

METHODOLOGY TO BE EMPLOYED	)	
IN DETERMINING THE RAILROAD	)	
INDUSTRY'S COST OF CAPITAL	)	Ex Parte No. 664
	)	

Attorneys & Practitioners

BEFORE THE
SURFACE TRANSPORTATION BOARD

	)	
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IN DETERMINING THE RAILROAD	)	Ex Parte No. 664
INDUSTRY’S COST OF CAPITAL	)	
	)	

WRITTEN HEARING TESTIMONY OF
THE WESTERN COAL TRAFFIC LEAGUE

In accordance with the Notice in the above-captioned proceeding that the Surface Transportation Board (“STB” or “Board”) served October 24, 2007, the notice of intent to participate that the Western Coal Traffic League (“WCTL”) filed November 20, 2007, and the Notice of Proposed Rulemaking (“NPR”) that the STB served August 14, 2007, as corrected August 20, 2007, WCTL provides this statement of testimony that its representatives, Robert D. Rosenberg, Thomas D. Crowley, and Dr. James E. Hodder, will present at the Board’s hearing scheduled for December 4, 2007.

The witnesses reserve the right to submit additional testimony in response to the testimony of other witnesses.

I. THERE IS NO SOUND BASIS FOR CONTINUED
 USE OF THE STB’S SINGLE-STAGE DCF MODEL

There is clearly no sound basis for continued use of the single-stage discounted cash flow (“DCF”) model that the STB has used for over 25 years to calculate the cost of equity (“COE”) portion of the current cost of capital (“COC”). The DCF model assumes that dividends (or at least earnings) will grow at the projected growth rate

in perpetuity. However, it is impossible for such dividends or earnings to grow at a rate significantly larger than that of the general economy because the dividends would eventually be larger than the economy itself.

Since 2003, the STB's COC has used a growth rate of at least 11%, while the economy has been growing, and is projected to continue growing, at a much lower rate taking inflation into account. In particular, for 2005, the STB used a so-called truncated consensus forecast of earnings growth in the railroad industry that was more than twice the rate of growth in the general economy roughly estimated at 6%. For the 2006 COC, the Association of American Railroads ("AAR") proposed a growth rate that was even higher.

An additional defect in the STB's use of the DCF method, at least in recent years, is that it generates a higher COC because the railroads have been increasing their freight rates. In other words, the regulatory effect is to enable the railroads to charge more (through an increased jurisdictional threshold, higher stand-alone costs, and/or continued findings of revenue inadequacy) because they have been charging more. This outcome is perverse in terms of economics and public policy.

The implausibility of the single-stage DCF analysis is confirmed by the fact that even the COE figures proposed by the AAR using the Capital Asset Pricing Model ("CAPM") are substantially below the railroad COE estimated by the DCF method for 2005.

The underlying growth estimates obtained from the Institutional Brokers Equity System (“IBES”) data are suspect as well. Only a limited number of forecasts appear to be included or available for consideration in the truncated average, the truncation means that the growth rate may actually reflect three or fewer forecasts, and there are large value spreads between the forecasts, rather than some broad consensus. In addition, there has been no demonstration that the IBES five-year forecasts for stocks in general and railroad stocks in particular have any historical accuracy.

Use of a single-stage DCF model may be appropriate in other contexts. For example, other industries reflect more stability, more pervasive regulation (which can contribute to stability), a greater portion of the COE in the dividend component, and/or lower projections in earnings. The fact that a single-stage DCF model may be used in those other industries does not make it appropriate for the railroad industry, especially at a time when it is characterized by rapid earnings growth, limited (and generally ineffective) regulation, relatively modest dividends, and relatively high earnings forecasts.

Some other method should be used instead to calculate the railroad industry COE.

II. CAPM PRESENTS A SOUND ALTERNATIVE FOR CALCULATING THE RAILROAD INDUSTRY COC

Fortunately, CAPM constitutes a well-established and well-accepted alternate methodology for determining the COE. As noted in the NPR, CAPM has become the dominant model for COE estimation.

A primary benefit of CAPM is that it explicitly addresses inflation (as reflected in the risk-free rate of return, typically as measured by the yield on long-term Treasury bonds) and risk, two key determinants of the cost of capital that are only implicit in the DCF model.

