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BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte No. 664

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

COMMENTS OF UNION PACIFIC RAILROAD COMPANY

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As its Comments in this proceeding, Union Pacific Railroad Company is submitting the attached Verified Statement of Robert M. Knight, Jr., Executive Vice President-Finance and Chief Financial Officer of Union Pacific Corporation and Union Pacific Railroad.

Respectfully submitted,

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September 27, 2007

VERIFIED STATEMENT

OF

ROBERT M. KNIGHT, JR.

My name is Rob Knight. I am the Executive Vice President-Finance and Chief Financial Officer of Union Pacific Corporation and Union Pacific Railroad. I was named to this position in January 2004. I am responsible for all financial activities of both the Corporation and Union Pacific Railroad.

I began my career with Union Pacific Corporation in 1980 and have held a variety of positions in Audit, Accounting, Finance, Human Resources, Quality, and Marketing and Sales. In 1996, I was named Vice President, Quality. In 1999, I was named Vice President and General Manager, Energy in Union Pacific Railroad's Marketing & Sales Department. In 2000, I became Vice President and General Manager, Automotive, also in the Marketing & Sales Department. I returned to Finance in May 2002, when I became Senior Vice President, Finance of Union Pacific Corporation, the position I held before my election to my current position. I have a bachelor's degree in business administration from Kansas State University and a master's degree in business administration from Southern Illinois University.

In my role as Chief Financial Officer at Union Pacific, I spend a great deal of my time talking with our shareholders, debt investors, financial analysts, and other members of the financial community about our plans for the future, our growth opportunities, and our capital investment needs. In recent weeks, many of our shareholders and other investors have expressed strong concerns about our prospects for future returns in light of the Board's proposal to revise its cost of capital calculation. As the Board is aware, the cost of capital is the rate of return required of a firm by the current and prospective holders of its securities, and the cost of equity is a component of the cost of capital that reflects the rate of return required by equity investors. Our equity investors (our shareholders) are telling us they believe the cost of equity as calculated in the Board's proposal is too low, and does not reflect the requirements of the equity marketplace for returns on our stock, or on rail stocks in general. Our shareholders have been buying our stock because they expect to see strong growth in earnings and cash flow in future years.

Perhaps even more critically, I believe investors are concerned that the move to adopt an unrealistically low cost of capital, thus limiting our potential revenue returns, signals a move away from the progress the rail industry has made since the Staggers Act, back toward a more regulated, lower return environment. Industries with low returns find it difficult to retain capital, and they are less attractive to equity investors and the capital markets generally. The concerns of the marketplace were dramatically illustrated on August 14, when the proposal was made public. On that day, the U.S. rail stocks dropped by an average of 3.8 percent – significantly more than the 1.8 percent decline in the broad market, as represented by the S&P 500. By the end of the week, after investors had time to study the Board's proposal, rail stocks had dropped by an average of nearly 7 percent, while the S&P 500 dropped less than 0.5 percent.

From my perspective as Chief Financial Officer at Union Pacific, I share investors' concerns. The Board's proposal to revise its cost of capital calculation threatens to undermine some of the basic assumptions that we have been relying upon in making capital investment decisions. The proposed CAPM methodology would have established a 2005 cost of equity that was 45 percent lower than the Board's currently established level, and far below the cost of equity that would be calculated using various alternative inputs for CAPM or other methodologies commonly used by the financial community. A lower cost of equity would in turn reduce the cost of capital calculated by the Board by approximately 39 percent.

I am also concerned that many do not understand what is truly at stake. I have heard people suggest that railroads are already able to invest substantial amounts of money based on our current earnings and that the Board's proposal will do no more than say that our revenues are adequate and thus maintain the *status quo.* As I discuss below, that view is seriously flawed. It fails to recognize that we have been investing in new capacity, and our shareholders have been permitting us to make those investments, based on expectations that our earnings will continue to improve. Changing how the cost of capital is calculated so that it is below most other estimates will undermine those expectations and thus our ability to continue investing for growth. In other words, in terms of our continued ability to invest in capacity growth, there is a very real risk that this proceeding will change the *status quo*.

