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**BEFORE THE  
SURFACE TRANSPORTATION BOARD**

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**EX PARTE 558 (Sub-No. 12)**

**RAILROAD COST OF CAPITAL - 2008**

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**COMMENTS OF  
ARKANSAS ELECTRIC COOPERATIVE CORPORATION**

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**Dated: May 20, 2009**

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SURFACE TRANSPORTATION BOARD**

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In its Decision served March 6, 2009, the Board directed the railroads to submit information needed to determine the railroad industry's cost of capital for 2008, and invited comments from interested parties. This document presents the comments of Arkansas Electric Cooperative Corporation (AECC). <sup>1/</sup> These comments address the estimation of the railroads' 2008 cost of common equity capital, and identify corrections that are needed to provide the stability and precision of that estimate that the Board is

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<sup>1/</sup> AECC is a membership-based generation and transmission cooperative that provides wholesale electric power to electric cooperatives, which in turn serve approximately 490,000 customers located in each of the 75 counties in Arkansas. In order to serve its 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 burns in excess of 6 million tons of Powder River Basin (PRB) coal annually. In addition, AECC holds an ownership interest in the Flint Creek plant, at Gentry, AR, which normally burns in excess of 2 million tons of PRB coal annually. Because of the large volume of coal used by these plants, the need for long-distance rail transportation to move this coal and the absence of rail competition at two of the plants, AECC has a direct interest in issues related to the financial health of the rail industry, and regulatory proceedings that make use of the railroad cost of capital.

seeking. These corrections counteract substantial errors introduced by (a) measurements and assumptions that improperly incorporate increases in the exercise of rail market power; and (b) fluctuations in the market valuation of the rail industry.

**A. Introduction and Summary of Recommendations**

In this proceeding, the Board is implementing for the first time its new method of averaging the results from the CAPM and multi-stage DCF models to determine the rail industry cost of equity capital. When the Board adopted this methodology earlier this year, it explained that its objective was to provide “a stable yet precise estimate of the cost of equity that we can use in future regulatory proceedings and to gauge the financial health of the railroad industry.” <sup>2/</sup> [emphasis added] The Board also observed that “...both approaches...if applied correctly should produce the same expected result.” <sup>3/</sup>

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<sup>2/</sup> STB Ex Parte No. 664 (Sub-No. 1), Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry’s Cost of Capital, decision served January 28, 2009 at p 15.

<sup>3/</sup> Id. at page 3, quoting from STB Ex Parte No. 664, Methodology to be Employed in Determining the Railroad Industry’s Cost of Capital, decision served Jan. 17, 2008 at p. 13.

However, as discussed in further detail below, experience has shown that employing the current versions of these models will not produce the stability, precision, and consistency the Board wants unless certain corrections are incorporated into them.

The corrections recommended by AECC are:

1. Suspend the reliance on mechanistic computations of beta that do not effectively control for market power effects, and which have proven to yield wildly fluctuating results. Instead, on an interim basis, the Board should set beta at the stable level that prevailed immediately prior to the beginning of observed increases in the exercise of rail market power.
2. Terminate in the multi-stage DCF calculation the use of stock prices from a single day outside the period under study to establish the market valuation. This practice distorts the calculation of the required return when (as in 2008) stock prices on the sampled day differ substantially from the average during the year. Instead, the Board should use a value that is fully representative of the period of time upon which the earnings projections are based.
3. Close a loophole in the multi-stage DCF computation through which analyst expectations of rail pricing that is so aggressive as to be inconsistent with Board policy and economic theory can insulate such pricing from Board scrutiny. To avoid this, the Board should only include aggressive projections of earnings growth up to the point at which such earnings would produce industry revenue adequacy. Beyond that point, earnings growth should be limited to that projected for the economy as a whole.

The corrections proposed by AECC would promote the consistency between CAPM and multi-stage DCF results that the Board assumed, and the stability and precision of the estimate of the cost of equity capital that the Board seeks. In doing so, the corrections would protect the Board's processes against the improper influence of actual or expected changes in the exercise of rail market power. Ultimately, they would protect the rail industry against the potential impacts on the measured cost of

equity capital associated with increased competitive pressures that prospectively may be unleashed by the Board or by Congress.

