BEFORE THE
SURFACE TRANSPORTATION BOARD

DOCKET NO. EP 558 (Sub-No. 18)

RAILROAD COST OF CAPITAL - 2014

REPLY COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION

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In accordance with the Board's decision served February 19, 2015, as corrected on February 25, 2015, Arkansas Electric Cooperative Corporation (AECC) 1/ submits these comments in reply to the "Comments of the Association of American Railroads and Its Member Railroads" filed April 20, 2015 (hereafter, "AAR Comments") regarding the railroad industry cost of capital for 2014.

1/ AECC is a membership-based generation and transmission cooperative that provides wholesale electric power to electric cooperatives, which in turn serve over 500,000 customers, or members, located in each of the 75 counties in Arkansas and in surrounding states. In order to serve its 17 member distribution cooperatives, AECC has entered into arrangements with other utilities within the state to share generation and transmission facilities. For example, AECC holds ownership interests in the White Bluff plant at Redfield, AR and the Independence plant at Newark, AR, each of which typically uses in excess of 6 million tons of Powder River Basin (PRB) coal each year. In addition, AECC holds ownership interests in the Flint Creek plant at Gentry, AR and the Turk plant at Fulton, AR, each of which typically uses on the order of 2 million tons of PRB coal each year. Because of the large volume of coal consumed by these plants, the need for long-distance rail transportation to move this coal, and the rail captivity of three of these plants, AECC has a direct interest in Board actions that may affect the price and service characteristics of coal transportation options.

INTRODUCTION AND SUMMARY

This reply, based on the information provided by AAR 2/ and other public information, highlights four considerations that are crucial to the proper measurement of the railroad industry cost of capital. These are:

1. The data for 2014 reveal a dramatic escalation of "supracompetitive" rail earnings – i.e., earnings above the level needed to provide a market return on invested capital. From 2013 to 2014, the Class I railroads' supracompetitive earnings increased by over $670 million, or 36%. That escalation demonstrates how urgently the public interest demands that the Board bring order to its regulatory practices pertaining to such excessive earnings, including remedial action to address demonstrated problems with the methodology it currently uses to estimate the rail cost of capital.

2. The data for 2014 continue to manifest the broad range of methodological problems discussed by AECC in Railroad Revenue Adequacy and Petition Of The Western Coal Traffic League To Institute A Rulemaking Proceeding To Abolish The Use Of The Multi-Stage Discounted Cash Flow Model In Determining The Railroad Industry's Cost Of Equity Capital, Docket Nos. EP 722 and 664 (Sub-No. 2), respectively (hereinafter cited "Docket Nos. EP 722/664"), such as excessively high CAPM cost of equity estimates produced by inflated "beta" values, and MSDCF estimates that are even higher than the CAPM values because of the way they ignore essential public interest responsibilities of the Board. Nothing in AAR's filing alters the need for the Board to address the issues AECC previously has raised.

2/ AAR's filing consists of 220 pages, and focuses largely on documentation of the computations performed by AAR and the data inputs used. AECC has not attempted to validate AAR's data inputs or replicate all of the details of AAR's computations.

3. Although AECC in Docket Nos. EP 722/664 documented severe problems with increasing beta values (and computed cost of capital) under the CAPM portion of the Board's cost-of-capital methodology, AAR doesn't even acknowledge or attempt to address directly AECC's evidence. It simply characterizes such increasing values as "expected". AAR's characterization is invalid.

4. In the cost of capital findings developed by AAR, results for more than half of the individual Class I railroads are either missing or nonsensical. Thus, the results of the incumbent methodology generated by AAR rest on a limited and biased sample.

Each of these considerations is discussed in further detail below.

Although the Board has stated that parties in this docket should apply the incumbent methodology for determining the railroad cost of capital, the foregoing considerations show that continued use of the incumbent methodology would be detrimental to the public interest to a degree that the Board may not have contemplated at the time of its decision initiating this proceeding. AECC recommends that the Board avoid any further reliance on this methodology, either by accelerating the Board's consideration of cost-of-capital methodology issues raised in Docket Nos. EP 722/664, or by adopting for interim use values that are representative of the financial markets in which a revenue adequate Class I rail industry is now able to effectively compete, and that are not known to be affected by the idiosyncratic problems that plague the incumbent methodology.

DISCUSSION

Supracompetitive Earnings

Data for 2014 reveal a substantial escalation of supracompetitive rail earnings. During 2014, supracompetitive earnings by the Class I railroads increased by over 36 percent, from the $1.87 billion computed previously for 2013 3/ to over $2.54 billion. 4/ This escalation increases the urgency of action by the Board to remedy problems with its incumbent methodology for estimating the railroad cost of capital, to cease reliance on that methodology, and to base its regulatory practices on accurate cost of capital estimates.

Even this 36% increase may understate the full extent of the growth in supracompetitive earnings during 2014, because AAR's 2014 figures incorporate large and unusual downward adjustments made by CP/Soo in the 2014 net income that it reported for revenue adequacy purposes. 5/ It is beyond the scope of these comments to investigate the

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3/ Docket Nos. EP 722/664, Opening Comments of Arkansas Electric Cooperative Corporation dated September 5, 2014 ("AECC Opening Comments"), Appendix A, Table A-1.

