

BEFORE THE
SURFACE TRANSPORTATION BOARD

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REVISIONS TO THE BOARD'S	)	
METHODOLOGY FOR	)	EP 664 (Sub-No. 4)
DETERMINING THE RAILROAD	)	
INDUSTRY'S COST OF CAPITAL	)	

REPLY COMMENTS OF THE WESTERN COAL TRAFFIC LEAGUE

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Pursuant to the notice of proposed rulemaking that the Surface Transportation Board (“STB” or “Board”) served in EP 664 (Sub-No. 4) on September 30, 2019 (the “Notice”), the Western Coal Traffic League (“WCTL” or “League”) submits the following reply comments. WCTL’s initial comments responded to the comments filed by Mr. Roger J. Grabowski of Duff & Phelps. Accordingly, these reply comments respond to the comments that the Association of American Railroads (“AAR” or “Railroads”) filed on January 15, 2020, and the accompanying Verified Statement of its expert, Dr. Bente Villadsen (“Villadsen VS”), of The Brattle Group.

In its initial comments, WCTL explained that the Board was entirely correct in perceiving a problem with the cost of equity (“COE”) portion of the railroad industry cost of capital (“COC”) that needed to be addressed, but that the Board had focused on a collateral issue, lack of stability, and overlooked the core problem, lack of accuracy. The League further explained that the Board can remedy both COE problems by relying exclusively on the Capital Asset Pricing Model (“CAPM”) with a current Market Risk Premium (“MRP”) and jettisoning the Multi-Stage Discounted Cash Flow model (“MSDCF”), rather than adopting the Step MSDCF as proposed in the Board’s

Notice. The CAPM-only approach with a current MRP will align the Board with independent published values, the financial and investment community, and the railroads themselves and produce accurate and stable COE and COC values that appropriately capture the opportunity cost of capital for railroad investment.

For its part, the AAR now agrees with the Board and WCTL that the 2018 MSDCF COE value is anomalous, a reality that the AAR disputed in its comments in EP 558 (Sub-No. 22), *Railroad Cost of Capital—2018*. Like WCTL, the AAR finds little value in the Board’s proposed Step MSDCF, albeit for different reasons.

The AAR does offer its own solution to what it now acknowledges is a problem. Rather than use the end-of-year earnings projections and contemporaneous stock prices/market capitalization in the MSDCF, the AAR proposes to incorporate such data with a one-month lag, as of the end of January of the following year, rather than the end of December of the review year, in order to attain an ostensibly better alignment between the earnings forecasts and the market capitalization. The AAR’s “solution” is very similar to the three-month lag that it presented in the first implementation of the MSDCF, which the Board rejected for reasons noted by WCTL.¹

¹ *Railroad Cost of Capital—2008*, EP 558 (Sub-No. 12) (STB served Sept. 25, 2009), at 9-10; *id.*, WCTL Comments filed May 20, 2009, at 6. One of the AAR’s criticisms of the Step MSDCF is that it introduces a true transition or phase-in in the second stage, which WCTL has previously proposed and the Board has previously rejected. WCTL expects the AAR to make the same criticism of WCTL’s CAPM-only proposal. However, previous rejection should not necessarily preclude reexamination and a different outcome. For example the AAR persists in urging use of replacement costs for revenue adequacy, even though its approach has been repeatedly rejected by the Board and its predecessor, was fully considered before it was rejected by the Railroad

By the AAR's own admission, if not design (Villadsen VS at 29), its proposed solution will have a significant impact for the 2018 COE, but COE values over time will be only slightly changed, as is also the case with the Step MSDCF.²

Accordingly, the AAR's proposal will, like the Step MSDCF, do little to address the discrepancy between the MSDCF and the Board's CAPM, much less an accurate CAPM calculated using a current MRP, such as the 7% figure endorsed by BNSF's Matt Rose.

The AAR's proposal also presents a host of problematic ramifications that only confirm the soundness of WCTL's recommended approach. Chief among these is the AAR's admission that the alignment of stock prices and earnings forecasts varies from time to time. Villadsen VS at 5-16. The existence of a solid alignment is a core premise of the MSDCF model. *Id.* at 6. Unless that alignment is assured, there is no basis on which to utilize the model. The AAR's admission, and its expert's demonstration, that the alignment fluctuates is a reason to reconsider the model's fundamental reliability.

The AAR's submission also reveals that the mostly unidentified analysts³ sharply cut their projections for railroad earnings between December 31, 2018 and

Accounting Principles Board, deviates from the Board's governing statute, and remains deeply problematic in numerous other respects, as those decisions and reviews noted.

² AAR Comments at 4 (Figure 1); Villadsen VS at 19 (Figure 7). The AAR deems the Step MSDCF "biased" because it will lower the COE values "systematically" (AAR at 1), albeit insignificantly. The AAR ignores how the MSDCF and Step MSDCF are biased relative to the current MSDCF, even with an historical MRP.