CAPM thus complies directly with the requirement in *FPC v. Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944), that “the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks.” CAPM achieves this objective by combining (a) a risk-free rate of return, which represents what investors are demanding for a risk-free investment that reflects expected inflation, and (b) a market equity risk premium that is then adjusted to reflect the nondiversifiable risk (beta) of the particular stock or, in this case, group of stocks.

Moreover, the CAPM estimate of the COE is constructed in an empirical and statistical manner, whereas the DCF method ultimately depends on the forecasts of individual analysts. While some have pointed out the room for disagreement in the selection of particular CAPM inputs, the variance in CAPM inputs is modest compared to that among analysts in the forecasts used in the DCF method. The AAR’s COC submissions in recent years have revealed numerous instances where one analyst’s estimate for a particular railroad is three or four times higher than that of another analyst. Moreover, the number of monthly analyst forecasts has been relatively small in recent

years, sometimes as few as four or even three analysts, meaning that after “truncation,” the so-called “consensus” reflects two or sometimes even just a single forecast.

CAPM is also not purely theoretical or speculative. If CAPM’s results were considered unsound or unrealistic, the model would not be popular in both financial and regulatory practice, and it would not be regularly taught in business schools and used on Wall Street.

Some academicians and others have advocated augmenting the basic CAPM equation with other factors, such as adjustments for size and market-to-book ratios. These efforts represent an extension, rather than a rejection, of CAPM. In large part, these efforts are designed to achieve a better statistical fit, typically with rather small classes of investments. However, these adjustments (beyond a modest reduction in the COE that could be made to reflect the large capitalization of the railroads, especially in recent years) do not appear to be particularly applicable to railroad stocks, and the basic CAPM analysis is suitable for calculating their COE.

III. THE NPR REPRESENTS A SOUND IMPLEMENTATION OF CAPM

The STB’s NPR proposes a sound and straightforward implementation of CAPM. Implementing CAPM involves choices among various inputs, and choices involve trade-offs, but the STB’s proposed trade-offs are generally sound and appropriate.

Both WCTL and AAR have agreed that there are some technical deficiencies in the NPR’s proposal such as the need to consider the intercept (alpha

value), calculation of beta based on a comparison of returns to the 90-day Treasury bill instead of a long-term Treasury bond, use of a 20-year Treasury bond instead of a 10-year Treasury bond as the risk-free rate of return, and use of the S&P 500 instead of the NYSE as the market proxy so as to facilitate openness and transparency in the calculation. These matters have very little impact on the resulting values, at least to date, as shown in the Reply Verified Statement of Thomas D. Crowley and Daniel L. Fapp submitted as part of WCTL's Reply Comments on October 27, 2007 ("Crowley/Fapp RVS").

The largest areas of disagreement involve the calculation of the equity risk premium ("ERP," sometimes referred to as the market risk premium or "MRP") and the calculation of beta.

A. The Equity Risk Premium ("ERP")

With respect to the ERP, the AAR favors a very long measurement period ostensibly because it provides for increased accuracy, but the real reason appears to be that it produces a higher figure. In particular, the AAR supports a starting date of 1926. However, other data is available with starting dates of 1900 and 1872 that yield lower figures. *See, e.g.,* Elroy Stimson, Paul Marsh, and Mike Staunton, *Global Evidence of the Equity Risk Premium*, 15 J. of Applied Corp. Finance 8 (Summer 2003) (noting lower ERP if data from 1900 is considered).

Moreover, there is abundant evidence that the ERP has been declining over time, or is at least at a lower level. In particular, evidence submitted by Kansas City

Southern shows that Morgan Stanley estimates a 4% ERP going forward, a figure that is quite consistent with the economic literature referenced in the Crowley/Fapp RVS. The 4% is also consistent with the results of annual polling of Chief Financial Officers.

Some research indicates that the higher returns obtained starting 1926 were unexpected and should not be considered a risk premium at all, especially for prospective purposes. Stimson, *et al., supra*, at 14 (“As a result many writers choose not to refer to historical excess returns as ‘risk premiums.’ To avoid confusion, we refer to the *expected* or ‘prospective’ risk premium when we are looking to the future.”) (original emphasis). *See also* Eugene F. Fama and Kenneth R. French, *The Equity Risk Premium*, 57 J. of Finance 637, 658 (April 2002) (“our main message is that the unconditional expected equity premium of the last 50 years is probably far below the realized premium”).

