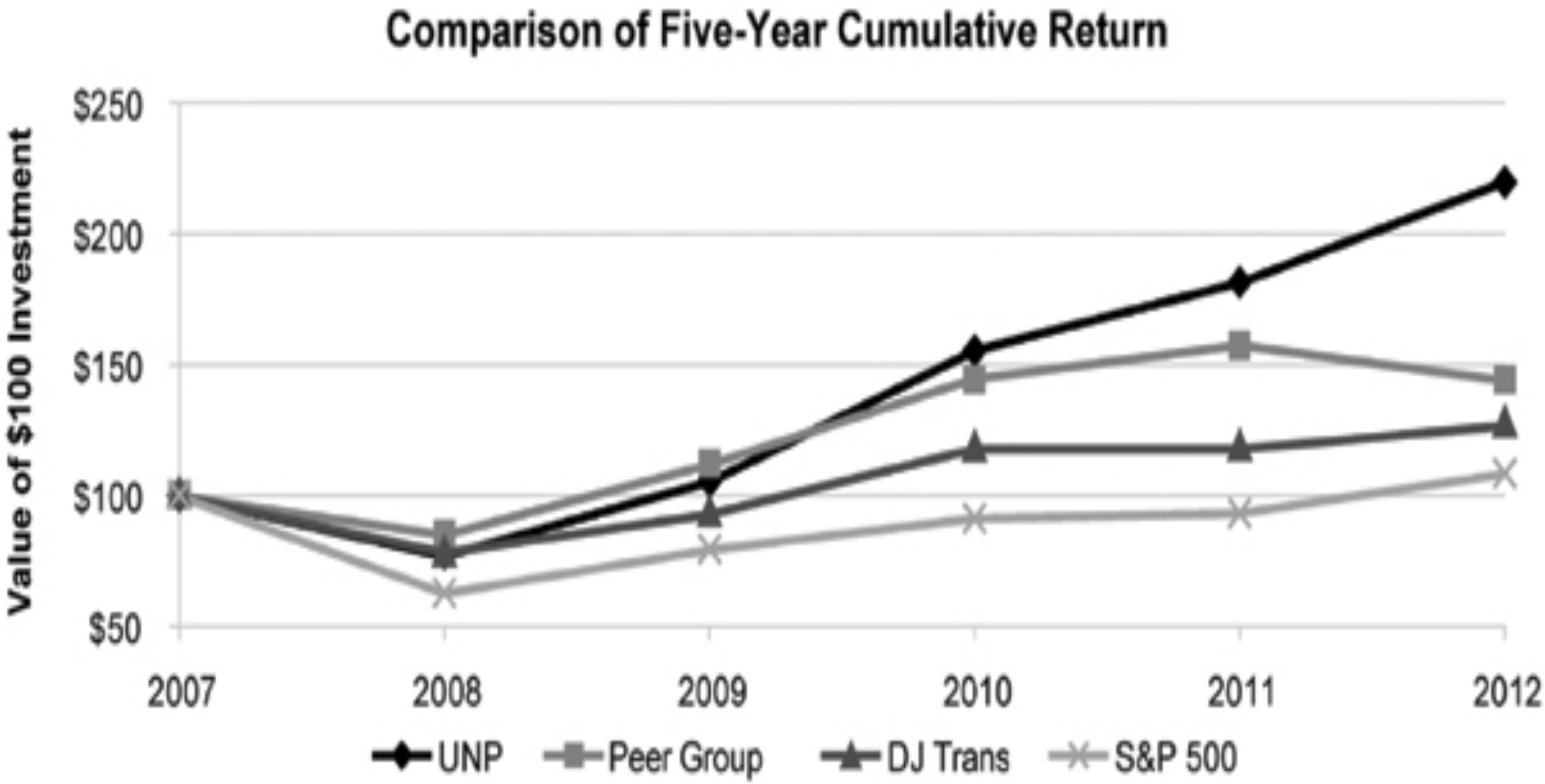
Appendix IV

Norfolk Southern Shareholder Return
2006 – Q2 2011

Source: Norfolk Southern