³ As explained in WCTL's initial comments, the bigger issue is that most analysts do not prepare long-term forecasts for the sampled railroads in the first place, which undermines reliance on a MSDCF approach altogether. WCTL Comments at 12-13.

January 31, 2019. *Id.* at 12 (Figure 4). Credit Suisse, the only identified analyst, reduced its forecast for UP from 21.2% to 12.6% (a 40.6% cut), for NS from 19.9% to 9.6% (a 51.8% cut), and for CSX from 27.4% to 12.2% (a 55.5% cut). In an efficient market, reductions of this magnitude should not occur in such a short period of time, absent some major event. *Id.* While Dr. Villadsen points to both the temporary decline in stock prices during this period, *id.* at 9 (Figure 2) and the lag in analyst updates tied to the release of earnings results, *id.* at 14 (Figure 5),⁴ those factors do not begin to explain how the earning projections could be cut so substantially in such a short period of time. If the railroads' prospects were dwindling so rapidly, one would expect analysts to update their projections more rapidly and to transmit alarms, rather than wait for the end of the year. Furthermore, the AAR makes no attempt to show how the January 2019 releases reflected sudden or unanticipated changes, or fell substantially short of expectations, which might explain the sharp cuts.

Furthermore, the decline and then rapid recovery in market capitalization during the period between December 1, 2018 and February 1, 2019, depicted in Dr. Villadsen's Figure 2, indicate that applying the MSDCF to the railroad equities on different days during the covered period would yield very disparate results. Again, this level of short-term volatility is to be avoided in a methodology intended to capture the

⁴ Dr. Villadsen compares the lag in broker estimates over the past ten years only for the end of December, January, and the first week in February. There is no attempt to consider the lag at other times of the year or how earnings forecasts change in response to earnings releases for the other three quarters.

long-term COC to be used for rate regulation. The relevant question is not what is the optimal timing for the forecasts and market caps, but whether the COE and COC changed significantly during this brief period, and whether a methodology that yields such implausible fluctuations should be used at all.

A closely intertwined problem with the AAR's band aid of a remedy is that the resulting MSDCF COE would be calculated not as of the end of the subject year, but instead as of the end of the first month of the following year. The Board rejected the AAR's initial proposed MSDCF implementation for that very reason. *Railroad Cost of Capital—2008, supra*, at 10 (“We agree with WCTL that 2009 data should not be included in the 2008 cost of capital.”).⁵ Making such an adjustment would also raise the question whether the MSDCF COE should instead be calculated at the midpoint of the subject year, *e.g.*, using July 31 data to calculate the MSDCF COE as of June 30. A related complication is the inconsistency in using capitalization as of one date for the MSDCF COE and as of another for the capital structure and the CAPM COE (although, as explained *infra*, the CAPM's stability makes its timing less consequential).

The AAR repeatedly touts the MSDCF's commercial acceptance, but that claim is suspect, at least for the railroad industry. Duff & Phelps, the current custodian of the MSDCF, no longer prepares MSDCF values for individual firms in the manner

⁵ The 2008 COC experience showed that timing matters. The 2008-2009 turmoil might have caused some COC fluctuation. The same cannot be said for the MSDCF fluctuations in recent years. In particular, the Morgan Stanley COC for the railroads has been very stable, as noted in WCTL's initial comments. WCTL Comments at 4 n.2.

calculated by the Board. The CAPM is the dominant methodology generally. Neither the AAR nor the Board has shown that any railroad investor assigns any weight to the railroad MSDCF figures, and the MSDCF COE for 2018 is more than double the value Mr. Rose endorsed. As shown in WCTL's opening comments, the evidence is overwhelming that the CAPM and associated values predominate and that the railroads themselves do not use the MSDCF to determine their internal COC. Even Dr. Villadsen did not utilize the Board's MSDCF in her recent testimonies for Portland General Electric and Southern California Edison, but instead used a standard MSDCF that: (a) defines cashflow as dividends plus buybacks (if those buybacks are material); (b) transitions to the terminal growth rate over five years starting year six, and (c) does not redefine cashflow in the terminal stage.⁶

Furthermore, Duff & Phelps does not use forecasts from a subsequent period in its MSDCF calculations.⁷ The AAR's claim that its revision "does not tinker with the Morningstar/Ibbotson model" (AAR at 4) is thus incorrect. Consequently, even

⁶ WCTL Comments at 11. The AAR asserts that if the second stage of the Step MSDCF transitions to the terminal growth rate, then it should also transition to the terminal cashflow definition, but the standard MSDCF model holds the definition of cashflow constant in all three stages.

WCTL explained on opening that utilities are a better candidate for application of the MSDCF. WCTL Comments at 11-12. In that regard, utilities did not experience the 11.6% decline in market cap during the December 1, 2018 to January 1, 2019 period referenced in the Villadsen VS at 8. Yahoo!Finance shows the Dow Jones Utility index went from 737.9 to 712.93 during that period, a modest decline of 3.4%.