A prospective expected ERP of 4%, or less, is also consistent with the result obtained by constructing a single-stage DCF analysis of the COE for the market as a whole. Specifically, one would take an average dividend yield of 2% and add a 6% (or lower)¹ general growth rate for the economy as a whole (over time, stocks as a whole are unlikely to grow faster than the general economy) to get an 8% overall market return. One would then subtract the current long-term Treasury bond yield of approximately

¹Dr. Hodder derived a 6% anticipated general growth rate in his original December 8, 2006 Verified Statement. The NPR used a lower figure for its consideration of a two-stage DCF model. Dr. Myers, on behalf of the AAR, noted values falling between the two in his September 27, 2007 Verified Statement. The 6% figure thus appears to represent a reasonable (meaning conservative or generous) upper bound.

4.5% to get a presently-implied ERP of 3.5% or maybe 4%. One could get to the same or nearly same figure by predicting a general long-term market return of 8% to 9% and then subtracting the long-term Treasury yield. The 5.2% risk-free rate calculated by the STB using a 50-year average thus appears reasonable, albeit on the generous side.

Additionally, some of the sources cited by the AAR and/or witnesses that have calculated a higher historic ERP have used shorter-term, and typically lower, Treasury note yields as the risk-free rate of return, which is inconsistent with the general consensus to use the 20-year bond for the risk-free rate. Shorter-term interest rates tend to be lower, and combining an ERP derived from a Treasury bill with a higher risk-free rate based on a longer-term Treasury note leads to an overstatement due to a double-count.

In short, the STB's proposed ERP is at least reasonable and is likely somewhat high.

B. Beta Issues

The beta adjustment is used to vary the average ERP to reflect the risk associated with the particular firm or group of firms. The NPR proposes to calculate beta using a ten-year measurement period calculated by comparing the monthly returns for the sample railroads relative to the NYSE average.²

²As noted *supra*, each return is measured relative to the risk-free rate, for which short-term Treasury bill yields should be used instead of long-Term Treasury bond yields, and the intercept should be considered, although neither factor has a financially

An alternative to having the STB construct its own beta would be to use a commercially-available beta. However, an advantage of having the STB construct its own beta is that the calculation can be made open and transparent, especially as commercial vendors, at least some of them, add their own adjustments, the merits of which are subject to debate.

That said, openness and transparency would be facilitated if the STB's calculations utilized the S&P 500 data instead of the NYSE as the market proxy. NYSE data appears to be available only from CRSP, which imposes substantial restrictions on confidentiality that prevent the underlying data from being disclosed to others, which in turn prevents or at least substantially impairs the full disclosure of the beta calculations. In contrast, S&P data appears to be readily accessible and without charge. The S&P data may reflect a smaller number of firms, but the NYSE adds relatively little in terms of market capitalization, and so use of the S&P 500 as the market proxy appears more desirable on balance at the present time.

The most contentious issue regarding beta has been the length of the measurement period, which the NPR proposes to be ten years, while five years is the length utilized by most commercial beta providers. However, the ten-year period results in additional stability, as there is less change from year-to-year. This stability is of value in working with a long-term COC for the Board's regulatory purposes, especially in terms

significant impact, as explained in the Crowley/Fapp RVS.

of avoiding excess volatility. Moreover, some academic research indicates that longer betas are more accurate than shorter betas. In contrast, betas based on measurement periods shorter than five years are generally not considered very reliable, especially if longer data is available.

While the AAR has attacked the STB's use of a ten-year beta measurement period, the fact is that the resulting values are not substantially different if the same calculations are made (even with the technical corrections noted earlier) using a five-year measurement period. Additionally, while the AAR has found some five-year betas that are higher than those calculated by the STB (with the technical corrections and either a ten- or five-year averaging period), there are other readily available five-year betas with comparable or lower values. Both of these matters are addressed in the Crowley/Fapp RVS.