**B. Background**

AECC's comments regarding the cost of capital determination for 2008 stem largely from considerations discussed in greater detail in two other Board proceedings: Ex Parte No. 664 (Sub-No. 1), Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital, and Ex Parte No. 680 (Sub-No. 1), Supplemental Report on Capacity and Infrastructure Investment ("Supplemental Report"). Relevant background considerations stemming from those proceedings are presented below.

**Ex Parte No. 664 (Sub-No. 1)**

In its Decision released January 28, 2009 in Ex Parte No. 664 (Sub-No. 1), the Board first established the method of averaging the results from CAPM and multi-stage DCF models to determine the rail industry cost of equity capital. That method is now being implemented for the first time in Railroad Cost of Capital – 2008.

In the January 28 Decision, the Board concluded:

Both the CAPM and the multi-stage DCF models we propose to use have their own strengths and weaknesses, and both take different paths to estimate the same illusory figure. By using an average of the results produced by both models, we harness the strengths of both models while minimizing their respective weaknesses. The result should be a stable yet precise estimate of the cost of equity that we can use in future regulatory proceedings and to gauge the financial health of the railroad industry. [emphasis added]

The Board specifically cited AECC for the proposition "...that the use of a multi-stage DCF model in conjunction with CAPM could enhance the precision of the

resulting cost-of-equity estimate.” However, this citation overlooks critical limitations associated with AECC’s endorsement that pertain directly to the precision (and stability) of the estimate. The passage from AECC’s comments cited by the Board explicitly references a “...multi-stage DCF model that doesn’t permit the estimated cost of capital to deviate excessively from the long-run growth rate of the economy as a whole” [emphasis added], and the way such a model “...appears to provide an element of protection against the potential influence of increased market power on the CAPM methodology.” <sup>4/</sup>

The Board also incorrectly characterized AECC as having argued that “...both methods overstate the cost of capital and essentially provide cover for the industry to charge higher prices.” The citation provided by the Board plainly shows that AECC’s conclusion as to whether the models overstate or understate the cost of capital depend upon whether one assumes the exercise of market power is increasing or decreasing:

[B]oth of the models upon which the Board plans to rely appear to translate the increased exercise of rail market power to artificial increases in the estimated cost of capital....In theory, the converse is also true. For example...if procompetitive initiatives were undertaken and the railroads’ fears came to pass, all else equal, the CAPM model would likely conclude that the railroad risk premium had declined, and the analyst expectations of future rail

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<sup>4/</sup> AECC acknowledges the subsequent discussions of these issues in the January 28 Decision in Ex Parte No. 664 (Sub-No. 1), which corroborate the absence of a foundation for the Board’s original cite.

earnings would likely drop. Both models would thereby report artificial decreases in the estimated cost of capital.” 5/

The Board’s characterization of AECC’s argument would only be plausible if the Board were implicitly assuming that the exercise of market power would always be increasing.

In short, AECC’s filings described in detail the causal relationships through which the Board could anticipate the susceptibility of the CAPM and multi-stage DCF models – individually or averaged together – to imprecision and instability as a result of changes in the exercise of rail market power.

#### Supplemental Report

Subsequent to its January 28 Decision in Ex Parte No. 664 (Sub-No. 1), the Board on April 8, 2009 released a report by Christensen Associates, *Supplemental Report to the U.S. Surface Transportation Board on Capacity and Infrastructure Investment*.

That report is the subject of the Supplemental Report proceeding.

In Supplemental Report, AECC explained how this Christensen study demonstrates that increasing rail rates in the face of declining volumes and factor prices, and continued improvements in productivity, cannot be blamed on short- or longer-term capacity considerations, but rather reflect the increased exercise of rail market power. 6/ The increasing significance of the market power issue is corroborated by

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5/ STB Ex Parte No. 664 (Sub-No. 1), Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry’s Cost of Capital, “Comments of Arkansas Electric Cooperative Corporation” (April 14, 2008) at p. 2.

6/ STB Ex Parte No. 664 (Sub-No. 1), Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry’s Cost of Capital, “Comments of Arkansas Electric Cooperative Corporation” (September 15, 2008) at p. 3.

