BEFORE THE

SURFACE TRANSPORTATION BOARD

Ex Parte No. 664

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

COMMENTS OF CSX TRANSPORTATION, INC.

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CSXT joins in, and fully supports, the comments of the Association of American Railroads (AAR) filed with the Board in this proceeding. These separate comments by CSXT are intended to underscore the critical importance of this proceeding, briefly expand upon certain points made by the AAR, and to note CSXT's intent to explore petitioning the Board to combine (or coordinate) its review of the railroads' cost of capital with a reassessment of the methodology for valuing each railroad's asset base.

As discussed below, a dramatic departure by the Board from the present cost of capital methodology will result in logically inconsistent and possibly economically inaccurate regulatory policies which, among other things, may cause unintended modifications of long and short term railroad business plans in reaction thereto.

This proceeding is one of the most important the Board is likely to conduct this decade. The Board's assessment of each carrier's cost of capital directly affects a number of its key regulatory tools and, in particular, drives the determination of whether an individual railroad is revenue adequate. Particularly in light of recent regulatory decisions affecting maximum rate regulation standards, it is essential that the Board – if it is to re-examine a quarter-century-long policy – not do so in a way that addresses only half the inputs to the policy-critical revenue adequacy determination.

The principle that railroads should be given an opportunity to achieve sustained revenue adequacy is the conceptual keystone of the Staggers Act. Embodied in the National Transportation Policy, 49 U.S.C. § 10101, it underlies the principle of differential pricing, exemption policies, and indeed most of the reforms established by the Staggers Act. Adhering to these longstanding principles and policies is imperative if carriers are expected to continue to invest in the maintenance and expansion of their networks, especially at a time when already congested highways are only at the beginning of an expected massive surge in traffic.[1]

The issues in this proceeding are far more fundamental than an economic analysis of carrier cost of equity – they are fundamental transportation policy issues. Of all the transportation modes in the nation, only the freight rail system is built and maintained with private capital. Highways, airports, waterways . . . all are taxpayer-funded. The motor carrier industry's cost of capital has nothing to do with the number of lane-miles on the interstate highways. But, the Board's decision about the correct measure of the railroad industry's cost of capital,

[1] *See*, *e.g.*, *Transportation: Invest in our Future, A New Vision for the 21st Century*, July 2007. American Association of State Highway & Transportation Officials.

together with the deemed value of the asset base — the denominator in the ROIC calculation to which the cost of capital is applied in determining revenue adequacy — has direct real-world implications for the rail industry's ability to invest in track, bridges, tunnels, signal systems, Information Technology, rail cars, and locomotives.

Accordingly, when the Board determines to reevaluate its conceptual approach to determining the railroads' cost of capital, it should do so with careful attention to the serious consequences of that decision, and make any change in a fashion that is consistent with sound economic principles. Since cost of capital directly affects a carrier's revenue adequacy determination – with its numerous significant real-world regulatory effects – CSXT submits that any change in the methodology for determining cost of capital requires reexamination of the manner in which the carriers' asset bases are valued as well. Because each have the potential to dramatically affect a carriers' revenue adequacy determination, revision of the cost of capital methodology prior to completion of a reexamination of asset base valuation cannot lead to sound policy and will result in significant uncertainty in carriers' long (and even short) term business plans.

CSXT acknowledges that despite the prospect of a new cost of capital determination, the Board initially declined to consider the need to reexamine whether book value or replacement cost should apply to asset base valuation in the context of its revenue adequacy determinations. However, CSXT respectfully submits that separating these two issues would be a serious error.

"Revenue adequacy" – a statutory provision designed to determine a railroad's financial health – essentially means earning a sustained return on the firm's asset base that covers (or exceeds) its current cost of capital. If either the determination of cost of capital or the asset base is wrong, the wrong conclusion about a carrier's revenue adequacy will inevitably follow.

In the 27 years since the Staggers Act, CSXT and its predecessors have occasionally approached – but never achieved – a year in which they earned their regulatory cost of capital (even if derived from the conservative book basis – as opposed to the reality-based replacement cost – of CSXT's asset base). As a consequence, until recent earning levels were achieved,[2] CSXT (and its predecessors) were forced to engage in an ongoing effort to rationalize their asset base, including abandoning branch lines and alternative overhead routes, removing excess yard tracks, and converting expensive under-used double track routes to single track, simply to maintain the needed infrastructure and meet its ongoing operating expenses. Investment in rolling stock has focused on locomotives and the few car types where investment could be justified, primarily coal cars, auto racks, and high cube grain cars.

CSXT's (and its predecessors') history of abandonments and short line spin-offs is a matter of record. The Board is well aware that over the past four years, CSXT has sold, leased or abandoned about ten percent of its network.