The AAR has also noted that betas are a statistical measurement and that betas thus contain a measure of potential statistical error, often expressed using a confidence interval. The AAR appears to claim that the presence of room for statistical error is a reason not to use CAPM at all or is a reason to use the upper end of values implied by the confidence interval.

WCTL does not agree with either position. Statistical error is a fact of statistical life, and if statistical error were to be deemed a fatal flaw, then one would not use statistics at all. The AAR has hardly established that the statistical error is so large as

to render beta measurement and CAPM unreliable, and ample real-world experience and financial activity demonstrate otherwise. Nor does the presence of statistical error provide a sound reason for choosing from the upper end of values included in the confidence interval inasmuch as the calculated value still represents the best unbiased estimated value. That is not to say that confidence intervals should be ignored, especially in considering shifts over time or whether separate analysis should be viewed as confirming or contradicting a particular analysis.

The AAR also appears to recommend, at least at times, an analysis based on weekly rather than monthly measurements. Weekly measurements obviously produce about four times as many measurements as monthly measurements for any given interval, but there is potential that the greater number of measurements will translate into increased statistical noise rather than a narrower confidence interval. Additionally, the trade-offs may well not be constant over time. In general, monthly measurement over a five or ten-year period should prove sufficient.

In short, the AAR has not identified any systematic bias in the STB's beta values. WCTL adds that it would seem surprising to find that the railroad industry has beta values substantially above 1.0 for a sustained period of time because of the relatively low risk associated with railroading.

C. Pitfalls of Choosing from the Middle of a Range of Values

The AAR has devoted some effort to arguing that the appropriate approach is to select from the middle (if not the upper end, a matter noted *infra*) of a range of values. This approach might have some merit under certain conditions, specifically, if (a) there was no good reason to think that some values were more probative than others, and (b) one knew that the values present were representative, randomly distributed, and/or otherwise free of bias.

Such conditions do not appear to be present in the current circumstances. One party has been able to find various values that support its position, but these values appear to be biased, that is, the values are higher than those calculated by the STB and the values appear to have been selected for that reason. Moreover, some of the higher beta values identified by the AAR have beta measurement periods of two and three years, which are significantly shorter than the five-year minimum period that is generally recommended. WCTL originally submitted a single value based on a single, respected source, but confronted with AAR's tactics, found other respected betas, based on five-year averaging periods, that confirm the reasonableness of the STB's beta calculations. (Much the same is true of the ERP as well.)

Under the present circumstances, the appropriate course is to select the values that appear to be most probative. The NPR's proposed approach of calculating a beta value directly is reasonable in this regard, especially if readily available data

(meaning S&P rather than NYSE) data is utilized. Comparison to other betas to confirm the reasonableness of the calculation is still of value, but such comparison confirms the reasonableness of the STB's derivation.

D. Reasonableness of the STB's Overall Results

The AAR and its individual members have claimed that the COE and COC results produced by the STB's CAPM analysis are too low to be reasonable. They have even gone so far as to rely on the higher figures originally submitted by WCTL witness Crowley concerning the 2005 COE (and later figures submitted by Crowley/Fapp addressing the COE in other recent years using the same methodology for the sake of consistency and to show trends)³ as confirming the unreasonableness of the STB's calculations.

However, the substance of the railroads' complaints has been that the values calculated by the NPR are lower than what the values have been in the past. The AAR has not shown that the NPR's values are unrealistic, and the far more reasonable interpretation is that the values in the past have been substantially overstated.

In particular, WCTL previously introduced a UBS Report stating that the consensus among the investment community, including railroad Chief Financial Officers, is that the railroad industry COC was 9.5%. This figure is not a "hard" one, *e.g.*, it does

³The primary reason that Mr. Crowley's figures were relatively high was the use of a relatively long-term historical ERP, a topic addressed *supra*.

not reflect the actual figures used by any single party, and it does not purport to derive the 9.5% or any other specific figure from financial sources, be it DCF or CAPM.

Nonetheless, as an indication of a consensus, it does provide a guidepost, and one that indicates that the STB's COC values have been overstated since at least 2004.⁴

WCTL also introduced figures for the COC of various individual railroads from S&P. That data revealed values ranging from 8% (for UP) to 9.1% (for NS). Those values are calculated as of 2006, and are higher, by a modest amount, compared to the 7.5% COC figure calculated by the NPR for 2005. In particular, these other values fall within the margin of error or underlying confidence interval in the NPR's approach.

