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SERVICE DATE – LATE RELEASE MAY 8, 2015

SURFACE TRANSPORTATION BOARD

NOTICE

Docket No. EP 722

RAILROAD REVENUE ADEQUACY

Docket No. EP 664 (Sub-No. 2)

PETITION OF THE WESTERN COAL TRAFFIC LEAGUE TO INSTITUTE A  
RULEMAKING PROCEEDING TO ABOLISH THE USE OF THE MULTI-STAGE  
DISCOUNTED CASH FLOW MODEL IN DETERMINING THE RAILROAD INDUSTRY'S  
COST OF EQUITY CAPITAL<sup>1</sup>

Decided: May 8, 2015

AGENCY: Surface Transportation Board.

ACTION: Notice of Public Hearing.

SUMMARY: The Surface Transportation Board (Board) will hold a public hearing on July 22-23, 2015, at its headquarters in Washington, D.C., to further examine issues raised in Docket No. EP 722 related to railroad revenue adequacy, and issues raised in Docket No. EP 664 (Sub-No. 2) on how the Board calculates the railroad industry's cost of equity capital.

DATES: The hearing will be held on July 22-23, 2015, beginning at 9:30 a.m., in the Hearing Room at the Board's headquarters located at 395 E Street, S.W., Washington, DC. The hearing will be open for public observation. Any party wishing to speak at the hearing shall file with the Board by July 8, 2015, a notice of intent to participate (identifying the party, the proposed speaker, and the time requested, and summarizing the key points that the speaker intends to address). The notices of intent to participate are not required to be served on the parties of record; they will be posted to the Board's website when they are filed. Parties shall file hearing exhibits, if any, by July 22, 2015.

ADDRESSES: All filings may be submitted either via the Board's e-filing format or in the traditional paper format. Any person using e-filing should attach a document and otherwise

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<sup>1</sup> These proceedings are not consolidated but are being addressed in the same decision for administrative convenience.

comply with the instructions at the “E-FILING” link on the Board’s website at “www.stb.dot.gov.” Any person submitting a filing in the traditional paper format should send an original and 10 copies of the filing to: Surface Transportation Board, Attn: Docket No. [EP 722 or EP 664 (Sub-No. 2), as the case may be], 395 E Street, S.W., Washington, DC 20423-0001.

Copies of written submissions will be posted to the Board’s website and will be available for viewing and self-copying in the Board’s Public Docket Room, Suite 131. Copies of the submissions will also be available (for a fee) by contacting the Board’s Chief Records Officer at (202) 245-0238 or 395 E Street, S.W., Washington, DC 20423-0001.

FOR FURTHER INFORMATION CONTACT: For Docket No. EP 722: Scott Zimmerman at (202) 245-0386. For Docket No. EP 664 (Sub-No. 2): Amy Ziehm at (202) 245-0391. Assistance for the hearing impaired is available through the Federal Information Relay Service (FIRS) at (800) 877-8339.

SUPPLEMENTARY INFORMATION: On April 2, 2014, the Board served a notice announcing that it would receive comments in Docket No. EP 722 to explore the Board’s methodology for determining railroad revenue adequacy and the use of revenue adequacy in rate reasonableness cases, and in Docket No. EP 664 (Sub-No. 2)<sup>2</sup> to explore how the Board calculates the railroad industry’s cost of equity capital. The Board coordinated the two proceedings by inviting comments in both cases on the same schedule. Comments and replies were due on September 5, 2014 and November 4, 2014, respectively.

Having reviewed the comments and replies filed in these proceedings, the Board will now hold a public hearing on July 22-23, 2015, beginning at 9:30 a.m., at its headquarters in Washington, D.C., to further examine these issues. The parties have raised a number of issues for the Board to consider. In Docket No. EP 722, many of the comments focused on the revenue adequacy component of Constrained Market Pricing, by which the Board judges the reasonableness of rail freight rates. The parties should be prepared to discuss issues related to the revenue adequacy constraint, as set forth in Coal Rate Guidelines, Nationwide (Coal Rate Guidelines), 1 I.C.C. 2d 520 (1985), and are invited to address the following questions:

- In Coal Rate Guidelines, the Interstate Commerce Commission indicated that revenue adequacy is a long term concept that should be measured “over time.” 1 I.C.C.2d at 536. Some comments suggest that revenue adequacy should be measured over a business cycle, while others suggest that a business cycle would not be sufficient. If the revenue adequacy constraint were to be utilized, what would be an appropriate time period? What

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<sup>2</sup> The Board instituted a rulemaking in this proceeding in response to a petition by the Western Coal Traffic League. Pet. of W. Coal Traffic League to Institute a Rulemaking Proceeding to Abolish the Use of Multi-Stage Discounted Cash Flow Model in Determining the R.R. Indus.’s Cost of Equity Capital, EP 664 (Sub-No. 2) (STB served Dec. 20, 2013).

would be an appropriate definition for a “business cycle” if the Board were to use that as a time measure?

