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BEFORE THE
SURFACE TRANSPORTATION BOARD

In the Matter of	)	
USE OF A MULTI-STAGE DISCOUNTED CASH FLOW METHODOLOGY IN DETERMINING THE RAILROAD INDUSTRY'S COST OF CAPITAL	)	STB Ex Parte No 664 (Sub-No 1)

REPLY COMMENTS OF THE WESTERN COAL TRAFFIC LEAGUE

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Dated October 15, 2008

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SURFACE TRANSPORTATION BOARD

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REPLY COMMENTS OF THE WESTERN COAL TRAFFIC LEAGUE

The Western Coal Traffic League ("WCTL" or "League") hereby submits its reply comments in response to the Notice of Proposed Rulemaking ("NPR" or "Notice") that the Surface Transportation Board ("STB" or "Board") served in this proceeding on August 11, 2008

There was a substantial disparity in the opening comments filed by the various parties in response to the Multi-Stage Discounted Cash Flow ("MSDCF") model proposed in the NPR WCTL's comments on the MSDCF model presented a thorough and detailed analysis of the Board's proposal, whereas those of the three other parties that commented[1] were quite short and offered little in content and specifics AECC generally deferred to WCTL The AAR's comments were brief and generally confined to

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[1]Those three other parties were Arkansas Electric Cooperative Corporation ("AECC"), the Association of American Railroads ("AAR"), and the United States Department of Transportation ("DOT")

supporting the NPR and reiterating some of its prior comments DOT added little other than expressing support for the NPR

WCTL expects that the AAR, and perhaps DOT as well, will say significantly more on reply Such tactics will leave WCTL without a meaningful opportunity to respond Under such circumstances, the STB should give little, if any, weight to their reply comments

WCTL believes the paucity of comments is due to several related factors that are directly under the Board's control In particular, the Board's NPR did not discuss the details of the AAR proposal that it proposed for adoption Beyond that, the NPR did not ask questions or seek comment on key assumptions and choices in the AAR model or even suggest that these matters were open for comment In particular, the NPR did not ask whether the inputs utilized in the AAR model were sound or even plausible, especially as applied to the railroad industry with its supposedly unique qualities, including its capital intensity Nor did the NPR request comment on whether the assumptions in the AAR's MSDCF proposal were more credible than those in the MSDCF models previously presented by WCTL [2] Instead, the NPR assumed, without seeking any comment, that the AAR model was necessarily superior to the two models

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[2]A further contributing factor was that the STB did not post the AAR's electronic workpapers (or WCTL's for that matter) that provide supporting data for the calculations, which information is not apparent from the NPR or even the AAR's comments as filed and posted

presented by WCTL because the AAR model was based, to some extent, on the model independently developed by Ibbotson The Board's NPR thus sought to "stack the deck" in terms of which model and issues would and would not be considered These actions represent serious deficiencies in the procedures and substantive approach utilized by the Board and should preclude adoption of the proposal in the NPR

To some extent, the NPR, as well as the comments of the AAR and DOT, dwell instead on whether the standard deviation in the estimation of the cost of equity ("COE") is reduced by combining the proposed MSDCF model with the Capital Asset Pricing Model ("CAPM") that the STB adopted earlier this year As WCTL explained in its comments, focusing on the standard deviation is a poor substitute for considering whether the underlying assumptions and choices are sound and whether the resulting COE estimate is plausible or accurate

Indeed, if the objective were to lower the standard deviation, there would appear to be at least two ways in which the result could be achieved within the CAPM approach itself that are worthy of further pursuit The first would be to use a longer beta measurement period Ironically, the Board originally proposed a beta measurement period of ten years, but did not adopt it in large part because of the AAR's opposition The second would be to use a lower market risk premium ("MRP"), such as one based on a shorter historical period (again, which the Board originally proposed and the AAR opposed) or a prospective assessment that more accurately and directly reflects the opportunity cost of capital While the MRP itself stays relatively constant (especially under the Board's 80-plus year measurement period), the MRP is multiplied by the beta, which tends to be the most variable element of the calculation, and the product tends to vary more than the risk-free rate of return ("RFR") Using a lower MRP would cause the relatively stable RFR to form a larger portion of the COE, thereby likely contributing to stability and reducing the standard deviation