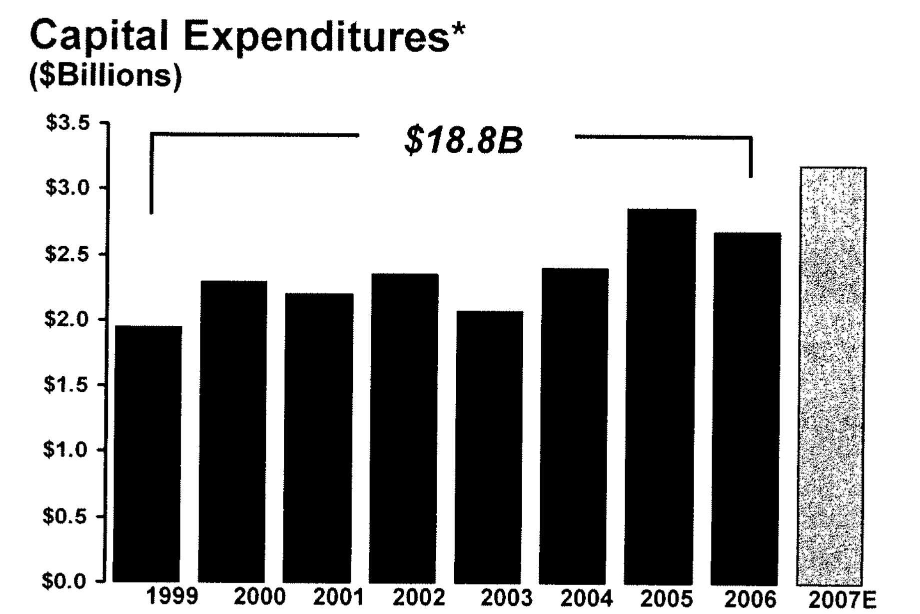
I understand that the Association of American Railroads, on behalf of Union Pacific and other railroads, is submitting comments that address the errors in the calculations and the suitability of the assumptions made by the Board. Consequently, I will not repeat concerns about how the 8.4 percent cost of equity for 2005 was calculated but will focus instead on the consequences of regulatory reliance on an unrealistically low cost of capital.

As I will explain, the Board's proposed method of calculating the cost of capital threatens Union Pacific's ability to earn an adequate financial return on our investments and our corresponding ability to invest in new capacity. I will also explain why shippers' claims that railroads are misallocating their revenues do not accurately portray the facts as they relate to Union Pacific. Finally, I will briefly address the relationship between the cost of capital and the Board's calculation of return on investment, and explain why the Board should re-examine in another proceeding its measure of return on investment to reflect more accurately the costs that railroads incur to replace their existing assets.

I. ADOPTION OF A FLAWED COST OF CAPITAL CALCULATION WILL THREATEN UNION PACIFIC'S ABILITY TO INVEST IN CAPACITY.

A. Union Pacific Has Been Investing In Growth.

Union Pacific, like other freight railroads, must make large capital expenditures every year just to maintain our existing network and service levels. Between 1999 and 2006, our capital expenditures have totaled almost $19 billion, which is nearly 20 percent of our revenue during the same period, as shown below in Chart 1. By comparison, the average U.S. manufacturer spends about 3.5 percent of revenue on capital spending.



*Capital equals cash capital spending plus lease financings

CHART 1

In 2007, Union Pacific's capital budget is $3.2 billion – by far the largest amount in our history, and 19 percent more than the $2.69 billion that we spent on capital in 2006. Of that $3.2 billion, we are spending more than $1.1 billion on growth capital – that is, capital investments designed to increase Union Pacific's capacity. The $1.1 billion – also a record amount– is nearly double our average investment in growth capital between 1999 and 2006, and more than 60 percent above our investment in 2006. To provide some additional perspective on the amount of resources we devote to capital spending, the $1.1 billion in 2007 growth capital alone is about 70 percent of our entire 2006 net income, while our total capital budget is *twice* last year's earnings. Even with all of this capital spending, our customers continue to urge us to invest even more in capacity in order to meet their growing needs for freight transportation.

Union Pacific is investing for growth today. However, we cannot base our capital investment decisions solely on the growing demand for freight transportation. Before we can prudently invest in the capacity that our customers want, we need some assurance that we can earn returns sufficient to justify making new investments. We are making – and have made – substantial investments because we believed that the underlying market demand for freight transportation and the current regulatory structure, would allow us to achieve sufficient returns. Union Pacific's record level of capital investment in 2007 reflects improvements we have seen in our returns and our anticipation that the trend of improved returns would continue into the future. But now, just as we are approaching the point at which our returns warrant the investment required to sustain and to grow our network, the current regulatory and legislative climate threatens those returns and makes future investment in additional capacity uncertain.