Investor Presentation

Appendix V

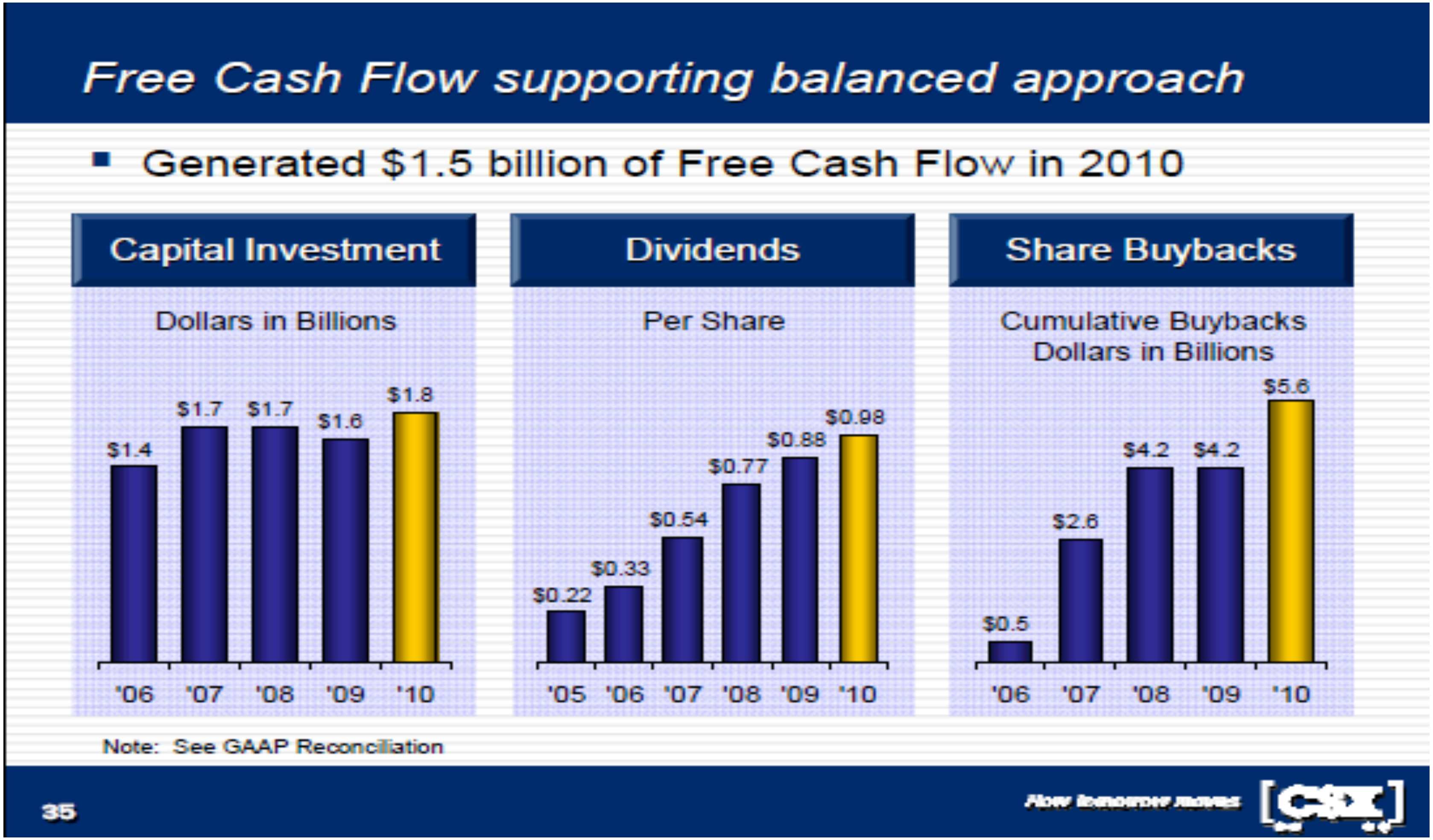
Union Pacific Five Year Shareholder Return
2007 – 2012



