

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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RAILROAD COST OF CAPITAL — 2020	)))))	STB Docket No. EP 558 (Sub-No. 24)
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**REBUTTAL COMMENTS OF THE ASSOCIATION OF AMERICAN RAILROADS
AND ITS MEMBER RAILROADS**

By a decision served on February 5, 2021, the Surface Transportation Board (“STB” or “Board”) instituted this proceeding to determine the railroad industry’s cost of capital for the year 2020. The Association of American Railroads (“AAR”) submitted the statement of the railroads on April 19, 2021. The only other interested person to submit comments was the Western Coal Traffic League (“WCTL”), which filed its reply on May 10, 2021.

The AAR reiterates that it followed the Board’s instructions to use the methodology followed in Railroad Cost of Capital – 2019, and WCTL does not dispute that. WCTL admits that aside from one concern on the value of market debt, “WCTL’s review of the AAR’s filing and the associated workpapers does not reveal any mathematical or associated data errors.”¹ There being no errors in AAR’s calculations, nor any claims that the AAR failed to follow the cost-of-capital calculation methodology set forth in Railroad Cost of Capital – 2019, the Board should determine that the railroads’ cost of capital for 2020 is 7.89 percent.

¹ Reply Statement of Western Coal Traffic League (WCTL) at 3.

I WCTL's Continued Collateral Attacks on the Board's Cost-of-Capital Methodology Should be Rejected.

As it has in past proceedings, WCTL makes several arguments that boil down to nothing more than complaints about STB's methodology for calculating the railroad cost of capital. Specifically, WCTL argues that the cost of capital decreased in 2020 from its level in 2019 and even more so from 2018 because of the structure of growth rates in the Multi-Stage Discounted Cash Flow model ("MSDCF"). WCTL ignores "the impact of the Covid pandemic and its impacts" to claim it is "skeptical that the railroad industry COC could decline so precipitously in just two years."² WCTL then blames the MSDCF's "instability...particularly with the absence of a transition in the second stage, the redefinition of cashflows for the third stage, and the failure to adjust for stock buybacks."³ What WCTL fails to note is these collateral attacks have been consistently rejected by the Board in the past.⁴ They should similarly be rejected here. As the Board has continuously stated, attacks on the underlying methodology are properly litigated through a proceeding on revising the methodology, not the annual cost of capital proceeding. Indeed, the Board's most recent proceeding regarding revisions to the cost of capital

² *Id.* WCTL does not even seem to believe it realistic to write-off the pandemic, as they conclude that things may change next year "particularly as the pandemic abates." WCTL at 8.

³ *Id.* at 3.

⁴ See *Pet. of the W. Coal Traffic League to Inst. a Rulemaking Proceeding to Abolish the Use of the Multi Stage Discounted Cash Flow Model in Determining the R.R. Indus.'s Cost of Equity Capital*, EP 664 (Sub-No. 2), slip op. at 1-2 (STB served Sept. 28, 2018); *Pet. of the W. Coal Traffic League*, EP 664 (Sub-No. 2), slip op. at 2 (STB served Aug. 14, 2017); *Pet. of the W. Coal Traffic League*, EP 664 (Sub-No. 2), slip op. at 2, 5, 9, 11-13 (STB served Apr. 28, 2017); *Pet. of the W. Coal Traffic League*, EP 664 (Sub-No. 2), slip op. at 11, 14, 17-18, 20 (STB served Oct. 31, 2016); *Use of a Multi-Stage Discounted Cash Flow Model*, EP 664 (Sub-No. 1), slip op. at 11-13 (STB served Jan. 28, 2009).

methodology, specifically rejected WCTL's claims regarding the insufficiency of the MSDCF.⁵

There the Board thoroughly explained:

WCTL's other suggestion, that Morningstar/Ibbotson MSDCF's "variability" is a reason to abandon it, has been implicitly rejected in the Board's decisions finding that Morningstar/Ibbotson MSDCF and [Capital Asset Pricing Model ("CAPM")] each have their own strengths and weaknesses that, when averaged together, lead to a more robust result. (Citations omitted).⁶

As it clearly did last year, and has many times prior, the Board should reject WCTL's collateral attacks on its methodology in this proceeding.

