

RAILROAD COST OF CAPITAL — 2017

EP 558 (Sub-No. 21)

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 DETERMINNING THE
RAILROAD INDUSTRY'S COST OF
EQUITY CAPITAL

EP 664 (Sub-No. 2)

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

Here we go again.

A decade ago, the Surface Transportation Board (“STB” or “Board”) conducted a multi-year review of the cost-of-equity component of its cost-of-capital methodology. The Board considered six rounds of comments, held two public hearings, and consulted with other federal agencies during that process, ultimately adopting the average of the Capital Asset Pricing Model (“CAPM”) and the Morningstar/Ibbotson multi-stage discounted cash flow (“MSDCF”) as the methodology to estimate the cost-of-equity component of the annual railroad industry’s cost of

capital calculation.¹ Four years ago, the Board indulged the Western Coal Traffic League (“WCTL”) and instituted a proceeding as a result of WCTL’s petition for rulemaking to consider the cost-of-capital methodology once again. The Board took two rounds of written comments, held a hearing, and received supplemental comments. The Board considered the arguments and evidence proffered by WCTL and other stakeholders and again affirmed the decision to use the average of CAPM and MSDCF to estimate the cost of equity.² The Board then considered and rejected not one, but two petitions for reconsideration filed by WCTL.³ In all, the Board has rejected attacks on the decision to use CAPM and MSDCF by WCTL no less than 10 times.⁴ Yet once again, WCTL is before the Board offering unsupported arguments in yet another

¹ *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry’s Cost of Capital*, EP 664 (Sub-No. 1) (STB served Jan. 28, 2009).

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*, EP 664 (Sub-No. 2) (STB served Oct. 31, 2016).

³ *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*, EP 664 (Sub-No. 2) (STB served Apr. 28, 2017); *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*, EP 664 (Sub-No. 2) (STB served Aug. 14, 2017).

⁴ See, e.g., *Railroad Cost of Capital – 2010*, EP 558 (Sub-No. 14) (STB served Oct. 3, 2011); *Railroad Cost of Capital – 2011*, EP 558 (Sub-No. 15) (STB served Sept. 13, 2012); *Railroad Cost of Capital – 2012*, EP 558 (Sub-No. 16) (STB served Aug. 30, 2013) (corrected decision); *Railroad Cost of Capital – 2013*, EP 558 (Sub-No. 17) (STB served July 31, 2014); *Railroad Cost of Capital – 2014*, EP 558 (Sub-No. 18) (STB served Aug. 7, 2014); *Railroad Cost of Capital – 2015*, EP 558 (Sub-No. 19) (STB served Aug. 5, 2016); *Railroad Cost of Capital – 2016*, EP 558 (Sub-No. 20) (STB served Aug. 7, 2017); *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*, EP 664 (Sub-No. 2) (STB served Oct. 31, 2016); *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*, EP 664 (Sub-No. 2) (STB served Apr. 28, 2017); *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*, EP 664 (Sub-No. 2) (STB served Aug. 14, 2017).

attempt to get the Board to overhaul its methodology to calculate the cost of equity to satisfy WCTL's results-oriented desire for a lower railroad industry cost of capital.

As it does every year, the Board issued a decision on February 8, 2018, to initiate this proceeding to determine the railroad industry's cost of capital for the year 2017. In its order, the Board specifically sought comment on four issues: "(1) the railroads' 2017 current cost of debt capital; (2) the railroads' 2017 current cost of preferred equity capital (if any); (3) the railroads' 2017 cost of common equity capital; and (4) the 2017 capital structure mix of the railroad industry on a market value basis."⁵

As it does every year, the railroad industry through the Association of American Railroads ("AAR"), submitted its calculation of the 2017 cost of capital on April 20, 2018 using the methodology specified by the Board. In that filing, the AAR calculated the railroads' overall cost of capital for 2017 at 10.52 percent, including a cost of common equity of 12.04 percent and a cost of debt of 3.57 percent.

