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SERVICE DATE – LATE RELEASE DECEMBER 20, 2013

SURFACE TRANSPORTATION BOARD

DECISION

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

Digest:[1] The Board is opening a rulemaking proceeding in response to a request that the agency abolish the use of the multi-stage discounted cash flow model in determining the railroad industry's cost of equity capital. The Board does not rule on the merits of the petition but will solicit public comments in a subsequent decision.

Decided: December 20, 2013

On August 27, 2013, the Western Coal Traffic League (WCTL) filed a petition requesting that the Board institute a rulemaking to abolish the use of the multi-stage discounted cash flow model in determining the railroad industry's cost of equity capital and instead rely exclusively on the Capital Asset Pricing Model.[2] On September 16, 2013, the Association of American Railroads (AAR) replied in opposition to WCTL's petition.[3] The Alliance for Rail Competition (ARC) and the Chlorine Institute (CI) filed letters in support of WCTL's petition.[4]

Each year the Board determines the railroad industry's current cost of capital. The Board then uses this cost-of-capital figure for a variety of regulatory purposes. It is employed in maximum rate cases, feeder-line applications, rail line abandonments, trackage rights cases, rail-merger reviews, and, more generally, in the Uniform Railroad Costing System. In addition, it is used annually to evaluate the adequacy of individual railroads' revenues.[5]

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[1] The digest constitutes no part of the decision of the Board but has been prepared for the convenience of the reader. It may not be cited to or relied upon as precedent. Policy Statement on Plain Language Digests in Decisions, EP 696 (STB served Sept. 2, 2010).

[2] WCTL's Pet. 1, Aug. 27, 2013.

[3] AAR's Reply 1, Sept. 16, 2013.

[4] ARC's Letter 1, Sept. 17, 2013; CI's Letter 1, Oct. 22, 2013.

[5] 49 U.S.C. § 10704(a)(2),(3); Standards for R.R. Revenue Adequacy, 364 I.C.C. 803 (1981), modified, 3 I.C.C.2d 261 (1986), aff'd sub nom. Consol. Rail Corp. v. United States, 855 F.2d 78 (3d Cir. 1988).

The Board calculates the cost of capital as the weighted average of the cost of debt and the cost of equity, with the weights determined by the capital structure (the fraction of capital obtained from debt or equity on a market-value basis) of the railroad industry. While the cost of debt is observable and readily available, the cost of equity (the expected return that equity investors require) cannot be directly observed. Because the cost of equity can only be estimated, the Board has adopted a finance model which makes a variety of assumptions about the current equity markets.

We will grant the petition requesting that the Board institute a rulemaking proceeding on cost of capital because WCTL's petition warrants further consideration. We are making no determination herein regarding the merits of WCTL's specific proposal to abolish the use of the multi-stage DCF model. Rather, we will establish further procedures for public comment and information requests and will address the arguments and issues already raised by the parties in their filings in subsequent decisions. In the near future, the Board intends to institute a proceeding on railroad "revenue adequacy." Issues regarding the cost of capital calculation – a component of the methodology that the Board currently uses to determine revenue adequacy – may arise during the course of that proceeding. Accordingly we intend to coordinate the processing of these two proceedings and will provide further guidance in a subsequent decision.

It is ordered:

1. WCTL's petition to institute a rulemaking is granted.

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

By the Board, Chairman Elliott, Vice Chairman Begeman, and Commissioner Mulvey.