⁷ Duff & Phelps so confirmed in a phone call with WCTL counsel on February 7, 2002. See also <https://www.bvresources.com/articles/bvwire/ye2019-data-are-now-in-the-cost-of-capital-professional> noting February 12, 2020 availability of Duff & Phelps cost of capital data through the end of 2019.

if the Ibbotson MSDCF is deemed to remain “commercially accepted,” the AAR now recommends a significant alteration to that model to achieve what the AAR depicts as more acceptable results. The end result is that the AAR would have the Board adopt a made-for-litigation model, which is what the Board set out to avoid in the first place.

The CAPM steers clear of all these problems. The CAPM is not made for litigation or even merely commercially accepted. It is instead the overwhelmingly dominant model, as even CSX acknowledged at the Board’s revenue adequacy hearing (Dec. 13, 2019 Tr. at 181). It is also not subject to the vicissitudes and distortions of timing that plague the MSDCF. WCTL’s opening comments demonstrated that the CAPM has been quite stable over the past ten years, with either an historical or current MRP. As the AAR states, “a more reliable [COE] is also likely to be less volatile.” AAR at 26; Villadsen VS at 27. The MSDCF also does not rely on snapshot inputs. The CAPM as employed by the Board uses: (1) a risk-free rate (“RFR”) that reflects an average for the review year, (2) a beta that represents five years of data (in order to reduce statistical noise) and that has been relatively stable in any event, and (3) a historical MRP that is inherently stable or, preferably, a current MRP that has been nearly as stable for the past ten years, makes more conceptual sense, and is broadly utilized.

The CAPM also has the benefit of simplicity. The calculation is essentially $a \text{ (MRP)} \times b \text{ (beta)} + c \text{ (RFR)}$, using readily accessible inputs. At the revenue adequacy hearing, CSX’s Sean Pelkey noted, on his own volition, that simplicity was one of the CAPM’s virtues, along with its related commercial acceptance.

The CAPM's commercial dominance is no small matter. While the AAR asserts that the CAPM has its limitations (AAR at 20), CAPM is what the market relies upon, as the Board has previously recognized. Even if it could be established – which the AAR has not -- that the hybrid methodology is conceptually more “robust” or theoretically more sound, the Board ultimately uses its COC and COE to reflect the return needed to attract capital for railroad investment. If the “more robust” hybrid methodology produces an answer of 8.88% (2016), 10.04% (2017), or 12.22% (2018), but the market answer is 7%, the market return should govern, as anything more confers an excess return compared to what is needed to attract or retain railroad capital.

The AAR makes a number of other statements in its comments that provide further support for the CAPM-only approach. In particular, the AAR begins its conclusion by invoking Occam's razor, *i.e.*, “the simplest solution is likely the right one.” *Id.* at 28. The simplest solution for calculating the railroad industry COE is to use the CAPM methodology that relies on accessible and stable inputs that do not vary significantly during the year or even over several years. CAPM is also, as CSX's Mr. Pelkey noted, the dominant methodology used by the financial and investment community as well as the railroads themselves. To proceed otherwise is to invite a repetition of the error and variability that has characterized the last eleven years of Board COE and COC determinations.

The AAR also invokes *Arizona Electric Power Cooperative, Inc. v. BNSF Ry.*, NOR 42113 (STB served Aug. 31, 2015), for the proposition that the Board uses “the most recent data available to prescribe rates at the most accurate level possible.” AAR at

28 n.11. Dr. Villadsen similarly notes that “[t]he cost of capital is a forward-looking concept.” Villadsen VS at 27. Those principles dictate use of the CAPM with a current MRP, what investors utilize to make investment decisions, and not a historical average MRP heavily influenced by events that transpired ninety years ago.

The AAR also asserts that an agency must provide a reasoned explanation for changing an existing practice and that “[a] fundamental change in the Board’s long-standing methodology for determining the [COE] should not be undertaken based on an unusual set of circumstances occurring in a single year.” AAR at 15-16, 17-18, 28, and authorities cited therein. WCTL can agree with those propositions as well. The problems that arose in 2018 are not unique or isolated, but instead exemplify problems that have been inherent in the Board’s hybrid methodology since its adoption. The MSDCF and hybrid values have been systematically overstated relative to the values and underlying methods used by the financial and investment community. The systematic overstatement provides more than enough “reasoned explanation” for fixing the problems in the Board’s existing approach. *Id.* at 15-16. Even the AAR “recognizes” that the Board can “overrule its prior requirement[s] ... to create[] a more accurate and reliable result,” and asks the Board to do exactly that. *Id.* at 27. While it is unfortunate and regretful that the Board has been unwilling to acknowledge and address the COE distortions previously, it has an opportunity to do so now, and should take it.

Respectfully submitted,

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