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June 2, 2014

Ms. Cynthia T. Brown
Chief, Section of Administration
Office of Proceedings
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423

Re: STB Docket No. EP 558 (Sub-No. 17), *Railroad Cost of Capital—2013*

Dear Ms. Brown:

Pursuant to the decision served by the Board on February 28, 2014, attached please find the Rebuttal Comments of the Association of American Railroads (AAR) in the above captioned proceeding.

Respectfully submitted,

Timothy J. Strafford
Counsel for the Association of
American Railroads

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 558 (Sub-No. 17)

RAILROAD COST OF
CAPITAL — 2013

REBUTTAL COMMENTS OF THE
ASSOCIATION OF AMERICAN RAILROADS
AND ITS MEMBER RAILROADS

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June 2, 2014

BEFORE THE
SURFACE TRANSPORTATION BOARD

RAILROAD COST OF CAPITAL — 2013	STB Docket No. EP 558 (Sub-No. 17)

REBUTTAL COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS AND ITS MEMBER RAILROADS

By order served February 28, 2014, the Surface Transportation Board ("Board") instituted this proceeding to determine the railroad industry's cost of capital for the year 2013. In its order, the Board sought comment on four issues: "(1) the railroads' 2013 current cost of debt capital; (2) the railroads' 2013 current cost of preferred equity capital (if any); (3) the railroads' 2013 cost of common equity capital; and (4) the 2013 capital structure mix of the railroad industry on a market value basis." *Railroad Cost of Capital – 2013*, EP No. 558 (Sub-No. 17) (STB served Feb. 28, 2014) ("*February Decision*").

On April 21, 2014, the railroads, through the Association of American Railroads ("AAR"), submitted their calculation of the 2013 cost of capital using the methodology specified by the Board. The AAR calculated the railroads' overall cost of capital for 2013 at 11.32 percent, including a cost of common equity of 12.96 percent and a cost of debt of 3.68 percent.

On May 12, 2013, the Western Coal Traffic League ("WCTL") filed reply comments. WCTL did not challenge any aspect of the AAR's calculations, but raised concerns regarding two policy matters beyond the scope of this proceeding as defined in the Board's decision. First, WCTL argued that the Board should defer or condition the 2013 cost of capital determination upon the completion of the rulemaking proceeding resulting from a WCTL petition in 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 Capital.* Second, WCTL raises questions about the inclusion of Kansas City Southern ("KCS") in this year's composite railroad, though WCTL acknowledges that KCS qualifies for inclusion under the Board's rules and does not advocate for KCS's exclusion. Ultimately, WCTL cannot contend that the AAR has not correctly executed the Board's instructions and calculated the railroad industry's cost of capital for 2013 according to the Board's rules. As such, the Board should adopt 11.32 percent as the railroad industry's cost of capital for 2013.

Discussion

I. The Board Should Not Defer or Condition the 2013 Cost of Capital Determination Pending the Outcome of EP 664 (Sub-No. 2).

The Board noted in the decision instituting this proceeding the many regulatory uses of the cost of capital. "The cost of capital finding made in this proceeding will be used in the determination of railroad revenue adequacy for 2013. It may also be used in other Board railroad proceedings, including, but not limited to, those involving the prescription of maximum reasonable rate levels; the determination of trackage rights compensation; the proposed abandonments of rail lines; railroad mergers; and applications to purchase feeder lines." *February Decision,* slip op. at 1.

