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ASSOCIATION OF
AMERICAN RAILROADS

Law Department

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May 19, 2006

Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Room 700
Washington, D.C. 20423

Re: Ex Parte No. 558 (Sub-No. 9), Railroad Cost of Capital – 2005

Dear Secretary Williams:

Please find enclosed an original and ten (10) copies of the Rebuttal Comments of the Association of American Railroads and Its Member Railroads in the proceeding referenced above. A copy of the same on a disk in MS Word format is also provided for the Board's convenience.

Please date-stamp the extra copy of the Rebuttal Comments and this letter, provided for that purpose, and return the same to the undersigned, via the individual hand delivering them.

Respectfully submitted,

Louis P. Warchot

Enclosures

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



RAILROAD COST OF
CAPITAL — 2005

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) EX PARTE NO. 558 (Sub- No. 9)
)

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

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May 19, 2006

In an order served on December 20, 2005, the Surface Transportation Board ("Board" or "STB") instituted this proceeding "...to determine the railroad industry's cost of capital for 2005." The Board's order required all Class I railroads to submit the necessary evidence to enable the Board to update the cost of capital findings of the previous year.¹

On March 31, 2006, the Association of American Railroads ("AAR") and its member railroads filed evidence of the railroads' cost of capital for 2005. The AAR computed all aspects of the cost of capital in accordance with the long-standing requirements of the Board.²

On April 28, 2006, the Western Coal Traffic League ("WCTL") filed *Reply Comments of the Western Coal Traffic League ("WCTL Comments")*. WCTL does not dispute either the mathematical accuracy of the AAR's calculations or the AAR's conformity with the computational requirements of the Board's orders. Rather, WCTL complains that "...the cost of capital for the railroad industry proposed by the AAR's filing for 2005 is entirely too high and is devoid of rational support."³ Through its proposal, WCTL seeks to fundamentally restructure the process by which the STB derives the cost of capital component of the revenue adequacy determination by substituting a cost of equity figure estimated using a Capital Asset Pricing Model (CAPM) methodology for the figure produced by the traditionally-used Discounted Cash Flow (DCF) analysis, required by the Board.

¹ *Railroad Cost of Capital – 2004*, Ex Parte No. 558 (Sub-No. 8) (STB served June 30, 2005).

² See Ex Parte No. 393 (Sub-No. 1), *Standards for Railroad Revenue Adequacy*, 3 I.C.C. 2d 261 (1986), *aff'd sub. nom.*, *Consolidated Rail Corporation v. United States*, 855 F.2d 78 (3rd Cir. 1988).

AAR believes that such a fundamental change in the well-established methodology cannot adequately be analyzed in the context of the annual determination being made in this proceeding. This is particularly so because the selection by the ICC, the Board's predecessor, of the DCF methodology — which has been relied upon in all cost of capital proceedings to date — was made after an extensive review of proposed calculation approaches, including CAPM, over a period of several years.⁴ As the AAR noted:

The Discounted Cash Flow (DCF) methodology has been used in all previous Cost of Capital proceedings to determine the cost of equity. The validity of the DCF approach is recognized by nearly every rate of return analyst in the United States, and among federal and state regulatory agencies, the DCF model is the most widely used method for determining the cost of equity.⁵

In contrast, the ICC found the CAPM deficient for its purposes. As the ICC stated when it selected evidence based upon the DCF method in the 1981 Cost of Capital proceeding:

...CAPM requires the use of many assumptions. These include the selection of a risk-free return series, the time period used in calculating the risk period, the selection of the market portfolio to derive the risk premium, the firms included in the industry, and the assessment of the variability of railroad equity value relative to a broad group of securities. Each of these can have a significant effect on the result obtained and each necessitates judgments on how best to define and measure it.⁶

And in rejecting the CAPM method in the 1982 Cost of Capital proceeding, the Commission noted that, "The theory underlying any CAPM is intuitively quite simple,

³ WCTL Comments at 2.

