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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. 18), *Railroad Cost of Capital—2014*

Dear Ms. Brown:

Pursuant to the decision served by the Board on February 19, 2015, attached please find the Rebuttal Comments of the Association of American Railroads 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. 18)

RAILROAD COST OF
CAPITAL — 2014

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

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RAILROAD COST OF CAPITAL — 2014	STB Docket No. EP 558 (Sub-No. 18)

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

By decision served on February 19, 2015, the Surface Transportation Board ("Board") instituted this proceeding to determine the railroad industry's cost of capital for the year 2014. In its order, the Board sought comment on four issues: "(1) the railroads' 2014 current cost of debt capital; (2) the railroads' 2014 current cost of preferred equity capital (if any); (3) the railroads' 2014 cost of common equity capital; and (4) the 2014 capital structure mix of the railroad industry on a market value basis." *Railroad Cost of Capital – 2014*, EP No. 558 (Sub-No. 18) (STB served Feb. 19, 2015) ("*February Decision*"). The decision also stated that this proceeding does not affect the ongoing proceeding that has resulted from Western Coal Traffic League's ("WCTL") petition for rulemaking 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*. *Id.*

On April 20, 2015, the railroads, through the Association of American Railroads ("AAR"), submitted their calculation of the 2014 cost of capital using the methodology specified by the Board. The AAR calculated the railroads' overall cost of capital for 2014 at 10.65 percent, including a cost of common equity of 12.06 percent and a cost of debt of 3.58 percent.

On May 11, 2015, WCTL and Arkansas Electric Cooperative Corporation ("AECC") separately filed reply comments. Neither party challenged any aspect of the AAR's calculations, but instead each collaterally attacked the Board's methodology to calculate the cost-of-equity component of the cost of capital and repeated arguments they have made in the pending EP 664 (Sub-No. 2) proceeding. Both WCTL and AECC argue that the Board should disregard its established methodology, or defer or condition the 2014 cost of capital determination upon the completion of the EP 664 (Sub-No. 2) proceeding.

Specifically, WCTL argues that the investment analysts' earnings per share growth rates for some carriers are overstated in the Morningstar/Ibbotson Multi-Stage Discounted Cash Flow Model ("Morningstar/Ibbotson MSDCF") due to stock repurchases. Both WCTL and AECC also selectively criticize aspects of the Board's Capital Asset Pricing Model ("CAPM") that they believe are too high, while ignoring aspects that may be too low. WCTL concludes, without analysis or evidence, that the risk-free rate and market risk premium components are too high. AECC claims that the beta value used in CAPM is inflated by the exercise of market power. Both WCTL and AECC attack the inclusion of Kansas City Southern ("KCS") and exclusion of BNSF Railway ("BNSF") from the composite railroad used to determine the cost of capital, though neither argue that the AAR has misapplied the Board's criteria for inclusion. Finally, AECC also makes the unsubstantiated claim that Class I railroads earn "supracompetitive" earnings.

For the reasons explained below, the Board should not make any of the adjustments to its methodology advocated for by WCTL and AECC. The Board has repeatedly made clear that the EP 558 annual cost of capital determination is not the proper forum to seek methodological changes to the cost of equity calculation. This is particularly appropriate this year, when the Board has built, and continues to build, an extensive record in another proceeding to consider whether changes to its methodology are warranted and has scheduled a public hearing for July. Ultimately, neither WCTL nor AECC can contend that the AAR has not correctly executed the Board's instructions and calculated the railroad industry's cost of capital for 2014 according to the Board's rules. As such, the Board should adopt 10.65 percent as the railroad industry's cost of capital for 2014.

Discussion

I. The Board Should Not Deviate from its Established Methodology in this Proceeding, or Defer or Condition the 2014 Cost of Capital Determination Pending the Outcome of EP 664 (Sub-No. 2).

For many years, the Board has noted in the decision instituting the annual cost-of-capital proceeding the many regulatory uses of the cost of capital. For example, in the decision instituting this proceeding, the Board noted that "[t]he 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. The last time the Board contemplated changes to its established methodology in 2008, the Board stated in the decision instituting a proceeding to calculate the rail industry's cost of capital for 2007:

> 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 and AECC offer no compelling rationale for the Board to take a different approach now.

Furthermore, the Board should not defer the determination of the 2014 railroad industry cost of capital because the arguments raised by AECC and WCTL here are simply self-serving and one-sided attempts to temporarily lower the cost of equity. Results-oriented and short-sighted attempts to manipulate any given year's calculation of the cost of capital should not persuade the Board to alter the sound methodology that the Board established after a thorough examination of the cost of equity in six rounds of comments and two public hearings. Should the Board ultimately decide to consider changes to its methodology in EP 664 (Sub-No. 2), it would need to address issues that could both increase and decrease the cost of capital calculation. *See* EP 664 (Sub-No. 2), AAR Opening Comments at 5, 41-45. There is no basis to hold the Board's many regulatory processes in limbo while WCTL and AECC attempt to argue for one-sided adjustments here.