4/ Computed from 2014 Form 250 data as Adjusted Net Railway Operating Income for the composite of the 7 reporting carriers ($14.65 billion) less the product of the mean of the beginning and end of year values of the Net Investment Base for the composite of the seven reporting carriers ($113.68 billion) and the 2014 rail industry cost of capital determined by AAR (10.65 percent).

5/ CP/Soo's Net Railway Operating Income for 2014 was over $390 million, but on Form 250 it recorded adjustments that had the effect of reducing that figure to a loss of $12 million. To the extent that those adjustments stem from the sale by CP (to Genesee and Wyoming) of a portion of the former DME, they appear to be both excessive and potentially inconsistent with the statute. The adjustments are excessive because CP in a news release to investors dated January 2, 2014 and posted on its website stated that the total magnitude of the loss it expected to experience as a result of the transaction was $240 million. The adjustments are potentially inconsistent with the statute because Section 10704(a) (2) specifically directs the Board to circumscribe its support for revenue adequacy achievement by individual carriers [Footnote continued next page]

details of those adjustments, which the Board presumably will examine carefully in its revenue adequacy assessments. If the Board were to determine that those adjustments are unwarranted or improper for revenue adequacy purposes, railroad supracompetitive earnings for 2014 would be approximately $2.95 billion, representing a 57.8 percent increase over 2013.

Whatever the exact value of supracompetitive earnings turns out to be, AAR's filing shows that the financial markets responded to the railroads' earnings increase by increasing the market capitalization (i.e., equity value) of the Class I railroads included in the sample by approximately 26 percent in one year. 6/ AAR tries to downplay this dramatic growth by arguing that it is supposedly "a similar pattern" to the growth in equity value experienced by the market as a whole. 7/ However, the plain fact is that the 26 percent growth in rail equity value documented by AAR is literally double the 13 percent 8/ increase in the S&P 500 that occurred in 2014.

[Footnote continued]
through application of a standard of "honest, economical, and efficient management". It is unclear how, under sound management, assets that had been acquired by CP in its purchase of DME only 6 years earlier could carry book values so far in excess of actual market values as to create such a substantial loss. Whatever the explanation, CP - by statute – must not be allowed to send the bill for its own management missteps – possibly including things like substantial overpayments for assets, sunk costs stemming from strategy reversals, accounting overvaluation of assets, etc. -- to shippers by using the resulting losses to increase its ability to exercise market power on the supposed basis of revenue inadequacy.

6/ The 26 percent figure is cited in AAR Comments, VS Gray at 25, and described as the increase from 2013 to 2014 in the average market capitalization of the composite of the four sampled railroads. The 26 percent figure also results from a comparison of the values for the last and first weeks shown in AAR Comments, VS Gray, Appendix G at page 5.

7/ AAR Comments, VS Gray at page 25.

8/ Calculated as the increase from 12/30/2013 (1841.07) to 12/30/2014 (2080.35).

AECC described in Docket Nos. EP 722/664 the resource allocation harms that result from supracompetitive earnings, and from overstatement of the actual cost of capital by the incumbent methodology. 9/ With respect to CAPM, AECC demonstrated that the beta factor estimated and applied in the Board's CAPM has incorrectly interpreted increases in the exercise of rail market power as increased risk, thereby raising the calculated cost of capital. With respect to MSDCF, AECC identified fundamental flaws in the stages of the Board's analysis that depend on analysts' expectations of carrier earnings growth, and also in the stage that depends on the long-term growth rate of the economy as a whole. 10/ The escalation of supracompetitive earnings increases the urgency of remedial action by the Board to address demonstrated methodological problems.

Manifestations of Methodological Problems

The data for 2014 continue to manifest the broad range of methodological problems discussed in Appendix A of AECC's opening comments in Docket Nos. EP 722/664. Although the CAPM beta value found by AAR for 2014 (1.2503) is slightly lower than the value for 2013 (1.3499), it still is higher than any other beta estimate since the introduction of CAPM in 2006, and causes the CAPM estimate for 2014 (11.82 percent) to exceed the estimated market cost of equity capital (determined by adding the Risk-Free Rate and the Market Risk

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9/ Docket Nos. EP 722/664, AECC Opening Comments at pages 14-17.

10/ Docket Nos. EP 722/664, AECC Opening Comments, Appendix A.

Premium) by 175 basis points. 11/ Likewise, MSDCF continues its track record of always producing cost of equity capital estimates even higher (12.30 percent) than those produced by the inflated beta values used in CAPM. While the MSDCF result is somewhat lower than the wildly excessive values found in the past, its use, when averaged with the CAPM result, still causes the estimated cost of equity capital (12.06 percent) to exceed the corresponding market cost by 199 basis points. In short, nothing in the AAR filing alters the need for the Board to address the issues AECC has raised.