(a) the Board's initiative in Ex Parte No. 688 to re-examine some of the basic ground rules of railroad competition it previously established; and, (b) the responsive congressional request that the Board suspend its initiative pending anticipated legislative action(s).

### Summary

In the Board's development of the new cost of capital methodology, AECC identified effects of the exercise of rail market power on the cost of equity capital estimates provided by both the CAPM and multi-stage DCF models. Recent developments indicate that systematic changes in the exercise of rail market power have been occurring. Consequently, the results from the two methodologies, and even the combination of those results that the Board has specified for use in Railroad Cost of Capital – 2008, may be imprecise or unstable.

#### C. Imprecision and Instability in Model Results

If it were possible to measure directly the cost of equity capital, the validity of different estimation methodologies would not be overly significant for the Board (i.e., since the value provided by the direct measurement could be used). However, since the underlying cost of equity cannot be measured directly, the validity of the estimates produced by the different methodologies assumes much greater importance, and must be assessed through indirect means.

The Board's own stated goal of a "stable yet precise" measure of the cost of equity capital provides a useful starting point for such an assessment. For any measure to be both stable and precise, the underlying phenomenon being measured

must possess a significant degree of stability – otherwise, a measure that was precise would not also be stable. For example, virtually any precise measure of petroleum prices during the past few years would exhibit little stability. The stability of the underlying phenomenon implied by the Board makes it possible to draw reasoned inferences from changes over time exhibited by different measures.

In addition, the Board has stated its own expectation that the CAPM and multi-stage DCF methodologies should yield results that are reasonably consistent with each other. As observed by the Board in Ex Parte No. 664, “In theory, both approaches seek to estimate the true cost of equity for a firm, and if applied correctly should produce the same expected result.” <sup>7/</sup> This principle makes it possible to draw reasoned inferences from differences between the results of the two methodologies that may be observed.

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<sup>7/</sup> See STB Ex Parte No. 664, Methodology to be Employed in Determining the Railroad Industry’s Cost of Capital, decision served Jan. 17, 2008 at p. 13.

In light of the above considerations, the following table summarizes major results from implementation to date of the CAPM and multi-stage DCF methodologies:

Year	CAPM Risk-free Rate	Market Risk Premium	Beta	CAPM-Total	Multi-stage DCF
2006 <sup>8</sup>	5.00	7.13	0.8604	11.13	Not used
2007 <sup>9</sup>	4.91	7.05	1.1027	12.68	Not used
2008 - proposed <sup>10</sup>	4.36	6.47	0.9338	10.40	16.29

This table shows that for CAPM, the risk-free rate and the market risk premium have declined in a stable pattern over time, but the total estimated cost of equity capital has fluctuated substantially (increasing by over 1.5 percent from 2006-2007, then decreasing by over 2.2 percent from 2007-2008) due to significant year-to-year changes in the value of beta. Also, the introduction of the multi-stage DCF model in 2008 has brought numerical results dramatically different from those of CAPM, which on their face do not come close to fulfilling the Board's stated expectation that the two models should produce basically the same result. These two issues are addressed in further detail below.

<sup>8/</sup> See STB Ex Parte No. 558 (Sub-No. 10), Railroad Cost Of Capital — 2006, decision served April 15, 2008.

<sup>9/</sup> See STB Ex Parte No. 558 (Sub-No. 11), Railroad Cost Of Capital — 2007, decision released September 26, 2008.

<sup>10/</sup> See STB Ex Parte No. 558 (Sub-No. 12), Railroad Cost Of Capital - 2008, "Comments of the Association of American Railroads and Its Member Railroads" (April 20, 2009).

**D. Discussion and Recommended Board Actions**

**Beta**

**Beta is a measure of the systematic, non-diversifiable risk associated with an asset relative to the market as a whole. It is an essential component of CAPM that is multiplied by the market risk premium to determine the return above the risk-free rate that is appropriate for the risk associated with the asset.**

**Fluctuation of the type observed in the value of beta is troublesome because of its fundamental inconsistency with the rationale for computing beta in the first place. Beta cannot provide a useful measure of the risk associated with investment in a particular firm or industry relative to the market as a whole if it regularly and randomly changes the characterization it provides. Obviously, circumstances may change from year to year, and it would not be reasonable to expect complete fixity of a true beta measure. However, in this case, the fluctuations have been substantial, as the measure has produced a flip-flop in the risk level it finds from below-average to above-average and back to below-average within a span of 3 years. Moreover, AAR witness Gray indicates that the computed value is now highly sensitive to the time period selected for study, as a preliminary run that omitted the final 3 months of the 5-year estimation period for 2008 produced a reported beta of 1.2143, while a similar run that added 3 months of extra observations (through the end of March 2009) to the 5-year**

estimation period resulted in a beta of 1.0074. 11/ Based on these results, witness Gray indicates that higher beta values should be expected in the future.

