SERVICE DATE – FEBRUARY 12, 2007

SURFACE TRANSPORTATION BOARD

DECISION

STB Ex Parte No. 558 (Sub-No. 9)

COST OF CAPITAL – 2005

Decided: February 9, 2007

One of our regulatory responsibilities is to determine annually the railroad industry's cost of capital. This determination is one component used in evaluating the adequacy of individual railroads' revenues each year under the procedures and standards mandated by Congress in the Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act) and promulgated in Standards for Railroad Revenue Adequacy, 364 I.C.C. 803 (1981), modified, 3 I.C.C.2d 261 (1986), aff'd sub nom. Consolidated Rail Corp. v. United States, 855 F.2d 78 (3d Cir. 1988). The cost-of-capital finding may also be used in other regulatory proceedings, including, but not necessarily limited to, those involving the prescription of maximum reasonable rate levels, the proposed abandonment of rail lines, and the setting of compensation for trackage rights.

BACKGROUND

The Board instituted this proceeding, by a decision served December 20, 2005, to determine the railroad industry's cost of capital for the year 2005. In response, the Association of American Railroads (AAR) submitted the information that is used in making the annual cost-of-capital determination under the discounted cash flow (DCF) approach followed in previous Board cost-of-capital decisions. The Western Coal Traffic League (WCTL) submitted a reply challenging the AAR's cost-of-equity calculation for 2005.[1]

WCTL challenged the inputs used by AAR as flawed and recommended replacing the DCF methodology with a "Capital Asset Pricing Model" (CAPM) method. WCTL argued that the estimate of the cost of equity is overstated for two reasons: (1) the growth rate was developed by stock analysts whose companies have a vested interest in selling stock; and (2) there was a mismatch between the 5-year growth rate used by AAR and the perpetual growth rate needed for the DCF model. In response, AAR argued that the DCF model is the established agency method for determining the cost of equity, that the CAPM method has been repeatedly

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[1] WCTL does not challenge AAR's calculations as to the railroad industry's capital structure and its cost of debt – the other two components of the cost-of-capital determination.

rejected by the agency, that investor forecasts of industry growth rates have always fluctuated, and that this proceeding is not the proper forum in which to challenge the DCF methodology.

In a decision served September 20, 2006, we concluded that there was insufficient evidence in this proceeding to justify a departure from long-established methodology used to calculate the cost-of-equity component. We observed that there is no uniform procedure for measuring stockholders' expectations as to future returns of a particular company or group of companies relative to the firm's overall risk, earnings potential and inflationary environment. This is necessarily a somewhat subjective process, as investor expectations are not readily observable. Over the years the calculation of the cost of common equity has produced thousands of articles and treatises by members of the financial, economic, and regulatory communities. There has not been a consensus as to how best to compute the cost of common equity and, in fact, there are many different ways in which it is computed by both investors and regulators. After considerable public discourse, this agency had settled upon the DCF model to derive the cost-of-equity component, a widely used method for determining the cost of equity, and that is the method that had been used by the agency for over 20 years.

We noted that there is a norm of regularity in government conduct that presumes an agency's duties are best carried out by adhering to the settled rule. We concluded that this presumption is particularly strong where, as here, a party seeks to replace an established methodology with one the agency has previously rejected. Thus, we decided to continue to use the DCF model unless a party provides compelling evidence that it is flawed.

Based on the evidence presented, we determined that WCTL's main concerns with the DCF model relate not to the model itself, but to one input that it now suggests is too subjective. We observed that the CAPM method has its own shortcomings. As previously noted, "CAPM requires the use of many assumptions … [and each] can have a significant effect on the result obtained and each necessitates judgments on how best to define and measure it." Railroad Cost of Capital – 1981, 365 I.C.C. 734, 741 (1982). We also noted that the position of WCTL was a reversal of the prior position of the shipper community that the "CAPM technique was conceptually and technically flawed." Railroad Cost of Capital – 1982, 367 I.C.C. 662, 670 (1983).

Finally, we observed that, since Railroad Cost of Capital - 1987, 4 I.C.C.2d 621 (1988), the agency has used the challenged consensus 5-year earnings per-share growth rate data published by Institutional Brokers Estimate system (IBES) to develop the growth rate estimates. IBES data reflect growth rate estimates from essentially all major brokerage firms. We concluded that we should not set this forecast aside simply because it is developed by stock analysts, when the basic inquiry is the level of return on equity demanded by the investment community. And we noted that, although the agency has been using this IBES data since 1988, WCTL offered no empirical evidence (as opposed to theoretical concerns) that the approach followed by the agency for the past 16 years has produced growth rate predictions that have proven to be systematically below the actual earnings growth. Therefore, we set the cost of capital for 2005 at 12.2% based on the submission by the AAR.

Nevertheless, we recognized that WCTL had identified a potential concern with an input to the DCF model that should be explored in more depth. We concluded that we should not discard the DCF method and switch to the CAPM model based on the limited record here. We explained that, before considering whether to make such a significant change, we would seek broader public input from other interested shippers, as well as from transportation experts, Wall Street analysts, financial experts and academics on the relative merits of this longstanding approach. And we would seek comments not only on the DCF and CAPM models, but on any other available recognized methods for determining the cost of capital. Accordingly, on September 20, 2006, we issued an advance notice of proposed rulemaking in STB Ex Parte No. 664, Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, to explore the most suitable methodology to calculate the cost of capital.

