

BEFORE THE
SURFACE TRANSPORTATION BOARD

Ex Parte No. 664

*METHODOLOGY TO BE EMPLOYED IN DETERMINING THE
RAILROAD INDUSTRY COST OF CAPITAL*

Comments

submitted by

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

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Dated: December 8, 2006

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These Comments are submitted by The National Industrial Transportation League (“League”) in response to the Advance Notice of Proposed Rulemaking issued by the Board on September 20, 2006. The due date for comments in this proceeding was extended to December 8, 2006 by order of the Board served October 23, 2006.

Under 49 U.S.C. 10704(a)(2), the Board is to maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers to “cover total operating expenses, including depreciation and obsolescence, plus a reasonable and economic profit or return (or both) on capital employed in the business.” Such revenue levels are to “provide a flow of net income plus depreciation adequate to support prudent capital outlays, assure repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation,” and to “attract and retain capital in amounts adequate to provide a sound transportation system in the United States.” *Id.*

At bottom, the standard that the Board is required to develop under Section 10704(a)(2) is intended to reflect whether rail carriers are financially healthy, specifically, whether they are earning their "cost of capital." The cost of capital figure so developed by the agency becomes the "benchmark" for determining whether each rail carrier is "revenue adequate" under the statute. Each carrier's actual returns are measured against the cost of capital standard, to determine whether that carrier is "revenue adequate."

There is clearly evidence that the Board's cost of capital determination and its revenue adequacy determination increasingly bear little resemblance to the reality perceived by the nation's financial markets. Railroad industry economic conditions in the last few years thus suggest strongly that the Board needs to revisit the methodology it uses to develop the cost of capital currently employed by the Board to determine revenue adequacy, and the methodology for calculating the carriers' actual returns.

According to the Board's statistics, as early as 2002, the difference between the cost of capital and the return on investment for Class I railroads had closed substantially.¹ The Board's methodology, however, failed to reflect actual returns on investments, which began to exceed the cost of capital for some railroads. While the Board's current reliance on the Discounted Cash Flow methodology for cost of capital determinations led to findings in 2004 and 2005 that, out of the seven Class I railroads, only Norfolk Southern achieved revenue adequate status, this conclusion contrasts sharply with financial evaluations by investment analysts. For example, in a March 15, 2006 report, James Valentine, a respected industry analyst from Morgan Stanley, estimated that the railroads overall would soon enjoy the best return on capital and valuation

¹ Presentation by Anthony B. Hatch, A Wall Street Perspective on Railroads (April 14, 2005).

multiples in decades.² For Class 1 railroads overall, Mr. Valentine estimated in one presentation that average returns on capital investments would climb to between 8 and 10 percent between 2006 through 2010.³ Mr. Valentine predicted that the estimated Return on Net Operating Assets in 2006 would meet or exceed 13 percent for CN, 10 percent for CP and BNSF, 9 percent for NS, and 8 percent for CSX.⁴

Most importantly, Mr. Valentine estimated that starting in 2005, CN, BNSF, NS, and CP all earned their cost of capital.⁵ Scott Flower, another industry analyst, similarly predicted that CN's return on invested capital in 2005 would exceed its cost of capital and that CP's cost of capital was in the same range as its return on invested capital.⁶ Five of the six major railroads were predicted to earn their cost of capital in 2006.⁷

Yet, despite these reports by respected industry analysts, the Board's methodology resulted in a declaration that in 2005, only Norfolk Southern exceeded its cost of capital. BNSF, CN, and CP were all short, and for both CN and CP far short, of earning their cost of capital in that year. If the Board continues to follow its methodology, a similar showing is likely in 2006, despite the industry's strong financial performance this year and in direct contrast to the judgments of the financial community. While the League does not believe that the Board's determination of the cost of capital should slavishly follow Wall Street, the widespread conclusion of the financial markets that many rail carriers are earning their cost of capital should

² James J. Valentine, Union Pacific: Raising Price Target as Our Thesis is Unfolding Earlier than Expected, 2 (March 15, 2006).

³ Presentation by James Valentine, et al., Railroad Financial Conditions and Their Implications for Coal Transportation (November 10, 2005).