Source: Union Pacific Securities and Exchange Commission Filing

Appendix VI

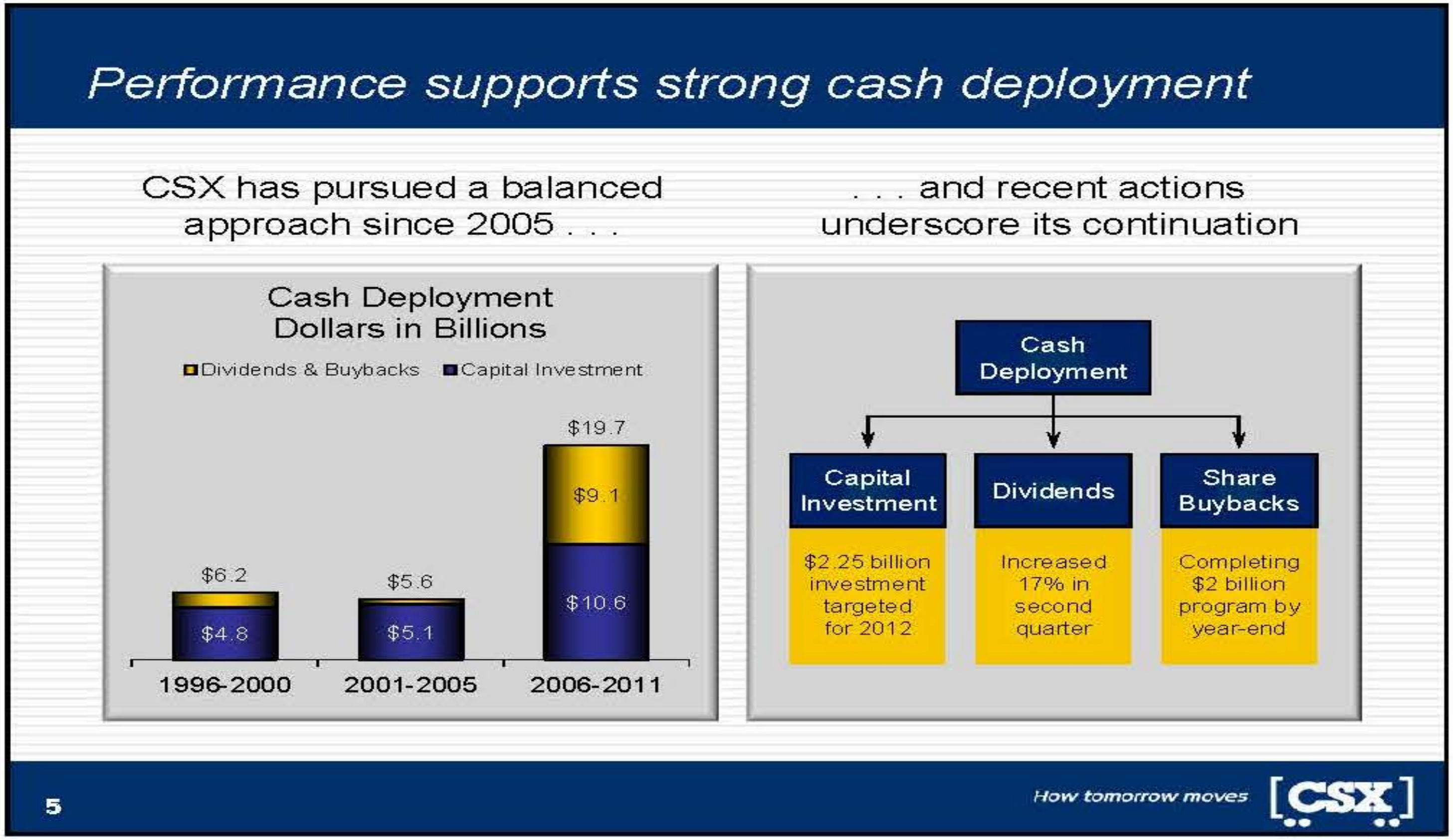
CSX Free Cash Flow
2006-2010