AAR seems so comfortable with the idea that they might come up with a beta of 1.20 or more that they neglect to offer any type of coherent explanation of industry changes that would account for this dramatic increase in the alleged riskiness of the rail industry. Indeed, the industry is consistently delivering strong financial performance in a most challenging economic environment. Moreover, AAR says nothing to dispel the obvious possibility that rail industry returns have been increasing relative to the economy as a whole due to the systematic increase in the exercise of rail market power rather than any consideration related to increased risk.

The silence of AAR regarding recent beta increases and instability is made particularly deafening by the documentation of historical rail beta levels provided by AAR in Ex Parte No. 664. Less than 2 years ago, AAR sponsored reply testimony by Professor Stewart Myers of MIT, an internationally-recognized expert in finance. Professor Myers documented for the Board the fact that, at least after the consummation of the mega-mergers of the late-1990's, the rail industry beta was stable at a level below 0.8 through 2004. 12/ Professor Myers' analysis further demonstrated

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11 See STB Ex Parte No. 558 (Sub-No. 12), Railroad Cost of Capital - 2008, "Comments of the Association of American Railroads and Its Member Railroads" (April 20, 2009) Verified Statement of John T. Gray at pp. 30-31.

12/ See STB Ex Parte No. 664, Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, "Reply Comments of the Association of American Railroads" (October 29, 2007) "Reply Verified Statement of Stewart C. Myers" at p. 16, Figure 1.

**how it was only after 2004 – the timeframe identified by many authoritative sources as the period when systematic changes in rail pricing practices began to occur – that beta began to increase.**

**In light of the expanding recognition of the exercise of increased rail market power, the ability of such market power to bias and destabilize estimates of beta, and the complete absence of any alternative explanation from AAR for the increasing magnitude and instability of beta, the Board should suspend its reliance on mechanistic computations of beta that do not effectively control for market power effects. On an interim basis, the Board should set beta at the level prevailing immediately prior to the beginning of observed increases in the exercise of rail market power. It could do so by estimating a new model using data only through 2004, by adopting as a proxy the stable value of approximately 0.70 shown for the period prior to 2005 in Professor Myers' analysis, or by whatever other means it deems appropriate. Absent a coherent explanation from the railroads, there is no reason for the Board to believe that the underlying risk of investing in railroads has materially changed relative to that of the economy as a whole.**

### **Disparity Between CAPM and Multi-Stage DCF Results**

Assuming that the unbiased value of beta is determined to be approximately 0.70, the corrected CAPM estimate of the cost of equity capital for 2008 would be 8.89 percent. <sup>13/</sup> This contrasts with AAR's multi-stage DCF estimate of 16.29 percent even more starkly than does the original AAR CAPM estimate of 10.04 percent. Whatever CAPM value is used, the disparity between the CAPM and multi-stage DCF results is so large as to call into question the entire proposition that the two methods are measuring the same underlying value.

Further review of the AAR's implementation of the multi-stage DCF model reveals two potential sources of at least a portion of the discrepancy. These include the apparent use of market valuations from a single point in time as the basis for the return calculations, and the inclusion in the model of rail earnings assumptions that would promote results contrary to stated Board policies. Each of these is addressed below.

**Market valuations** – As described by AAR witness Stangle, the multi-stage DCF computations analyze the anticipated growth in future earnings as a function of “stock market values that reflect the release of year-end financial statements.” <sup>14/</sup> In

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<sup>13/</sup> This and subsequent CAPM estimates presented in this section adopt for computational purposes the values of the risk-free rate and the market risk premium presented by AAR. Use of these figures in this context is not intended to constitute a validation of their development, or a prejudgment of issues that may be identified by other parties.

