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BEFORE THE
SURFACE TRANSPORTATION BOARD

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In the Matter of:	)	
RAILROAD COST OF CAPITAL – 2011	)	Ex Parte No. 558 (Sub-No. 15)

REPLY STATEMENT OF THE WESTERN COAL TRAFFIC LEAGUE

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Pursuant to the notice that the Surface Transportation Board ("STB" or "Board") served in the above-captioned proceeding on February 3, 2012, as modified on March 29, 2012, the Western Coal Traffic League ("WCTL" or "League")[1] submits its reply statement in response to the opening statement filed by Association of American Railroads and its member railroads ("AAR" or "Railroads") on April 20, 2012.

I. SUMMARY

The AAR appears to have generally followed the STB's cost of capital methodology. However, the AAR's cost of debt calculations present significant implementation issues regarding the use of proprietary data for bond prices, the failure to reflect that a substantial portion of the railroad debt is callable, and the treatment of

[1] WCTL is a voluntary association, whose regular membership consists entirely of shippers of coal mined west of the Mississippi River that is transported by rail. WCTL members currently ship and receive in excess of 175 million tons of coal by rail each year. WCTL's members are: Ameren Energy Fuels and Services, Arizona Electric Power Cooperative, Inc., CLECO Corporation, Austin Energy (City of Austin, Texas), CPS Energy, Entergy Services, Inc., Kansas City Power & Light Company, Lower Colorado River Authority, MidAmerican Energy Company, Minnesota Power, Nebraska Public Power District, Omaha Public Power District, Texas Municipal Power Agency, Western Farmers Electric Cooperative, Western Fuels Association, Inc., and Wisconsin Public Service Corporation.

floatation costs. The AAR's cost of equity calculations again highlight the conceptual limitations of the STB's MSDCF methodology in the face of high growth rates, as exacerbated by continued reliance on an overstated market risk premium in the CAPM methodology. The AAR's capital structure calculations err in the treatment of operating leases and government grants.[2] These matters are addressed further below.

II. COST OF DEBT

Regarding the cost of debt, the AAR has previously utilized Standard & Poor's ("S&P") as its source of bond price data. This year, the AAR switched to Bloomberg, apparently in order to obtain fuller coverage of the railroad bonds. The AAR claims Bloomberg covers 97% of the carriers' bonds, as contrasted with 38% coverage utilizing S&P. *See* Verified Statement of AAR Witness Gray ("Gray V.S.") at 8 and Appendix O. For the 2010 determination, the AAR (and the STB) relied on traded values for only 52% of the market value of debt, and more complete coverage of the market is inherently desirable.

However, the Gray V.S. at footnote 7 reveals that the AAR's Bloomberg data come from "Bloomberg Professional," which "is available as a subscription service." In other words, the AAR has chosen to rely on proprietary data. The AAR's electronic

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[2] WCTL recognizes the STB's prior statements that the annual cost of capital dockets are not to be utilized for seeking changes to the STB's basic methodology. However, the STB has an ongoing obligation to ensure that its methodology is reasonable and yields reasonable results, and a methodology that may yield reasonable results in some circumstances may not yield reasonable results in other circumstances. Whether the methodology yields reasonable results must be assessed on a regular basis, and the STB should not make an annual cost of capital determination unless it believes that the values presented are reasonable. To the extent necessary or appropriate, the STB may wish to consider these comments as a request to initiate a further rulemaking.

workpapers confirm that the data is proprietary. An attempt to access the Bloomberg data in the AAR's workpapers yields the text "Must Pay Bloomberg for these data" instead of actual data. As a result, the AAR's calculations cannot be verified from its workpapers.

The STB has previously addressed the AAR's efforts to rely on proprietary data for the cost of capital determination. In Ex Parte No. 558 (Sub-No. 10), *Railroad Cost of Capital -- 2006* (STB served April 15, 2008), at 7, the STB rejected the AAR's attempt to rely on the "S&P 500 Total Return" index because the data was proprietary. The STB found the AAR's use of such data to be "disconcerting" in that the AAR and its expert witnesses (as well as WCTL) had previously objected to an earlier STB proposal to rely on proprietary data. *Id*. WCTL does not understand why an approach that was "disconcerting" before should now be permissible. Moreover, the AAR's own calculations at Appendix O show only a modest difference in the results using publicly-available S&P data. (However, the AAR does not appear to have provided a workpaper for its calculations for the S&P data, and so that aspect of its calculations also cannot be confirmed.)