The Board has made clear that challenges to the Board's established cost-of-capital methodology are beyond the scope of the annual cost of capital calculation proceeding to avoid parties seeking to bias the calculation in their favor. 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. Despite these clear admonitions from the Board, WCTL and AECC nevertheless suggest methodological changes in this proceeding that would bias the calculation down, without addressing any of the issues with the methodology that would cause the calculation to increase. Moreover, the Board has developed an extensive record in EP 664 (Sub-No. 2) and has announced a public hearing for July. The Board should not short circuit that process and make changes to the methodology in this proceeding without fully considering the record and testimony in that proceeding. The Board should continue to apply its established methodology unless and until it decides to make changes to the methodology in the EP 664 (Sub-No. 2) proceeding.[1]

II. Assumptions in the Morningstar/Ibbotson MSDCF May Understate, not Overstate, the Cost of Equity in the Presence of Stock Repurchases.

Should the Board consider the specific arguments raised by WCTL and AECC, nothing raised in this proceeding warrants a change to the Board's established methodology. For

[1] Moreover, the Board cannot depart from its established methodology without conducting a rulemaking, where it would notice any new methodology for public comment. The current methodology is clearly a legislative rule that cannot be changed without following the procedural requirements of the Administrative Procedure Act.

example, WCTL reiterates its perennial contention that stock repurchases by some railroads "taint" the use of earning per share growth rates in the Ibbotson/Morningstar MSDCF.[2] The Board correctly rejected this argument when it was first raised in 2008. *Use of a Multi Stage Discounted Cash Flow Model in Determining the Railroad Industry Cost of Capital*, EP 664 (Sub-No. 1)(STB served Jan. 23, 2009), slip op. at 12. Nothing has changed since then to warrant reconsideration of that decision.

Moreover, as demonstrated by the AAR in EP 664 (Sub-No. 2), stock repurchases by railroads to do not bias the cost-of-equity results of the Morningstar/Ibbotson MSDCF upwards. Instead, they may have the effect of causing the cost of equity to be understated, because the model does not explicitly include such distributions in its consideration of free cash flows to shareholders. Thus, the model does not reflect the reality that distributions to shareholders are shifted forward in time by repurchases, and therefore the model understates the cash flows that shareholders expect to receive in earlier years, while overstating the cash flows available in later years. Holding everything else constant, shifting forward the expected cash flows should raise the cost of equity estimate, not lower it. *See* AAR Opening Comments at 34-36, Villadsen Opening V.S. at 14-18. The Morningstar/Ibbotson MSDCF may thus understate the cost of equity by failing to shift the cash flows forward. If the STB were to consider trying to model the presence of stock repurchases on the cost-of-equity estimates, the STB would need to

[2] WCTL states in a footnote, "the AAR's IBES growth rates for each carrier include a forecast from an "undisclosed" source." WCTL Reply at 2 & fn. 2. As WCTL no doubt realizes from reading the cited appendix pages App. L, pp. 2-5, it is the IBES source, not the AAR's source, which is undisclosed. IBES growth rates have been utilized by the Board in calculating the cost of capital for nearly 30 years. *See Railroad Cost of Capital – 1996*, EP 558 (STB served July 16, 1997) slip op. at 9 & fn. 22 (noting that agency has relied on IBES growth rates since 1987).

address <u>both</u> the impact on growth forecasts for cash flows and the countervailing impact from shifting forward the expected cash flows in time.

WCTL claims that this method of modeling buybacks mysteriously creates a "double-count" of cash flows. According to WCTL, "[T]he MSDCF already purports to capture all available cash flow, regardless of whether distributed through dividends or buybacks or retained." WCTL Reply at 3. But this misses the point entirely. As stated by Dr. Villadsen in EP 664 (Sub-No.2), "The Morningstar/Ibbotson MSDCF determines free cash flow [using a specific formula] and ignores the total cash flow available for shareholders." Villadsen V.S. at 16. Importantly, the Morningstar/Ibbotson MSDCF model does not account for the *distribution* of cash to shareholders in the form of repurchases. "Because the expected cash flow is discounted, cash flow that occurs early contributes more to current stock price than cash flow that occurs later. This is important because the cash that accrues to shareholders from share buybacks occurs immediately rather than later and therefore makes a substantial contribution to the stock price and hence the cost of equity." *Id.* at 17. Therefore, as Dr. Villadsen testified, "it is necessary to consider not only the impact on the growth rate of the share buybacks but also on the cash distributed to shareholders through the buyback. These two factors bias the result in the opposite directions and are therefore potentially offsetting." EP 664 (Sub-No. 2), AAR Opening Comments, Villadsen V.S. at 17-18. In short, there is no double count, just an attempt to properly model the entire effect of a stock buyback program on the MSDCF model.