<sup>14/</sup> See STB Ex Parte No. 558 (Sub-No. 12), Railroad Cost of Capital – 2008, “Comments of the Association of American Railroads and Its Member Railroads” (April 20, 2009) Verified Statement of Bruce E. Stangle at p. 6.

stable markets, reliance on valuation data from a single point in time may provide a degree of computational simplicity without substantial adverse consequences. However, 2008 saw wide swings in market valuation that undermine reliance on data from any specific point in time, particularly one drawn from well into 2009.

This can be illustrated using stock price data for UP parent Union Pacific Corp. (UNP). After starting 2008 at \$62.12 <sup>15/</sup>, UNP shares stayed above \$60.00 for most of the year, reaching the \$80.00 plateau on a few occasions. Despite a slide during September and October, UNP was still above \$60.00 as late as November 13, but slid further to close out the year at \$47.80. After the first quarter of 2009 began with 3 days over \$50.00, UNP spent the rest of the first quarter below \$50.00, reaching a low of \$33.62 on March 9. The price on the date of the market valuation apparently used in the multi-stage DCF analysis (March 31, 2009) was \$41.11. Thus, the multi-stage DCF analysis for 2008 determined the required yield from a valuation drawn from well into 2009 that bears little relationship to the valuations prevailing during the time the 2008 earnings were being generated and reported.

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<sup>15/</sup> UNP share prices drawn from <http://finance.yahoo.com/echarts?s=UNP#chart2:symbol=unp;range=20080102,20090331;indicator=volume;charttype=line;crosshair=on;ohlcvvalues=0;logscale=on;source=undefined> :

When the "base" is set artificially low in this manner, the return required to generate a given projected growth in earnings is correspondingly inflated. 16/ As indicated in Table No. 11 on page 23 of the verified statement of AAR witness Gray, the average valuation of common equity for the 4 largest U.S. Class I railroads in 2008 was \$109.851 billion. By comparison, the valuation of the same railroads shown in the AAR Workpapers (Part 1) as of March 31, 2009 for use in the multi-stage DCF is \$63.790 billion. All else equal, use of valuation data from March 31, 2009 rather than the average for 2008 caused the multi-stage DCF to find a required return of 16.29 percent, rather than the 9.46 percent that would produce an equivalent stream of earnings if applied to the average 2008 valuation. 17/

AAR provides no definitive rationale for this practice, other than to assert that it is used by Morningstar/Ibbotsen. While at some point in history the release of year-end financial statements around the end of March of the following year may have provided significant guidance to the investment community, the myriad quarterly reports, analyst conferences and projections, earnings guidance updates, financial blogs, and other information sources that flood the financial marketplace have left little more to say about a firm's performance in a given year by the time the end of March of the following year rolls around.

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16/ Conversely, in a year when the valuation at a set point in time is atypically high, the return required to generate a given projected growth in income would artificially be understated.

17/ It is noted that the 9.46 percent figure is close to the CAPM estimate of 10.40 developed by AAR, and even closer to the 8.89 percent figure that would result from application in CAPM of the historical beta value of 0.70 discussed in the text.

**Whether or not figures generated by Morningstar/Ibbotson are unnecessarily inaccurate and unstable, the experience of 2008 illustrates why the Board should revisit this practice. Given that the railroads already compute the average equity valuation for the year, the Board should extend use of this value to ensure that required returns are computed in the multi-stage DCF model on an equity base that is fully representative of the period of time from which the anticipated earnings are projected. Any other approach inherently leads to inaccuracy and instability in the reported results.**

**Rail earnings assumptions – As described by AAR witness Stangle, the multi-stage DCF model applies analysts' assumptions regarding earnings growth for the first 10 years of the analysis period. However, the assumed earnings growth (on the order of 10 percent per year) is inconsistent with both the economic theory and the Board's stated policy regarding supra-competitive rail earnings.**

**In STB Ex Parte No. 552 (Sub-No. 12), the Board found that as of 2007, 2 of the 7 Class I railroads had achieved revenue adequacy. Moreover, the Board's numerical findings suggested that of the remainder, none would require more than a 50 percent increase in earnings to achieve revenue adequacy. 18/ All else equal, 10 percent annual earnings growth would push the industry as a whole into the realm of supracompetitive earnings well before the end of the fifth year of such growth.**

