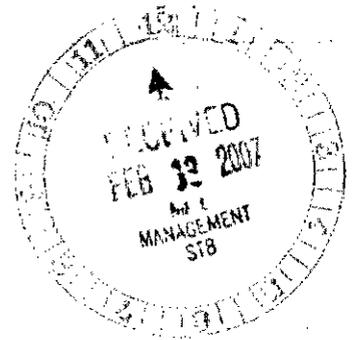


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SURFACE TRANSPORTATION BOARD
EX PARTE 664 – RAILROAD COST OF CAPITAL
SUMMARY OF
THE TESTIMONY
OF
CHARLES W. KING

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**SURFACE TRANSPORTATION BOARD
EX PARTE 664 – RAILROAD COST OF CAPITAL
SUMMARY STATEMENT OF CHARLES W. KING**

My name is Charles W. King. I am President of the economic and management consulting firm of Snavely King Majoros O'Connor & Lee, Inc. ("Snavely King"). Snavely King was founded by the late Carl M. Snavely, Jr. and me in 1970 to conduct research on a consulting basis into the rates, revenues, costs and economic performance of regulated firms and industries. The firm has a professional staff of 12 economists, accountants, engineers and cost analysts. Most of its work involves the development, preparation and presentation of expert witness testimony before federal and state regulatory agencies.

Qualifications

Attachment A to this statement is a brief resume of my professional experience. Attachment B is a listing of my expert witness appearances (more than 300) before state and federal regulatory agencies. While not all of these appearances dealt with the cost of capital, many of them did. The following appearances, all of which occurred since January 1, 2000, addressed the cost of capital of public utilities:

<u>Commission</u>	<u>Case No.</u>	<u>Utility</u>
Delaware P.S.C.	04-152	Tidewater Utilities (water)
Illinois Commerce Com.	02-0690	Illinois-American Water Company
Kentucky P.S.C.	2002-145	Columbia Gas of Kentucky
Kentucky P.S.C.	2004-67	Delta Gas Company
Maryland P.S.C.	9036	Baltimore Gas & Electric Company
Michigan P.S.C.	U-14547	Consumers Energy Company
Missouri P.S.C.	ER-2006-0315	Empire District Electric Company
New Jersey B.P.U.	TMO02080739	United Telephone Company
North Dakota P.S.C.	PU-400-00-521	Xcel Energy, Inc.
North Dakota P.S.C.	PU-399-01-186	Montana-Dakota Utilities (Elec)
North Dakota P.S.C.	PU-399-02-183	Montana-Dakota Utilities (Gas)
North Dakota P.S.C.	PU-04-97	Montana-Dakota Utilities (Gas)
Wisconsin P.S.C.	2055-TR-102	CenturyTel of Central Wisconsin
Wisconsin P.S.C.	5846-TR-102	Telephone USA, LLC

Summary

This statement addresses two aspects of the procedure by which the Surface Transportation Board (STB or Board) determines the cost of capital of the railroad industry:

- The determination of the growth component of the DCF formula; and
- The problems of regulatory circularity wherein the Board's findings of revenue adequacy influence the calculation of the rate of return by which that revenue adequacy is assessed.

I demonstrate that the 15.18% return to equity found in the Board's September 15, 2006 decision is unrealistically and unreasonably high. First, it is well above the market's overall experienced returns to equity as measured from 1926 and from 1971. Also, it is well above the estimates of the market's current required returns as measured by four other utility rate-of-return witnesses. This difference exists notwithstanding that, by two Value Line measures, railroads are less risky than the market overall. Additionally, the 15.18% return vastly exceeds any return to electric or gas utilities awarded by state regulatory commissions during the past year.

Additionally, the 12.2% overall cost of capital that results from applying the very high 15.18% equity cost to the market value of the railroads' equity is well above the cost of railroad capital as estimated by two Wall Street analyst firms. Those estimates are in the range of 6.1% to 9.2%.

The cause of the Board's extraordinarily high rate of return to equity is the growth factor, derived from I/B/E/S' survey of investment analysts. Those analysts estimate that the railroads will enjoy a 13.66% annual rate of earnings growth. The reasons for this rapid growth – reduced trucking competition and growth of intermodal traffic – cannot be expected to last forever, as implicitly assumed by the Board's procedure. Ultimately,

railroad earnings growth will have to trend toward the rate of earnings growth in the economy.

For this reason, I recommend that the Board adopt the two-step growth factor estimation procedure used by FERC for pipeline companies. FERC computes a growth factor based two-thirds on analysts' forecasts and one-third on projected nominal GDP growth. Using this approach, the railroads' rate of earnings growth would be 10.61% rather than 13.66%. When the 1.52% dividend yield is added, the return to equity would be 12.13%. This return bears a reasonable relationship to the market's overall returns.

In its *Hope Natural Gas* decision, the Supreme Court struck down the use of a "fair value" rate base on the grounds that it made regulation circular: the regulators' actions affected the determination of the fair value. Because market-dominant traffic, potentially subject to the Board's regulation, is now a much larger portion of the railroads' traffic and accounts for the overwhelming proportion of their profits, the Board should consider two sources of regulatory circularity.

The first source of circularity is the DCF formula, where the increased profitability of market-dominant traffic influences the forecasts of analysts which are used in the DCF formula. The inflation of the growth factor that results from the use of these forecasts is largely responsible for the Board's findings of revenue insufficiency and the relaxed regulation which results from that finding. This source of circularity is the growth factor, reflective of analysts' forecasts. The impact of these forecasts can be mitigated by the adoption of FERC's two-step formulation for the growth factor.

The second source of circularity is the use of market values, rather than book values to determine the capital structure used in weighting debt and equity costs. Because of the greatly increased profitability of market-dominant traffic, the stock prices of the railroads have been bid up to quite high levels, well above book values. When these stock values are used to weight debt and equity in computing the overall rate of

return, the much higher cost of equity inflates the return, contributing to findings of revenue inadequacy. This source of circularity can be eliminated by reverting to the use of book values in weighting debt and equity in the capital structure.

Using book value weights for debt and equity, the 12.13% equity cost developed using the FERC two-step DCF procedure and the Board's 5-year average cost of debt at 5.70%, I arrive at an overall cost of capital of 8.91%, which is within the capital costs estimated for the railroads by two investment analyst firms. Under this benchmark, the BNSF would be found revenue adequate.

In summary, I recommend that the Board:

- Continue to use the DCF formulation to determine the cost of capital for the railroads.
- Adopt the two step procedure used by FERC for identifying the growth factor in the DCF formula.
- Use the book value of debt and equity in determining the capital structures of the railroads.

Respectfully Submitted,



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