WCTL disregards how stock repurchases affect direct distributions to shareholders and instead simply reduces the overall growth rates by the percentage average of some of the railroad's rate of share repurchases. WCTL says AAR "suggested" this "type of adjustment" in

EP 664 (Sub-No. 2), *see* WCTL Reply at 2. But the AAR did not advocate this sort of crude, one-sided adjustment. Instead, the AAR argued that if the Board were to adjust the model to account for *both* the effect of share repurchases on shares outstanding and the actual cash distributed directly to shareholders, the impact would be *de minimus*. *See* EP 664 (Sub-No. 2), AAR Reply, Villadsen V.S. at 28-29. Ultimately, the calculations proffered by WCTL only illustrate the unremarkable principle that if you change the inputs to the model, the resultant calculation changes. Thus, even if the Board was to consider changes to the cost of capital methodology within the context of this proceeding – and it should not – the Board must reject WCTL's unfounded and incomplete adjustment to the Morningstar/Ibbotson MSDCF model

III. Selective Criticisms of Aspects of CAPM Raised in this Proceeding are Baseless

WCTL and AECC also suggest one-sided adjustments to CAPM intended to lower the cost of equity. WCTL concludes without analysis that the risk free rate and market risk premium are too high. But as the AAR demonstrated in its evidence in EP 664 (Sub-No. 2), there is no single way to calculate market risk and market risk premiums can vary widely. *See* EP 664 (Sub-No. 2), AAR Reply at 18-19. The Board's approach based on all available historical returns from 1926 is reasonable and supported by economists. *Id.* The 7.0% premium resulting from the Board's methodology is well within a range of reasonable values. Indeed, a recent study by economists at the Federal Reserve Bank of New York reviewed 20 different approaches to calculating a market risk premium and found premiums at an all-time high. *Id.* (citing F. Duarte & C. Rosa, *The Equity Risk Premium: A Consensus of Models* (2013).

Similarly, AECC repeats the argument it made in EP 664 (Sub-No. 2) that the betas used by the Board in its CAPM calculation are too high and reflect an increase in the railroads' exercise of market power. But there is no correlation between the exercise of market power and an increase in beta. *See* AAR Reply, EP 664 (Sub-No. 2) at 25-26 (citing relevant academic literature). Instead, the AAR showed that it is much more plausible that railroad betas have simply recovered from the impact of the financial crisis. It is also possible that they have increased due to other factors that affect the non-diversifiable risk of the railroad industry, such as massive capital expansions and/or changes in traffic mix. EP 664 (Sub-No. 2), AAR Reply, Villadsen Reply V.S. 34-47.[3]

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

The Board should also reject WCTL's and AECC's argument that BNSF should be included and that KCS should be excluded in the composite railroad used to determine the railroad industry's cost of equity for 2014. In its opening evidence, the AAR included KCS and excluded BNSF because KCS meets the stated criteria of *Railroad Cost of Capital – 1984*, 1 I.C.C.2d 989 (1985) and BNSF does not. Neither WCTL nor AECC disputes that fact and neither offers an alternative approach.

V. Railroads Do Not Earn "Supracompetitive" Returns

Finally, though wholly irrelevant to the calculation of the 2014 cost of capital calculation, AECC's claim that railroads earned "supracompetitive" returns in 2014 are unfounded. AECC Reply at 4, citing AECC Comments, EP 722/664 (Sub-No. 2). To justify this claim, AECC performs the rudimentary annual revenue adequacy calculation that compares the industry cost of capital as calculated by the AAR in this proceeding to Form 250 data on Adjusted Net Railway

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[3] The AAR also rejected the unsupported factual assertion that railroads are exercising increased market power. *Id.*

Income and the book value of the Net Investment Base for the 7 Class I railroads. The AAR has provided extensive economic testimony in EP 722 that demonstrates that such short-term analysis has no substantive or legal import. Successful firms operating in competitive markets routinely earn returns in excess of their industry's cost of capital. It is simply incorrect as a matter of economics to assume that a firm earns monopoly or "supracompetitive" returns if it earns a rate of return greater than its industry's cost of capital. *See* EP 722, AAR Opening Comments, Kalt V.S. 32-35; Brinner V.S. at 12-13 and Exh. 2.

Conclusion

The Board should determine that the railroads' cost of capital for 2014 is 10.65 percent.

Respectfully submitted,

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June 1, 2015

CERTIFICATE OF SERVICE

I hereby certify that on this 1st day of June, 2015, I have caused a copy of the foregoing to be served by first class mail, postage prepaid, on the following:

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