And as it does every year, WCTL filed reply comments on May 11, 2018 collaterally attacking the Board's methodology to calculate the cost-of-equity component of the cost of capital. Seeking to avoid previous, clear admonitions of the Board that this annual cost-of-capital proceeding is not the proper forum to raise such arguments, WCTL also styles this year's reply as a petition to reopen EP 664 (Sub-No. 2), despite having had two previous petitions for reconsideration of decisions in that docket rejected by the Board. In its filing, WCTL concedes that the AAR has correctly executed the Board's instructions and calculated the railroad industry's cost of capital for 2017 according to the Board's rules. That should be the end of the

⁵ *Railroad Cost of Capital – 2017*, EP No. 558 (Sub-No. 21) (STB served Feb. 8, 2018).

matter. Nonetheless, the AAR, as it does every year, responds to WCTL's arguments to highlight that they lack merit and that the Board should not reopen EP 664 (Sub-No. 2).

Discussion

I. The AAR Followed Established Board Procedures in this Proceeding

WCTL effectively concedes that the Board should adopt the AAR's calculation of the railroad industry's cost of capital in this proceeding by stating, "WCTL accepts that the AAR generally followed the Board's prescribed methodology for estimating the cost of capital ("COC") for the railroad industry for 2017 at 10.52%."⁶ Contrary to WCTL's position, that should be the end of the inquiry. The Board has properly observed that "[i]t is settled administrative law that an agency need not, and as a matter of sound procedure should not, permit parties to relitigate generic rules in individual proceedings that apply those rules."⁷ As such, the Board has repeatedly stated that the annual EP 558 cost-of-capital determination is not an appropriate forum to raise methodological issues or to propose changes to the Board's rules.⁸

The Board has long understood that permitting a party like WCTL to make selective, cherry-picked presentations in the annual cost-of-capital calculation — without considering the totality of the model — should not be allowed. Among other reasons, allowing parties to debate changes in the methodology "can lead to protracted litigation that will delay the release of a cost-

⁶ WCTL Reply Comments at 2.

⁷ *Railroad Cost of Capital – 2008*, EP 558 (Sub-No. 12), slip op. at 2 (STB served Sept. 25, 2009) (citing *Tribune Co. v. FCC*, 133 F.3d 61, 68 (D.C. Cir. 1998)).

⁸ *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, slip op. at 18 (STB served Jan. 17, 2008)).

of-capital figure needed for a wide variety of regulatory functions.”⁹ Moreover, the Board has made clear that it will not defer the annual cost-of-capital calculation while considering challenges to its methodology.¹⁰ The Board has now concluded on four separate occasions that the average of CAPM and the MSDCF will produce the best estimate of the rail industry’s cost of equity for the Board’s regulatory purposes.¹¹ Accordingly, the Board should adopt the AAR’s calculation of the 2017 railroad industry cost of capital.

II. WCTL Has Not Met Its Burden of Showing that the Board Should Reopen the EP 664 (Sub-No. 2) Proceeding

The Board should also reject WCTL’s petition to reopen EP 664 (Sub-No. 2). The Board may grant a petition to reopen only if the petition presents material error, new evidence, or substantially changed circumstances in the decision being challenged. 49 U.S.C. § 1322(c); 49 C.F.R. § 1115.4. The alleged grounds for reopening must be sufficient to show that, if accepted, they would lead the Board to materially alter its prior decision. *Canadian Nat’l Ry.—Control—EJ&E W. Co.*, FD 35087 (Sub-No. 8), slip op. at 4 (STB served Apr. 26, 2017); *Montezuma Grain Co. v. STB*, 339 F.3d 535, 541-42 (7th Cir. 2003).

⁹ *Methodology to be Employed in Determining the Railroad Industry’s Cost of Capital*, EP 664, slip op. at 18 (STB served Jan. 17, 2008).

¹⁰ *Railroad Cost of Capital – 2007*, EP 558 (Sub-No. 11), slip op. at 2 (STB served Apr. 23, 2008).

