BEFORE THE

SURFACE TRANSPORTATION BOARD

STB EX PARTE NO. 664

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

PUBLIC HEARING COMMENTS OF THE

U.S. DEPARTMENT OF AGRICULTURE

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AUTHORITY AND INTEREST

The Secretary of Agriculture is charged with the responsibility under the Agricultural Adjustment Act of 1938 and the Agricultural Marketing Act of 1946 to represent the interests of agricultural producers and shippers in improving transportation services and facilities by, among other things, initiating and participating in Surface Transportation Board (Board) proceedings involving rates, charges, tariffs, practices, and services.

INTRODUCTION

The Department of Agriculture (USDA) thanks the Board for holding this hearing which allows interested parties the opportunity to more fully debate the Board's proposed methodology to calculate the railroad industry's cost of capital. The issues involved in estimating the railroad industry's cost of capital merits the Board's careful deliberation of the record and careful consideration of the basic inputs and assumptions of its proposed methodology.

An accurate estimate of the railroad industry's cost of capital is important because the Board is required to balance the railroad industry's need for an adequate return on investment with protecting shippers from excessive rail rates.[1] The accuracy and fairness of many of the Board's regulatory decisions depend upon an accurate and unbiased estimation of cost of capital, particularly in regard to the cost of equity which, unlike the cost of debt, can only be estimated.

Among other things, the estimation of the cost of capital is important in: (1) determining whether railroads are revenue adequate; (2) which rail tariff rates are deemed

[1] Rail Transportation Policy, ICC Termination Act of 1995, §10101.

to be excessive; (3) revenue-to-variable cost ratios; and (4) whether the Board should allow abandonment of a rail line. Consequently, the outcome of this proceeding can have important ramifications for our nation's agricultural producers, shippers, and rail carriers.

The methodology and data used to estimate the railroad industry's cost of capital should be reasonably accurate, fair to both shippers and railroads, transparent to all stakeholders, and provide estimates that are relatively stable from year to year. USDA contends that the Board's proposed methodology more closely fulfills these criteria than the rail industry has stated, but recognizes that some adjustments to the methodology may be appropriate. The record of this proceeding has provided numerous comments and verified statements that could help guide the Board in determining the best methodology.

USDA recommends that the Board use the Capital Asset Pricing Model (CAPM) as its primary method of estimating the cost of equity and has no objection to the use of a properly designed and unbiased 3-stage Discounted Cash Flow model to check the reasonableness of the CAPM estimate. In addition, USDA strongly urges that the Board reject the railroads' recommendation to choose a cost of equity toward the upper end of the range of multiple estimates. Finally, USDA recommends that the Board reject the use of an inflation adjusted asset base when estimating the railroad industry cost of capital.

ESTIMATE OF COST OF EQUITY MUST BE UNBIASED

The Association of American Railroads (AAR) states that the Board has derived an unreasonably low estimated cost of equity. To correct this, the AAR suggests that the Board consider multiple estimates of the cost of equity and choose a value toward the upper end of the range when anticipated growth in demand from shippers is expected to require large new capital investments in property (AAR Reply Comments, pg. 2-3, 21-22).

USDA strongly opposes the use of any methodology which would provide a biased estimation of the railroad industry's cost of equity in order to encourage investment in rail infrastructure. Such a biased estimate would be expected to result in the misallocation of resources and reduced economic efficiency. USDA believes it is far more important to develop a methodology that is as accurate as possible rather than to arbitrarily choose a pre-determined level at the upper end of a range. The development of accurate cost of capital estimates will be far more fair to all parties.

The estimation of the cost of capital is important in determining which rail tariff rates are deemed to be excessive, revenue-to-variable cost ratios, and whether the Board should allow abandonment of a rail line. Consequently, USDA contends that a policy decision to encourage investment in rail infrastructure should be implemented in ways that do not impact the fairness of the Board's basic decisions in these areas.

Furthermore, USDA contends that it is just as important for the Board to protect and encourage shipper and producer investment as to do so for railroad carriers. If the estimated cost of equity is too low, it would be expected to hinder railroad investment and if the estimate is too high, it would be expected to hinder shipper and producer investment.

Thus, USDA agrees with DOT that the "difficult task of balancing the Staggers Act's sometimes inharmonious goals is best met in this proceeding by adopting the methodology that produces the most realistic estimate of the cost of capital" (DOT Reply Comments, October 29, 2007, pg. 7). The various options for estimating the risk free rate of return, β, the market risk premium, and the appropriate time period from which to draw historical data should be closely evaluated against their effects upon the desired characteristics of being reasonably accurate, fair to both shippers and railroads, transparent to all stakeholders, and provide estimates that are relatively stable from year to year. To meet the requirements for being unbiased and fair, the chosen methodology must have a sound theoretical basis but reflect marketplace realities.

REPLACEMENT COST ASSET BASE IS INAPPROPRIATE

Some parties have recommended the use of a replacement cost asset base (Reply Comments of The Children's Fund, pp. 1-6; BNSF, pg. 4). USDA recommends that the Board not approve the use of a replacement cost asset base when calculating the railroad industry cost of capital.

A replacement cost asset base has serious deficiencies when used to estimate the cost of capital. The first deficiency is that it could provide windfall profits for rail carriers at the expense of shippers. The cost of debt already includes a risk premium for expected inflation and financial theory implies that the cost of equity also would include such a risk premium. Thus, a replacement cost asset base would allow railroads to double dip on the costs of inflation.

A second deficiency is the difficulty determining reliable replacement costs and implementing these values in a regulatory situation. In particular, the table in Appendix 1 values all locomotives, freight cars, and track miles at the replacement value (Reply Comments of The Children's Fund, pg. 6). USDA notes that all of these items have had considerable usage and all have a life span that provides a certain level of use over the lifetime of the assets. It is incongruous that the proposed replacement valuation ignores this wear and does not provide lower values for outdated technologies. None of the sane parties in this proceeding would purchase used equipment at the same price as new equipment of the same model. Thus, it seems inappropriate and unfair to expect shippers to pay new prices (through higher rail rates) for partially depreciated, old, or worn out railroad assets.

CONCLUSION

The issues involved in estimating the railroad industry's cost of capital merits the Board's careful deliberation of the record and careful consideration of the basic inputs and assumptions of its proposed methodology. The accuracy and fairness of many of the Board's regulatory decisions depend upon an accurate and unbiased estimation of cost of capital, particularly in regard to the cost of equity which, unlike the cost of debt, can only be estimated.

The estimation of the railroad industry's cost of capital should be reasonably accurate, fair to both shippers and railroads, transparent to all stakeholders, and provide estimates that are relatively stable from one year to the next. USDA contends that the Board's proposed methodology more closely fulfills these criteria than the rail industry has stated, but recognizes that some adjustments to the methodology may be appropriate. Therefore, USDA recommends that the Board:

- Use the Capital Asset Pricing Model (CAPM) as its primary method of determining the cost of equity and has no objection to the use of a properly designed and unbiased 3-stage Discounted Cash Flow model to check the reasonableness of the CAPM estimate.
- Reject the railroads' recommendation that the Board choose a cost of equity toward the upper end of the range of multiple estimates.
- Reject the use of an inflation adjusted asset base in the estimate of railroad industry cost of capital.

Respectively submitted,

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CERTIFICATE OF SERVICE

I, Bruce Blanton, certify that on this 27th day of November, 2007, I caused a copy of the foregoing document to be served by first-class mail, postage prepaid, on all parties of record in STB Ex Parte No. 664.

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