⁴ *Id.*

⁵ James Valentine & Michael Manelli, Air Freight and Surface Transportation, 3 (Sept. 20, 2005).

⁶ Scott Flower, Zen and the Art of Railroad Management: Eighth Annual Capital Spending Survey (Mar. 30, 2005).

⁷ James Valentine & Michael Manelli, Canadian National: Dinner with the Dean of Railroading, 3 (Sept. 20, 2005); *see also* James Valentine & Michael Manelli, Air Freight and Surface Transportation, at 1 ("We have even greater conviction that the [railroad] industry will consistently earn its cost of capital over the next few years . . .").

strongly suggest to the Board that its cost of capital methodology certainly needs to be revisited, and is likely flawed.

Moreover, in addition to the evidence provided by the financial markets, there are internal indications that the Board's methodology is in need of repair. Despite record earnings by many rail carriers in 2005, the Board's methodology indicates that several major rail carriers were further from revenue adequacy in 2005 than they were in 2004. The table below sets out the STB's cost of capital determination in each of the last five years; each Class I rail carrier's actual returns over that same time frame; and the cost of capital "deficit" for each rail carrier, which is simply the difference between the STB's cost of capital standard and the actual returns earned:

Revenue Adequacy Determinations										
Year	2005		2004		2003		2002		2001	
STB Cost of Capital Determination	12.20		10.10		9.40		9.80		10.20	
	Actual Return	C of C Deficit	Actual Return	C of C Deficit	Actual Return	C of C Deficit	Actual Return	C of C Deficit	Actual Return	C of C Deficit
BNSF	9.76	2.44	5.84	4.26	6.20	3.20	6.40	3.40	7.10	3.10
CSX	6.23	5.97	4.43	5.67	4.00	5.40	5.20	4.60	4.60	5.60
GTW (CN)	8.07	4.13	5.95	4.15	4.50	4.90	3.10	6.70	4.90	5.30
KCS	5.89	6.31	8.30	1.80	3.70	5.70	6.50	3.30	7.00	3.20
NS	13.21	--	11.64	--	9.10	0.30	9.10	0.70	8.30	1.90
SOO (CP)	8.89	3.31	3.28	6.82	0.90	8.50	5.70	4.10	5.90	4.30
UP	6.34	5.86	4.54	5.56	7.30	2.10	8.60	1.20	7.60	2.60
Bold indicates revenue adequate railroads.										

This table shows that the cost of capital "deficit" for both UP and CSX was higher than it had been at any time in the past five years.⁸ CN – by all accounts one of the strongest carriers

⁸ But compare the conclusions in James Valentine, "Union Pacific: Raising EPS Well Above Management's Guidance Again," April 21, 2006; and, James Valentine, Morgan Stanley Research, CSX: Raising EPS as Efficiency Gains Likely Sustainable, April 20, 2006

financially⁹ – was just as far away from revenue adequacy in 2005 as it had been in 2004, despite a jump in its actual return of more than two percentage points. BNSF was almost as far from revenue adequacy in 2005 as it had been in 2001 through 2003, years where its financial performance was not nearly as strong as it was last year.

At least one reason for these anomalies is that the agency's cost of capital determination overall jumped from 10.10 percent in 2004 to 12.20 percent in 2005 – a twenty percent increase in the cost of capital requirement in a single year, in the absence of an increase in inflation or any other circumstance that would appear to explain such a substantial increase. For all the previous years since 2001, the agency's cost of capital figure had "traded" in a narrow range, from 10.2 percent at the high end to 9.4 percent at the low end.

Therefore, the League urges the Board to undertake a thorough re-examination of the methodology used for determining the rail industry's cost of capital, and the methodology for calculating rail carrier's individual rate of return.

Respectfully submitted,

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⁹ See, James Valentine, Morgan Stanley Equity Research, "Canadian National: In the Face of Weak Traffic, CNI Still Exceeds EPS Expectations," January 25, 2006; James Valentine, Morgan Stanley Equity Research, "Canadian National: Analyst Day Proves Once Again that CNI Sets the Gold Standard for Railroads," November 21, 2005