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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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**MOTION OF  
ARKANSAS ELECTRIC COOPERATIVE CORPORATION  
FOR LEAVE TO RESPOND TO REBUTTAL COMMENTS OF  
ASSOCIATION OF AMERICAN RAILROADS**

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**Dated: July 7, 2009**

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SURFACE TRANSPORTATION BOARD

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Arkansas Electric Cooperative Corporation (AECC) respectfully moves for leave to respond to certain rebuttal comments of the Association of American Railroads ("AAR").

AECC recognizes that the Board's Notice of this proceeding did not contemplate that a commenting party would have an opportunity to respond to a rebuttal filing by a railroad party. Decision, Ex Parte 558 (Sub-No. 12), Railroad Cost of Capital – 2008, served March 6, 2009. However, under the special circumstances of this case, AECC believes that the Board should permit this brief and limited response to the rebuttal comments filed by AAR 1/ because:

1. AAR's "rebuttal" is in effect a motion to strike AECC's comments, to which AECC ought to be allowed to respond; and

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1/ "Rebuttal Comments of the Association of American Railroads and its Member Railroads" (June 19, 2009) (hereafter, "AAR Rebuttal Comments").

2. In several respects, AAR's rebuttal to AECC's comments misrepresents or mischaracterizes what AECC said in its comments. Clarification of these instances should be helpful to the Board, and will prejudice no party.

Accordingly, AECC requests that the Board receive and consider the following additional comments.

A. **The Board Should Reject AAR's Demand That The Board Disregard AECC's May 20, 2009 Comments**

The comments submitted by AECC on May 20, 2009 identified three problems arising in AAR's estimation of the rail cost of capital for 2008:

- the computation of beta in CAPM has exhibited unexplained increases and become unstable;
- the multi-stage DCF results have been affected in an unforeseen way by fluctuations in market capitalization; and,
- the multi-stage DCF results require the Board to embrace projections of supra-competitive earnings that are inconsistent with the public interest.

AAR asserts that the Board should disregard AECC's comments because they are allegedly an improper attempt to relitigate issues regarding the cost of capital methodology that were addressed in Ex Parte No. 664, Methodology to be Employed in Determining the Railroad Industry's Cost of Capital ("Methodology"), or in 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 ("MSDCF"). Although AAR does not expressly move to strike AECC's comments, disregarding AECC's comments, as AAR demands, would be no different in practical effect from striking them. AAR's argument is wrong. AECC's comments are not barred by the Board's rulings in Methodology and MSDCF and should be considered by the Board.

**AECC's comments rely on information drawn from sources that did not exist at the time comments and evidence were submitted in Methodology, or MSDCF. These sources include AAR's opening submission in the instant proceeding, the Board's revenue adequacy determination for 2007, and patterns of stock price changes observed between 2008 and early 2009. This new information demonstrates the existence of problems AECC previously had described in conceptual terms.**

**AAR may not like the fact that this new information has arisen, but it offers no reason why the Board must now ignore relevant circumstances that did not exist at the time of the earlier proceeding. The Board under 49 U.S.C. Section 722(c) holds sweeping authority to accept and act on such new evidence. AAR cites no authority for its claim that the Board is precluded from considering these changed circumstances, because it has none. It apparently hopes that by falsely accusing AECC of repeating old material, it will distract the Board from exercising its authority to address the problems that new evidence shows are undermining the stability and validity of its cost-of-capital determination.**

**AAR also argues that as a matter of Board procedure, the issues raised by AECC can only be raised in an Ex Parte 664 rule-making and not in the present proceeding. This argument mischaracterizes the nature and scope of AECC's recommended changes. AAR cites guidance provided by the Board in Ex Parte No. 664 regarding the use of 664-numbered proceedings to pursue methodological changes. This guidance reflected the Board's handling of WCTL's challenge to the original single-stage DCF model, which was first advanced in a 558-numbered proceeding, but ultimately was**

addressed in Ex Parte No. 664 (which completely replaced the single-stage DCF model with CAPM). A subsequent 664-numbered proceeding added the multi-stage DCF model to CAPM, yielding the methodology now in use.

As an active participant in both of the 664-numbered proceedings, AECC does not dispute the reasonableness of relying on such proceedings to address the formation of the basic methodology. However, contrary to AAR's characterization, AECC's suggestions in the instant proceeding do not alter the basic methodology adopted by the Board in MSDCF (i.e., averaging of CAPM and multi-stage DCF results). Rather, they adjust specific parameters within that methodology to address specific problems observed when the methodology is applied to the data for the given year. For example, the potential biases associated with the use of market capitalization values from a single day in the year following the year under study only came to light because of the extraordinary fluctuations of such values that arose in the computations for 2008.

Because the problems were identified by AECC on the basis of data filed in a 558 proceeding, and because they could be addressed without changing the basic methodology, refusing to consider this information in this proceeding, as AAR would have the Board do, would unduly interfere with the Board's achievement of important policy goals. Under 49 U.S.C. Section 10101, the Board has mandates ". . . (13) to ensure the availability of accurate cost information in regulatory proceedings \* \* \*; and (15) to provide for the expeditious handling and resolution of all proceedings . . . ." Although it may be appropriate to use a 664 proceeding to consider wholesale methodology changes, it would be inefficient and unduly burdensome to require that a new and

separate 664 proceeding be instituted to implement the kind of adjustments suggested here by AECC, which are needed to deal with anomalies that have been observed in the application of the existing methodology to data within a 558 proceeding, and to ensure accurate results are achieved in the 558 proceeding. AAR's approach would sacrifice the accuracy of the results of the 558 proceeding, and the fact that issues could eventually be addressed in a 664 proceeding would only have practical significance to the extent that analogous issues arise in future years.