Motion for Reconsideration

On October 11, 2006, WCTL filed a timely motion for reconsideration, arguing that it was material error to adhere to the Board's established DCF methodology. It first argues that we should have either held this proceeding in abeyance pending the outcome of the rulemaking or issued interim findings subject to later revision, which WCTL claims is the established practice of the agency. Alternatively, WCTL asserts that, if there is enough doubt or question to warrant a rulemaking, there should have been enough doubt to replace the existing methodology with CAPM. Finally, WCTL argues that it was material error to use the consensus 5-year earnings per-share growth rate data published by IBES.

On October 24, 2006, the AAR responded, arguing there was no material error because the limited record in this proceeding did not present sufficient evidence to support rejecting an established methodology the agency has used for over 20 years.

DISCUSION AND CONCLUSIONS

WCTL alleges material error in the decision below in two key respects. First, it claims that the DCF calculations used by the agency contained a "pivotal error" in using the IBES forecasts. Second, it argues that the Board departed from some "established practice" by not either holding the decision in abeyance or issuing interim cost-of-capital findings.[2] As neither

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[2] WCTL's third argument, that if there was enough doubt to institute a rulemaking there was enough evidence to reject the existing approach, is unpersuasive. Our decision to conduct a broader rulemaking is not an admission that the existing approach is flawed, but instead a prudent exercise of our regulatory responsibility to explore whether there are superior

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argument is persuasive, for the reasons discussed below, the motion for reconsideration will be denied.

It is undisputed that the basic DCF methodology is a well-established method for calculating a firm's cost of capital. Although there are a wide variety of alternative methodologies available, WCTL presented no evidence that the basic approach itself is flawed or has fallen into disuse. In contrast, the AAR submitted testimony that the approach remains well-established.

It is also undisputed that an agency has an obligation to adhere to its precedent unless a party offers a reasoned basis to depart from that precedent. This norm of regularity is particularly important where, as here, a party seeks to replace an established methodology with one the agency has previously rejected. Indeed, we are witnessing a reversal of position, as the shipper community originally objected to the use of CAPM, arguably because at the time it resulted in a higher cost of capital calculation. Railroad Cost of Capital – 1982, 367 I.C.C. 662, 670 (1983). As there are many different ways to estimate the cost of equity, the Board must take great care not to swing back-and-forth between parties' preferred methodologies based on the results of the different approaches.

Accordingly, we properly determined not to depart from long-established methodology in this proceeding unless a party presented compelling evidence that it is flawed. WCTL has not made that showing. Rather, it attacks the methodology based on its results. Similarly, WCTL provided no compelling evidence that the continued use of the IBES forecasts was erroneous. On reconsideration, WCTL argues that the 2005 growth forecasts "appear suspect." In the proceeding below, it cited some financial textbooks to suggest that the forecasts were too high. This evidence, while sufficient to justify exploring the issue in a broader rulemaking (where we might benefit from hearing from the financial experts whose textbooks were quoted), does not provide compelling evidence of a flaw in the use of those forecasts, particularly where there is no evidence that the IBES forecasts are routinely overstated.

WCTL also contends that the use of these 5-year consensus earnings forecasts was flawed because it raises the cost of capital "just because the covered railroads are enjoying increasing earnings and stock prices in the short-term."[3] AAR properly notes, however, that the interaction between the cost of capital under the DCF approach and increased stock prices is not so simple. While increasing stock prices may influence the five-year consensus earnings

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alternatives available and to hear from all interested parties before making a decision of industry-wide significance.

[3] WCTL Mot. Recon. at 4.

forecasts (which raises the cost of equity), it may reduce the dividend yield (which lowers the cost of equity).[4] Thus, this methodology, used by numerous regulators, does not on its face allow regulated entities to charge more simply because they are enjoying increased earnings. If WCTL contends otherwise, it should submit testimony from financial experts in STB Ex Parte No. 664 for broader public consideration.

We continue to believe that the appropriate course here is to adhere to our established methodology while we explore this issue in a broader rulemaking proceeding. The record in this case is simply too bare to support a departure from long-established precedent. There are numerous ways to calculate the cost of capital. In fact, there are numerous ways to apply CAPM. And switching our methodology will have a widespread impact on the industry. Before taking such a step, we should hear the views of other interested parties (including other shipper groups), financial experts and academia, and if possible consult with other state or federal agencies that are also charged with calculating a cost of capital for the industries they regulate. In addition to obtaining written comments from interested parties in Ex Parte No. 664, we have also scheduled a hearing in that docket to further explore this matter.[5]

We need not and will not hold this decision in abeyance or issue interim cost of capital decisions while we explore this issue in depth. As stated above, the record does not support a departure at this point from our precedent without further comment and study. Moreover, we have no “established practice” of holding cases in abeyance. The three instances noted by WCTL were unusual factual circumstances.[6]

Finally, this cost-of-capital calculation is an integral component of many other decisions the Board must make, including the revenue adequacy determination that we must make annually by statute. It is also a component in our Uniform Railroad Costing System, which the Board provides to other parties for use in pending regulatory matters, as well as for other private uses. Because WCTL failed to justify a departure from the continued use of the DCF model at this time, it was not material error to adhere to established practice and issue final cost-of-capital calculations while we explore in more depth whether our existing approach should be replaced with superior alternatives.

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[4] See AAR Reply at 12-13 (citing V.S. Rockey at 9).

[5] See Methodology To Be Employed In Determining The Railroad Industry’s Cost Of Capital, STB Ex Parte No. 664 (served Jan. 12, 2007).

[6] See AAR Reply at 6-7.

It is ordered:

1. The petition for reconsideration is denied.

2. This decision is effective on its date of service.

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

Vernon A. Williams
Secretary