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**18/ STB Ex Parte No. 552 (Sub-No. 12), Railroad Revenue Adequacy – 2007 Determination, decision served September 26, 2008.**

**A method, like the current multi-stage DCF, that permits earnings growth into the supracompetitive range violates a critical principle articulated by the Board in**

**Ex Parte No. 664:**

**Permitting a carrier to earn excessive profits would harm the public and the nation's entire economy because customers would ultimately pay higher prices for goods sold as the transportation rates are passed along. Consumers would therefore be expected to reduce their consumption of a wide variety of goods, to a greater or lesser extent, based on higher shippers' prices. 19/**

**This principle is fully consistent with economic theory, which provides no justification for earnings in excess of the level needed to achieve revenues sufficient to cover costs and provide a market return on required assets (i.e., revenue adequacy).**

**To rectify this problem, which becomes more tangible and urgent as the industry approaches more closely the achievement of industry revenue adequacy, the Board should truncate a portion of the analysts' projections of earnings growth above that of the economy as a whole. Specifically, the Board should only permit such earnings to enter the multi-stage DCF computation up to the point where such earnings growth would produce industry revenue adequacy. Beyond that point, earnings growth should be limited to that projected for the economy as a whole. 20/**

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**19/ See STB Ex Parte No. 664, Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, decision served Jan. 17, 2008 at p. 11.**

**20/ It is noted that AECC is not proposing to use "the growth rate of the entire economy for all years in the Morningstar/Ibbotson model" and its proposal therefore does not "...defeat the purpose of [the Board's] criteria requiring a multi-stage model." See STB Ex Parte No. 664 (Sub-No. 1), Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital, decision served January 28, 2009 at p. 11.**

If it does not introduce such a limitation, the Board would be in a position of acknowledging the absence of a public interest foundation for supracompetitive earnings, but nevertheless permitting analysts' projections of such earnings to inflate the multi-stage DCF results, the Board's estimate of the cost of equity capital and the supracompetitive returns that industry actually achieves. To avoid taking the untenable de facto position that "we will protect the public interest unless the analysts expect that we won't", the Board should take reasonable steps to ensure that its procedures are not used to convert analysts' assumptions of supra-competitive earnings into self-fulfilling prophecies.

E. Conclusion

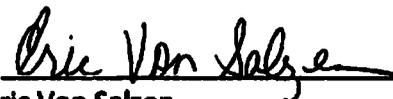
The Board's original stated expectations were that the multi-stage DCF model would produce results that are reasonably consistent with those produced by CAPM, and that the average of the two model results would produce a stable and precise estimate of the cost of equity capital. Unfortunately, the actual experience with these models demonstrates that the use of the one-day market valuation and the incorporation of analysts' projections of supracompetitive earnings in the multi-stage DCF approach, along with the estimation of beta in CAPM, introduce significant errors and instabilities. This is especially true in the situation where, as here, the exercise of market power has changed or is expected to change.

The corrections proposed by AECC are reasonable, transparent and straightforward to implement. They preserve the practice of averaging the two model results, and improve the consistency of those results with each other. The corrections

also permit incorporation of analysts' expectations that exceed the long-term growth rate of the economy, provided that such expectations do not entail the generation of supra-competitive earnings by the industry.

These corrections would promote the stability and precision of the cost of equity capital estimated by the Board. They would protect the Board's processes against the improper influence of actual or expected changes in the exercise of rail market power. Indeed, they would protect the rail industry against the potential impacts of increased competitive pressures that prospectively may be unleashed by the Board or by Congress.

Respectfully submitted,



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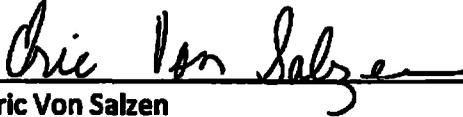
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Dated: May 20, 2009

**CERTIFICATE OF SERVICE**

I hereby certify that on this 20<sup>th</sup> day of May 2009, I caused a copy of the foregoing document to be served by first class mail, postage prepaid, on the persons listed on the Surface Transportation Board Service List for this Docket.

  
Eric Von Salzen