

SURFACE TRANSPORTATION BOARD

DECISION

Docket No. 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 EQUITY CAPITAL

Digest:¹ This decision denies a petition of the Western Coal Traffic League (WCTL) to reopen prior Board decisions served on October 31, 2016, April 28, 2017, and August 14, 2017, regarding the use of the multi-stage discounted cash flow model in the agency's estimation of the railroad industry's cost of capital.

Decided: September 28, 2018

On February 8, 2018, the Board instituted a proceeding to update the railroad industry's cost of capital for 2017. R.R. Cost of Capital—2017, EP 558 (Sub-No. 21) (STB served Feb. 8, 2018). The Board received comments from the Association of American Railroads (AAR) providing the information used to make the annual cost-of-capital determination. In a filing dated May 11, 2018, the Western Coal Traffic League (WCTL) replied to AAR's submission in Docket No. EP 558 (Sub-No. 21), Railroad Cost of Capital—2017, and petitioned the Board to reopen decisions that the Board served in this docket on October 31, 2016; April 28, 2017; and August 14, 2017. WCTL argues that there is new evidence and changed circumstances that the multi-stage discounted cash flow model (MSDCF), used to determine the cost of equity capital (COE) component of the cost of capital, is generally unsuitable for estimating the railroad industry COE and that the impacts of the Tax Cuts and Jobs Act of 2017 (Tax Cuts and Jobs Act) have made evident and exacerbated the flaws of the MSDCF in 2017.² (WCTL Pet. 2-5, May 11, 2018.) WCTL requests that the Board reopen the previous decisions to adjust the COE methodology by eliminating the use of the MSDCF and to delay issuing the 2017 cost-of-capital determination until the Board has done so. (Id. 1-2, 7.)

¹ The digest constitutes no part of the decision of the Board but has been prepared for the convenience of the reader. It may not be cited to or relied upon as precedent. See Policy Statement on Plain Language Digests in Decisions, EP 696 (STB served Sept. 2, 2010).

² The Tax Cuts and Jobs Act, enacted December 22, 2017, reduced the federal corporate income tax rate from a maximum of 35%, see 26 U.S.C. § 11(b) (2012), to a flat 21%, effective January 1, 2018. See Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97, § 13001(a), 131 Stat. 2054, 2096.

On June 1, 2018, AAR filed reply comments in opposition to WCTL's petition. On June 14, 2018, WCTL submitted a petition for leave to submit a surreply as well as a surreply to AAR's June 1 reply comments.³

For the reasons discussed below, WCTL's petition to reopen will be denied. However, the effects of the Tax Cuts and Jobs Act on the MSDCF will be considered in Railroad Revenue Adequacy—2017 Determination, Docket Nos. EP 552 (Sub-No. 22) et al., in which the Board is seeking comments on whether a one-time adjustment to the MSDCF estimates and other metrics for 2017 to account for these effects would be appropriate and, if so, the appropriate adjustment methods. See R.R. Revenue Adequacy—2017 Determination, EP 552 (Sub-No. 22) et al., slip op. at 3-5 (STB served July 27, 2018). The Board notes that on September 5, 2018, WCTL filed comments in that matter.

BACKGROUND

Each year, the Board determines the railroad industry's current cost of capital and then uses this figure in a variety of regulatory proceedings, including railroad revenue adequacy determinations, rate reasonableness cases, feeder-line applications, rail line abandonments, trackage rights cases, and rail merger reviews. The annual cost-of-capital figure is also used as an input in the Uniform Railroad Costing System.

The Board calculates the cost of capital as the weighted average of the cost of debt and the COE. See Methodology to be Employed in Determining the R.R. Indus. Cost of Capital, EP 664, slip op. at 3 (STB served Jan. 17, 2008). While the cost of debt is observable and readily available, the COE (the expected return that equity investors require) can only be estimated. *Id.* Thus, estimating the COE requires relying on appropriate finance models. *Id.* In 2009, the Board moved from a COE estimate based solely on the Capital Asset Pricing Model (CAPM) to a COE estimate based on a simple average of the estimates produced by the CAPM and the MSDCF models. At that time, WCTL opposed the inclusion of the MSDCF in the Board's COE methodology. As detailed below, since the Board's 2009 decision to include the MSDCF in the COE calculations over WCTL's objections, the Board has repeatedly denied subsequent requests by WCTL to abandon the use of the MSDCF and rely solely on the CAPM.

