

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte 664

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

REPLY COMMENTS
of
THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

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Dated: October 29, 2007

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The National Industrial Transportation League ("League") is pleased to submit these Reply Comments in response to the Notice of Proposed Rulemaking served March 28, 2007 ("NPR").

As noted in the League's opening Comments filed September 27, 2007, the Board's calculation of the industry's cost of capital affects some of the basic components of the Board's regulatory responsibility, and a correct determination is important for the Board to successfully achieve its Congressional mandate. In its Comments, the League supported the Board's proposal to revise its determination of the industry's cost of capital. The League noted that the Board's current calculation had become substantially divorced both from the exterior reality of the rail industry's financial condition; and that the Board's calculation of the industry's cost of capital, especially in recent years, was also internally suspect, showing odd and inexplicable swings from one year to the next. See, League Comments, p. 3. The League also approved the Board's reliance on the data and procedures used by the Federal Reserve Board ("FRB") in proposing CAPM as its revised methodology. The League believes that the Board has made a careful and

thorough review of both the techniques used by the FRB and by other federal agencies as well as in the academic literature, in coming to its conclusion that the DCF model should be abandoned and that the CAPM procedures should be adopted. Finally, the League noted that the Board's proposed methodology appears to much more closely mirror the judgments of the financial markets as to the financial health of individual rail carriers than does the Board's current methodology. See, League Comments, pp. 4 to 6.

A. The Board Is Clearly Justified in Adopting the CAPM Model

The comments in this proceeding show that the Board is clearly justified in adopting the CAPM methodology to replace the DCF methodology. As noted by the AAR, the Board's DCF model was adopted in 1982, AAR Comments, p. 2, and thus is now more than twenty-five years old. While the AAR cites the Board's longstanding reliance on the DCF model as a reason for continuing its use, see *id.*, the League believes that precisely the opposite is true: the very age of the DCF model used by the Board and the advances in financial analysis over the last twenty-five years suggests that a re-evaluation and adoption of modern practices is long overdue. In fact, the Congress expected that the Board would periodically have to update its methodology, and ordered the Board to do so: Section 10704(a)(2) specifically states that the Board shall maintain "*and revise as necessary* standards and procedures for establishing" adequate revenue levels for rail carriers. 49 U.S.C. 10704(a)(2) (emphasis added).

The Board is correct that "modern finance practices have changed since the last time the agency reviewed its cost of capital methodology" and that the Board's simple DCF approach "has been displaced by more sophisticated and precise techniques to estimate the cost of equity." NPR, p. 4. Indeed, the Norfolk Southern notes that CAPM is not an unreasonable choice, and in fact looks at its own cost of capital from a CAPM perspective. Norfolk Southern Comments, p.

2. CSX also notes that CAPM is used broadly for non-regulatory purposes. CSXT Comments, p. 8. AAR witness Hubbard states that he well understands the STB's reluctance to continue its use a single-stage DCF model, AAR Comments, Hubbard V.S., p. 15, and AAR witness Myers notes that CAPM is a "very useful" methodology that is "widely used in practice by corporations that estimate or update their cost of capital," AAR Comments, Myers V.S., pp. 3, 5. The Department of Agriculture ("DOA") notes that CAPM estimates of the cost of equity will be less affected by volatility in railroad stock prices, and use of CAPM will "break the circularity between railroad freight rates, the level of railroad profitability, and the cost of capital." DOA Comments, pp. 3-4. All of these comments, and others, indicate that the CAPM model should be adopted.

B. There is No Basis For Arbitrarily Using the "Upper Range" of Any Model or Combination of Models Nor for Adjusting a Proper Calculation of the Railroad's Cost of Capital to Achieve a Particular Result

In its Comments, the AAR argues that the Board should consider a "range" of estimates of the cost of equity, and adopt a point estimate for each year within the "middle to upper portion of that range." AAR Comments, p. 13.

There is no basis for such an approach, and indeed the AAR's suggestion would enmesh the Board in unrelenting disputes both as to the extent of the range and as to where within the range the Board should prescribe the cost of equity. In fact, more than twenty-five years ago, the Board rejected an approach to the requirements of the statute that developed a range of numbers for determining revenue adequacy, see *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803, 807 (1981). Moreover, there is no principled way of determining just where in the "range" the cost of equity should be set. The best, most transparent and non-arbitrary approach is for the Board to adopt a modern, well-supportable and supported methodology for determining the

railroad's cost of capital; make sound judgments as to the factors that go into that determination; and develop a result.