B. An Unrealistically Low Regulatory Cost Of Capital Threatens Future Railroad Investment.

The Board's calculation of an unrealistically low cost of capital will jeopardize our ability to continue our strong capital investment program by reducing future return potential in two separate but related ways.

The most immediate impact to returns will come through revenue reduction as the cost of capital is applied in individual rate cases. A lower cost of capital increases the amount of traffic that is subject to rate regulation and increases the likelihood that the Board will find a challenged rate to be unreasonably high and order us to reduce the rate. The Board has further increased the risk that our rates will be constrained by regulation through its recent decisions regarding both large and small cases that make it much less costly for shippers to bring rate cases and much easier for them win the cases they bring.

Shippers who are urging the Board to adopt a lower cost of capital understand the very real connection in their own businesses between generating the revenue needed to earn their cost of capital and making investments. If the Board accedes to their short-sighted designs, their victory in reducing rates will come at a cost to the shipping public's and the nation's interests in promoting investment in transportation infrastructure. We understand that nobody likes to pay higher rates, but we cannot invest to grow our rail network unless we are allowed to earn adequate returns from that investment.

The longer term impact on Union Pacific's future return potential will come as an unrealistically low cost of capital is used by the Board to determine overall "revenue adequacy." When the Board calculates the cost of capital, it effectively tells the company, our shareholders, and financial markets the maximum level of returns that we will be allowed to achieve over time. As the Board's predecessor, the Interstate Commerce Commission explained, when a railroad, over time, achieves an "average return on investment equal to its cost of capital" it will be considered "revenue adequate."[1] Once a railroad achieves revenue adequacy, the Board will not allow it to establish rates for regulated traffic that would generate higher returns: "Our revenue adequacy standard represents a reasonable level of profitability for a healthy carrier. It fairly

[1] *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520, 536 (1985).

rewards the rail company's investors and assures shippers that the carrier will be able to meet service needs for the long term. Carriers do not need greater revenues than this standard permits, and we believe that, in a regulated setting, they are not entitled to any higher revenues."[2]

A lower cost of capital makes it much more likely that Union Pacific will be deemed revenue adequate in the very near future. Under the Board's current cost of capital calculation, Union Pacific has never been considered revenue adequate. Under the Board's new calculation, Union Pacific would have been revenue adequate in 2002 and 2003.[3] But if the cost of equity used by the Board in this calculation is inappropriately low, it will not truly reflect the returns required in the marketplace. This will create a situation in which our company's returns will be constrained by the Board's revenue adequacy standard before we have actually achieved the level of returns considered adequate by the capital markets – the criteria that this calculation was originally designed to reflect.

Union Pacific cannot estimate the impact that an unrealistically low regulatory cost of capital will have on our revenue and returns in the next few years because that depends on the actions of others. But there can be no reasonable dispute about the long-term risks. And it is precisely these long-term risks that we must consider when we are deciding whether and how much to invest in growing our network today. If the outlook for returns is uncertain, we will not be able to make the kind of long-term investments our customers, and our country, will need in the future.

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[2] *Id.* at 535.

[3] As I discuss in Part III of this statement, the constraint will have a particularly pernicious effect on carriers because the return on investment component of the revenue adequacy determination overstates the return that carriers are generating on their invested capital.

Decision-making about investments in railroad facilities and equipment – particularly new investments to increase network capacity – requires taking a long-term perspective. New railroad capacity can take years to place into service, and once it is placed into service, the investment remains committed for decades. For example, we started constructing the Marysville bypass in September 2002. It was not until spring 2006 that the first trains used this $47 million project, which moved the company's double main line out of downtown, added six passing tracks and closed 11 grade crossings to improve safety and velocity for approximately 70 trains per day. In short, the decisions we are making today about investing in new capacity are not based on current returns; rather, our decisions must be based on the returns we anticipate achieving over the next several decades or more.