On August 27, 2013, WCTL filed a petition requesting that the Board institute a rulemaking to abolish the use of the MSDCF in determining the railroad industry's COE and instead rely exclusively on the CAPM. WCTL's petition also argued that there were problems with the CAPM that required modification. The Board opened a rulemaking proceeding in which it received comments and held a hearing. In a decision served on October 31, 2016, the Board declined to issue a Notice of Proposed Rulemaking and closed the proceeding. See Pet. of

³ AAR submitted a letter on July 5, 2018, requesting that the Board reject WCTL's surreply. While the Board's regulations do not generally permit "replies to replies," 49 C.F.R. § 1104.13(c), in the interest of having a more complete record, the Board will accept WCTL's surreply.

W. Coal Traffic League to Institute Rulemaking Proceeding to Abolish Use of Multi-Stage Discounted Cash Flow Model in Determining R.R. Industry's Cost of Equity Capital (October 2016 Decision), EP 664 (Sub-No. 2), slip op. at 2 (STB served Oct. 31, 2016). The Board found unconvincing WCTL's arguments for abolishing use of the MSDCF and for changing the CAPM methodology. Accordingly, the Board concluded that the COE component of its annual cost-of-capital estimate for the railroad industry should be calculated, as it has been since 2009, by using a simple average of the estimates produced by the existing CAPM and MSDCF models. Id.

On November 21, 2016, WCTL filed a petition for reconsideration of the October 2016 Decision. The Board denied WCTL's petition for reconsideration in a decision served on April 28, 2017. Pet. of W. Coal Traffic League to Institute Rulemaking Proceeding to Abolish Use of Multi-Stage Discounted Cash Flow Model in Determining R.R. Industry's Cost of Equity Capital (April 2017 Decision), EP 664 (Sub-No. 2), slip op. at 1 (STB served Apr. 28, 2017).

WCTL filed a second petition for reconsideration on May 11, 2017. In a decision served on August 14, 2017, the Board denied WCTL's second petition for reconsideration. Pet. of W. Coal Traffic League to Institute Rulemaking Proceeding to Abolish Use of Multi-Stage Discounted Cash Flow Model in Determining R.R. Industry's Cost of Equity Capital, EP 664 (Sub-No. 2), slip op. at 1 (STB served Aug. 14, 2017).

DISCUSSION AND CONCLUSIONS

A party may seek to reopen a Board decision by submitting a petition that (1) presents new evidence or substantially changed circumstances that would materially affect the case, or (2) demonstrates material error in the prior decision. 49 U.S.C. § 1322(c); 49 C.F.R. § 1115.4 (petition to reopen must meet the requirements of 49 CFR § 1115.3 (c) and (d) and must state in detail how the proceeding involves material error, new evidence or substantially changed circumstances). "To warrant reopening, the new evidence must be newly available, and the new evidence or substantially changed circumstances must materially affect the prior decision." Riffin—Petition for Declaratory Order, FD 34997 et al., slip op. at 6 (STB served, Oct. 29, 2012). A petition to reopen must also show that the alleged new circumstance "would mandate a different result." Montezuma Grain Co. v. STB, 339 F.3d 535, 541-42 (7th Cir. 2003).

Here, WCTL argues that the gap between the COE estimated by the MSDCF and the CAPM widened in 2017 and thus represents new evidence that the estimates produced by the MSDCF are distorted. WCTL claims that this distortion is the result of flaws with the growth rates used by the Board in the MSDCF. WCTL also argues that the impacts of the Tax Cuts and Jobs Act constitutes both changed circumstances and new evidence demonstrating the unsuitability of the MSDCF for estimating the railroad industry COE. (WCTL Pet. 6-7, May 11, 2018.)