Moreover, the Board should not "shade" its cost of capital determination to achieve a particular result. Such an action would be inconsistent with the cost of capital/revenue adequacy standard that the Board has adopted. Specifically, in *Standards for Railroad Revenue Adequacy*, the Board noted:

The standard we will use to measure the adequacy of the rate of return is the current cost of capital. Such a standard is widely agreed to be the *minimum necessary* to attract and maintain capital in the railroad, or any other, industry. [footnote omitted] The cost of capital is the rate of return required of a firm by current and prospective holders of its securities.

The *minimum rate of return* that will allow railroads to obtain investment funds is the cost of capital.

364 I.C.C. at 809, 810 [emphasis added]. Thus, it would be inconsistent with the regulatory standard adopted by the Board for the agency to incorporate other factors in order to artificially inflate the cost of capital.

Indeed, it is precisely *because* the cost of capital is used in a variety of other contexts, such as the calculation of the variable costs of a particular movement, that any attempt to inflate the cost of capital to achieve a particular result would be extremely troubling. Why should, for example, the calculation of the variable cost for a movement of a commodity from Origin X to Destination Y be raised or lowered because, on the one hand, for example, rail carriers need funds for expanded investment that have nothing to do with the movement at issue, or because, on the other hand, a shipper believes that its commodity should be favored for some policy goal? While factors such as the need for funds for expanded future investment may be appropriate for policymakers to consider in other settings, the Board's determination of the industry's cost of

capital should be neutral. Simply put, in its determination of the railroads' cost of capital, the Board should simply call balls and strikes, and not attempt to mandate a particular score.

C. The Board's Proposal Will Not Adversely Affect the Railroad Industry's Ability To Raise Equity Capital

A number of railroad comments suggest that the Board's proposal will impair the ability of railroads to attract and retain capital and will allegedly discourage further investment in rail capacity. See, *e.g.*, BNSF Comments, p. 2. The record that already exists in this proceeding belies such a conclusion. The Comments of Atticus Capital LP attach a very recent (July 15, 2007) report by the investment firm of Morgan Stanley. See Atticus Capital Comments, Attachment by Morgan Stanley "Little Regulatory Risk to Railroad Pricing Story Before 2011." ("Morgan Stanley Report") This report, which was well aware of the possibility that the Board would adopt a CAPM methodology, states that even if the Board would adopt a CAPM methodology, that would not be a cause for investors' concern. See, Morgan Stanley Report, p. 4. As noted in the comments of the National Grain and Feed Association, Berkshire Hathaway increased its holding in BNSF by 10 million shares even after the Board announced its proposal. As noted in the Morgan Stanley Report and by other comments in this case, see WCTL Comments, p. 13, most railroad traffic is not subject to regulation. Moreover, as noted by the Morgan Stanley Report, the fact that the Board has found that revenue adequacy requires returns equal to the cost of capital over a long term means that the "revenue adequacy" constraint set forth in the Board's rate reasonableness standards will not come into play for a number of years. See Morgan Stanley Report, p. 4.

D. The Board's Key Technical Choices Regarding CAPM Are Sound and Supported By the Comments Submitted In This Proceeding

Although the League will leave a number of the more technical aspects of the CAPM determination to other Commenters, it appears to the League that the Board's key technical choices regarding CAPM are sound and supported by the Comments submitted in this proceeding.¹

While the AAR notes minor criticisms of the Board's use of the 10-year T Bond rate to derive the estimate of a risk free return (though the AAR concedes that use of the 10-year T Bond rate would be an "acceptable" approach), AAR Comments, p. 21, the AAR's major disagreement with the Board's approach appears to be in the calculation of the market risk premium. The Board has used a market risk premium of 5.2 percent for 2005, based upon monthly New York Stock exchange data over a 50-year period. The AAR argues that the period is too short, an error that allegedly biases the value downward.

However, an examination of the data provided by the AAR's own experts indicates that the Board's use of the 50 year period is well supported. Exhibit 2 to the Hubbard/Stangle statement submitted by the AAR shows that equity risk premiums since 1957 are on average well below equity risk premiums since 1926. Though the AAR argues that risk premiums have been dropping "for the past few years," that is a substantial understatement. According to Exhibit 2 of the Hubble/Stangle statement, equity risk premiums have been dropping consistently for the last *twenty five* years, and even the equity risk premium for the past forty years is below that proposed by the Board. On the other hand, extension of the equity risk premium period all the

¹ The AAR argues that the Board has failed to provide a clear and transparent method for determining the cost of equity, and complains that the Board has failed to provide complete workpapers. AAR Comments, pp. 16-20. However, the railroads' argument on this point appears overblown: in a footnote, the AAR concedes that its experts "have been able to replicate, or come close to replicating, most if not all of the Board's calculations." AAR Comments, p. 16. An examination of the verified statements of the AAR's witnesses, however, reveal no significant

way back to 1926 would encompass very different financial conditions than those that exist today, or have existed since 1957. Indeed, the AAR's own witness Myers concedes that, although the most commonly cited averages run from 1900 or 1926 to date, "estimates that exclude the Great Depression and World War II are also useful. . . ." Myers Verified Statement, p. 6. Witness Myers also notes that some research indicates that the expected future market risk premium is probably less than historical averages, see Myers' V.S., p. 10, fn. 10, again supporting the Board's use of its 50-year average.