**B. AAR Mischaracterizes AECC's May 20, 2009 Comments**

In purporting to respond to AECC's proposals to correct identified problems with AAR's calculation of the cost of capital, AAR's rebuttal comments present several serious mischaracterizations of AECC's position or are so misleading as to warrant correction. These are addressed below.

**1. AECC's Recommendations Are Not "Result Oriented"**

AAR repeatedly and falsely characterizes AECC's recommendations as a "result-oriented" attempt to minimize the computed cost of capital. On the contrary, AECC has pointed out how its proposals would protect the rail industry in the event pro-competitive reforms are adopted by the Board and/or Congress. AECC Comments at pages 5-6. 2/ Similarly, AECC's proposals would protect the industry in times when

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2/ Indeed, analysts already have observed that rail stocks are "tracking below market trends" in 2009, and have cited the changing posture of the Board and Congress as significant contributing factors. See, for example, <http://www.railwayage.com//content/view/696/121/>.

market capitalization is increasing substantially (i.e., as opposed to the strong downward trend observed in the data for 2008). AECC Comments at page 15, footnote 16. AAR seems content to go for its 13 percent cost of equity capital for 2008, and to leave for another day any worry about the fact that the circumstances which produce the extraordinarily high figure this year may produce dramatically lower numbers in future years.

2. **AAR Misrepresents the Problem of Supra-Competitive Earnings That AECC Identified**

In a misleading attempt to respond to AECC's point regarding the inconsistency with the public interest of supra-competitive rail earnings, AAR cites a discussion by the Board in MSDCF that focused on rail pricing power over regulated traffic. However, AECC's point, to which AAR ultimately does not respond, is that the public interest does not permit or support supra-competitive rail earnings. As the industry achieves revenue adequacy, the objective of U.S.C. 49 Section 10704(a)(2) is satisfied, and it becomes appropriate and necessary for the Board to pursue objectives other than improved carrier financial health. Economic theory certainly provides no foundation for permitting supra-competitive earnings by an industry, and would only conclude that such earnings demonstrate the existence of insufficient competition. Indeed, 49 U.S.C. Section 10101(6) provides a specific mandate for the Board "to maintain reasonable rates where there is an absence of effective competition and where rail rates provide revenues which exceed the amount necessary to maintain the rail system and to attract capital" (i.e., to prevent, and not promote, supra-competitive rail earnings). The railroads' casual prediction of future rail rate increases, "[b]ecause

rail rates have fallen since the enactment of the Staggers Act in 1980”, 3/ ignores the Board’s important public interest responsibilities that transcend carrier revenue adequacy.

**3. The “Tech Bubble” Cannot Excuse The High Beta Used By AAR**

AAR witness Gray provides a lengthy lecture in which he purports to explain the very high recent values of beta in CAPM as being the natural byproduct of the passage of time since the “tech bubble”, for which he cites past AAR witness Stewart Myers as an authority. 4/ AECC has also cited Professor Myers and recognizes his expertise. However, Professor Myers refutes, rather than supports, Mr. Gray’s positions.

Long after the end of the “tech bubble”, Professor Myers provided testimony before the Board dated October 29, 2007 in Ex Parte No. 664. In this testimony (at pages 6-8), Professor Myers observed how a 5-year (rather than 10-year) estimation period for beta would exclude the undesirable effects of the tech bubble. From the available 5-year data, Professor Myers was comfortable offering a “most likely” beta value of 0.96, from a range of plausible values of 0.86-1.06.

This estimate confirms the reasonableness of the concerns expressed by AECC regarding both the level and the instability of the beta estimates now being provided by AAR. AAR’s own expert, using post-tech bubble data, estimated both a beta value and a range of plausible values that are far lower than those AAR now seeks to justify. While AECC respectfully submits that Professor Myers’ estimates are at the high

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3/ AAR Rebuttal Comments at page 12.

4/ AAR Rebuttal Comments, “Verified Statement of John T. Gray” at pages 9-10.

end of what his own data show, those estimates are far more reasonable than the rapidly-escalating and unstable values that result from AAR's use of the most recent data.

C. Summary and Conclusions

AAR's mischaracterizations and misleading arguments do not change the fact that in AAR's 2008 cost of capital determination

(a) the computation of beta in CAPM has shown unexplained increases and instability;

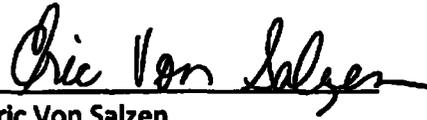
(b) the multi-stage DCF results have been affected in an unforeseen way by fluctuations in market capitalization; and,

(c) the multi-stage DCF model requires the Board to embrace projections of supra-competitive earnings that are inconsistent with the public interest.

AECC's recommendations provide the Board with potential corrective actions that would address these issues, at least on an interim basis, within the instant proceeding.

Although further consideration of such issues could also take place in a future 664 proceeding, the Board surely did not intend to paint itself into a corner where it retains no ability to respond to difficulties caused by the mechanistic application of the basic cost of capital methodology, which may become evident in 558 proceedings. While those difficulties give AAR's constituents a 13 percent cost of equity capital for 2008, in future years they could just as easily yield inappropriately low estimates.

**Respectfully submitted,**

A handwritten signature in black ink that reads "Eric Von Salzen". The signature is written in a cursive style and is positioned above a horizontal line.

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**Dated: July 7, 2009**

**CERTIFICATE OF SERVICE**

**I hereby certify that on this 7th day of July 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