Union Pacific will not be able to maintain its current level of capital investment, much less increase our level of investment to accommodate the growing customer demand for rail service, unless we and our shareholders are confident in our ability to earn an adequate rate of return on that investment in coming years. Union Pacific is a publicly owned company. As a publicly owned company, we have a fiduciary duty to our owners (our shareholders) to operate the company in a profitable manner and make prudent decisions regarding future capital investments. We could not continue to invest capital in something that has an unreasonably low return imposed on it. Moreover, our shareholders would not allow it. They would insist that more cash be returned to them, in the form of higher dividends or share repurchases. In the longer term, investors would move away from the rail industry, toward companies in industries where returns are in line with their requirements. Our debt investors would also recognize that our economic prospects have deteriorated. They, too, would move to other industries, or charge us higher rates and impose less favorable terms to reflect the greater credit risk. This is not a scenario that our customers, our shareholders, or the nation can afford.

Union Pacific has demonstrated that it will invest in new capacity when the opportunity for future returns justifies making new investments. We have been investing in new capacity in anticipation of improved returns, and the pace of our investment has increased as we are finally approaching a point where our financial returns justify new investment. The Board's proposal threatens our ability to earn the returns we need right at the time when the need for investment in the nation's transportation infrastructure has never been higher. The Board should be reaffirming the policies that allowed the railroad industry to reach a point where we can help meet this need, not adopting proposals that threaten to reverse that success.

II. UNION PACIFIC HAS USED INCREASED REVENUES TO EXPAND CAPACITY, PROVIDE SHAREHOLDERS AN IMPROVED RETURN ON THEIR INVESTMENT, AND MAINTAIN CRITICAL FINANCIAL FLEXIBILITY.

As I discussed above, and will discuss in even more detail below, Union Pacific devotes considerable resources to investing in assets to provide safe transportation and meet the demands of our customers. As demand has pressed the existing capacity and prices have risen (as happens in free markets) Union Pacific has increased its capital expenditures while taking steps to improve returns to our shareholders. WCTL's claim that railroads have misallocated revenues they earned between 2003 and 2006 is certainly false with respect to Union Pacific. Union Pacific has used the revenues it earned over that period to increase significantly its level of capital investment, as well as to provide shareholders with an improved return on their investment and maintain the financial flexibility that is critical in our capital intensive industry. It is critical that we consider all three objectives: it is only by fulfilling our obligations to our shareholders and debt-holders that we can continue to invest in capacity growth.

A. Union Pacific Has Significantly Increased Its Capital Investment, And Particularly Its Investment In Growth Capital.

As discussed above, Union Pacific had been investing hundreds of millions of dollars in capital each year, long before the revenue increases described by WCTL, based on our belief that future returns would justify that investment. In fact, Union Pacific would not be in the position to increase its revenues today if we had not been investing hundreds of million dollars a year over the past decade when revenues were not what they are today. Those earnings are the result of investments made years, even decades, in the past.

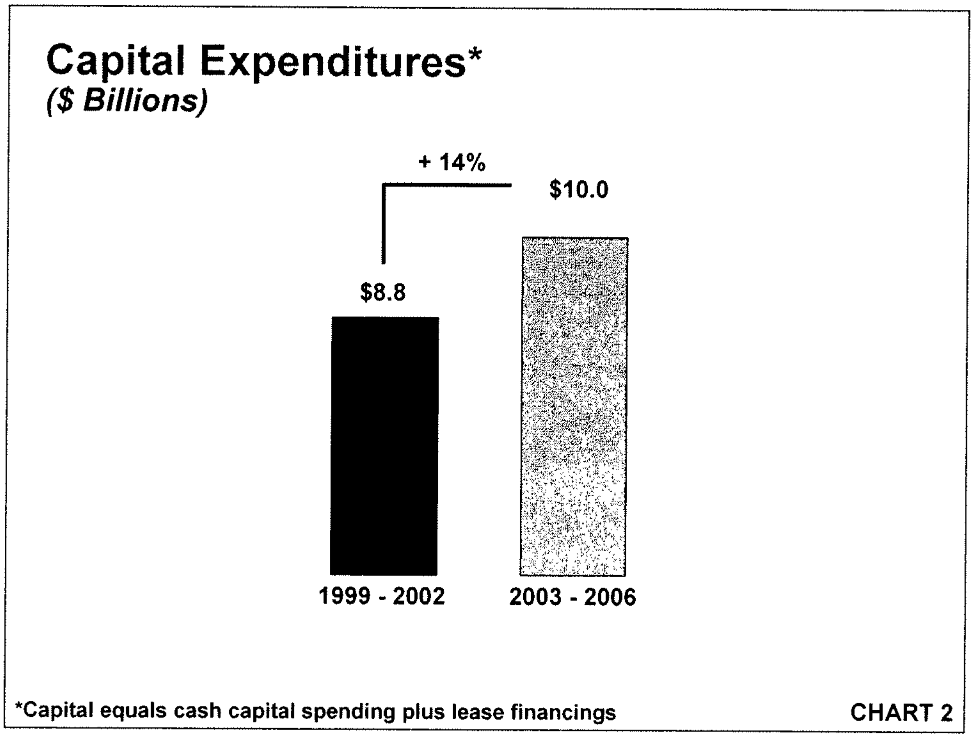
Because Union Pacific's decisions about capital investment are primarily based on our expectations about the railroad's ability to earn adequate financial returns in the future, one should not necessarily expect an increase in rail revenue to produce a sudden surge in capital investment. Even so, WCTL's claim that railroads have not increased their capital spending as revenue has increased in recent years is not true with respect to Union Pacific.