In short, if the Board considers stability or the standard deviation to be a significant problem, it is largely one of the Board's own creation, and it should not be utilized as a pretext for increasing the railroad industry COE beyond a level that is already unwarranted relative to other independent estimates of the COE, as explained in WCTL's opening comments and addressed further *infra* Additionally, the focus on stability seems to be a relatively recent development In particular, WCTL does not recall that the Board, the AAR, or DOT expressed any concern when the railroad industry cost of capital ("COC") under the prior single-stage discounted cash flow ("SSDCF") methodology jumped from 10 1% in 2004 to 12 2% in 2005 or was proposed to jump still further to 13 8% in 2006

The Board's focus should be whether changes to its methodology contribute to a more realistic and plausible estimate of the COE Unless a proposed change results in a superior estimate in terms of realism and plausibility, it should not be adopted The Board's failure to ask this question, or even give it meaningful consideration in its NPR, represents a failure to comply with the most basic elements of reasoned decision-making In particular, there is abundant evidence, which WCTL had presented to the STB even before it issued its NPR, that its CAPM approach yielded an excessive COC, especially as a result of the extremely long-term historic MRP That excess would only be exacerbated by combining the CAPM with the even higher figures resulting from the AAR MSDCF proposal

Specifically, as WCTL noted in its opening comments, the investment community (including Standard & Poor's and the UBS report of the industry "consensus") places the railroad industry COC for 2006 at 8% to 9 5%, below the 9 94% figure that the STB calculated for 2006 in its first application of CAPM However, the STB's recent 2007 CAPM determination in Ex Parte No 558 (Sub-No 11), *Railroad Industry Cost of Capital -- 2007* (STB served Sept 26, 2008), reveals a very sharp increase in the railroad industry COC, all the way to 11 33%, an increase of 14% The increase does not appear to reflect increased risk as such or a substantial surge in perceived long-term inflation risks, instead, it reflects escalating exercise of market power by the railroad industry over the past five years The railroad industry should not be rewarded with a higher cost of capital because it has been raising its rates, as WCTL has repeatedly noted in its filings, including its opening comments However, the MSDCF approach proposed by the AAR and the Board would cause the COC to increase even further

The only apparent virtue of the AAR approach discussed in the NPR is that it is based upon the Ibbotson 3-stage model that was independently developed However, there is every reason to think that the AAR proposed the Ibbotson-based approach not because it was independently developed, but because it yields what are favorable results for the railroad industry, meaning a higher COE for the AAR and its member railroads

While independence may be desirable, it provides no assurance that a model will yield accurate and realistic results, especially as applied to a specific industry, and all the more so if that industry has unique or relatively rare characteristics As WCTL explained in its opening comments, the AAR variant of the Ibbotson model relies on various assumptions that are unwarranted and that contradict positions that the AAR and the Board have taken elsewhere In particular, the model assumes that very aggressive assumptions (especially for what is a long-established industry) as to growth for a period as short as three years will prove accurate for ten years, which is a dubious proposition, as explained in the Fama French article that WCTL referenced in its opening comments The limited sampling (only the four largest Class I railroads) prevents the average from being reflective of the industry as a whole, which is the guiding intent for at least the second stage of the model, and also creates a fatal circularity, that is, the railroads are going to be allowed to charge more because they have been charging more The model also assumes that depreciation will exactly offset capital expenditures after ten years, a claim that is completely at odds with the AAR's own studies (such as the Cambridge

Systematics report) and the Board's focus on the need to expand the capacity of the railroad industry The model also gives no attention to working capital requirements, the importance of which has been brought home by the difficult economic events of the past few weeks Moreover, the proposed approach involves a reduction in transparency and in outlier elimination (a potential source of instability) compared even to the discarded SSDCF model