- In Coal Rate Guidelines, the Interstate Commerce Commission stated that “[a] railroad seeking to earn revenues that would provide it, over the long term, a return on investment above the cost of capital would have to demonstrate with particularity: (1) a need for the higher revenues; (2) the harm it would suffer if it could not collect them; and (3) why the captive shippers should provide them.” Id. at 536 n.36. Some comments allude to this language in suggesting that, in the case of a revenue adequate railroad, that railroad should be required to justify rate increases on captive shippers. Should the Board consider requiring a revenue adequate railroad, whose increased rate has been challenged, to justify the increase on a complaining captive shipper? Would such an approach be consistent with the Board’s governing statute and/or relevant case law?
- Constrained market pricing imposes constraints on the extent to which a railroad may charge differentially higher rates on captive traffic, and several comments contend that captive shippers should not be required to differentially provide returns in excess of adequate revenue levels. Should a revenue adequate railroad’s ability to differentially price be limited for all captive shippers or for a subset of captive shippers that are most likely to be subject to the railroad’s market power? Is there a way to identify those shippers that are most likely to be subject to the railroad’s market power, such as through Revenue to Variable Cost ratios, the Revenue Shortfall Allocation Method, or something approximating the Maximum Mark-up Methodology used in the Board’s rate proceedings?

Additionally, the parties should be prepared to further explore the following issues raised in the comments and replies:

- Some comments suggest that revenue adequacy should be tied to the availability of competitive access remedies. What competitive access remedies would be appropriate (and consistent with the Board’s governing statute) when a railroad is revenue adequate? Because a proposal regarding competitive access remedies is currently pending before the Board, see Petition For Rulemaking to Adopt Revised Competitive Switching Rules, Docket No. EP 711, parties are asked to specifically consider the impact of revenue adequacy on that proposal, particularly in light of the recent service issues faced by the industry.
- Some comments argue that any proposal that would limit the railroads’ return on investment would negatively impact the railroads’ ability to invest in their networks and expand capacity. Please discuss the impact of your revenue adequacy proposals on the railroads, again, in light of the recent service issues faced by the industry.

With respect to Docket No. EP 664 (Sub-No. 2), the parties should be prepared to discuss whether the method the Board uses to make its annual industry cost of equity capital determinations needs to be modified and how such modifications, if any, should be implemented. The parties are also invited to discuss the following issues raised in the comments:

- As part of its annual cost of capital determination, the Board uses a Multi-Stage Discounted Cash Flow (Multi-Stage DCF) model. Some comments suggest that the Board's Multi-Stage DCF model is biased upward. Does such a problem exist and, if so, how is it best corrected?
- Since 2009, the Board has relied on the Capital Asset Pricing Model (CAPM) as part of its annual cost of capital determination. Under CAPM, "beta" is used to measure the amount of non-diversifiable risk of the railroad industry. Some comments note that betas for the railroad industry have ranged above and below 1.0 since 2009. Do those changes in beta reflect actual differences in the riskiness of the railroad industry? Should the Board consider setting beta equal to 1.0 or some other figure?
- Some comments suggest that the Board's approach for determining the "market risk premium" under CAPM is atypical. Is the Board's methodology sufficiently reliable or are there more commonly used approaches that the Board should consider adopting?
- Certain comments note that the Board's CAPM analysis currently relies on a sample of four observations. Does this sample adequately reflect the railroad industry, or would using a broader sample, such as the S&P 500, lead to a more realistic estimate in determining the cost of equity?
- Some comments contend that the Board should consider changes to how it determines Return on Investment. Would changes to the Return on Investment methodology require changes to the Cost of Capital methodology? Should the Board consider adjusting how it determines Return on Investment (e.g., using replacement costs) and how could those adjustments be implemented in a practicable manner?

**BOARD RELEASES AND LIVE VIDEO STREAMING AVAILABLE VIA THE INTERNET:** Decisions and notices of the Board, including this notice, are available on the Board's website at [www.stb.dot.gov](http://www.stb.dot.gov). This hearing will be available on the Board's website by live video streaming. To access the hearing, click on the "Live Video" link under "Information Center" at the left side of the home page beginning at 9:30 a.m. on July 22-23, 2015.

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

It is ordered:

1. A public hearing will be held on July 22-23, 2015, at 9:30 a.m., at the Board's headquarters at 395 E Street, S.W., Washington, DC, as described above.
2. By July 8, 2015, any party wishing to speak at the hearing shall file with the Board a notice of intent to participate (identifying the party, the proposed speaker, and the time requested, and summarizing the key points that the speaker intends to address). The notices of

intent to participate need not be served on the parties of record. Parties appearing at the hearing shall file hearing exhibits, if any, by July 22, 2015.

3. This decision is effective on its service date.

By the Board, Joseph H. Dettmar, Acting Director, Office of Proceedings.