



ASSOCIATION OF AMERICAN RAILROADS
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June 1, 2017

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

Re: EP 558 (Sub-No. 20), *Railroad Cost of Capital—2016*

Dear Ms. Brown:

Pursuant to the decision served by the Board on February 28, 2017 in the above captioned proceeding, please find the attached rebuttal comments of the Association of American Railroads (AAR).

Respectfully submitted,

Timothy J. Strafford
Counsel for the Association of
American Railroads

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

RAILROAD COST OF
CAPITAL — 2016

EP 558 (Sub-No. 20)

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

By a decision served on February 28, 2017, the Surface Transportation Board (“STB” or “Board”) instituted this proceeding to determine the railroad industry’s cost of capital for the year 2016. In its order, the Board specifically sought comment on four issues: “(1) the railroads’ 2016 current cost of debt capital; (2) the railroads’ 2016 current cost of preferred equity capital (if any); (3) the railroads’ 2016 cost of common equity capital; and (4) the 2016 capital structure mix of the railroad industry on a market value basis.”¹

On April 20, 2017, the railroads, through the Association of American Railroads (“AAR”), submitted their calculation of the 2016 cost of capital using the methodology specified by the Board. The AAR calculated the railroads’ overall cost of capital for 2016 at 8.86 percent, including a cost of common equity of 10.31 percent and a cost of debt of 3.43 percent.

On May 11, 2016, WCTL filed reply comments. As it has done for the last several years, WCTL did not challenge any aspect of the AAR’s calculations, but instead collaterally attacked

¹ *R.R. Cost of Capital – 2016*, EP No. 558 (Sub-No. 20) (STB served Feb. 28, 2017) (“February decision”).

the Board's methodology to calculate the cost-of-equity component of the cost of capital. In so doing, WCTL repeated arguments that it has unsuccessfully made in previous EP 558 and EP 664 proceedings, despite the clear admonitions of the Board that this annual Cost of Capital proceeding is not the proper forum to raise such arguments.² This year, WCTL repeats its claim that the Board's methodology produces a cost-of-capital estimate that exceeds estimates used by investors. WCTL also continues to selectively manipulate aspects of the Board's Capital Asset Pricing Model ("CAPM") to produce a lower cost-of-equity estimate, while ignoring adjustments that would increase the calculation.

Despite repeated and consistent rulings by the Board, WCTL has once again presented results-driven, repetitive, and misleading arguments seeking to drive the railroad industry cost of capital to a value lower than the Board's considered methodology would produce. For the reasons explained below, the Board should not make any of the adjustments to the cost-of-capital calculations presented by the AAR in its opening comments. As WCTL concedes, the AAR has correctly executed the Board's instructions and calculated the railroad industry's cost of capital for 2016 according to the Board's rules. Nonetheless, the AAR responds to WCTL's reply comments to highlight that the selective attacks on the Board's methodology lack merit.

² On the same day, WCTL also filed a second petition for reconsideration of the Board's decision to reject WCTL's petition for rulemaking asking the Board to no longer use a multi-stage discounted cash flow model in calculating the cost of equity component of the cost of capital. The AAR separately replied to that petition on May 31, 2017.

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, "[t]he AAR appears to have followed the Board's established methodology for estimating the cost of capital ("COC") for the railroad industry for 2016 at 8.86%."³ 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."⁴ 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.⁵

The Board's rationale for insisting that all methodological challenges be raised and vetted in a broader rulemaking context is entirely sound. 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-of-capital figure needed for a wide variety of regulatory functions."⁶ In this proceeding, WCTL has again offered exactly the sort of

³ WCTL Reply Comments at 1.

⁴ *R.R. 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)).

⁵ *See, e.g., R.R. 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)).

⁶ *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital*, EP 664, slip op.

selective, results-oriented proposals that have no place in the annual determination, seeking to bias the calculation down, without addressing any issues in the methodology that would cause the calculation to increase. Moreover, the Board has concluded on three separate occasions that the average of CAPM and the Morningstar/Ibbotson Multi-Stage Discounted Cash Flow model will produce the best estimate of the rail industry's cost of equity for its regulatory purposes.⁷

WCTL does not contend that the AAR erred in any of its calculations. Instead, WCTL suggests that the AAR "omitted data on individual bond prices from its cost of debt ("COD") calculations on the grounds that the data is proprietary to Bloomberg."⁸ But the AAR followed established procedure in the annual EP 558 Cost of Capital proceedings by using bond price data from Bloomberg Professional, a subscription service used since the 2011 cost of capital proceeding.⁹ WCTL and the Board have access to all of the data necessary to confirm AAR's calculations.¹⁰ WCTL should be aware of this, as the Board explicitly noted that the AAR's use of Bloomberg subscription bond data was appropriate and supported in 2012 and the AAR has consistently followed the same procedures since then.¹¹

at 18 (STB served Jan. 17, 2008).

⁷ *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).

⁸ WCTL Reply at 1.

⁹ *See R.R. Cost of Capital – 2015*, EP No. 558 (Sub-No. 19), slip op. at 4 (STB served Aug. 5, 2016).

¹⁰ *See* AAR Opening Comments, Gray V.S., Appendix A.