Despite these uses, WCTL suggests that the Board should defer establishing the cost of capital for 2013 pending the outcome of the EP 664 (Sub-No. 2) proceeding because the Board did not calculate a cost of capital for 2006 or 2007 according to the usual timelines while the Board considered the cost of capital methodology in EP 664, *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital.* Inexplicably, WCTL ignores the fact that immediately following that experience, the Board decided not to defer the establishment of a cost of capital while it considered what type of multi-stage discounted cash flow model ("multi-stage DCF") to include in the cost of equity calculation in EP 664 (Sub-No. 1), *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital.* In the decision instituting a proceeding to calculate the rail industry's cost of capital for 2007 during that time, the Board stated:

> Cost of capital continues to play an important role in the regulation of railroads. It is the profitability threshold that plays a key role in determining whether a railroad is revenue adequate (in which case certain ratemaking freedoms cannot be exercised). In rail abandonment proceedings cost of capital serves as the basis for determining opportunity costs. In trackage rights cases, cost of capital serves as the basis for calculating the rent for trackage usage. For ratemaking purposes, cost of capital is used to compute the capital carrying costs for "stand-alone" rail operations. Given its critical role in the regulation of railroads, it is important that it be determined promptly even if the Board is considering changing the existing approach. *See Use of a Multi-Stage Discounted Cash Flow in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664 (Sub-No. 1) (STB served Feb. 11, 2008).

Railroad Cost of Capital – 2007, EP 558 (Sub-No. 11) (STB served Apr. 23, 2008), slip op. at 2. WCTL offers no compelling rationale for the Board to take a different approach now.

Furthermore, the Board should not defer the determination of the 2013 railroad industry cost of capital because WCTL's petition for rulemaking is nothing more than a bid to temporarily lower the cost of equity by eliminating the use of a multi-stage DCF. Such a results-oriented and short-sighted attempt should not persuade the Board to alter the conclusion that the Board reached after a thorough examination of the cost of equity in six rounds of comments and two public hearings. The Board concluded there that the use of two established financial models that utilize different assumptions, like CAPM and the multi-stage DCF, leads to a more reliable estimate of the cost of equity than any single model standing alone. There is no basis to hold the Board's many regulatory processes in limbo while WCTL attempts to argue otherwise.

II. The AAR Constructed the Composite Railroad Consistent With the Board's Rules

The Board should also decline WCTL's invitation to consider whether KCS should be included in the composite railroad used to determine the railroad industry's cost of equity for 2013. In its opening evidence, the AAR included KCS because KCS meets the stated criteria of *Railroad Cost of Capital – 1984*, 1 I.C.C.2d 989 (1985). WCTL does not contend otherwise. Instead, WCTL theorizes that it may not be "appropriate" to include KCS in the composite sample because the Board's cost of capital methodologies utilize historical data from years when KCS was not eligible for inclusion in the composite sample, though WCTL could not bring itself to advocate one way or the other on including KCS because "inclusion appears to have very modest effect on the calculations for the 2013 cost of capital." WCTL reply at 5. WCTL further questions the Ibbotson/Morningstar multistage DCF's use of an unweighted average in calculating growth rates. *Id.*

Such challenges to the Board's established cost-of-capital methodology are beyond the scope of this proceeding. The Board has repeatedly stated that the annual EP 558 cost-of-capital determination is not an appropriate forum to raise methodological issues or propose changes to the Board's rules. *See, e.g., Railroad Cost of Capital – 2010*, EP 558 (Sub-No. 14)(STB served Oct. 3, 2011) (citing *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital*, EP 664 (STB served Jan. 17, 2008), slip op. at 18). WCTL is well aware of the

Board's ruling that such changes should be proposed in a petition for rulemaking, as it has pursued such a petition to re-litigate the Board's use of a multistage DCF in EP 664 (Sub-No. 2). WCTL has not provided any reason that the Board should deviate from its rules here and has not shown that any aspect of the AAR's opening evidence should not be adopted.

Conclusion

The Board should determine that the railroads' cost of capital for 2013 is 11.32 percent.

Respectfully submitted,

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Counsel for the Association of American Railroads
and Member Railroads

June 2, 2013

CERTIFICATE OF SERVICE

I hereby certify that on this 2nd day of June, 2014, I served by first class mail, postage prepaid, a copy of the forgoing on the following:

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