37227 SERVICE DATE – SEPTEMBER 20, 2006
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SURFACE TRANSPORTATION BOARD

DECISION

STB Ex Parte No. 664

METHODOLOGY TO BE EMPLOYED IN DETERMINING THE RAILROAD INDUSTRY'S COST OF CAPITAL

AGENCY: Surface Transportation Board

ACTION: Advance Notice of Proposed Rulemaking

SUMMARY: The Board is seeking comments on the appropriate methodology to be employed in determining the railroad industry's estimated cost of capital to be used in future annual cost-of-capital determinations. We are also soliciting comments on how evidence should be submitted and analyzed in future cost-of-capital proceedings.

DATES: Comments on the advance notice are due on or before November 6, 2006.

ADDRESSES: Send comments (an original and 10 copies) referring to [STB Ex Parte No. 664] to: Surface Transportation Board, 1925 K Street, NW, Washington, D.C. 20423-0001.

FOR FURTHER INFORMATION CONTACT: Paul Aguiar, (202) 565-1527. [Assistance for the hearing impaired is available through the Federal Information Relay Service (FIRS) at 1-800-877-8339.]

SUPPLEMENTARY INFORMATION: Section 205 of the Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act) first codified the requirement for the Board to establish and maintain standards for railroad revenue adequacy. This provision stated that railroad revenues should provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation, and attract and retain capital in amounts adequate to provide a sound transportation system in the United States. Subsequent laws (including the ICC Termination Act of 1995) have retained this requirement. Thus, each year the Board makes a determination of which railroads are or are not revenue adequate.

The annual determination of the railroad industry's cost of capital is used in evaluating the adequacy of railroad revenues each year. It may also be utilized in other Board proceedings, including, but not necessarily limited to, those involving the prescription of maximum reasonable rate levels.

The cost-of-capital calculation has three elements: (1) the railroads' cost-of-debt capital; (2) the railroads' cost of preferred stock equity capital; (3) the railroads' cost of common stock equity capital; and (4) the capital structure mix of the railroad industry on a market value basis. With respect to the cost of equity, there are essentially two general approaches. It can be estimated directly by estimating its component parts, the factors for which investors ask compensation. These parts are the real time value of money, a premium for expected inflation, and a premium for risk. This is commonly referred to as the Capital Asset Pricing Model (CAPM) methodology. Alternatively, it can be estimated indirectly on the basis of the return expectations embodied in the prices investors are willing to pay for stocks, the Discounted Cash Flow (DCF) methodology. The point has often been raised, most notably by the railroads, that investors place less importance on historical growth factors than on the analysts' forecasts, thus making the forecast more meaningful. Other parties contend that investors do rely on historical trends and tend to discount the analysts' forecasts as being overly optimistic.

The Board has, for all previous cost-of-capital determinations, relied upon the DCF methodology to determine the railroads' cost of capital. We have also used the Institutional Brokers Estimate System (IBES) consensus forecast data to determine the growth rate ("g") component of the DCF formula. While the Board has relied on the use of the DCF methodology for determining the cost of common equity, there are other methodologies that could be employed. These include the CAPM, risk premium methods other than CAPM, earnings-price ratios, and the comparable earnings method.

We are seeking comments on the appropriate techniques and methodologies to be used to develop and evaluate the evidence submitted for the cost of capital. Parties should discuss any changes in underlying railroad industry economic conditions that would create the need to change the methodology currently employed by the Board, and how any proposed methodology will overcome the shortcomings, if any, of the currently used DCF method.

This proceeding will provide all interested parties an opportunity to comment on the DCF model, the proper source for the inputs to that model, and whether the Board should adopt an alternative to that method, such as the CAPM model, for future cost-of-capital determinations.

This action will not significantly affect either the quality of the human environment or the conservation of energy resources.

Pursuant to 5 U.S.C. 605(b), we certify that the proposed action would not have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act.

Board decisions and notices are available on our website at WWW.STB.DOT.GOV.

Decided: September 15, 2006.

By the Board, Chairman Nottingham, Vice Chairman Mulvey, and Commissioner Buttrey.

Vernon A. Williams
Secretary