¹¹ *See R.R. Cost of Capital – 2011*, EP 558 (Sub-No. 15), slip op. at 4 (STB served Sept. 13, 2012) ("AAR's bond calculations were available for verification in Appendix A of the filing. Further, summary tables of data provided by both Bloomberg and S&P were made available for review in AAR's

II. WCTL's Selective Use of Excerpts from a Single Analyst Report Cannot be Relied on to Support an Alternative Cost-of-Capital Calculation

Despite being told by the Board three times over the last eight years that the railroad industry cost of capital should be calculated as the simple average of the Board's CAPM model and the Morningstar/Ibbotson MSDCF and being admonished that the annual EP 558 proceeding is not the proper forum for alternative methodologies, WCTL asks the Board to adopt a cost of capital of 7.47 percent based on a two-page excerpt from a Morgan Stanley investment analyst report.¹² The Board should reject this request out of hand as inconsistent with its instructions in this proceeding. But if the Board chooses to consider the alternative cost-of-capital value submitted by WCTL at all, it should reject it as unsupported and without merit.

The excerpt submitted by WCTL cannot be relied on by the Board as indicative of what the financial and investment community estimates the railroad industry's cost of capital to be. For the second consecutive year, neither the submitted excerpts, nor WCTL's argument, provide any clear insight into the assumptions underlying the Morgan Stanley report or the purposes to which their weighted average cost-of-capital ("WACC") estimates are intended. In stark contrast to the AAR's opening submission, which included ample and transparent support for all of the data applied to the Board's established methodology, there is no way for the Board to know how Morgan Stanley arrived at its estimates of the submitted companies' WACC. The report excerpt merely states its uses as a 10-year DCF, presumably to calculate a target stock price and that it

workpapers.").

¹² WCTL Reply at 2, 7.

assumes the carriers' WACC.¹³ The task at hand in this proceeding is to calculate the cost of capital pursuant to established procedures, not to assume it.

Moreover, an investment analyst's conclusions about the cost of capital will be of limited probative value to the Board. The Board and the financial community have very different reasons for utilizing a cost-of-capital estimate. The Board has noted it uses its annual cost-of-capital estimate in the determination of railroad revenue adequacy. 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."¹⁴ By contrast, investment analysts like those that prepared the Morgan Stanley report are seeking to derive an optimal stock price, and use a variety of data to guide investors in deciding whether or not the company's stock price is likely to rise or fall. This guess at the future direction of a company's stock price is narrower and qualitatively different than the Board's objective of estimating the railroad industry's cost of capital for the preceding year to be used for a variety of regulatory purposes.

WCTL also errs in calculating a composite WACC based on the analyst report. WCTL's Table 1 incorrectly uses AAR's market value for common equity and calls it "AAR Market Capitalization." By doing so, WCTL ignores the impact of debt in their weighting. WCTL also errs by using the cost of preferred equity (3.64 percent) as the cost of debt (3.43 percent) throughout their analysis. Finally, WCTL attempts to account for the impact of the analyst

¹³ WCTL Reply Exhibit A (emphasis added).

¹⁴ February Decision at 1.

report using an after-tax cost of debt by make an adjustment using a federal corporate tax rate, but does not include the impact of state taxes. Thus, WCTL's submission of 7.47% as the railroad industry's cost of capital is wholly unreliable.

III. WCTL's Selective Manipulations of Aspects of CAPM Should be Rejected

WCTL also provides misleading argument suggesting a lower CAPM cost-of-equity calculation than the Board's procedures would establish. For the second consecutive year, WCTL uses the wrong risk-free rate with the market risk premium that it recommends. In 2015, WCTL used the Duff & Phelps market risk premium (referred to as equity risk premium or "ERP") of 5.00 with the AAR-calculated beta and a risk-free rate of 2.55 percent. But as the AAR pointed out on rebuttal last year, Duff & Phelps explicitly stated that their "recommended ERP was developed in relation to (and should be used in conjunction with) a 4.0%" risk-free rate.¹⁵ That sleight-of-hand, along with rounding a 3.55 percent cost of debt to 3.5 percent, enabled WCTL to present a 7.70 percent weighted average cost of capital for 2015 – when their calculation should have resulted in 8.89 percent.¹⁶

Now WCTL is back, using the Duff & Phelps recommended equity risk premium (conditional) of 5.5 percent, but continuing to fail to use the corresponding normalized risk-free rate that "should be used in conjunction" with the risk premium.¹⁷ This year, WCTL used 2.2 percent for the risk-free rate, when it should have used 3.5 percent with their selected market risk premium.¹⁸ As a result, WCTL calculated a CAPM cost of equity of 8.53 percent. Correcting

¹⁵ Duff and Phelps describes their various equity risk premiums in Appendix 3 of their 2016 *Valuation Handbook Guide to Cost of Capital*.

¹⁶ See Appendix BB in AAR Rebuttal filed June 1, 2016.

¹⁷ See Appendix 3 in the Duff & Phelps 2017 *Valuation Handbook U.S. Guide to Cost of Capital*.

¹⁸ Although the WCTL filing says 2.22% under the Risk Free Rate heading in Table 2, Table 2 in their

these errors, WCTL's cost-of-equity calculation becomes 9.81 percent and the cost-of-capital calculation rises to 8.51 percent. If their debt cost mistake noted above is also corrected (cost of debt corrected from 3.64 to 3.43 percent), their cost-of-capital calculation becomes 8.46 percent – not far off from the AAR's correctly calculated 8.86 percent.

Conclusion

The Board should reject WCTL's arguments and determine that the railroads' cost of capital for 2016 is 8.86 percent.

Respectfully submitted,



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June 1, 2017

work papers shows 6.31 percent under the Risk-Free Rate heading. The 6.31 percent is actually the beta of 1.1467 multiplied by their market risk premium of 5.5 percent. Nonetheless, WCTL calculates a cost of equity of 8.53 percent, which is the 6.31 percent plus a risk free rate of 2.22 percent.

CERTIFICATE OF SERVICE

I hereby certify that on this 1st day of June, 2017, 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
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Kathleen Birch