Moreover, the Verified Statement of AAR witness Myers notes that the Board's risk premium figure is calculated from the New York Stock Exchange index, and recommends that the Board use the S&P 500 Index. But AAR witness Myers' Table 3 indicates that the long term S&P equity risk premium calculation since 1956 is 5.00%, or lower than the New York Stock Exchange figure of 5.2% used by the Board.

Thus, the Board's technical choice of the equity risk premium appear to be sound and well-supported.

Additionally, although the AAR complains that the Board's CAPM calculation is too low, it is clear that a number of individual railroads use CAPM in estimating their own cost of capital. For example, the Norfolk Southern states directly that it looks at its own cost of capital from a CAPM perspective, and CSXT also notes that it considers CAPM to be a useful tool. See, Norfolk Southern Comments, p. 2; CSXT Comments, p. 8. Presumably, other rail carriers may also use CAPM to derive an estimate of their own cost of capital. However, it is striking that no rail carrier has revealed to the Board what its own CAPM calculation actually is, an omission

inability to understand either the agency's procedures or its sources. AAR witness Myers indicates that he has been able to replicate the Board's calculations even for individual railroads to "close tolerances." Myers V.S., p. 8.

that suggests that the answer may support the STB's own calculation, in contradiction to the AAR's arguments.

Finally, the railroads argue that the 10-year time period chosen by the Board to calculate betas for each carrier is too long. See, AAR Comments, pp. 25-26 and Hubbard/Stangle V.S., para. 21-26. The Western Coal Traffic League agrees with the railroads on this point, suggesting that, while a 10-year period is reasonable, a five-year period would also be reasonable. WCTL Comments, p. 7. However, the railroads' evidence shows that adoption of a five-year period would produce betas that are as low or lower than the betas proposed by the STB. As shown by AAR witnesses Hubbard and Stangle, the ten-year betas for the four major Class I railroads estimated by the STB as of December 2005 averaged .80. See Hubbard/Stangle V.S., Exhibit 3a. The five-year betas shown by these AAR witnesses from Ibbotson average .74.

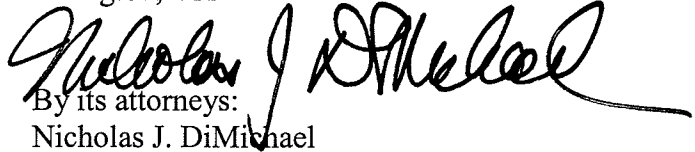
In addition, the AAR Comments appear to agree with the comments of WCTL that the Board should not set the beta at 1.0. AAR Comments, pp. 26-27; WCTL Comments, p. 8. However, the railroads own data appears to belie the notion that rail industry participants have a beta greater than one. Specifically, the railroads' data as presented by AAR witnesses Hubbard and Stangle indicate that the five-year beta for the four major Class I carriers derived by both Ibbotson and Value line as of December 2005 is clearly less than one. See, Hubbard/Stangle V.S., Table 3a. This is not surprising, given the fact that some portion of the railroads' traffic is not subject to intermodal competition, a portion that appears to be growing as the industry has become increasingly capacity-constrained.

CONCLUSION

The League appreciates this opportunity to present its views to the Board on this matter.

Respectfully submitted,

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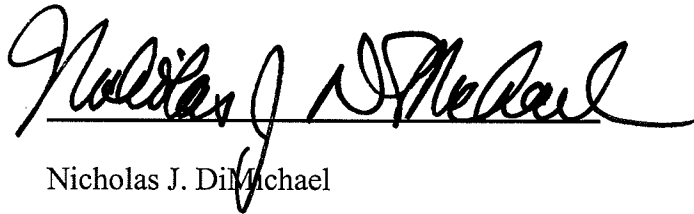


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Dated: October 29, 2007

Certificate of Service

I hereby certify that I have on this 29th day of October 2007 caused a copy of the foregoing Reply Comments of The National Industrial Transportation League to be served on all parties to this proceeding by first class mail, postage prepaid, or more expeditious method of delivery.



Nicholas J. DiMichael