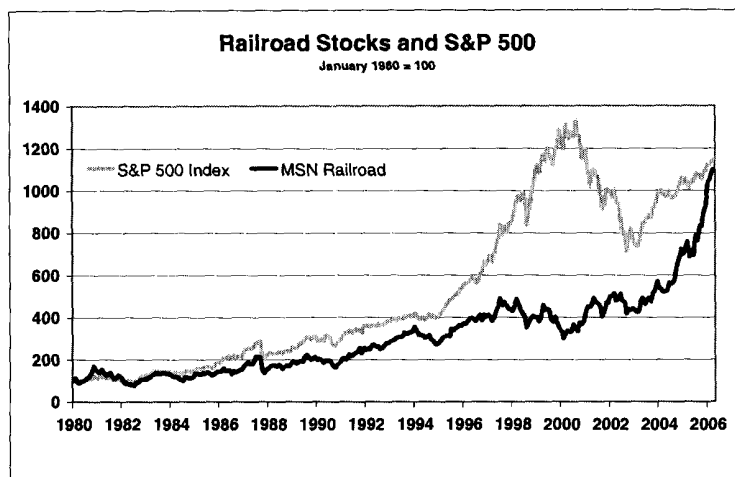
⁴ This fact is recognized by WCTL in WCTL Reply Comments at 7.

⁵ Comments of the Association of American Railroads and Its Member Railroads, Ex Parte No. 558 (Sub- No. 9), *Railroad Cost of Capital – 2005*, pp. 2–3.

⁶ Ex Parte No. 415, *Railroad Cost of Capital – 1981*, 365 I.C.C. 734, at 741.

although the actual development of a particular model can be complex and judgmental in nature.”⁷

WCTL argues that the DCF methodology is no longer valid because of the recent performance of rail stocks. While rail stocks have outpaced the market recently, we note that they have lagged the market for most of the past 25 years and are only now close to equaling the gains achieved by the broader market since 1980 (see graph). In applying the DCF methodology in all cost of capital proceedings since 1982, the ICC has used a truncated average of published long-term earnings growth forecasts by a large number of security analysts to obtain an estimate of the investors’ consensus of earnings growth expectations. These growth expectations have been higher in some years — as they are now — and lower



in other years as the industry’s prospects have changed, but this fact does not justify a rejection of the DCF methodology — and certainly not the adoption of CAPM.

WCTL also points to the fact that the capital structure shifted in 2005 as a result of the significant rise in the market value of railroad equities, increasing the weight accorded to the cost of equity. In fact, the capital structure fluctuates from year to year based upon the amount of debt and equity outstanding (both preferred and common) — and the value

⁷ Ex Parte No. 436, *Railroad Cost of Capital – 1982*, 367 I.C.C. 662, at 669.

placed on each by the market. We note that rising interest rates over the past two years, which tend to reduce the market value of outstanding debt, have also contributed to the shift in the capital structure in favor of equity. Yet despite this combination of forces acting on both debt and equity valuations, the actual 2005 capital structure — 69.6 percent equity — is lower than the equity weight from 1991–1997, when it ranged from 69.8 percent to 76.1 percent.

Finally, WCTL asserts that CAPM has attracted a broader following, pointing to the 1990 Nobel Prize in Economics awarded to Dr. William F. Sharpe for his work in developing the CAPM method. However, as pointed out by the Royal Swedish Academy of Sciences in awarding his portion of the economics prize, Dr. Sharpe's achievement flowed from a 1964 essay on the topic,⁸ and it is fair to expect that the ICC was aware of the contributions of Dr. Sharpe by the early 1980s when it elected to rely upon the DCF approach.

In sum, WCTL's petition to reject and replace the AAR-computed 2005 railroad industry cost of capital should be rejected. The annual process by which the cost of capital is derived has been a routine procedure wherein significant amounts of data are collected, processed through a long-standing, mandated formula, and presented to the STB for verification and approval. The annual determination process was not designed to accommodate a revisiting of the most basic elements of the computational framework.

The WCTL's request would reopen one of the most fundamental, complex, and thoroughly reviewed aspects of the revenue adequacy determination methodology. If this

⁸ Press Release from the Sveriges Riksbank (Bank of Sweden), *Prize in Economics Sciences in Memory of Alfred Nobel for 1990 (16 October 1990)*.

component and the associated tenets were again to be properly and adequately deliberated, the resources and time required would no doubt again be substantial and beyond the confines of the instant annual proceeding. This is particularly so regarding a methodology that this agency has already found wanting. Although these rebuttal comments do not attempt to present a thorough response to the assertions of the WCTL filing, it is certainly not evident from the filing that, in comparison to the DCF methodology, CAPM would be any more probative or practically applied today.

Respectfully submitted,



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