BEFORE THE

SURFACE TRANSPORTATION BOARD

STB Ex Parte 664

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

COMMENTS

of

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

The National Industrial Transportation League
1700 North Moore Street
Suite 1900
Arlington, VA

By its attorneys:

Nicholas J. DiMichael
Karyn A. Booth
Thompson Hine LLP
1920 N Street, N.W.
Washington, D.C. 20036
(202) 263-4103

Dated: September 27, 2007

BEFORE THE

SURFACE TRANSPORTATION BOARD

STB Ex Parte 664

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

COMMENTS

of

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

The National Industrial Transportation League ("League") is pleased to submit these Comments in response to the Notice of Proposed Rulemaking served March 28, 2007. In that Notice, the Board is seeking public comments on its proposal to significantly revise the way that it calculates the cost of capital for the rail industry.

This is an extraordinarily important proceeding. The Board's calculation of the industry's cost of capital affects some of the most basic components of the Board's responsibility, and a correct determination is critical to the Board successfully achieving its Congressional mandate. The Board's calculation of the industry's cost of capital directly determines whether individual rail carriers are deemed to be "revenue adequate" under 49 U.S.C. §10704(a)(2). That determination, in turn, directly affects the availability of certain regulatory relief, see *e.g.,* Ex Parte 347 (Sub-No. 1), *Coal Rate Guidelines – Nationwide*[1] Moreover, the determination of the

---

[1] The Board's "revenue adequacy" constraint is only applicable to carriers that have been "revenue adequate" over a certain period of time. See, *id.,* 1 I.C.C.2d 520 (1985).

industry's cost of capital is an important input into a wide variety of other important regulatory calculations.[2]

In comments submitted to the Board at the Advance Notice of Proposed Rulemaking ("ANPR") phase of this proceeding, the League urged the Board to make significant revisions in its determination of the industry's cost of capital. The League noted that the Board's calculation had become substantially divorced from *exterior* reality of the rail industry's financial condition as expressed by the nation's financial markets. Specifically, while the nation's financial markets were unanimously indicating that the industry's financial position was rapidly becoming stronger and that numerous carriers were achieving or close to achieving returns at the level of their cost of capital, the results of the Board's analysis showed an industry that was in ill-health and financially stagnant. Indeed, the League noted that the Board's cost of capital determinations showed that a number of carriers were further from achieving revenue adequacy in 2005 than they had been in previous years.

Moreover, the League noted that the Board's calculation of the industry's cost of capital, especially in recent years, were also *internally* suspect, showing odd and inexplicable swings from one year to the next. Specifically, under the DCF method, between 2004 and 2005, the agency's cost of capital determination jumped over twenty percent (from 10.1 percent to 12.2 percent, a 20.8% increase) and, according to a filing by the AAR in this proceeding at the ANPR stage, the cost of capital was estimated to increase to 13.8% in 2006, or another 13%. This would have resulted in an increase of over one-third in the cost of capital in just two years, in the

---

[2] The agency's cost of capital forms an important input in, for example, the calculation of Stand Alone Cost under the Board's SAC constraint, see *e.g.,* STB Docket No. 42088, *Western Fuels Association, et. al v. BNSF Railway Company,* served September 10, 2007, slip op. at 135; and in the Board's calculation of variable cost, which is, for example, used for determining the jurisdictional threshold under 49 U.S.C. §10707.

absence of any increase in inflation or any other circumstance that would justify such a substantial increase.

Thus, the League strongly supports the Board's determination to review its procedures for calculating the railroad industry's cost of capital, and strongly supports the Board's determination to modernize its procedures by adopting the Capital Asset Pricing Model.

I. THE BOARD'S PROPOSED METHODOLOGY IS BASED ON CAREFUL RESEARCH ON SOUND ECONOMIC ANALYSIS AND THE PRACTICE OF OTHER RELEVANT GOVERNMENT AGENCIES

While the League is not in a position to comment on the technical aspects of the Capital Asset Pricing Model (CAPM) proposed by the Board, the League believes that the Board has clearly made a careful and thorough review of both the techniques used by other federal agencies as well as the academic literature, in coming to its conclusion that the DCF model should be abandoned and that the CAPM procedures should be adopted. The League applauds the Board's consultation of the Federal Energy Regulatory Commission, the Canadian Transportation Agency, and the Federal Reserve Board, and its review of the current economic literature. In particular, reliance by the STB on the analyses performed by the Federal Reserve Board appears very sound.