WCTL respectfully submits that the matter warrants further attention and a more forthcoming submission from the AAR. In particular, a data sample that covers only 38%, or even 52%, of the market value may not be suitable for the STB's purposes.[3]

[3] Of course, a similar problem attaches to the fact that the AAR's and the STB's calculations entirely exclude BNSF, which would comprise a substantial percentage of the composite sample. Before being acquired by Berkshire Hathaway, BNSF generally had the lowest cost of equity of the four included Class I railroads. Also, the post-

It may be appropriate to consider (a) whether there are suitable non-proprietary sources of bond data other than S&P, (b) assuming a proprietary source must be utilized to achieve needed coverage, whether some other source should be used in addition to or instead of Bloomberg, and (c) whether a mechanism can be devised to provide appropriate access to the Bloomberg data. In any event, it is improper for the AAR to ignore STB precedent without any acknowledgement that it is doing so.

A second flaw or limitation in the AAR's cost of debt analysis is the failure to take into account that a significant amount of the railroads' debt is callable. For example, Morningstar identifies UP debt with a face value of approximately $6 billion as being callable. *See* http://quicktake.morningstar.com/stocknet/bonds.aspx?symbol=unp.[4] The callability of the debt is significant for STB purposes in at least two respects.

First, all things being equal, a bond that is callable will be less desirable to investors, compared to a noncallable bond, because the issuer may call the bond if interest rates fall, depriving the investor of the upside return (a bond with an above-market interest rate will otherwise command a premium). Callability provides an asymmetric benefit/option to the issuer, which causes the bond to trade at a discounted market value, which increases the effective interest rate (coupon payment divided by the reduced market value).

Second, and related, the STB has denied stand-alone railroads the benefits of the callability feature, or at least the ability to refinance debt when interest rates fall,

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acquisition BNSF should have a lower cost of debt due to its affiliation with its parent, which enjoys a superior credit rating.

[4] UP's 2011 10-K reports that UP's outstanding long-term debt totaled $8.9 billion.

on the grounds that such refinancing is inconsistent with railroad industry cost of capital. Consider, for example, the treatment in STB Docket No. 41191 (Sub-No. 1), *AEP Texas North Co. v. BNSF Ry.* (STB served Sept. 7, 2007), at 106-07:

> Moreover, AEP Texas has provided no evidence that lenders would be willing to refinance this debt at current low rates. AEP Texas' evidence pertains to the issuance of new debt, not the refinancing of existing debt. This distinction is important because, to the extent that the TNR would issue bonds to generate capital, AEP Texas has not demonstrated that the TNR could buy back its bonds (and that it could do so at no cost). If interest rates fall, the TNR would have to pay a premium for the bonds to repurchase them as part of refinancing. For these reasons, we find that AEP Texas' refinancing of its debt is insufficiently supported. Accordingly, we rely on the Board precedent of applying a weighted average cost of debt during the construction period, weighted by the construction dollars expended in each year.

The STB's treatment whipsaws shippers as they are forced to pay a cost of debt that reflects a premium for the callability feature, but they are not allowed to take advantage of the callability in stand-alone cases when interest rates do fall. Adding to the Catch-22, the STB applies a heavy, and seemingly unrebuttable, presumption in rate cases to use of the industry cost of capital. If the cost of capital is going to be increased through that premium, then shippers should be allowed to take full advantage of the associated callability.

Third, the Morningstar information indicates that CSX, NS, and UP have all issued debt pursuant to SEC Rule 144A (17 CFR § 230.144A). Rule 144A creates a non-exclusive safe harbor that allows issuers to place debt through private placements to qualified institutional buyers without registering the securities, thereby avoiding or reducing floatation costs for the securities. Thereafter, the buyers may sell the securities to other qualified institutional buyers, although that restriction on resale may expire after a period of time. One of the benefits of Rule 144A is that the absence of the registration requirement reduces the floatation costs. The carriers would not utilize Rule 144A unless it provided some benefits, as use of its procedures is optional and qualified institutional buyers could instead purchase debt that had been issued more conventionally. The floatation costs should thus be adjusted to reflect the carriers' use of this practice. It further follows that a stand-alone railroad should be able to utilize Rule 144A to reduce its floatation costs in conjunction with any refinancing.