WCTL focuses on the period from 2003 through 2006 as the period in which rail revenues have been increasing. For purposes of responding to WCTL's claim, I agree that it is fair to consider the period of increasing rail revenues to have begun in 2003, but to see the full picture, one must also consider the years before 2003.

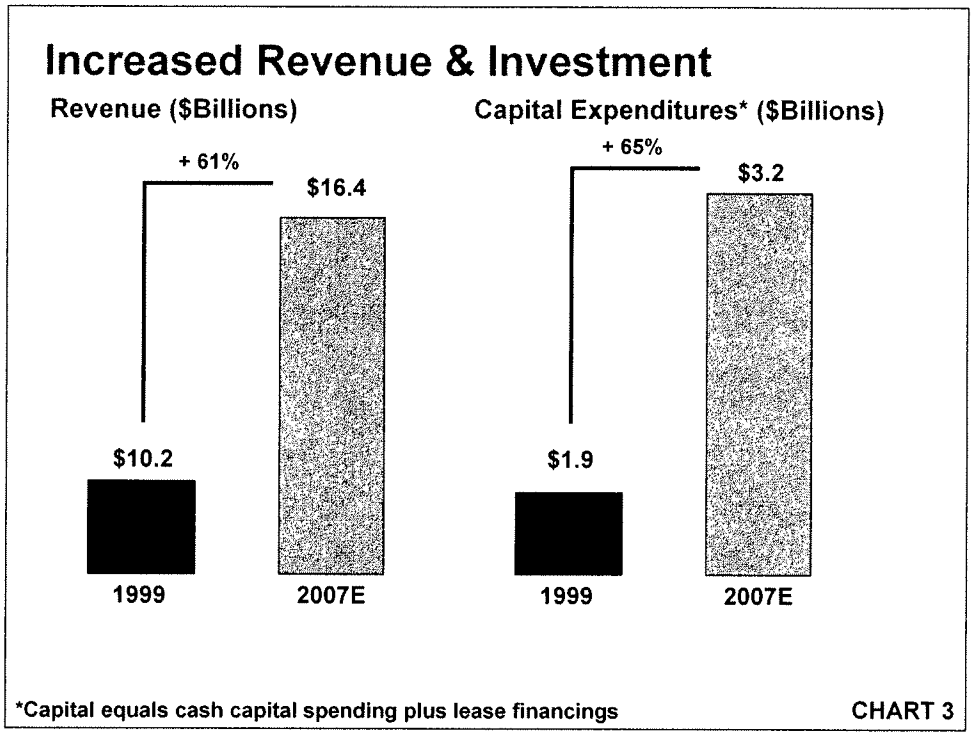
- In the four-year period from 2003 through 2006, Union Pacific's revenues increased at a compound annual growth rate of 10.4%.
- By comparison, in the four-year period from 1999 through 2002, Union Pacific's revenues increased at a compound annual growth rate of 3.1%.

Accordingly, a good way to test WCTL's claim that railroads have not been using their increased revenues to invest is to compare Union Pacific's revenue and capital spending in the four-year period from 2003-2006 to the four-year period from 1999-2002. The results show that Union Pacific's capital spending has increased substantially as revenue has increased.