Also consistent with past filings, WCTL again makes a results-based argument that the cost of capital should be lower than what was calculated for 2020, even though 2020 was the lowest cost of capital ever calculated. In an attempt to show that the 2020 result is still not low enough, WCTL uses multiple alternative calculations to show the cost of capital is "overstated."⁷ One option cites Morgan Stanley investor reports; yet, the Board has advised that "challenges to the Board's cost-of-capital methodology, such as WCTL's argument regarding the use of Morgan Stanley's cost of capital, should be addressed in Docket No. EP 664 (Sub-No. 2) and not within this annual Docket No. EP 558 proceeding."⁸ Another offers the option of deriving the railroad cost of capital with only CAPM and the Duff & Phelps current market risk premium ("MRP") and risk-free rate ("RFR").⁹ Yet, a third, manipulates the cost of

⁵ See *Revisions to the Board's Methodology for Determining the Railroad Industry's Cost of Capital (Revisions)*, EP 664 (Sub-No. 4), slip op. at 5 (STB served June 23, 2020).

⁶ *Id.*

⁷ WCTL at 3.

⁸ *R.R. Cost of Capital—2016*, EP 558 (Sub-No. 20), slip op. at 9 (STB served Aug. 7, 2017); see *R.R. Cost of Capital—2012*, EP 558 (Sub-No. 16), slip op. at 10 (STB served Aug. 30, 2013); *Methodology to Be Employed in Determining the R.R. Indus. Cost of Capital (Methodology)*, EP 664, slip op. at 18 (STB served Jan. 17, 2008).

⁹ WCTL at 4-5.

capital calculation using only CAPM with Duff & Phelps current MRP.¹⁰ Finally, WCTL suggests to reduce the already historic low cost of capital by using a market-implied MRP.¹¹ These alternative calculations are nothing more than inappropriate collateral attacks on the Board's methodology.

Just last year in the cost of capital methodology proceeding, the Board "decline[d] to adopt WCTL's alternative proposals" noting the "Board has explicitly rejected some, such as WCTL's requests to either move to a CAPM-only approach or to change the Morningstar/Ibbotson MSDCF regarding cashflows and growth rates, in prior decisions."¹² The Board's cost of capital proceeding also rejected WCTL's similar claims regarding alternative cost of capital calculations, explaining that "[a]lthough WCTL offers alternative cost-of-capital valuations, the mere existence of alternative methodologies does not mean that the Board's methodology is flawed. As the Board has stated previously, 'there is no single 'correct' methodology for determining cost of capital.'"¹³ WCTL's claims rehash arguments already rejected by the Board *twice* last year, and they should be rejected this year as well.

II. The AAR Properly Accounted for the Average Value for Debt.

In addition, WCTL notes one specific concern with the AAR submission. WCTL claims that the average market value of debt for the Class I railroads produced by AAR in accordance with the Board's methodology differ from the "fair market values that the Class I railroads

¹⁰ *Id.* at 6.

¹¹ *Id.* at 6-7.

¹² *Revisions* at 5.

¹³ *R.R. Cost of Capital—2019*, EP 558 (Sub-No. 23), slip op. at 10 (STB served Aug. 5, 2020); *see also R.R. Cost of Capital—2016*, EP 558 (Sub-No. 20), slip op. at 9 (STB served Aug. 7, 2017); *Pet. of the W. Coal Traffic League*, EP 664 (Sub-No. 2), slip op. at 2 (STB served Apr. 28, 2017).

report on their 10-K reports” as though this is a problem.¹⁴ As such WCTL requests “some reconciliation should still be provided.”¹⁵ First, WCTL admits it knows why the values are different, “[t]he explanation may be that the AAR uses average monthly market values and the 10-Ks present end of year values.”¹⁶ The AAR uses average monthly market values for a simple reason, that is what the Board directed when it stated the calculation components should be done “using the methodology followed in Railroad Cost of Capital—2019.”¹⁷ The AAR followed the procedures required of the Board, as it has previously in 2019 and prior, and any requests to change such procedures are inappropriate in this docket. As the Board has explained before, the “AAR’s bond calculations [are] available for verification in Appendix A of the filing” and this fact remains for 2020.¹⁸ The Board should reject WCTL’s arguments here and enforce its precedent that ensures the proper consideration of the annual cost of capital determination.¹⁹

Second, WCTL requests a reconciliation of the AAR’s figures with those of the individual railroad 10-Ks. While such is not required under the procedures, the workpapers do provide, as WCTL admits, a “reconciliation of the AAR’s market values to the 10-K values.”²⁰ Moreover, the AAR’s data uses averages throughout the year, not a year-end snapshot, like the 10-Ks, as doing so provides a more accurate representation of the market values. Further, the workpapers

¹⁴ WCTL at 1.

