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BEFORE THE SURFACE TRANSPORTATION BOARD

Ex Parte No. 664

METHODOLOGY TO BE EMPLOYED IN DETERMINING THE RAILROAD INDUSTRY'S COST OF CAPITAL

ASSOCIATION OF AMERICAN RAILROADS' MOTION TO MODIFY PROCEDURAL SCHEDULE

Pursuant to 49 C F R § 1104 7(b), the Association of American Railroads ("AAR") respectfully requests that the Board extend the due date for the submission of comments in this proceeding by 45 days, from the present date of September 13, 2007 to October 29, 2007, with a corresponding extension for reply comments from October 15, 2007, to November 28, 2007 The requested extension is essential in order to permit AAR and other interested parties to analyze and address the Board's extraordinarily important and far-reaching proposal to adopt a Capital Asset Pricing Model ("CAPM") methodology for calculating the rail industry's cost of equity capital [1]

The manner in which the Board proposes to implement the CAPM methodology would result in a reduction of nearly 40 percent in the Board's calculation of the rail industry's cost of capital for 2005, the most recent year for which the Board has made a cost of capital determination *See* Corrected Notice at 8 This reduction would have profound effects in many different types of regulatory proceedings and contexts The Board's proposed schedule, which

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[1] See Ex Parte No 664, *Methodology to be Employed in Determining the Railroad Industry Cost of Capital* (served August 14, 2007) ("Notice"), *id* (served August 20, 2007) ("Corrected Notice")

provides only 30 days for opening comments, does not allow sufficient time for thorough analysis of the Board's proposals Additional time is needed for interested parties to review and examine the Board's proposed implementation of the CAPM methodology, and to understand the assumptions implicit in that implementation The requested extension of time is consistent with the procedural schedule previously adopted in the prior phase of this proceeding, and is eminently reasonable in light of the significance of the Board's current proposal

In support of its request, AAR states as follows

1 In its Advance Notice of Proposed Rulemaking ("ANPR") in this proceeding (served September 20, 2006), the Board requested comments on the appropriate methodology to be employed in determining the railroad industry's equity cost of capital, including the continued advisability of using the Discounted Cash Flow ("DCF") methodology, on which the Board had relied for more than two decades in every previous cost-of-capital determination, as well as potential alternative methodologies, including CAPM

2 The procedural schedule adopted in the ANPR allowed interested parties 47 days to submit opening comments ANPR at 1 At AAR's request, the Board subsequently extended that time to a total of 79 days for opening comments, finding that the "proposed extension of time is reasonable" Decision served October 23, 2006 After receiving opening comments, the Board then provided an opportunity for interested parties to submit oral and written testimony, which was due more than two months after the submission of opening comments, and nearly five months after the initial ANPR Notably, the ANPR, which was slightly more than two pages in length, did not contain any detailed proposal for the adoption of a particular methodology Rather, the ANPR requested more general comments on the alternative methods available for calculating the cost of capital

3 Approximately six months after receiving oral and written testimony, and eleven months after the issuance of the ANPR, the Board issued its Notice, in which it announced its intent to discontinue its use of the longstanding DCF methodology and to adopt in its stead the CAPM methodology In its eleven-page decision and appendix, the Board described its proposed implementation of the CAPM methodology in some detail, but it did not include all of the workpapers and calculations needed to permit AAR and other parties to understand all the assumptions implicit in the proposal (See Notice at 7 n 13) AAR formally requested such workpapers on the same day that the Notice was released, and received them six days later, on August 20, 2007 The Board also served a Corrected Notice and Corrected Decision on August 20, 2007, revising the cost of equity and cost of capital figures contained in Tables 1 and 2 of the original Notice (at 7-8) Before the Board's service of the Corrected Notice (and the release of the underlying workpapers), AAR and other interested parties could not begin a meaningful analysis of the Board's proposed implementation of the CAPM methodology Moreover, in the short time it has had to review the workpapers produced yesterday, AAR has determined that it will need to procure certain data inputs to be able to replicate the Board's calculations, a requirement that will use up some additional amount of time

4 It is essential that parties have the opportunity to analyze fully the Corrected Decision before responding to the Board's request for comments The Board has previously recognized that the CAPM methodology is particularly sensitive to the judgments and assumptions utilized in its implementation As the Board stated in the Notice, the Interstate Commerce Commission previously rejected the use of CAPM because "it requires the use of many assumptions (and each) can have a significant effect on the result obtained and each necessitates judgments on how best to define and measure it" Notice at 6, *citing Railroad Cost of Capital 1981*, 365 I C C 734, 741 (1982) The Board also stated that while the theory

underlying the CAPM method is relatively simple, "the actual development of a particular model can be complex and still requires the exercise of judgment " *Id* at 2 The Board also acknowledged that "there are disputes over how to apply the [CAPM] model and whether newer methods are superior," and stated that "we are aware that more complex CAPM models exist than the simple version" described in the Notice *Id* at 6-7