Source: CSX Investor Presentation

Appendix VII

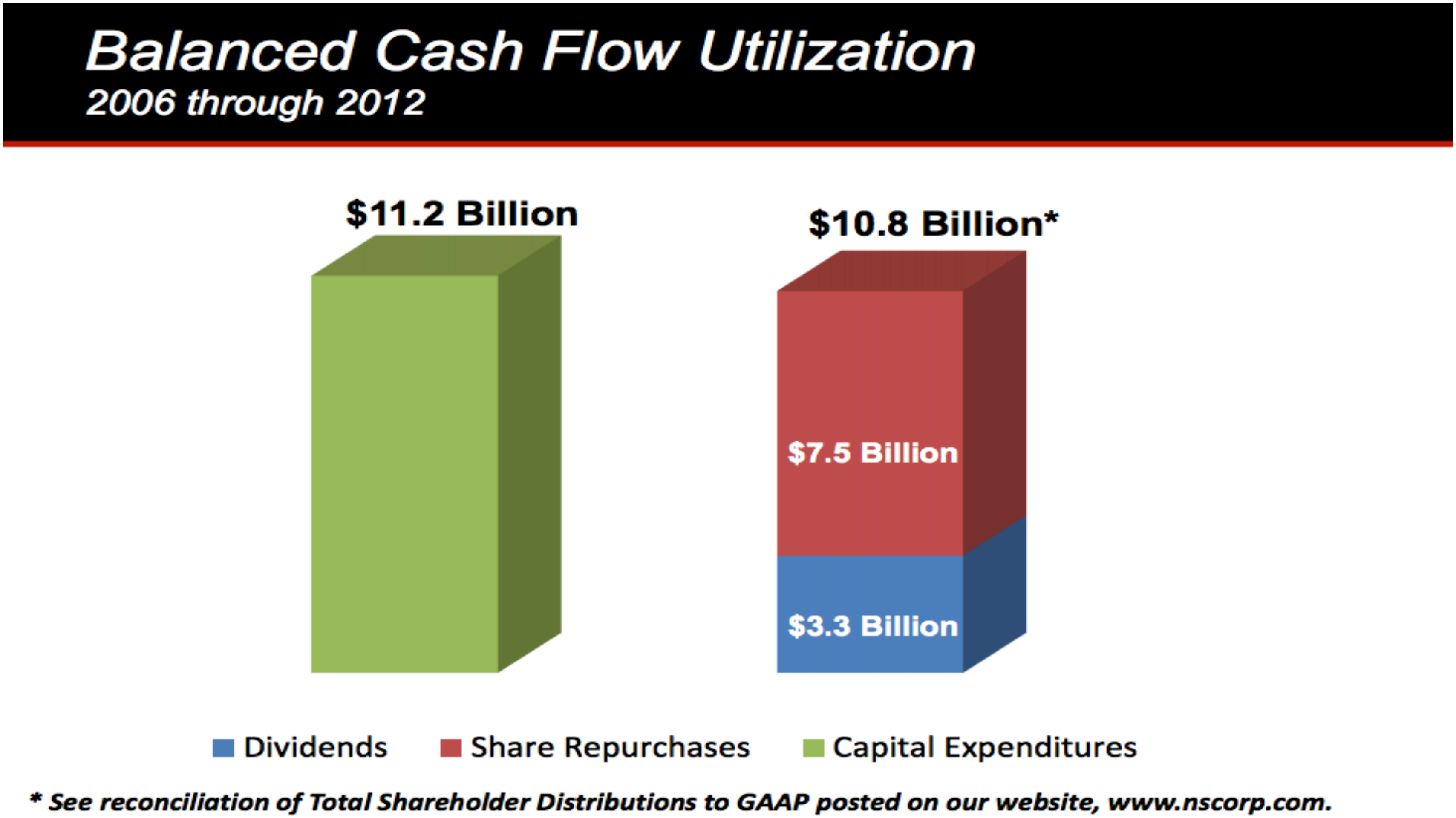
CSX Cash Deployment
2006-2011 compared to 1996-2005