¹⁵ WCTL at 2.

¹⁶ WCTL at 2.

¹⁷ *R.R. Cost of Capital – 2020*, EP 558 (Sub-No. 24), slip op. at 2 (STB served Feb. 5, 2021).

¹⁸ *R.R. Cost of Capital – 2011*, EP 558 (Sub-No. 15), slip op. at 4 (STB served Sept. 13, 2012)

¹⁹ See *Methodology* at 18 (“one (Docket No. EP 558 sub-numbered proceedings) for the annual estimate and another (Docket No. EP 664 sub-numbered proceedings) for petitioners to advocate changes to the cost-of-capital model”).

²⁰ WCTL at 2.

provide the underlying data to the extent possible without disclosing any proprietary data. The Board has specifically addressed this approach as sound, finding the use of Bloomberg subscription bond data appropriate.²¹ This process has been sufficient in prior years, and WCTL has provided no justification to change the process now.

III. The Beta Calculation Shows Railroad Stocks Have Risk.

In the AAR's opening, Mr. Gray's Verified Statement factually explains that "[t]he 2020 beta is lower than the beta for 2019 (1.0941), and is the lowest since 2009. However, this is the twelfth consecutive year that the railroad beta has been above 1.0, further demonstrating that railroad stocks are consistently more volatile and are regarded as having more risk than does the market generally."²² WCTL takes issue with this statement and selectively cites it to make spurious claims that it is an oversimplification and an overstatement. It is neither. Beta is the coefficient of systematic, non-diversifiable risk, so it seeks to estimate the measure of non-diversifiable risk of the railroads, as compared to the market as a whole. Beta above 1.0 indicates more risk and below 1.0 indicates less risk, as comparable to the market as a whole. As is required, Mr. Gray used the 5-year rolling average to calculate beta. Whether it includes a timeframe of financial collapse or not is immaterial, because that is used per the Board's

²¹ *R.R. Cost of Capital – 2011* at 4 ("The use of a subscription service for outstanding bond data is permissible and consistent with past annual cost-of-capital proceedings... the Board will accept the data submitted by AAR as the best evidence of record. AAR's bond calculations were available for verification in Appendix A of the filing. Further, summary tables of data provided by both Bloomberg and S&P were made available for review in AAR's workpapers.").

²² AAR Opening, Gray V.S. at 35-36.

direction, and was adopted by the Board at WCTL's suggestion in 2006.²³ As the Board explained in its decision "a 5-year period is more common and will provide a more forward-looking estimate that will better and more quickly reflect the changing nature of the rail industry."²⁴ There is no dispute from WCTL that the beta is calculated incorrectly; there is no dispute that this is the lowest beta since 2009; there is no dispute that beta has been above 1.0 for twelve straight years—these are all facts, and the logical conclusion to those facts – beta being consistently above 1.0—is that there is risk in railroad stocks.²⁵

Conclusion

In sum, WCTL concedes that AAR correctly calculated the cost of capital. Therefore, the Board should determine that the railroads' cost of capital for 2020 is 7.89 percent.

Respectfully submitted,



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²³ *Methodology*, at 9-10 ("WCTL takes the position that, while a 10-year period is reasonable, it is 'towards the longer end of what is generally considered reasonable,' and that a measurement period of 5 years would be reasonable. WCTL observes that a 5-year period is the approach used by Morningstar/Ibbotson and other notable providers of cost-of-capital estimates.")

²⁴ *Id.* at 10.

²⁵ To the extent WCTL points to partial year betas for individual railroads, such cherry-picking of "evidence" flies in the face of prior claims by WCTL that "[a] period any shorter than 5 years is likely to introduce excessive volatility and noise as values may fluctuate significantly from year-to-year." WCTL Opening, *Methodology*, EP 664, at 7 (Sept. 27, 2007).

CERTIFICATE OF SERVICE

I hereby certify that on this 2nd day of June, 2021, I caused to be served by electronic mail a copy of the foregoing on the following:

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/s/ Kathleen Birch
Kathleen Birch