¹¹ *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry’s Cost of Capital*, EP 664 (Sub-No. 1) (STB served Jan. 28, 2009); *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*, EP 664 (Sub-No. 2) (STB served Oct. 31, 2016); *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*, EP 664 (Sub-No. 2) (STB served Apr. 28, 2017); *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*, EP 664 (Sub-No. 2) (STB served Aug. 14, 2017).

In deciding whether to reopen, the Board must also weigh the magnitude of the alleged bases for reopening against countervailing equitable concerns regarding administrative finality, repose, and detrimental reliance by the industry and the public. *See, e.g., S.R. Investors, Ltd., d/b/a Sierra R.R.—Aban.—In Tuolumne County, Cal.*, AB 239X (ICC served Jan. 20, 1988) (“we must balance concerns of administrative finality, repose and detrimental reliance with whatever factors favor reopening”), *aff’d sub nom. Friends of Sierra R.R. v. ICC*, 881 F.2d 663, 667 (9th Cir. 1989); *Theodore Roosevelt Conservation P’ship. v Salazar*, 616 F.3d 497, 511 (D.C. Cir. 2010) (agency is not required to “behave like Penelope, unraveling each day’s work to start the web again the next day”); *Pyco Industries, Inc.—Feeder Line Application—Lines of S. Plains Switching, Ltd.*, FD 34890 (STB served June 11, 2010) (“The administrative process might never end if parties could come back to the Board years after a final decision to try out a new theory.”). Here, WCTL has a high burden to overcome given the history of litigation over the cost of equity.

WCTL’s unsupported arguments do not meet this burden and are without merit. WCTL complains that growth rates used in the MSDCF are “unrealistic” because growth rates improved from 2016 to 2017.¹² But 2015 and 2016 were down years in the rail sector, with lower growth rates reflecting challenges facing the industry. Far from being unrealistic, growth rates in 2017 have rebounded to similar values used in previous years as shown in the chart below.

¹²WCTL Reply at 3.

Year	MSDCF Stage II Growth Rate ¹³
2008	13.61
2009	12.18
2010	12.83
2011	14.62
2012	14.07
2013	12.47
2014	12.68
2015	5.49
2016	7.47
2017	13.55

Similarly, WCTL complains that “[t]he MSDCF thus projects that railroad earnings will quadruple from the 2017 starting level by January 1, 2028. Quadrupling of railroad overall earnings (not merely earnings per share) in such a short period, on top of the increase that already occurred in 2017, and without any subsequent retrenchment, is highly unlikely.”¹⁴ Such an increase in earnings would not be unprecedented. R-1 data demonstrate that railroad ordinary income (after-tax income before extraordinary items) increased from \$226,583,000 to \$1,129,392,000 from 1970 to 1980. From 2005 to 2015, railroad ordinary income increased from \$4,916,536,000 to \$14,470,416,000 and from 1995 to 2005, railroad ordinary income increased from \$2,438,999,000 to \$4,916,536,000.¹⁵

¹³ Second stage growth rates, along with other MSDCF inputs, are published by the Board in Table 11 of the Appendix in its annual cost-of-capital decision. *See, e.g., Railroad Cost of Capital – 2016*, EP 558 (Sub-No. 20), slip op. at 18 (STB served Aug. 7, 2018).

¹⁴ WCTL Reply at 3.

¹⁵ R-1 data reproduced in *Railroad Facts* (2017 ed.) at 21.

WCTL acknowledges that its complaints about the growth rates used in the second stage of the MSDCF are not new.¹⁶ In fact, the Board has repeatedly rejected them as unfounded.¹⁷ Perhaps recognizing that the Board has already rejected its arguments, WCTL attempts to use the recent tax cut as an opportunity to renew its complaint with the MSDCF's use of growth rates in the second stage. WCTL contends that "[i]n fact, the MSDCF and CAPM both reflect the Tax Cut and Jobs Act, but the MSDCF does so improperly because of the way that it is constructed."¹⁸ Neither of those statements is accurate.