In short, the NPR's values appear to be quite realistic.

While the AAR has attacked the NPR's figures as being too low, the railroads have not introduced anything that reveals what they consider their own internal COE and COC to be, or the inputs from which they are derived (beyond an acknowledgment by NS that it considers both DCF and CAPM and that the two yield consistent figures). It stands to reason that the railroads would need to develop some sense of their internal COE and COC in order to conduct their operations (especially considering their supposed capital-intensity, their large stock buyback programs, and their increased dividends), and their failure to present any evidence of what they use internally

⁴The STB's 2003 COC value was 9.4%, but that is the only value in recent years that has fallen below 9.5%. In contrast, the 2002 COC value was 9.8%.

is conspicuous. Moreover, they undoubtedly track what various analysts use as estimates of their COC, and yet they have refrained from presenting that information as well. The implication is that the information they have failed to present is not helpful to their cause and is being withheld for that reason.

IV. USE OF A MULTI-STAGE DCF MODEL OR SOME OTHER METHOD OF COC ESTIMATION AS A CHECK ON THE CAPM CALCULATION

As WCTL has previously stated, there is no single way to estimate the COE portion of the COC. Moreover, models represent a simplification of a more complicated reality, and models thus have the potential to cease providing accurate and reliable results when conditions change. Accordingly, there is value in applying a “common sense” check to the COE calculation, no matter what methodology is used.

A multi-stage DCF model is particularly useful as a check on the CAPM results. In essence, a multi-stage DCF model blends a shorter-term (*e.g.*, five-year) growth rate for the particular firm or industry with an overall growth rate for the general economy, perhaps with the benefit of some sort of transitional phase-in. A multi-stage DCF model thus attempts to take advantage of the relative simplicity of the DCF model, while incorporating a transition to the long-term growth for the general economy so as to avoid unreasonable results. Moreover, the DCF model and the CAPM uses different inputs, *e.g.*, inflation and risk are only implicit in the DCF model estimates, but are explicit in the CAPM model, making the two particularly complimentary.

WCTL presented results of a multi-stage DCF analysis both in Dr. Hodder's original Verified Statement and in the Crowley/Fapp RVS. Those results were quite consistent with the results of the CAPM analysis. WCTL adds that both analyses used a 6% terminal growth rate, which appears to be on the high side, and Dr. Myers appears to agree, at least as suggested by his identification of lower growth rates in his testimony (although his growth rates are higher than those used by the STB).

As noted in the NPR, one of the limitations of the multi-stage DCF approach is that there is no necessarily correct version to utilize, there is little, if any, basis for choosing between variants, at least closely-related ones, and closely-related ones will yield different results, even if the differences are often minor. In particular, one needs to determine which initial growth rate to use (and/or what source to utilize), the period of time that will be governed by that initial growth rate, the terminal growth rate, when the terminal growth rate will begin, whether to use a transition mechanism, and, if so, what length and what sort of phase-in. WCTL believes that the multi-stage DCF analyses it presented, especially in the Crowley/Fapp RVS, are all quite reasonable in this regard, although minor changes would still produce relatively minor changes in the result.

WCTL does not suggest that CAPM is perfectly precise. In particular, there is, as noted *supra*, room for statistical error and judgment in the derivation of the various inputs, particularly beta, for which a confidence interval can be constructed. (Again, this confidence interval appears to be much smaller than that surrounding the forecasts of

different analysts of the growth in earnings used in the DCF model.) Nonetheless, a virtue of CAPM relative to the DCF method is that the DCF method involves more manipulation and less transparency. This virtue is a significant one, especially given the STB's apparent inclination for mechanical approaches to economic and financial issues, *e.g.*, its recent elimination of most movement-specific adjustments for calculating variable costs.

In contrast, WCTL does not believe that the Ohlson-Juettner ("O-J") and residual income valuation ("RIV") models are particularly useful. As explained in Dr. Hodder's most recent verified statement, both models incorporate some of the basic elements of a multi-stage DCF model, but both are rather complicated and quite dependent on accounting data and do not enjoy the level of support and experience of the multi-stage DCF model, especially in the corporate finance context. Under the circumstances, there is no good reason to devote further consideration to them at the present time.