In addition, the AAR has included in its floatation costs calculation costs that are incurred by the railroad itself, as distinguished from costs that the underwriter subtracts from the offering. Gray V.S. at 21-22 and Appendix F. The AAR should provide additional information from which it can be determined if such costs are included in the general and administrative costs typically incurred by a stand-alone railroad. Otherwise, the stand-alone railroad and captive shipper may have to pay twice for such costs, once in the cost of capital itself, and a second time in the direct costs of the stand-alone railroad.

III. COST OF EQUITY

While the AAR appears to have followed the STB's methodology for estimating the cost of equity, WCTL has no confidence in the accuracy of the results, especially in the continued use of the MSDCF method and the use of an excessive market risk premium in the CAPM analysis.

In particular, the 15.83% result of the MSDCF analysis exceeds the 11.31% result of the CAPM analysis by more than four percentage points. WCTL understands that the STB prefers to use two methods to generate stability in the results, and that the result is achieved in part in 2011 because the CAPM figure is reduced from 2010 even thought the MSDCF figure is increased. However, a discrepancy of four percentage points, corresponding to 40% (15.83%/11.31%=1.3996), between the two figures should trigger meaningful analysis as to which figure is more plausible, rather than a declaration that an agency with supposed expertise is unable to determine which figure is more accurate.[5] Indeed, the 15.83% MSDCF result for 2011 is even higher than the 15.18% cost of equity that the STB derived for 2005 using the discredited SSDCF methodology. At the very least, the STB should be willing to consider evidence, such as WCTL has submitted previously, showing that respected third-party analysts such as S&P, UBS, etc., consider the cost of capital of the railroads to be at 10% or lower.

Moreover, little effort is required to ascertain why the MSDCF analysis yields such an unrealistically high figure. The AAR derives a five-year growth rate of 14.62%. Gray V.S. at 40. That growth rate translates into a virtual doubling of cash flow (or earnings) after five years ($1.1462^5=1.978$). That rate of growth may well be realistic given the railroads' pricing power and the prospects of economic recovery.[6] However,

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[5] *See* NOR No. 42113, *Arizona Elec. Power Coop., Inc. v. BNSF Ry. & Union Pac. R.R.* (STB served Nov.22, 2011), at 137 ("it is just as likely that CAPM results in a cost of equity that is too low").

[6] The MSDCF model employs a multi-year average measure of cash flow as a percentage of revenues. Accordingly, the growth contemplated is sustainable, long-term growth, as opposed to a year or two of unusual growth that may be followed by a year of

the STB's MSDCF model then posits that the growth will continue for an additional five years. As a result, the model projects that at the end of ten years, the railroads' free cash flow will have almost quadrupled ($1.1462^{10}=3.914$) from the baseline level, before reverting to the growth rate for the general economy of 5.19%, which is just 35% of the five/ten-year growth rate used by the model.[7]

In WCTL's view, such a quadrupling for a large, stable, and mature industry over a ten-year period is patently unrealistic. Not surprisingly, the market (as reflected in the current railroad stock prices, increased as they are over 2010, as reflected in the beta and equity/debt ratios) does not believe the STB's projection. The consequence of that disbelief is an overstated cost of capital, defined as the discount rate required to reconcile those projected cash flows with the market price on a net present value basis. If, however, the STB actually believes that the carriers' already healthy cashflows will quadruple over the next ten years, especially in the absence of projections of high inflation, then there is no basis for continuing to maintain the pretense that the railroads are anything but revenue adequate.

The Board should be aware that the Canadian Transportation Agency ("CTA") issued its Decision No. 425-R-2011 on December 9, 2011, regarding its methodology for calculating the cost of capital. The decision and its appendices can be accessed at http://www.cta-otc.gc.ca/eng/consultations-costofcapital/milestones#191195.

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retrenchment. Accordingly, the fact that the carriers might experience enormous growth in a single year does not validate the ten-year growth projection.

[7] Gray V.S. at 40. Significantly, the 5.19% represents a 61 basis point reduction from the 5.8% long run nominal growth rate used for 2010. *Id*. at 41.

