

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



STB Ex Parte No. 664

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

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REPLY COMMENTS OF UNION PACIFIC RAILROAD COMPANY

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**METHODOLOGY TO BE EMPLOYED IN DETERMINING
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REPLY COMMENTS OF UNION PACIFIC RAILROAD COMPANY

Union Pacific Railroad Company ("UP") joins in the reply comments filed by the Association of American Railroads ("AAR"). Because this proceeding is critically important to UP, we are also submitting these comments to provide our separate response to claims that the proposed changes to the methodology for calculating the cost of capital will not affect future investment in infrastructure that is needed to accommodate the growing demand for railroad transportation. We also respond briefly to shipper proposals for artificially manipulating the debt-to-equity weighting used in cost of capital calculations.

A. An Unrealistically Low Regulatory Cost Of Capital Threatens Future Railroad Investment.

Several shipper groups, including the Western Coal Traffic League ("WCTL"), claim to recognize the importance of investment in transportation infrastructure but incorrectly assert that the Board's proposal will not jeopardize railroad investment. WCTL Comments at 13, *see also* National Grain & Feed Association Comments at 4 ("NGFA sees no reason, however, why those goals would be thwarted in the least if the Board takes the action it proposes.")

WCTL in particular engages in unproductive demagoguery, asserting that the Board's proposal may depress railroad stock prices, but that the public should not be concerned because railroads have been using increased earnings to provide returns to shareholders rather than invest in infrastructure, and also because railroads can always borrow any money they might need to fund investments in infrastructure *See* WCTL at 13-14.

UP squarely addressed those erroneous claims in its opening comments Robert Knight, UP's Executive Vice President-Finance and Chief Financial Officer, demonstrated that UP devotes a tremendous portion of its revenue to capital investment and that, by any variety of measures, UP's increases in capital spending have significantly outpaced UP's revenue growth *See* UP Op., Knight V.S at 13-16 UP has also used earnings to provide returns to its owners in the form of dividends and stock repurchases. As Mr Knight explained, UP's shareholders – individuals, retirement funds, pension funds, charitable organizations, and others – invested in the company based on their understanding that UP would do its best to maximize the return on their investment *See id* at 17-18. Mr Knight also observed, however, that UP's payments to those investors continue to lag behind those of most other S&P 500 companies and publicly traded members of WCTL *See id* at 18-19

Mr Knight also explained why the Board's proposal, which would result in an unrealistically low cost of capital calculation, threatens UP's ability to continue its current high level of investment in infrastructure He explained that UP has been reinvesting its earnings in capital projects based on an expectation that it would be allowed to earn returns sufficient to justify those investments, and that UP's management and owners would not permit the current high level of capital investment to continue unless they are confident in UP's ability to earn an adequate rate of return on that investment. *See id* at 8-11.

WCTL ignores the critical role of reinvested earnings when it asserts that the cost of capital is irrelevant to future investment because “railroads have not raised capital by issuing stock to the public in many, many years ” WCTL Comments at 13 The Interstate Commerce Commission recognized long ago that setting the cost of capital too low means that greater returns would be available from other investments and that “[r]ailroad management has little incentive to reinvest funds generated by ratepayers in continued rail uses if greater returns are available elsewhere ” *Standards for Railroad Revenue Adequacy*, 364 I C C 803, 810 (1981) “Railroads are private companies whose stockholders would not permit such reinvestment ” *Id*

WCTL also asserts that an unduly low cost of capital would be irrelevant because railroads can raise funds for investment by “increase[ing] their debt.” WCTL Comments at 14 WCTL fails to recognize that railroads face the same issue in deciding whether to take on debt as in deciding whether to reinvest earnings railroad management and shareholders will not allow the company to incur new debt to invest in infrastructure when returns are set unduly low

WCTL should recognize that the regulatory cost of capital can create a genuine impediment to infrastructure investment Recent press reports state that a joint venture that included MidAmerican Energy Holdings Company, the parent company of WCTL member MidAmerican Energy, might “drop plans to invest \$3 billion in Texas electricity lines after state regulators set a lower return on equity than was requested ”¹ Texas regulators had set a 9.96 percent return on equity, much higher than the Board’s proposed cost of equity in this proceeding, but lower than the 10.4 percent to 11.4 percent that the venture wanted. *Id*

¹ Edward Klump, “American Electric-Buffett Venture May Drop Texas Plan,” Bloomberg News (Oct 17, 2007), available at <http://www.bloomberg.com/apps/news?pid=20601072&refer=energy&sid=ac14.eNJKOQ>

Railroads face the same issues as WCTL's members. If railroads' returns are capped by an unduly low cost of capital – which would be the result of the Board's proposal – railroads will face pressure to reduce capital spending regardless of the source of funds. Shareholders will expect the railroads to provide appropriate returns through higher dividend payments and share repurchases, and they will then seek more favorable returns in other industries.

