

701—76.5 (434) Income capitalization approach to unit value.

76.5(1) The income capitalization approach to unit value estimates the market value of the operating property by dividing the income stream generated by the operating assets by a market-derived capitalization rate based on the costs of the various sources of capital utilized or available for use to purchase the assets generating the income stream.

a. The net railway operating income to be capitalized shall be a weighted average net railway operating income. The weighted average net railway operating income shall consist of an average of the three 12-month periods immediately preceding the valuation date. Each of the three preceding 12-month periods shall be weighted by multiplying the first preceding period by 60 percent, the second preceding period by 30 percent, and the third preceding period by 10 percent. There shall be no adjustment for the company's current-year deferred income taxes to this income stream.

b. The department may also utilize a "free cash flow model" in calculating the railway operating income to be capitalized. The "free cash flow model" shall consist of an average of the five 12-month periods immediately preceding the valuation date. Each of the five preceding 12-month periods shall be given equal weighting in the calculation of the five-year average railway operating income to be capitalized. Each year the net railway operating income shall be adjusted by adding the current-year deferred income taxes associated with maintenance expenditures, adding the current-year depreciation expense, and subtracting the current-year capital expenditures necessary to maintain the plant.

c. The department may give consideration to both calculations of operating income as described in this subrule to determine the railway operating income to be capitalized. The department may also consider, in both calculations, adjustments for extraordinary, unusual, and infrequent items. These adjustments would not be expected to occur annually and are different from the typical railroad business operations. The purpose and intent of the income indicator of value is to match income with sources of capital and therefore every source of capital utilized or available to be utilized to purchase assets should be reflected in the capitalization rate determination as well as all operating income. The department shall not include a separate adjustment to either income stream for noncapitalized operating leases. In the event the railroad company has no income or has a negative income, the indicator of value set forth in this subrule shall not be utilized.

76.5(2) If any operating property is clearly not income producing and, therefore, is not reflected in the income stream, the value of that asset shall be determined separately and added to the value of the other operating property as determined using the income indicator of value. The capitalization rate shall be adjusted, if necessary, for the market rate of return for the sources of capital utilized to purchase such non-income-producing properties where the sources can be clearly identified; otherwise the cost of the sources of capital shall be presumed to be equal to the overall market-weighted costs of the other sources of capital.

76.5(3) If the railroad company is one which can earn a return on assets purchased with sources of capital, excluding the company's deferred income taxes, the income will reflect the earnings on those assets, and as a consequence, a separate adjustment to the capitalization rate is required. The capitalization rate shall be determined by utilizing, where appropriate, market rates of return weighted according to a market determined capital structure. All sources of capital shall be considered in the capital structure as well as market costs associated with each source of capital; otherwise the cost of the sources of capital shall be presumed to be equal to the overall market-weighted costs of the identified sources of capital. The following is an example of the application of this rule.

| | (1) | (2) | (3) | (4) |
|-----------------|-----------------|-----------------------------|---------------|-----------------------------------|
| | Market Value | Market Rate of Return | % to Total | Component (Col. 2 × Col. 3) |
| Common Stock | 60,000 | 15% | 66.67 | 10.00 |
| Preferred Stock | 5,000 | 13% | 5.55 | .72 |
| Debt | 25,000 | 12% | 27.78 | 3.33 |
| | <u>90,000</u> | | <u>100.00</u> | <u>14.05</u> |

This rule is intended to implement Iowa Code section 434.15.

[ARC 2657C, IAB 8/3/16, effective 9/7/16]