V. THE RAILROADS' CONCERNS ABOUT ADVERSE EFFECTS OF A REASONABLE CAPM CALCULATION ARE UNFOUNDED

The AAR and its member railroads devote substantial effort to claiming that adoption of a lower COC will cripple their ability to attract needed capital and that the consequence will be that the industry will be unable to serve its existing customers and certainly potential future customers, leading to a doomsday scenario for the railroads, their customers, the nation's highways, and eventually the nation as a whole.

The AAR's claims are grossly exaggerated. The AAR presented much the same claims, and in much the same manner, in opposing the adoption of a productivity adjustment for the rail cost adjustment factor ("RCAF"). However, adoption of the RCAF productivity adjustment has not imposed any harm to the overall health of the railroad industry. Indeed, it can be argued that the productivity adjustment has made the industry more productive, as the industry laggards have had an additional incentive to improve their performance. Moreover, the STB's and ICC's calculation of productivity has provided quantification of the "missing link" by which the railroad industry's financial health has continued to improve even as shippers appear to enjoy the benefit of declining rates.⁵ Use of an accurate COC should also facilitate more appropriate regulation of the railroad industry.

The AAR's primary complaint appears to be that the reduction in their recognized COC will prevent them from obtaining needed funds. However, the railroads have no vested interest in an unreasonably calculated or inflated COC, and available evidence indicates that the regulatory COC has been systematically overstated relative to the railroad industry's actual COC. Moreover, the railroads have not submitted any information about what they consider their internal COC to be, although they undoubtedly have such information in their possession. The information that WCTL has been able to

⁵The explanation is that railroad rates have actually increased relative to cost per unit of output, even as the rates appear to have fallen relative to input prices.

locate (the UBS Report and the S&P studies) indicates that the financial community views the railroad industry as having a COC quite consistent with that calculated by the NPR. Indeed, the COC claimed by the railroad industry appears to be substantially out of line with returns in the stock market as a whole.

Moreover, one must question the impact of the regulatory COC on the railroads' overall financial health. The regulatory COC's primary, if not exclusive, import relates to the regulation of the railroads, and the fact is that most railroad rates are not subject to regulation. Adoption of a lower COC will not substantially alter that reality. Obviously, the regulatory COC has some potential significance for those rates that are subject to regulation, and may lower the jurisdictional threshold for a modest segment of railroad traffic. Nonetheless, captive shippers paying common carrier rates in excess of the jurisdictional threshold on non-exempt traffic face many other obstacles before they can obtain any rate relief. Moreover, it is unclear when, if ever, revenue adequacy will become a meaningful constraint on railroad rates.

The railroads may also be claiming that they need the high rates from their captive traffic to finance their expansion so as to enable their systems to serve other traffic. However, if that other traffic cannot cover its full cost of expansion, then requiring captive shippers to pay more to enable the carriers to serve that traffic amounts to forced subsidization.

Additionally, the STB's regular findings of revenue inadequacy do not appear to reflect reality, especially the fact that the railroads are generally regarded to be in very good financial condition (as evidenced by, for example, the high Investability Quotient ratings from S&P). Moreover, various railroads have recently attracted substantial investments from financially-sophisticated firms known for long-term investments that are unlikely to invest in enterprises that are financially suspect or that are unable to earn their long-term COC. Recognizing that the railroads have a lower COC and are in quite attractive financial health would simply represent a reconciliation of STB findings with economic and financial reality. In contrast, a regulatory approach that does not reflect the relative good financial health of the railroad industry is apt to result in poor regulation and may taint the financial picture of the industry as well, at least to the extent that financial markets take the regulatory picture seriously.