B. The Board Should Not Artificially Manipulate The Weighting Of Railroad Debt And Equity.

In the Notice of Proposed Rulemaking, the Board rejected WCTL's request that the Board treat operating leases as debt for purposes of the cost of capital calculation. See Notice at 8. WCTL nonetheless urges the Board to address the treatment of operating leases as debt, as well as broader issues regarding the capital structure of the rail industry. See WCTL Comments at 10-12. As AAR explains in its comments, these topics are beyond the scope of the current rulemaking, which is limited to the methodology to be used in calculating the cost of equity capital. Moreover, WCTL fails to acknowledge the full implications of its proposals.

For example, WCTL fails to address the fact that treating operating leases as debt would affect more than just the cost of capital. Implementing WCTL's proposal would require railroads to develop alternative financial statements and would have important implications for other regulatory calculations, particularly revenue adequacy calculations. The Board appeared to recognize these issues when it explained that adopting WCTL's proposal "would require a change to our procedures for determining revenue adequacy." Notice at 8.

Currently, operating leases are not identified on railroad balance sheets. Operating lease payments are reflected in railroad income statements as an expense. (They are listed as "rent" on Schedule 410 of the R-1.) Treating operating leases as debt would be a more

complicated matter and would require adjustments to railroad income statements and balance sheets. Railroads do have some leases that are treated as debt under GAAP, called "capitalized leases." Capitalized leases are reflected on railroad balance sheets by increasing both assets (to reflect the book value of the asset) and liabilities (to reflect the debt used to purchase the asset). If railroads were suddenly required to treat operating leases as debt, basic accounting principles would require them to include the value of the asset in their asset base, which would increase the carrier's investment for purposes of calculating return on investment, which would in turn affect revenue adequacy calculations.

Moreover, the transition would not be easy. When a railroad records a lease as debt, each year it must reduce the asset value (to reflect depreciation) and the liability (to reflect payments of principal on the lease), and it must record interest payments and annual depreciation as expenses on its income statement. Thus, in order to reflect an operating lease as if it involved debt, one would have to back out the rental payments from the railroad's income statement, add the book value to the railroad's asset base as reflected on the balance sheet, and then develop and record appropriate principal and interest payments (which would require making assumptions about the term and interest rate for the debt), as well as depreciation expenses, for each year since the lease. Most operating leases at issue have very long terms, and thus to treat existing leases as debt, one would have to review and restate many years of transactions.

UP provides the financial community with a calculation of its debt-to-equity ratio that reflects the net present value of operating leases, but providing that calculation as additional financial information is not the same as reflecting the full implications that such an alternative calculation would have for regulatory purposes, including in particular revenue adequacy determinations.

The Board was also correct not to accept WCIL's premise that the current capital structure of the railroad industry is somehow inappropriate. The industry's capital structure mix in 2005 (approximately 30 percent debt, 70 percent equity) was not significantly different than it was throughout most of the 1990s, until the mix shifted as a result of mergers and "significant declines in the market value of the railroads' common stock during the year." *Railroad Cost of Capital – 2000*, 5 S.T.B. 853, 860 (2001).

WCTI also is off base when it criticizes the Board for its "blithe acceptance of the nominal capital structure." WCIL Comments at 11. The Board should not substitute its judgment for that of the railroads. As Mr. Knight explained in UP's opening comments, UP carefully calibrates its debt activities in order to maintain its standing in debt markets so that borrowing costs do not rise above acceptable levels. See Knight V.S. at 19.

The agency has previously rejected calls to interfere with railroad decision-making on questions of capital structure. As the ICC explained back in 1979: "Whether a substantial increase in the debt ratio could safely be adopted by the railroads is not a judgment to be made lightly. Such an increase would have effects on the carriers' liquidity, and their credit in the capital markets. We are inclined to accept the judgment of railroad management in this area, where there is no evidence that capital structures are being manipulated to obtain an undue advantage in regulatory proceedings." *Adequacy of Railroad Revenue (1979 Determination)*, 362 I.C.C. 344, 359 (1979).²

² Moreover, as AAR observes in its reply comments, within a broad range, the debt-to-equity ratio should have no significant effect on the weighted average cost of capital.

C. Conclusion.

UP has been investing in new capacity for many years based on our anticipation that the returns would eventually warrant that investment. The Board also has a responsibility to take a long-term view and resist calls to adopt a cost of capital methodology that is designed to produce results that are unrealistically low. The Board should adopt a balanced cost of capital methodology that preserves our ability and incentives to continue investing in the capacity that shippers are demanding.

Respectfully submitted,

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