As explained further below, the 2017 MSDCF-CAPM gap is not new evidence in any material sense, and the issues raised with respect to the Tax Cuts and Jobs Act will be considered in Docket Nos. EP 552 (Sub-No. 22) et al.

Gap Between the CAPM and the MSDCF Model. With respect to the MSDCF-CAPM gap in 2017, which was 2.59%, WCTL argues:

The perpetuation of the MSDCF-CAPM disparity in 2017 . . . is proof that the MSDCF is distorted by high growth rates, as WCTL has long contended. The comparative 2017 equity costs constitute new evidence, not previously available, that the gap between the MSDCF and the CAPM has not disappeared, as the Board erroneously concluded two years ago, and that the flaws in the Board's MSDCF methodology persist.

(WCTL Pet. 6, May 11, 2018.) This argument misrepresents the Board's rationale in the October 2016 Decision. In that decision, the Board did not conclude that the MSDCF-CAPM gap had disappeared or would necessarily disappear in the near future. The Board did note that the gap had narrowed in recent years. October 2016 Decision, EP 664 (Sub-No. 2), slip op. at 12 (noting that the MSDCF-CAPM gap for 2015 was 0.02%).⁴ The Board also stated that it would not be surprising if the CAPM produced higher COE estimates than the MSDCF in the near future given that, in the past, the CAPM estimates had exceeded the MSDCF estimates for a period of years. *Id.* However, the Board pointed this out in response to WCTL's argument that the MSDCF estimate was consistently exceeding the CAPM estimate and that MSDCF must therefore be flawed. The October 2016 Decision in no way suggested that the validity of the MSDCF going forward was somehow dependent upon the continued closing or elimination of the MSDCF-CAPM gap, as WCTL's argument suggests. In fact, the Board explicitly stated that a MSDCF-CAPM gap does not undermine the validity of the MSDCF but that divergent movements of the two models is evidence that the Board's MSDCF/CAPM hybrid approach is serving its intended purpose. October 2016 Decision, EP 664 (Sub-No. 2), slip op. at 12; see also April 2017 Decision, EP 664 (Sub-No. 2), slip op. at 7 (finding that the MSDCF-CAPM gap should be expected to fluctuate and that the MSDCF consistently producing higher COE estimates than the CAPM did not undermine the validity of the MSDCF).⁵ The Board reasoned that because COE can only be estimated, using different models with different assumptions and inputs—which naturally leads to differing estimates—is necessary to provide stable and robust results. October 2016 Decision, EP 664 (Sub-No. 2), slip op. at 12.

In short, the widening of the MSDCF-CAPM gap in 2017 is in no way inconsistent with the Board's previous decisions. Accordingly, the fact that a gap continues to exist is not a fact that would alter the Board's previous decisions and therefore does not provide a basis to reopen those decisions.

⁴ The gap for 2016 was 0.26%.

⁵ In acknowledging that the CAPM estimate has been consistently lower than the MSDCF estimate since the adoption of the hybrid approach, the Board noted that the risk-free rate component of CAPM has been extremely low in the past several years. "This fact demonstrates why the Board relies on two models—if one model is skewed by an unforeseen factor, the other model can serve as a check." October 2016 Decision, EP 664 (Sub-No. 2), slip op. at 12.

To the extent that WCTL’s argument can be construed as asserting that the size of the 2017 gap—rather than the mere continued existence of a gap—constitutes new evidence that would materially affect the Board’s previous decisions, this argument too is unavailing. In the October 2016 Decision, in discussing the average MSDCF-CAPM gap for the 2008–15 time period, the Board stated that it “does not believe that the 2.75% deviation between the two estimates undermines the reliability of the MSDCF methodology.” *Id.* at 11. The gap in 2017 was even smaller, at 2.59%. Accordingly, the size of the 2017 gap does not constitute new evidence that warrants reopening the Board’s previous decisions.⁶

MSDCF Growth Rates Assumptions. WCTL argues that the gap between the MSDCF estimates and the CAPM estimates is primarily caused by unrealistic growth rates assumed by the MSDCF. (WCTL Pet. 3, May 11, 2018.) According to WCTL, the MSDCF features unrealistic growth rates because the MSDCF lacks a transition mechanism, causing high growth rates to effectively apply for eleven years. (*Id.*) WCTL states that, as a result, the 2017 MSDCF estimate projects that railroad earnings will quadruple from the 2017 starting level by January 1, 2028, which WCTL claims is “highly unlikely.” (*Id.*) The Board has already addressed these arguments in previous proceedings.