Source: CSX Investor Presentation

Appendix VIII

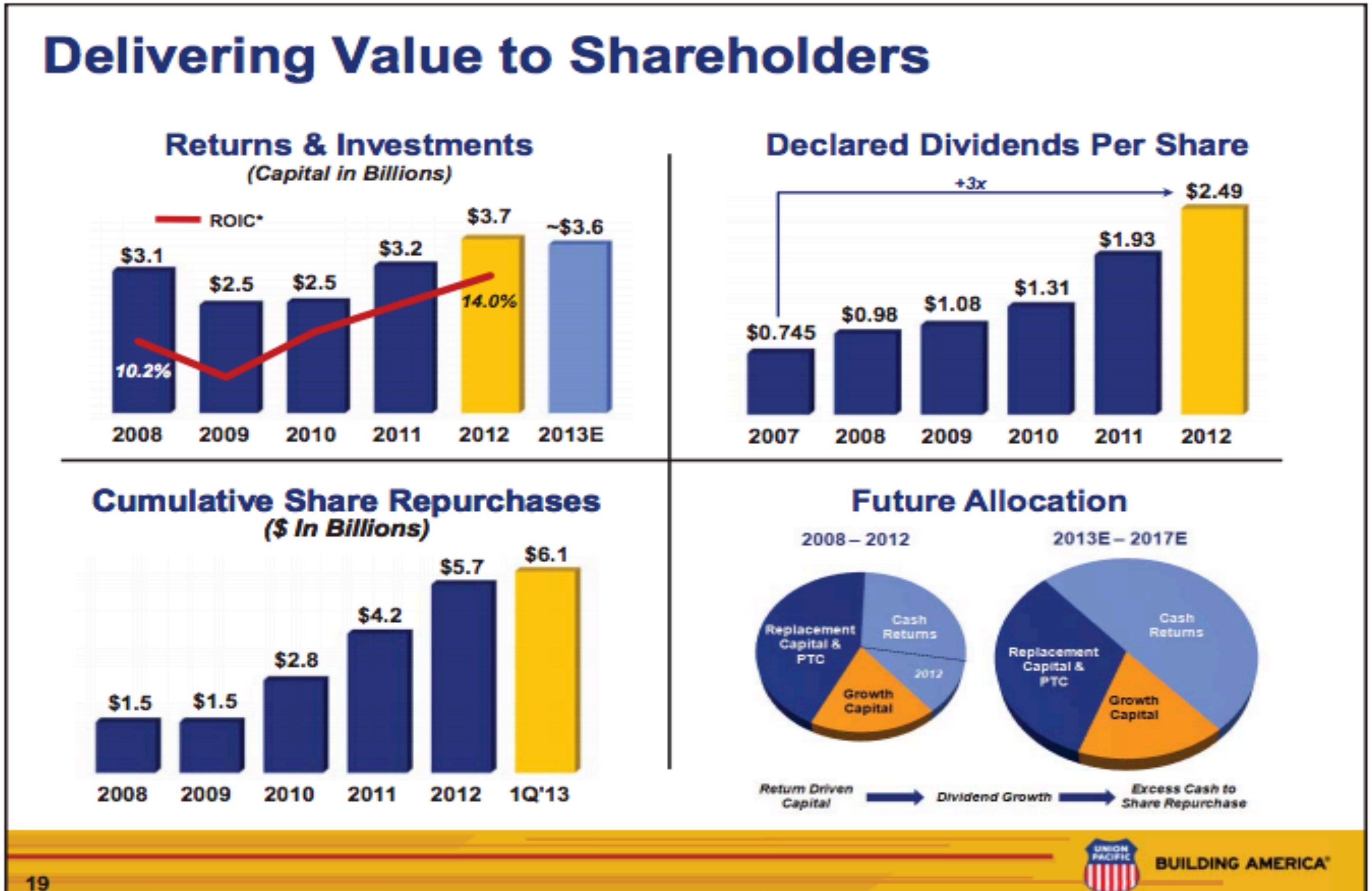
Norfolk Southern Balanced Cash Flow 2006-2012



Source: Norfolk Southern Investor Presentation

Appendix IX

Union Pacific's Dividends and Share Repurchases 2008-2012



Source: Union Pacific Investor Presentation

Appendix X

CSX Falling Operating Ratio
Fourth Quarter 2006 - 2010

Source: CSX Investor Presentation

Appendix XI