SURFACE TRANSPORTATION BOARD
OFFICE OF ECONOMICS, ENVIRONMENTAL ANALYSIS, AND ADMINISTRATION

April 6, 2006

Mr. Charles W. King
Snavely King Majoros O'Connor & Lee, Inc.
Economic and Management Consultants
1220 L Street, NW Suite 410
Washington, DC 20005

Dear Mr. King:

This letter responds to your complaint, originally filed with this Board dated January 12, 2006 and perfected on February 6, 2006, in which you make a request for correction of errors pertaining to the consolidated costs of the Grand Trunk Corporation (GTC). Your request was referred to my Office by Marilyn Levitt, the Board's Information Quality Officer.

In your request you assert that the RSAMs for the GTC are extraordinarily and incorrectly high: due either to being incorrectly calculated or to being based on incorrect cost inputs. Specifically, you requested that the Board timely (1) investigate the revenue and cost reporting of the GTC; (2) correct the cost data; and (3) restate the RSAM benchmarks for GTC for both 2002 and 2003.

The complaint is accompanied by a report written by Mr. Tom O'Connor of your office. Mr. O'Connor provides a detailed examination of the RSAMs computed for the GTC and its predecessor railroads Illinois Central (IC) and Grand Trunk Western (GTW) for the years 1996-2003. In that report, Mr. O'Connor points out that the RSAM for GTC in 2002 is much larger than the RSAMs for both GTW and IC in 2001. He further points out that the acquisition of Wisconsin Central (WC) during that year could not possibly account for such a large difference in the RSAMs, as WC was a much smaller railroad. He concludes that a significant error in the computation of variable costs for GTC must have occurred. According to Mr. O'Connor, only such an error could lead to the observed increase in RSAM.

My Office has completed a thorough investigation of the cost inputs and calculation of the RSAM figures for the years 2002-2003. The cost inputs are developed from the waybill sample and the R-1 data filed by GTC. The R-1 annual report is verified by independent public accountants applying agreed-upon procedures developed by the Board. We found no material errors in the reporting of revenue and cost data by the GTC for the years cited in your complaint.

Further, we considered the possibility that changes in the techniques used to account for international traffic may have had an effect on the variable cost estimate. A significant change in that technique did occur between 2001 and 2002. We investigated that change in technique to determine if it could have skewed the estimate of variable costs for GTC. In 2001, variable costs were summed for all traffic terminating in the United States (traffic originating in the United States but terminating in Canada was excluded). In 2002, the technique was changed so that costs were summed only for the United States portion of every shipment. Analysis of the waybill data for the two years, however, indicates that the resulting changes were not significant enough to give rise to the RSAM differences cited in your request.

We find that your assertion that the GTC RSAM figures were "extraordinarily and incorrectly high" is not the result of erroneous cost inputs or an erroneous computation of variable costs, but rather, is caused by a revaluation of IC assets. When Canadian National (CN) acquired IC in 2000, its assets were revalued to reflect the purchase price CN paid to acquire IC. The revalued assets were significantly higher than the asset values that were carried on the books of the IC prior to the acquisition. This was a purchase accounting transaction recorded in accordance with the Board's Uniform System of Accounts (USOA).

For regulatory purposes, IC and GTW remained separate railroads reporting separate R-1's to the STB through year-end (December 31) 2001. In 2002, for the first time, GTC became the reporting carrier for R-1 purposes. The write-up of the IC assets was incorporated into the R-1 report of GTC, which, as the holding company for the US subsidiaries of CN, was the company that recorded the write-up at the time IC was purchased.

Writing-up the value of the assets leads to a higher RSAM for the following reasons:

1. When assets have a higher value, the annual depreciation and return on investment (capital) expense increases. This leads to higher variable costs. In URCS, equipment depreciation is 100% variable and road property depreciation is 50% variable.

2. A higher asset value leads to a higher Tax-Adjusted Net Investment Value. Multiplying this higher value by the railroad's cost of capital leads to a higher required profit.

Because of this large increase in the book value of the railroad, there was a large increase in the railroad's variable cost, a large increase in the railroad's fixed cost, and a large increase in RSAM. The following table shows the change in asset valuations from 1999-2003 for the IC, GTW, and GTC:

Table 1. Tax Adjusted Net Investment Values for IC, GTW, and GTC (Dollars in Thousands)

Year	GTW	IC	GTW+IC	GTC
1999	$ 325,908	$1,113,006	$1,438,914	
2000	$ 431,817	$1,078,943	$1,510,760	
2001	$ 420,251	$1,021,387	$1,441,638	
2002				$4,364,525
2003				$4,439,085

The Tax Adjusted Net Investment Value of the GTC in 2002 was three times the value of the IC and GTW railroads taken together in 2001. As Mr. O'Connor pointed out in his report, this could not have been caused by the acquisition of the much-smaller WC. This was due, however, to the write-up in 2000 of the IC assets. This caused the variable capital expenses to increase by a large amount while remaining expenses (on a unit cost basis) remained rather flat.

The following table shows the cost per ton-mile for the waybills from GTW, IC, and GTC for 2001 and 2002. For 2001, the amounts are for GTW and IC added together. For 2002, the amounts are for GTC. The second column shows the variable portion of capital expenses per ton-mile, and the third column shows the remaining variable expenses per ton-mile. As Table 2 clearly shows, the non-capital variable expenses per ton-mile remained more stable between the two years, increasing less than 6%, while the variable capital expenses increased by more than 56%. The better stability of the non-capital variable expenses supports the conclusion that the change in waybill accounting methods did not have a major effect on the estimate of variable costs, while the dramatic increase in variable capital expense supports the conclusion that the write-up in value of the IC assets contributed strongly to an increase in variable costs.

Table 2. Expenses per Ton-Mile for 2001 and 2002

Year	Capital Expense per Ton-Mile	Remaining Expense per Ton-Mile
2001	0.35 cents	0.66 cents
2002	0.56 cents	0.70 cents

We believe that our analysis of the data and information, and our interpretation of the results, satisfactorily resolve the disputed elements outlined in your complaint. No materially significant errors were found in cost inputs used or in methodologies and calculations applied in the development of the RSAM numbers; therefore, no restatement of the RSAM is required.

We have fully complied with currently effective Information Quality Guidelines in responding to your complaint. If you are dissatisfied with our response to your request, you may submit a Request for Reconsideration within 30 calendar days of the dated response to the original request.

Respectfully,

Leland L. Gardner
Director
Office of Economics, Environmental Analysis and Administration

cc: Marilyn Levitt