In the proceeding initially adopting the MSDCF, WCTL argued, as it does today, that it was unrealistic for the MSDCF to assume that the high level of growth forecasted by analysts for the first five years would continue throughout the second stage of the MSDCF rather than assuming a gradual transition to the third stage and noted that such an assumption resulted in an MSDCF estimate in which earnings would “double in the first five years and, therefore, quadruple in the ten-year period covered by the first two stages of the model.” (See WCTL Opening Comments 6-9, Sept. 15, 2008, Use of a Multi-Stage Discounted Cash Flow Model, EP 664 (Sub No. 1).) The Board rejected this argument in 2009, explaining that using the average of forecasted growth rates for the individual railroads from stage 1 as the growth rate for stage 2 is reasonable because “the returns of individual firms should revert to the industry average over time” and that adjusting the model to use a gradual transition would not provide a significantly different result. Use of a Multi-Stage Discounted Cash Flow Model in Determining the R.R. Indus. Cost of Capital, EP 664 (Sub-No. 1), slip op. at 8-9 (STB served Jan. 28, 2009). In 2016, the Board rejected similar arguments, explaining that using the average of stage 1 growth rate projections as the stage 2 growth rate was reasonable because it is not realistic to predict growth for individual companies beyond 5 years and because “attempting to create smoother transitions

⁶ The Board recognizes that the accounting adjustments caused by the Tax Cuts and Jobs Act may have led to the increased MSDCF COE estimate for 2017, and in turn the widening in the MSDCF-CAPM gap. See R.R. Revenue Adequacy—2017 Determination, EP 552 (Sub-No. 22) et al., slip op. at 2-3. However, the issue of whether the tax cuts have skewed the MSDCF estimate for 2017 is a separate issue from whether the continued existence of a gap or the size of the 2017 gap, in and of themselves, constitute evidence of flaws in the MSDCF. The impacts of the tax cut will be considered by the Board in Docket Nos. EP 552 (Sub-No. 22) et al., as explained further below.

between the stages would only add more complexity to the MSDCF model, but not necessarily more precision.” October 2016 Decision, EP 664 (Sub-No. 2), slip op. at 13.

WCTL does not identify any material error in the Board’s previous decisions nor does it claim that there is new evidence or changed circumstances that would alter these previous decisions with respect to the MSDCF’s growth rate assumptions. WCTL merely points to the growth rates assumed in the 2017 MSDCF estimate and claims they are “highly unlikely” without any supporting analysis.⁷ (WCTL Pet. 3.) Accordingly, the Board need not further address this argument.⁸

Effects of the Tax Cuts and Jobs Act on the MSDCF Estimate. WCTL makes several arguments relating to its assertion that the MSDCF fails to accurately incorporate the effects of the tax cut, which WCTL itself describes as a “one-time event,” into the COE estimates it produces. (WCTL Pet. 4-5, May 11, 2018.) Specifically, WCTL argues that (1) the MSDCF counts the effects of the one-time tax cut multiple times because it bases growth rates in the second stage on growth rate estimates in the first stage; (2) the MSDCF artificially increases terminal stage cashflow by removing depreciation, deferred taxes, and capital expenditures, a problem that is exacerbated by the tax cut, which created significant negative deferred taxes; and (3) the MSDCF’s use of earnings per share growth as a proxy for cash flow growth skews the MSDCF COE estimates, particularly in 2017 where the tax cut increased 2017 earnings but not cash flow.⁹ (*Id.*; WCTL Surreply 3.) The Board has previously addressed the assumptions of the MSDCF that WCTL highlights in these arguments and found that they were reasonable. See Use of a Multi-Stage Discounted Cash Flow Model, EP 664 (Sub-No. 1), slip op. at 8-10 (rejecting