First, as Union Pacific's revenue increased from $42.9 billion in 1999-2002, to $52.9 billion in 2003-2006, Union Pacific's total capital expenditures have also increased – from $8.8 billion in 1999-2002, to $10.0 billion in 2003-2006, as shown below in Chart 2. Thus, Union Pacific's total capital spending increased by an average of more than $300 million per year between the two periods.

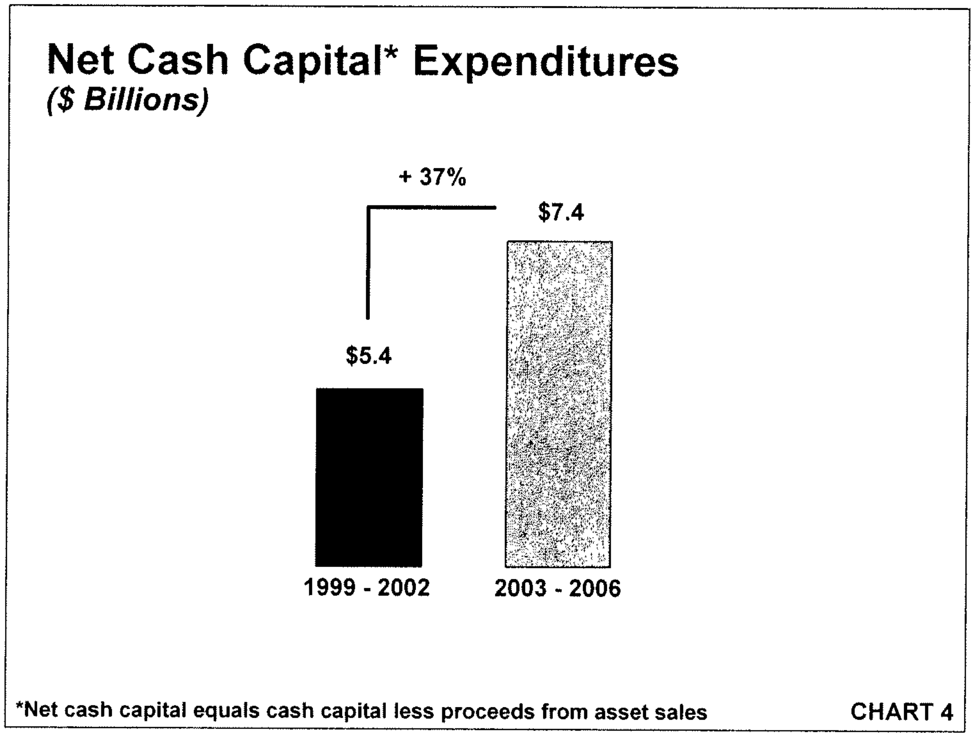


Moreover, Union Pacific's capital budget for 2007 is more than $695 million above the average for 2003-2006, and approximately 19 percent more than its capital budget for 2006. If Union Pacific meets its current revenue and capital spending targets in 2007, Union Pacific's capital spending in 2007 will exceed its capital spending in 1999 by 65 percent, while Union Pacific's revenue in 2007 will exceed its revenue levels in 1999 by 61 percent, as shown below in Chart 3.



Second, WCTL suggests that the relevant measure of railroad capital investment is the amount of cash expended on capital projects net of asset sales. This measure excludes the costs of long-term lease financing of our capital equipment. We believe that excluding long-term lease financing costs does not provide a complete picture of our capital investment decisions. WCTL also suggests netting out proceeds of assets sales, though this makes little sense because the decision to sell an idle asset is unrelated to the decision to expend capital. However, even using the measure suggested by WCTL, Union Pacific's capital expenditures have increased as our revenue has increased.

As Union Pacific's revenue increased by 23 percent between 1999-2002 and 2003-2006, Union Pacific's cash capital expenditures (net of asset sales) increased by more than 37 percent, from $5.4 billion in 1999-2002, to $7.4 billion in 2003-2006, as shown below in Chart 4. Viewed from another perspective, Union Pacific's cash capital spending (net of asset sales) increased by an average of $504 million per year between the two periods. Moreover, Union Pacific's budgeted cash capital spending for 2007 is $844 million above the average in 2003-2006.