WCTL has noted that the recent rate increases of the railroads have generated additional funds that have been used more to increase dividends, engage in stock buybacks, and/or to reduce long-term debt than to increase capital expenditures, including capacity expansion. The railroads have taken great exception to WCTL's observation and have countered that their capital expenditures remain high, current revenues provide an important source of funds for current operations, and/or their dividend and stock buyback levels are all appropriate. However, if, in the railroads' view, the ostensible benefit of the higher COC is to enable them to charge higher rates to

generate more funds, then it is certainly appropriate to consider whether those increased funds are going to benefit the shippers who provided them, are instead going to benefit other shippers that use other portions of the network (and/or who receive higher priority over captive shippers in the event of any conflict), and/or are going to reward railroad stockholders, especially if those stockholders stand to benefit more if the railroads avoid the creation of excess, or even adequate, capacity.

The railroads' contentions may ultimately devolve to a contention that it is in society's best interests for the railroads to receive such a subsidy. That may be an interesting argument, but, as discussed more fully *infra*, it is one to be considered by Congress and not by the STB. Nothing in the STB's governing statute gives the STB the authority to award the railroads an operating subsidy through an inflated COC or any other means, and numerous provisions of the ICC Termination Act of 1995 previously cited by WCTL clearly indicate that no such subsidy is intended or permitted. For example, the national rail transportation policy is "to allow to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation" (49 U.S.C. § 10101(1)), "to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which *exceed* the amount *necessary* to maintain the rail system and to attract capital" (*id.* at § 10101(6) (emphasis added)), and "to encourage honest and efficient management of railroads (*id.* at § 10101(9)).

The railroads' recent reduction in their long-term debt is of particular concern. In the real world with tax consequences, equity capital is more expensive than debt capital when the firm has reasonable debt levels, and the reduction in debt consequently tends to increase the overall COC. This matter is especially significant for calculating variable costs, where a before-tax cost of capital that reflects a gross-up for corporate income taxes is utilized. Moreover, significant segments of the financial community believe that the railroads are currently underleveraged, and some railroads appear to share that perception. Accordingly, the reduction in long-term debt seems inconsistent with the railroads' statements of their need to invest in infrastructure and capacity expansion.

In short, it is one thing for the railroads to claim that they need more funds to meet future demands, but it is another thing for the railroads to take the increased funds they are receiving from charging higher rates (due at least in part to a perceived shortage of capacity) and use those funds to reward their stockholders and reduce their debt rather than to invest in supposedly needed infrastructure.

In any event, the STB's task should be to calculate an accurate COC, not to calculate an inaccurate COC in order to benefit some other purpose.

VI. THE RAILROAD COC SHOULD NOT BE INCREASED TO REFLECT A COE ADDER OR ANY OTHER ADDITIVE

The AAR and its member railroads have also indicated that the COE should be explicitly increased above the mid-point of the applicable range or otherwise applicable value in order to ensure that the industry can generate adequate capital. This proposal of the railroads amounts to a subsidy in a very thin disguise.

As WCTL has previously explained, the ICC Termination Act of 1995 (the “ICCTA”) does not provide any support for a subsidy, and a number of its provisions are directly to the contrary. In particular, Congress in 49 USC § 10704(a)(2) directed the STB to determine the revenue adequacy of carriers, which the STB and its predecessor have chosen to define in reference to the current COC, *i.e.*, whether the carrier’s revenues are “adequate, under honest, economical, and efficient management, 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.” The specified threshold is whether the carrier’s revenues are adequate and whether the return is reasonable, and there is no provision for any assisted recovery above that level. If there is more return than is needed, then the revenues and return are excessive, and the carrier is not operating “under honest, economical, and efficient management.”

Moreover, § 10704(a)(2)(A) and (B) state specifically that revenue levels are to be “adequate to support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects

of inflation” and “attract and retain capital in amounts adequate to provide a sound transportation system in the United States.” Again, the specified recovery is to be “adequate,” and nothing more.

Additionally, a subsidy constitutes bad economic and regulatory policy. The subsidy, to the extent it is effective at all, would come at the expense of captive customers, and captive customers are the customers that are supposed to be protected by regulation. In particular, one of the purposes of use of stand-alone cost as a measure of rate reasonableness is to prevent subsidization, and that analysis cannot fulfill that function if the stand-alone cost embodies a COC that reflects a subsidy. Furthermore, the subsidy would serve to reduce output by the affected customers, *e.g.*, it would result in higher power prices in the case of WCTL members, contributing to economic dislocation, contrary to the express policies of the ICCTA.