Significantly, the NPR and the comments of the AAR and DOT offer no defense of the specific choices and inputs of the model or explanation of how they are appropriate for the railroad industry Instead, the claim is that the model is appropriate precisely because it is generic and not developed (although it is modified) for purposes of estimating the railroad industry COE Even more remarkably, the NPR's proposal, endorsed not only by the AAR but also by the DOT, is that the MSDCF proposal, regardless of its flaws, should receive equal weight with CAPM in determining the railroad industry COE In other words, the Board and the two other parties propose giving equal weight to a rigorous CAPM methodology that reflects a specific analysis of the railroad industry and a very generic methodology that makes a number of questionable assumptions, including some critical ones that are unwarranted and/or contradict assertions made by the AAR or the Board itself in other contexts

In addition, the Board proposes to take this step without any explicit consideration of the fact that the MSDCF proposed by the Board results in a higher COE than under the CAPM, whereas the models previously presented by WCTL result in a lower COE The NPR does not articulate any technical reason why the AAR proposal should be superior to WCTL's proposals, yet they have substantially different impacts, and the Board avoids any discussion of that impact altogether

As WCTL and its experts have explained previously, utilizing more than one model to estimate the COE has the potential to be a very useful exercise, but the second model should not be mechanically applied and should instead be used as a basis for comparison, analysis, and, if possible, reconciliation Instead, the Board, supported by the AAR and DOT, propose to apply the MSDCF in the most mechanical fashion possible, as half of the average along with CAPM The Board should be able to make a more reasoned and informed assessment of the probative value of the MSDCF calculation

WCTL further observes that the current, and unfortunately ongoing, economic tumult appears likely to have serious consequences for matters extending far beyond the determination of the railroad industry COE and COC Attempting to gauge those consequences until events have played themselves out more fully is apt to be an exercise in speculation On the other hand, ignoring current developments altogether amounts to an exercise in denial

That said, the Board's underlying CAPM assumption in its 2007 cost of capital determination (and its 2007 revenue adequacy determination as well) that the average long-term return for equities (or at least the S&P 500, which covers most of the domestic capitalization) will be 11 96% (reflecting an RFR of 4 91% and a MRP of 7 05%) appears to be inordinately generous in light of more recent developments WCTL wonders if the STB really expects that the market will produce such a lofty return such that it should be used as the basis for determining the railroad industry COE Stated different, does the STB expect that a generic publicly-traded corporation must achieve a long-term average return of 11 96% in order to be able to attract equity capital in the current environment?[3] Even assuming that the STB really believes the 11 96% market return is realistic, the MSDCF calculations proposed by the Board in the NPR yield a higher COE and thus implicitly presume an even higher return Given other evidence that the railroad COC is under 10% (and by a significant amount according to at least Standard & Poor's), WCTL does not see how the Board's proposed use of MSDCF can possibly contribute to a more accurate, realistic, credible, plausible, or useful COE Instead, it is simply a mechanism to allow the railroads to charge more because they have been charging more

Accordingly, the NPR's MSDCF proposal should not be adopted Its assumptions are unwarranted and it yields results that lack credibility Any combination with CAPM will degrade, rather than enhance, the resulting COC estimate If the Board

[3]To be sure, a corporation could alternatively attract debt capital at a lower cost, but under the Modigliani-Miller theorem embraced by the Board, there would be a commensurate increase in the COE that would cause the overall COC to remain constant

wishes to pursue a sound MSDCF methodology, it should give meaningful consideration to WCTL's prior proposals Beyond that, the Board's NPR is defective It does not ask the right questions and it attempts to assume its conclusions Independence is not a sufficient substitute for accuracy Nor does a reduced standard deviation provide any assurance that the resulting estimate is more accurate If stability were so important, the STB could and should have adopted a longer beta measurement period and a lower market risk premium

Accordingly, the Board should not adopt the MSDCF proposal in its NPR

Respectfully submitted,

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