5 The Board's annual determination of the rail industry's cost of capital is used in evaluating the adequacy of railroad revenues pursuant to 49 U S C § 10704(a) The cost of capital is also highly significant in many other types of Board proceedings, including those involving the determination of maximum reasonable rate levels, the determination of trackage rights compensation, proposed abandonments of rail lines, railroad mergers, applications to purchase feeder lines, and other proceedings using the Uniform Railroad Costing System ("URCS")

6 The Board's proposed implementation of the CAPM methodology would result in an immediate and extraordinary reduction in the Board's calculation of the rail industry's cost of capital According to the Board's calculations, its proposed implementation of the CAPM methodology would reduce the industry's cost of capital for 2005 from 12 2 percent to only 7 5 percent – a reduction of nearly 40 percent The dramatic change implied by the Board's calculations makes it essential that parties have adequate time to scrutinize the Board's methodology and its execution of that methodology

7 A further indication of the need for sufficient time for AAR and other interested parties to fully analyze the Board's Decision is found in the fact that the Board's proposed implementation of the CAPM methodology would result in a calculated cost of capital for 2005 that is nearly *1 4 percentage points lower* than the cost of capital calculated by the principal proponent of the CAPM methodology, the Western Coal Traffic League ("WCTL")

See WCTL Comments at 7 (served July 25, 2007) Using WCTL's proposed implementation of the CAPM methodology, the rail industry's cost of capital would be 8 87 percent for 2005 and 9 57 percent for 2006 Although AAR does not agree with or endorse WCTL's calculations, the fact that the Board's proposed implementation of the CAPM methodology produces a cost of capital considerably lower than that calculated by WCTL (and by the other sources cited by WCTL) further illustrates the need for all interested parties to examine closely the assumptions and judgments implicit in the Board's proposed implementation

8 Although the Board's proposal to adopt the CAPM methodology itself is highly significant, the Board's *implementation* of the CAPM methodology may be of equal or even greater importance Given the role that capital costs play in the calculation of URCS costs, a sudden and dramatic reduction in the calculated cost of capital for the rail industry could directly affect a wide variety of regulatory proceedings, and could have significant impacts in other commercial contexts as well Indeed, a sharp reduction in the industry's calculated cost of capital could impair the railroads' ability to attract needed investment and to continue improving capacity and service to their customers

9 Because the Board's proposal would dramatically affect the entire rail industry, including its shareholders and investors, it will be necessary for AAR to consult with its member railroads regarding their review of and response to the proposal In addition, the Board's proposal would significantly affect rail shippers and the broader public interest in a healthy rail industry For this reason, the Board should allow sufficient time for comment to permit meaningful participation in this important proceeding by interested parties in addition to railroads and shippers

10 Under the current procedural schedule, opening comments would be due on September 13, 2007, 30 days after the Board served its Notice, and only 24 days after service of

the Corrected Notice This period includes the Labor Day holiday, which effectively reduces the available time for review and comment by several days, and would leave only 17 business days between the service of the Corrected Notice and the due date for opening comments This brief period stands in stark contrast to the much more reasonable timetable that the Board afforded for the submission of comments on its Advance Notice of Proposed Rulemaking

11 For these reasons, AAR and other interested parties require a reasonable amount of time beyond the period provided for in the Corrected Notice in which to analyze the Board's implementation of the CAPM model, to consult with experts on that methodology about the manner in which the Board proposes to implement it. and to prepare constructive and focused comments for the Board's consideration AAR suggests that a modest extension of 45 days until October 29, 2007, is necessary and appropriate for those purposes, and given the significance of the Board's proposal to the railroad industry and all of its constituents, should be viewed as a fair and reasonable one AAR further requests that the Board keep the 30 day interval between the filing of opening and reply comments, moving the due date for the latter to November 28, 2007

CONCLUSION

For the foregoing reasons, AAR respectfully requests that the due date for the submission of comments in this proceeding be extended as described above

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Dated: August 21, 2007

CERTIFICATE OF SERVICE

I hereby certify that on this 21st day of August, 2007, I caused a copy of the foregoing Motion to Modify Procedural Schedule of the Association of American Railroads in Ex Parte No 664, "Methodology to be Employed in Determining the Railroad Industry's Cost of Capital," to be served on all parties of record in this proceeding by first class mail, postage prepaid or more expeditious method of delivery

M. M. Wolfe

Matthew Wolfe