The AAR and its witnesses have referred to how the Federal Energy Regulatory Commission sometimes grants COE “adders” for firms subject to its regulation, but such adders occur under very different circumstances. Specifically, the adders are pursuant to explicit Congressional authorization and instruction, the adders are only for investment for which there is otherwise insufficient marketplace incentive, the incentives are to improve reliability, reduce delivered costs of power, or achieve other competitive benefits (beyond what is already a fairly demanding open access requirement), the adders are typically limited to 50 basis points above the mid-point COE

range, and the adders do not cause the COE to exceed the range of otherwise reasonable COE values. The COE values apparently sought by the railroads do not conform to any of these criteria.

In short, the railroads have not articulated any viable basis for seeking an increased COE.

VII. THE STB CAN, SHOULD, AND MUST REVIEW THE CAPITAL STRUCTURE OF THE RAILROAD INDUSTRY

While the NPR does not include a proposal to review the capital structure of the railroad industry, WCTL submits that such review is fully appropriate and necessary for calculating a reasonable COC.

Use of the CAPM produces a post-tax COC that has little sensitivity to the capital structure. The reason is that assigning a greater weight to debt or increasing the leverage serves to increase the cost of the equity, and the increase in the cost of equity serves to offset the greater weight assigned to debt, the less expensive of the two COC components. The increase in the COE is reflected under the CAPM through use of the levered beta.

However, URCS, used to determine variable costs and the jurisdictional threshold, utilizes a pre-tax COC reflecting an explicit adjustment for taxes, *i.e.*, the COE is divided by 1.0 minus the marginal corporate tax rate of 35%. This explicit introduction of taxes causes the URCS calculation to be sensitive to the capital structure, and a higher portion of equity results in a higher pre-tax COC, even if the capital structure has little or

no bearing on the post-tax COC that is used for calculating stand-alone costs and for measuring revenue adequacy.

In addition, WCTL has previously submitted abundant evidence showing that the financial community, and even the railroads themselves, treat operating leases as debt and not an expense.

The standard practice in other regulatory contexts is to consider the capital structure as part of the determination of the COC. Nothing in the text of the ICCTA suggests that the treatment of the railroad industry COC should be any different. In particular, the national rail transportation policy is “to maintain reasonable rates where there is an absence of effective competition and where rail rates provides revenues which *exceed* the amount necessary to maintain the rail system and to attract capital. 49 USC § 10101(6) (emphasis added). Excessive equity increases the COC above that necessary to maintain the rail system and to attract capital. Moreover, excessive equity is counter to the element of the national policy “to encourage honest and efficient management of railroads” since excessive costs are inconsistent with efficiency. For the same reasons, excessive equity is counter to the requirements in 49 USC § 10704(a)(2) regarding revenues that are “adequate,” not excessive, “under honest, economical, and efficient management” to cover capital costs, reflecting “the repayment of a reasonable level of debt,” and permitting “the raising of needed equity capital,” rather than excessive equity.

The AAR has argued that the capital structure is not subject to review because the capital structure is a matter determined by generally accepted accounting principles (“GAAP”). However, the cost of capital, especially the cost of equity, is not a GAAP concept at all, and to say that GAAP must be used to determine a matter that is not even part of GAAP is nonsensical.

Accordingly, the STB is empowered to, meaning that it can, review the capital structure as part of its determination of the COC; the STB should review the capital structure as part of its determination of the COC so that the COC will be reasonable and comply with the STB’s statutory requirements; and the STB must review the capital structure because failure to do so results in a COC that does not comply with the STB’s statutory requirements.

VIII. CONCLUSION

For the reasons stated above, and in the prior evidence submitted by WCTL in this proceeding as well as in the proceedings concerning the 2005 and 2006 COC, the STB should adopt the COC methodology proposed in its NPR with only minor revision. The STB should also review the railroads’ capital structure as part of its COC determination.

Respectfully submitted,

THE WESTERN COAL
TRAFFIC LEAGUE

Of Counsel:

Slover & Loftus
1224 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 347-7170
Dated: November 27, 2007

By: William L. Slover
/s/ Robert D. Rosenberg
Slover & Loftus
1224 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 347-7170
Attorneys & Practitioner