The CTA decided to rely exclusively on the CAPM approach, and not on a combined CAPM/MSDCF approach, "find[ing] one model to be clearly superior, in that CAPM satisfies all [the CTA's] identified criteria for an appropriate cost of equity model, while the DCF and ERP[8] Models fall short in some areas." CTA Decision at ¶ 209. The CTA added that combining CAPM and MSDCF models "becomes entirely judgmental" "as there are no theoretical guidelines for combining estimates from cost of equity models." *Id.*, ¶ 214. The CTA earlier retained the Brattle Group to conduct a study of the cost of capital methodology, in which it noted the difficulty inherent in the MSDCF model:

> The major source of debate for the DCF model is determining the dividend growth rate, particularly for the long-term. There is generally no publicly available data on forecast growth rates for periods longer than 5 years. Unfortunately, the forecast growth rate has a major effect on the cost of equity estimated by the DCF method.
>
> The DCF approach is conceptually sound if its assumptions are met, but can run into difficulty in practice because those assumptions are so strong, and hence unlikely to correspond to reality.

CTA Decision, Appendix B, ¶ 134 (quoting Brattle Report at 52-53). WCTL respectfully submits that the STB's stage two growth rates reflect precisely the concern noted by the CTA and the Brattle Group.

While the STB's methodology does average the MSDCF value with the CAPM value, there is ample reason to conclude that the MSDCF value itself is significantly overstated (albeit not to the same extent as the CAPM value). In particular, the AAR posits (using the STB's methodology) that the market risk premium is 6.62%,

[8] The ERP model consists essentially of a CAPM model without a beta adjustment.

based on the returns beginning in 1926. But conditions have changed since 1926. As explained by the CTA:

> [I]t is also argued that a longer period gives too much weight to distant market events that may have no bearing on current market conditions. As suggested in the Brattle Report (page 25), "returns over more recent periods are likely to be a better measure of investor expectations going forward, because the economy and capital markets have evolved so much over time."

CTA Decision at ¶ 36.

When combined with the CAPM risk-free rate of 3.62%, the result is an STB finding that that investors in the current environment expect equities (specifically, the S&P 500) to provide a long-term return of 10.24%. Such a conclusion flies in the face of widespread investor sentiment that expectations have changed in recent years and now reflect a "new normal" with substantially diminished returns. For example, a recent article in *The Economist* concluded that the data and analysis "suggests a nominal return of 6% on equities."[9]

Simply stated, there is a distinct lack of support for the STB's premise that investors expect equities to deliver a long-term return of 10.24%. The overstatement is particularly significant because the 10.24% purports to represent the opportunity cost of equity capital, before adjustment for firm-specific systemic or non-diversifiable risk, *i.e.*, the return that the railroad industry must supposedly provide in order to attract (or retain) equity capital. To the extent that opportunity cost figure is overstated, the jurisdictional

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[9] "Shares and shibboleths: How much should people get paid for investing in the stock market" (March 12, 2012), available at http://www.economist.com/node/21550273.

threshold will be overstated, shippers will be unable to bring rate cases, shippers with successful rate cases will face maximum reasonable rates that are overstated, and individual carriers may appear to be revenue inadequate, when they really are not. In short, a key question for the STB is whether the 10.24% represents a reasonable measure of expectations for equity investors in the current environment.

What is completely untenable, however, is the use of a MSDCF methodology that generates a cost of equity that is 450 basis points greater than a vulnerable CAPM figure, especially in the absence of any perceived need to evaluate whether the discrepancy in the two estimates suggests that something might be wrong in the underlying assumptions. Indeed, the 15.83% MSDCF cost of equity and the 1.1623 CAPM beta (Gray V.S. at 35)[10] imply an expected market return of 14.13%.[11] The STB should state if it considers such a figure to be realistic in the current environment.

IV. CAPITAL STRUCTURE

The capital structure should be adjusted to reflect operating leases and grants received by railroads.

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[10] The CTA also decided to continue using a Blume adjustment to the beta (relying on a weighted average of roughly 2/3 the measured beta and 1/3 an assumed beta of 1.0). The CTA explained that "[m]ost financial data providers, such as Bloomberg, and Value Line, report adjusted betas using Blume's methodology as their default beta," and the agency "considers it appropriate to employ a methodology that is used by the majority of financial data providers, insofar as investor expectations are formed by financial analysts." CTA Decision at ¶¶ 379-380.