⁷ While AAR argues that such a growth rate would not be unprecedented, (see AAR Reply 6-7 (referring to prior MSDCF growth rates and prior earnings increases over other 10-year periods)), WCTL disagrees. (WCTL Surreply 2 (responding, for example, that in only one of the 10-year periods did railroad earnings increase by the same amount as projected here and that was a period characterized by high inflation).) The Board need not resolve this dispute regarding the comparison of current growth projections with actual past railroad industry growth given that WCTL has not supported its claim that the alleged quadrupling of earnings is unrealistic. Nowhere, for example, does WCTL demonstrate that the current earnings forecasts are not taking into account today’s economic environment and future anticipated events, such as changes in inflation.

⁸ As with the size of the MSDCF-CAPM gap, the issue of whether the level of the growth rates is, by itself, evidence of a flaw in the MSDCF is distinct from the issue of whether the accounting adjustments caused by the Tax Cuts and Jobs Act may have inflated the growth rates assumed by the MSDCF. The separate issue of whether the growth rate assumptions of the MSDCF reasonably incorporate the effects of the Tax Cuts and Jobs Act will be considered in Docket Nos. EP 552 (Sub-No. 22) et al., as explained further below.

⁹ WCTL’s petition and surreply also contain various arguments in response to AAR’s assertions that the 2017 CAPM COE estimate does not accurately reflect the effects of the tax cut. These arguments do not need to be addressed here given that no party is seeking the elimination or modification of the CAPM.

WCTL's argument that use of the average of the first stage growth estimates as the growth rate for the second stage is unreasonable); id. at 12-13 (rejecting WCTL's argument that the terminal stage cash flow calculation should not set net investment and deferred taxes to zero); id. at 11-12 (rejecting WCTL's arguments that the MSDCF's use of earnings per share growth as a proxy for cash flow growth is flawed because it does not take into account the exercise of stock options, share buybacks, or changes in working capital).

The Board recognizes, however, that the significant accounting impacts resulting from the Tax Cuts and Jobs Act could potentially impact the MSDCF estimates for 2017. R.R. Revenue Adequacy—2017 Determination, EP 552 (Sub-No. 22) et al., slip op. at 3-4. The Board does not believe, however, that the potential effects of a significant one-time event, such as the Tax Cuts and Jobs Act, should cause the Board to abandon an industry-accepted model upon which it has relied for years to provide stability to its estimates. Rather, to the extent that the MSDCF may not accurately reflect the effects of the initial implementation of the Tax Cuts and Jobs Act, it is more appropriate to consider a one-time adjustment to the MSDCF as part of the annual cost-of-capital proceeding. Accordingly, the Board has sought comments on whether a one-time adjustment to its 2017 annual cost of capital determination would be appropriate to more accurately reflect the rail carriers' financial state for 2017, and if so, how such an adjustment should be made.¹⁰ Id.

For the reasons stated above, WCTL has failed to show new evidence or changed circumstances that would materially affect the Board's previous decisions in this proceeding.¹¹ WCTL's petition to reopen will therefore be denied.

It is ordered:

1. The petition to reopen is denied.
2. This decision is effective on its service date.

By the Board, Board Members Begeman and Miller.

¹⁰ In that proceeding, the Board has proposed to increase the carriers' deferred taxes figures by the amount of deferred tax liability removed from the carriers' financials because of the tax cut, while also removing the same amount from the carriers' net income figures. However, the Board has also invited interested parties to comment on potential alternative methods and parties are therefore free to suggest other approaches.

¹¹ WCTL does not make any claim of material error other than an unsubstantiated claim in the concluding sentence of its petition. In a petition alleging material error, a party must do more than simply make a general allegation; it must substantiate its claim of material error. See Can. Pac. Ry.—Control—Dakota, Minn. & E. R.R., FD 35081, slip op. at 4 (STB served May 7, 2009). Accordingly, WCTL's passing reference to material error need not be addressed further.