CAPM estimates the cost of equity as $RF + \text{Beta} \times \text{MRP}$, where RF is the risk-free rate, MRP is the market-risk premium, and Beta is the measure of systematic, non-diversifiable risk. The market-risk premium measures the additional return (over and above the risk-free rate) that an equity investor requires as compensation for the greater risks (including the risk of bankruptcy) associated with a diversified portfolio of equity. CAPM largely relies on historical data to project the cost of equity in the future. The model uses five years of historical data to estimate Beta. The market risk premium utilizes all available historical stock market data and the risk-free rate is based on an annual value of interest rates from the year. Thus, the effect of the tax cut on the cost of capital will be seen in CAPM only over time.

¹⁶ WCTL Reply at 3.

¹⁷ *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*, EP 664 (Sub-No. 1), slip op. at 8-10 (STB served Jan. 28, 2009); *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*, EP 664 (Sub-No. 2), slip op. at 13-14 (STB served Oct. 31, 2016); *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*, EP 664 (Sub-No. 2), slip op. at 6 (STB served Apr. 28, 2017).

¹⁸ WCTL Reply at 4.

In contrast, the MSDCF looks forward and uses current and estimated future cash flows to estimate the cost of equity. WCTL accurately notes that “[t]he recent tax cut reduced the value of the deferred tax liabilities, and the reduction is accounted for as income. Income and deferred taxes are both key inputs in the MSDCF. Mr. Gray’s Appendix K shows massive increase in net income for all four railroads in 2017, but much of the increase comes from the reduction in deferred taxes.”¹⁹ But WCTL fails to notice that the accounting increase in net income in 2017 does not impact the model’s calculation of 2017 cash flow at all.²⁰ That is because the model ordinarily adds deferred taxes to income before extraordinary items and depreciation (less capital expenditures) to establish the initial cash flow. In 2017, the value of deferred taxes is a large negative number, reflecting the fact that the lower corporate tax rate has decreased the current value of deferred taxes to be paid in the future. The model thus subtracts out the deferred taxes valuation from cash flow in 2017. That is appropriate – cash flow did not increase as a result of this accounting change.

The model *does* capture the effect of the tax cut in the terminal stage.²¹ In the AAR Opening Comment, Mr. Gray explained that the “model’s terminal cash flow is calculated by multiplying revenue for 2017 times the five-year average ratio of income before extraordinary items to revenue.”²² Thus, the model reflects the accounting change in 2017 as one piece of the calculation of five-year income, increasing the terminal value of the firm. This is appropriate; value has been shifted in 2017 from liability to equity in retained earnings on the balance sheet to

¹⁹ *Id.*

²⁰ See AAR Opening Comments, Gray V.S. at 40, Table No. 13.

²¹ See *id.*, Gray V.S., Appendix K.

²² *Id.*, Gray V.S. at 41.

balance out the reduction in future tax liabilities. That is, the model tracks the accounting treatment of a large decrease in future tax liability – it increases the value of the firm.

Conclusion

WCTL does not contend that the AAR erred in any of its calculations. Instead, WCTL seeks once again to attack and overturn the Board's considered cost-of-equity methodology without introducing any new evidence and failing to demonstrate material error or changed circumstances. As such, the Board should adopt 10.52% as the rail industry's cost of capital for 2017 and reject WTL's petition to reopen EP 664 (Sub-No. 2).

Respectfully submitted,

A handwritten signature in blue ink, appearing to read 'Kathryn D. Kirmayer', written over a horizontal line.

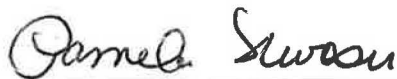
Kathryn D. Kirmayer
Timothy J. Strafford
Association of American Railroads
425 Third Street, S.W., Suite 1000
Washington, DC 20024
(202) 639-2506
Counsel for the Association
of American Railroads

June 1, 2018

CERTIFICATE OF SERVICE

I hereby certify that on this 1st day of June, 2018, I have caused a copy of the foregoing to be served by first class mail, postage prepaid, on the following:

Robert D. Rosenberg
Slover & Loftus
1224 Seventeenth St, NW
Washington, DC 20036-3003

A handwritten signature in cursive script, reading "Pamela Nwosu", written in black ink.

Pamela Nwosu