[11] 15.83% less the 3.62% risk-free rate is 12.22%, and 12.22% divided by the 1.1623 beta implies a market risk of premium of 10.51%. The 10.51% implied market risk premium plus the 3.62% risk-free rate implies an average market return of 14.13%.

WCTL has previously contended that operating leases should be classified as debt. WCTL submits that the STB should reexamine the issue, especially as the Financial Accounting Standards Board ("FASB") is far along towards adopting a rule to require such treatment for financial reporting purposes. *See* http://www.fasb.org/jsp/ FASB/ FASBContent_C/ProjectUpdatePage&cid=900000011123. The change should be made for cost of capital purposes in advance of the change by the FASB, as the investment community already generally treats railroad operating leases as debt.

For example, Union Pacific includes in its annual report a calculation of return on invested capital ("ROIC") that treats operating leases as debt, using a 6.2% discount rate that "reflects current interest rates and financing costs." *See* http://www.sec.gov/Archives/edgar/data/ 100885/000119312512038569/ d288752d10k.htm, at pp. 34, 39. The adjustment increases UP's 2011 debt by $3.847 billion (43%), according to UP's 10-K. Increasing the debt of the composite sample by the UP figure (without any change for CSX or NS) raises the industry capital structure from 20.8% debt to 23.2% debt, and reduces the after-tax cost of capital to 11.41% (assigning a 6.2% interest rate to the UP operating leases).

A recent article demonstrates that Moody's frequent practice in rating the debt of nonfinancial firms is to treat operating leases as debt and that such adjustments are significantly associated with lower ratings and higher bond yields.[12] Other firms that

[12] Pepa Kraft, *Rating Agency Adjustments to GAAP Financial Statements and Their Effect on Ratings and Bond Yields* (2001), available at http://papers.ssrn.com/sol3/ Delivery.cfm/SSRN_ID1876672_code1104503.pdf?abstractid=1266381&mirid=1. The article analyzes data from 2002-2008.

follow a similar practice include Fitch,[13] S&P,[14] and Morgan Stanley.[15] The carriers presumably enter into operating leases because they consider them to be cheaper than, or otherwise superior to, the alternatives, and it is appropriate to include the leases in assessing the carriers' capital structure.

Significant distortions flow from a failure to recognize that the market views operating leases as debt. In particular, the market views the carriers as having greater leverage than is revealed by relying on a conventional accounting measure of debt, and the greater leverage logically serves to increase the risk and associated cost of both debt and equity. The cost of debt is supposedly measured directly (assuming suitable data), whereas the cost of equity is inferred, but both still reflect the market's assessment of risk (under the efficient market hypothesis). A capital structure weighting that ignores the operating lease debt necessarily assigns too much weight to the equity portion, which is the most expensive portion of the capital structure, thereby overstating the weighted average cost of capital.[16] The overweighting and associated overstatement

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[13] Fitch, "Operating Leases: Updated Implications for Lessees' Credit (Fitch Ratings, Aug. 5, 2009), http://www.fitchratings.com/creditdesk/reports/ report_frame.cfm?rpt_id=462222 (noting use of multiples and discount rate methods to value the liability).

[14] Standard & Poor's, "2008 Corporate Criteria: Ratios and Adjustments (April 15, 2008), http://www.standardandpoors.com /prot/ratings/ articles/en/us/?articleType=HTML&assetID=1245326738639 (noting use of discount method).

[15] Morgan Stanley, "Freight Transportation Fast Track" (May 7, 2012), at 8 (noting that adjusted net debt "includes capitalized operating leases, based on the 7x convention).

[16] The distortion posed by the unrecognized leverage persists under the Modigliani-Miller theorem. To illustrate, even with 100% equity, meaning no conventional debt, the actual weighted average cost of capital would still need to reflect the lower cost of debt attaching to the operating leases. In other words, the cost of equity under a 100% equity structure (no conventional debt) would still reflect an increase due to the operating leases, and the operating leases should serve to reduce the overall cost of capital.

becomes more consequential when the after-tax cost of capital is converted to a before-tax cost of capital for URCS purposes by dividing the equity portion by 1.0 minus the marginal corporate tax rate of 35%.