CAPM Beta Inflation

In Docket Nos. EP 722/664, AECC documented and discussed in detail the problems associated with increasing beta values (and computed cost of capital) under the Board's CAPM methodology. AAR offers no direct response to this information, but it purports to justify such values for 2014 as being "expected" (see AAR Comments, VS Gray at 34, esp. fn 36). AAR's supposed explanation is nonsensical on multiple levels. The tech stock "bubble" it references ended many years before the data series AAR actually uses. AAR's argument boils down to the baseless proposition that the fact railroads were less volatile than tech stocks during the bubble somehow implies that they now are more volatile than the market average. AECC long ago forewarned the Board of the improper effects that changes in the exercise of rail

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11/ Calculated using the values for the RFR (3.07 percent) and MRP (7.00 percent) developed by AAR. The use of those values here is for the purpose of measuring the impact of the calculated beta, and is not intended as a validation or endorsement of the data or methods used by AAR to estimate those parameters.

market power would have on measured beta values, 12/ and has demonstrated that, as predicted, the run-up of beta values has coincided with an increased exercise of rail market power. And, notably, before the run-up occurred, AAR's own experts were fully comfortable that a beta value of less than 1 was appropriate for the risk profile of the rail industry relative to the market as a whole, as the Board observed in Docket No. EP 664, Decision served Jan. 17, 2008, at page 10 fn 28. The opportunity the Board has provided for this issue to be explored at the upcoming public hearing in Docket Nos. EP 722/664 should help to establish further clarity.

Missing and Implausible Values

Under the current methodology, cost of capital results for more than half of the individual Class I railroads are either missing or implausible. Data for all of BNSF, and for the U.S. operations of CP and CN, are excluded from the analysis altogether (on the basis of their non-railroad or foreign parent companies). In the case of BNSF, this leads to understatement of the true industry cost of capital, because it excludes the availability to BNSF of low-cost capital from its corporate parent, Berkshire Hathaway. 13/ And despite the longstanding recognition of

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12/ See, for example, Docket No. EP 664, Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, Comments of Arkansas Electric Cooperative Corporation (September 26, 2007) at page 3, as discussed further in Docket Nos. EP 722/664, AECC Opening Comments, Appendix A at page 5, fn 3.

13/ The general proposition that Berkshire Hathaway ownership would improve the availability of investment capital for BNSF was discussed widely at the time of the acquisition, and has been borne out in the form of a pattern of robust investment levels fostered by a corporate attitude that takes a more long-term view of investment worthiness without having to answer to Wall Street. (See, for example, comments attributed to BNSF President and CEO Carl Ice in "BNSF's $6 Billion Capex Budget Targets More Capacity to Take on More Traffic" in Progressive Railroading (February 2015).) The ready availability of investment capital to BNSF under Berkshire Hathaway ownership is demonstrated by the fact that since 2010 (the time of BNSF's acquisition by Berkshire Hathaway), net investment by the Class I rail industry as a
[Footnote continued next page]

KCS as the most financially precarious of the Class I's, the MSDCF results developed by AAR indicate that KCS has the lowest cost of equity capital among the sampled carriers. 14/ The railroad filing thus manifests some of the idiosyncratic aspects of the current methodology and its results for 2014. Anomalies caused by the use of a small sample of railroads are another issue that the Board has identified to be explored at the upcoming public hearing in Docket Nos. EP 722/664.

CONCLUSIONS AND RECOMMENDATIONS

Overall, the AAR filing demonstrates that the issues identified by AECC in Docket Nos. EP 722/664 pertaining to estimation of the railroad cost of capital are persisting, and that the harms to the economy and the public interest that would stem from continued application of the current methodology are worsening. In light of this evidence, the Board should accelerate its consideration of the need for methodological change discussed in Docket Nos. EP 722/664 to enable appropriate reforms to be implemented in the 2014 determination. Alternatively, the Board should suspend its application of the current methodology for 2014, and instead make interim use of cost of capital data for the market as a whole, along the lines

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[Footnote continued]
whole has increased by $19,768,357,000, and that of this amount, BNSF alone has accounted for $9,602,342,000, or 48.6%. It is both ironic and a source of material bias for the estimation of the cost of capital to exclude a carrier that accounts for so much of the industry's investment activities, and does so on terms that are less restrictive than those faced by the included firms.

14/ AAR Comments, VS Gray at page 44.

that in the past the Board itself has considered, 15/ that AECC has endorsed, 16/ and that the Board has identified for discussion at the upcoming public hearing in Docket Nos. EP 722/664. Such market-level data are insulated from the many carrier- and industry-specific problems that have been shown to plague the incumbent methodology.

Respectfully submitted,

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15/ See, for example, Docket No. EP 664, Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, decision served August 14, 2007 at page 11.

16/ Docket Nos. EP 722/664, AECC Opening Comments at Appendix A, pages 7-8.

CERTIFICATE OF SERVICE

I hereby certify that on this 11th day of May, 2015, I caused a copy of the foregoing to be served by first class mail, postage prepaid, on:

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