II. THE BOARD'S PROPOSED METHODOLOGY APPEARS TO MUCH MORE CLOSELY MIRROR THE JUDGMENT OF THE FINANCIAL MARKETS AS TO THE FINANCIAL HEALTH OF INDIVIDUAL RAIL CARRIERS

As briefly noted above, in its Comments at the ANPR stage, the League noted that, while the Board's current reliance on the Discounted Cash Flow methodology for cost of capital determinations led to findings in 2004 and 2005 that, out of the seven Class I railroads, only Norfolk Southern achieved revenue adequate status, this conclusion contrasts sharply with financial evaluations by investment analysts. For example, James Valentine, a respected industry analyst from Morgan Stanley, estimated that, starting in 2005, CN, BNSF, NS, and CP all earned their cost of capital.[3] The League noted that, despite this and similar reports by respected industry analysts, the Board's methodology resulted in a declaration that in 2005, only Norfolk Southern exceeded its cost of capital. BNSF, CN, and CP were all far short of earning their cost of capital in that year.

The Board's new CAPM proposal appears to much more closely mirror the judgment of the nation's financial community with respect to the financial health of each of the nation's rail carriers. Specifically, the table below compares the "revenue adequacy" of each of the nation's Class I carriers in the years 2003 through 2005 under a cost of capital determination using both the current DCF model and the proposed CAPM procedures:

Comparison of Railroad Revenue Adequacy 2003 through 2005 – Current and Proposed Method for Determining the Cost of Capital

	2005			2004			2003		
STB DCF Cost of Capital	12.20			10.10			9.40		
Proposed CAPM Cost of Capital	7.5			7.1			6.7		
	Actual Return	**Revenue Adequate?**		**Actual Return**	**Revenue Adequate?**		**Actual Return**	**Revenue Adequate?**	
		DCF	**CAPM**		**-DCF-**	**CAPM**		**DCF**	**CAPM**
BNSF	9.76	No	Yes	5.84	No	No	6.20	No	No
CSX	6.23	No	No	4.43	No	No	4.00	No	No
CN	8.07	No	Yes	5.95	No	No	4.50	No	No
KCS	5.89	No	No	8.30	No	Yes	3.70	No	No
NS	13.21	Yes	Yes	11.64	Yes	Yes	9.10	Yes	Yes
CP	8.89	No	Yes	3.28	No	No	0.90	No	No
UP	6.34	No	No	4.54	No	No	7.30	No	Yes

The table above shows that, in 2005, while only the Norfolk Southern was deemed to be "revenue adequate" under the Board's current procedures, under the proposed procedures the

[3] James Valentine & Michael Manelli, Air Freight and Surface Transportation, 3 (Sept. 20, 2005).

Norfolk Southern, BNSF, CN and CP would all have been deemed "revenue adequate" – the same carriers that Mr. Valentine identified as achieving their cost of capital in 2005.

Looking back to 2004 and 2003, the Board's proposal would have continued to identify NS as achieving revenue adequacy in both of those years, but would also have identified the UP as achieving revenue adequacy in 2003 and the KCS as achieving revenue adequacy in 2004. The Board's proposal conforms to the "facts on the ground" in those years as well. In 2003, UP reported the highest annual operating revenues in its history and record levels of net income; the highest return on equity that it had in the previous eight years; and numerous other volume and revenue records.[4] In 2004, KCS similarly reported record operating income and net income.[5] Clearly, then, the Board's proposed methodology much more closely reflects the actual financial health of the industry than its current methodology.

III. CONCLUSION

The League appreciates this opportunity to present its views to the Board on this important matter.

---

4 See, Union Pacific Annual Report, p. 1 and UP 2003 Form 10-K, pp. 9, 13-14

5 See, Kansas City Southern Annual Report, pp. 1, 3, 6.

Respectfully submitted,

The National Industrial Transportation League
1700 North Moore Street
Arlington, VA

Nicholas J. DiMichael

By its attorneys:
Nicholas J. DiMichael
Karyn A. Booth
Thompson Hine LLP
1920 N Street, N.W.
Washington, D.C. 20036
(202) 263-4103

Dated: September 27, 2007