Third, comparisons between Union Pacific's revenue and total capital spending or cash capital will understate changes in capital spending for capacity expansion, which appear to be the focus of WCTL's claims. Union Pacific's capital spending includes "non-growth capital" and spending on "growth capital." "Non-growth capital" is predominantly spending designed to maintaining a safe and sound operation at existing capacity levels. "Growth capital," on the other hand, is spending designed to expand capacity, such as investment in new track and facilities or increasing equipment fleets.

The relationship between increased revenue and spending on growth capital has been especially strong: as Union Pacific's revenue has increased, Union Pacific has increased its spending on growth capital in both absolute and relative terms. Specifically, while Union Pacific's revenue increased by 23 percent between 1999-2002 and 2003-2006, its spending on growth capital increased by 53 percent, from $1.8 billion in 1999-2002 to $2.8 billion in 2003-2006, as shown below in Chart 5. Viewed from another perspective, Union Pacific's spending on growth capital increased by an average of $243 million per year between 1999-2002 and 2003-2006.

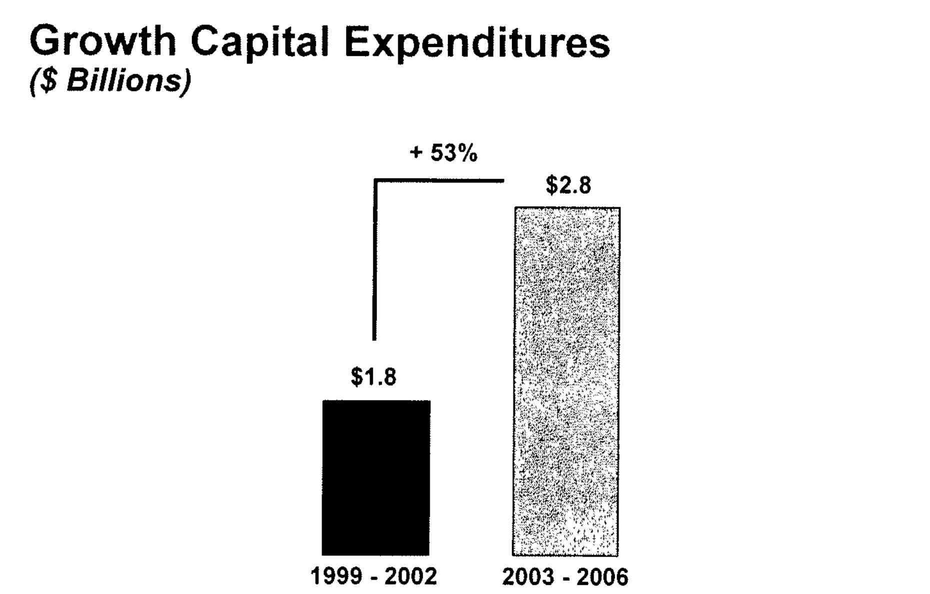


CHART 5

Moreover, Union Pacific's budget for growth capital spending in 2007 is $1.1 billion, which is $412 million above the average spending in 2003-2006. If Union Pacific meets its current revenue and growth capital spending targets in 2007, Union Pacific's revenue will exceed its revenue levels in 1999 by 61 percent, while Union Pacific's growth capital spending will exceed its growth capital spending in 1999 by a full 97 percent.

B. Union Pacific Has Used Its Increased Revenues To Improve Returns To Shareholders And Maintain Critical Financial Flexibility.

As discussed above, as Union Pacific's revenues grew between 2003 and 2006, our capital investment increased as well. Union Pacific also took steps to increase its dividends, and we have made stock buybacks in 2007. We believe that we have appropriately balanced our spending between valid, competing demands. In fact, the firms that Union Pacific competes with in capital markets are distributing returns to shareholders in the form of cash at comparable or higher levels.

WCTL essentially argues that railroads should be directing all of their recent increases in revenue to invest for growth instead of paying dividends to shareholders – or at least that they should not be complaining about the impact of the Board's decisions on their ability to invest in capacity expansion unless they are spending all of their recent increases in revenue on capacity expansion. However, WCTL misapprehends our concern about the likely impact of the Board's cost of capital proposal, and its suggestion that we have the wrong priorities does not recognize our obligation to provide returns to our shareholders or our need to maintain the financial flexibility that is so critical in a capital-intensive industry. WCTL members surely understand these trade-offs, because they face the same issues in managing their own finances.