WCTL acknowledges that the STB previously rejected WCTL's efforts to have operating leases treated as debt. *See, e.g.,* Ex Parte No. 664, *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital* (STB served Jan. 17, 2008), at 15. WCTL continues to find the STB's reasons to be less than persuasive. First, insofar as the STB maintains that treating operating leases is inconsistent with GAAP, the fact is that the concept of a current cost of capital and its individual constituents as implemented by the Board (MSDCF, CAPM, current cost of debt, and weighting the capital structure by market value instead of book value) are also inconsistent with and deviate from GAAP.[17] To insist that one element of a non-GAAP calculation conform to GAAP is nonsensical.

Second, insofar as the concern is that short-term operating leases should not be included, the simple solution is to require the carriers to identify which of their operating leases are short-term. The information is certainly readily available to the carriers, and their 10-K filings already include a discussion of their operating leases.[18]

[17] The CTA approach utilizes book, rather than market, values and the actual (embedded) cost of debt and thus adheres far more closely to GAAP.

[18] The additional information could be provided as part of the AAR's annual cost of capital filing, which relies extensively on information that is not part of the R-1. However, the STB could also modify the R-1, just as the STB is modifying the R-1 to require the separate reporting of positive train control costs. Ex Parte No. 706, *Reporting Requirements for Positive Train Control Expenses and Investments* (STB served Oct. 13, 2011).

The possibility that some leases may need to be excluded is hardly a reason to determine that all leases should be excluded.[19]

Third, UP's own reporting to its investors identifies and employs a means to "rationally re-weight the costs of debt and equity" and, if needed, to determine a current cost of debt that can be assigned to operating leases.[20] There may be other means to make the calculation, and perhaps the carriers and analysts can offer constructive input in that regard, but to exclude any adjustment on the basis that the weight must be inferred makes no sense. By that reasoning, the cost of equity should be excluded because it cannot be perceived directly.

In addition, consideration should be given to the treatment and reporting of funds that the railroads received under grants from the federal government (*e.g.*, Recovery Act Transit Investments for Greenhouse Gas and Energy Reduction (TIGGER) grants) as well as from state and local governments (such as contributions for locating intermodal distribution facilities). These grants appear to be significant (at least in comparison to the $200,000 that the AAR noted is the internal floatation cost for a railroad issuance of debt) and growing.

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[19] UP considers the operating leases discussed *supra* as being sufficiently long-term to include in its ROIC calculation.

[20] The STB criticized WCTL for not having "acknowledged or addressed how we could rationally re-weight the costs of debt and equity, which are themselves a function of the actual debt-equity ratios of the carriers." Ex Parte No. 664, *supra*, at 15. The STB's premise (that the costs of debt and equity reflect the debt-equity ratios) is sound, but it draws the wrong conclusion. Market investors perceive operating leases as debt, and thus ascertain the costs of equity and debt, and their relative weightings, on that basis. To proceed as if the operating leases were not perceived as debt is to overstate the costs of both equity and debt and also to overweight the equity component.

The assets purchased and investments made with such grants (or possibly with low-interest loans, which should also be identified) presumably enter the investment base of the carriers, where they become eligible for a return of and return on investment at the before-tax cost of capital as part of the URCS program. The 11.57% after-tax cost of capital claimed by the AAR translates into a 17.36% before-tax cost of capital. Such investments are also presumably encompassed within the investments considered in the STB's revenue adequacy determinations.[21] It is one thing for the public/taxpayers to provide the carriers with such benefits. It is another thing to require shippers to compensate the carriers for those benefits already provided by the public/taxpayers.

V. CONCLUSION

The STB should adjust the cost of capital in accordance with the comments stated above.

Respectfully submitted,

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[21] A stand-alone railroad could potentially take advantage of such grants, as any restriction on doing so would constitute an entry barrier. Nonetheless, the public has an interest in knowing the magnitude and nature of these grants, and it would be helpful if the carriers were required to identify each individual grant in their R-1 reports or some other readily accessible location.

CERTIFICATE OF SERVICE

I hereby certify that on this 10th day of May 2012, I have caused true and accurate copies of the foregoing Reply Statement of the Western Coal Traffic League to be served upon all parties on the service list in this proceeding by first class mail, postage prepaid.

/s/ Robert D. Rosenberg