However, as the CSXT network has been streamlined, even greater cost savings have come from productivity increases than from shrinking the asset base. As

[2] These earnings did not even bring the railroads up to the median return on equity for Fortune 500 companies.

study after study has shown, nationwide, the competitive forces of the marketplace, together with these advances in productivity, drove rail rates down for more than twenty years.

CSXT continues to invest significant capital in maintaining and improving its extensive rail infrastructure. However, many bridges and tunnels – while well maintained – were originally built more than a century ago. Over time and as needed, these bridges and tunnels will have to be replaced, rebuilt, or substantially renewed. A look at the costs required to replace these assets shows that those expenditures will far exceed the historical cost basis used for reporting assets under generally accepted accounting principles. For example, two major CSXT bridges that were partially destroyed by Hurricane Katrina had an aggregate historical cost of less than $5 million, but actually cost over $90 million to repair.

The above example highlights a collateral consequence of using historical costs instead of replacement costs as part of the revenue adequacy determination. The Board's proposal to change the regulatory cost of capital methodology without considering the true investment requirements that the rail industry is facing will lead to constrained capital spending at a time when the U.S. is facing a transportation capacity crisis. Now, the argument will surely be made that the Board has always used book value in its revenue adequacy determinations. That is true. It is also true that until recently the vast majority of present Class I carriers (and their respective predecessors) showed no real prospect of achieving earnings that might approach a level consistent with earning their cost of capital over a sustained period of time. And, it is further true that no sitting Chairman of the ICC or the STB ever found it necessary to call a hearing – as this Board did – on capacity limitations and infrastructure needs. (STB Ex Parte No. 671, Rail Capacity and Infrastructure Requirements, Public Hearing dated April 11, 2007.)

The nation stands at the beginning of a new transportation era, an era that requires foresight in public policy the likes of which has not been needed since the 1970's when one-fourth of the nation's railroad networks were in bankruptcy and there was serious discussion of "nationalizing" the rail system. In this context and in light of the recent and anticipated capital expenditures announced by the railroads, it is difficult to comprehend the desire to change fundamentally one key factor in determining revenue adequacy – cost of capital – without at least attempting to reexamine an equally important factor – asset base determination.

Therefore, the Board simply cannot confine its attention to the relative merits of CAPM versus DCF. If it is to reexamine its formulae, it must do so with an eye to sound public policy outcomes. That means reexamining both the cost of capital and the true value of the asset base against which it is applied.

Accordingly, CSXT makes the following suggestions and observations for the Board's consideration:

- Despite broad use of CAPM for non-regulatory purposes, a strong case can still be made for retaining DCF as the Board's regulatory standard. Over time, DCF and CAPM tend to give the same or similar results. In addition, while DCF may be dependant on certain assumptions, CAPM also requires considerable subjective judgments. Those judgments will need to be made annually and no doubt will be highly contentious. To make the correct annual decision, the Board will naturally need more time and resources to complete its analysis, thus adding delay and uncertainty to the regulatory process in the meantime.

- Those who use CAPM today do so to support what are largely subjective business judgments – not formulaic outcomes. Therefore, analysts using CAPM to estimate the expected return for a company can take into consideration uncertainties in key assumptions (such as Beta, the market risk premium, and the risk-free rate) to CAPM when their ultimate (and subjective) investment or capital structure decisions for that company are made. That is hardly the case with the formulaic application of the Board's proposed cost of capital decision – once decisions on key CAPM inputs are made, the outcome provides no opportunity to weigh the reliability or confidence of the estimates under the current proposed methodology.

- The Board has tracked carrier performance for over 25 years using an economically valid analytical tool. Jettisoning the DCF model will deprive the Board and the public of a reliable "road map" showing where the rail industry has been and a valuable aid in setting regulatory policy to drive where it is going. DCF should not be abandoned without compelling reasons to do so. Rather, CSXT fully supports the AAR's proposal to consider a range of estimates of the cost of equity, ultimately adopting a point estimate within the middle to upper portion of that range.

- Upon receipt of a timely petition in accordance with the Board's August 14, 2007 Notice of Proposed Rulemaking in this proceeding, the Board should consider combining or coordinating its cost of capital reexamination with a reexamination and/or new proceeding regarding replacement cost determinations.

Conclusion

The Board's proposal to alter its quarter-century-long policy on railroad cost of capital would be a sea change in regulatory policy. If the Board concludes that such a radical change is necessary, CSXT respectfully requests that the Board also address at the same time the replacement cost valuation of the carriers' asset bases. An economically unjustified half-correction could severely restrict carriers' abilities to re-invest in their networks at a time when the nation's transportation infrastructure is strained and more – not less – transportation capacity is needed.

Respectfully submitted,

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