When we allocate what remains of our revenue after paying operating expenses, interest on loans, and taxes, and after investing in maintaining safe operations, we still face two important, related demands that affect the long-term health of the company: we must provide returns to our owners, and we must maintain flexibility in accessing the capital markets.

Our owners (our shareholders) – individuals, retirement funds, pension funds, charitable organizations, and others – have invested in our company based on the understanding that we will do our best to maximize the return on their investment. Returns to equity investors come through increasing the value of the company (*i.e.*, increasing the stock price as a result of efficiency gains and capital investments) and by passing along cash generated by the business (*i.e.*, paying dividends and making share repurchases).

In providing returns to our equity investors, we strive to achieve an appropriate balance between investing in growth and providing returns in the form of dividends and share repurchases. In recent years, as our returns have improved, we have come closer to achieving that balance.

As I have discussed extensively, Union Pacific has invested an enormous amount of capital in growth – more than $2.8 billion from 2003 through 2006. Over the same period, we paid $1.2 billion in dividends and had no share repurchases. Union Pacific's dividend payments actually lag far behind those of most other S&P 500 companies. Currently, Union Pacific's dividend yield is 1.2 percent; the average for a S&P 500 company is 1.6 percent; and the average for publicly traded members of WCTL is 3.8 percent, as shown below in Chart 6. Based on the most recent fiscal year-end data, publicly traded WCTL members paid out 54 percent of their net income as dividends, compared with an average of 26 percent for S&P companies, and only 20 percent for Union Pacific.

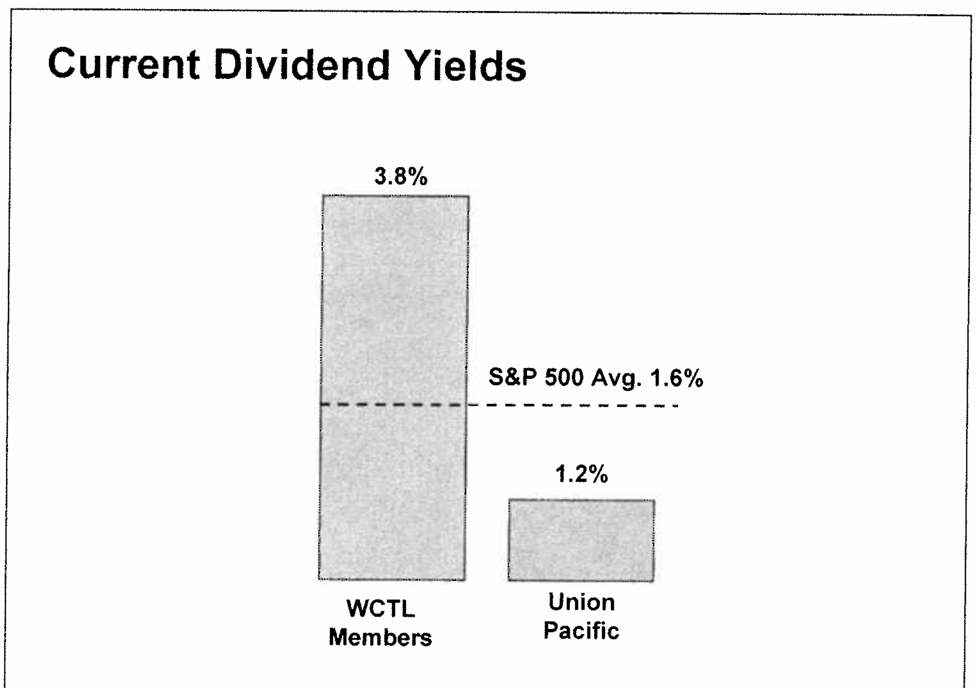


CHART 6

As I mentioned, Union Pacific had not made any share repurchases through 2006, though we have started to make share purchases in 2007. In this respect, also, we are lagging behind other large companies. S&P 500 companies have been repurchasing shares in record amounts – they spent $437 billion on share repurchases in 2006, $349 billion in 2005, and $197 billion in 2004. Publicly traded WCTL members spent $857 million on share repurchases in 2006. Again, Union Pacific made no share repurchases during this period.

Union Pacific also has responsibilities to its debt investors. WCTL criticizes railroads' use of cash to repay long-term debt and claims that their debt/capital ratios are too low. However, Union Pacific carefully calibrates our debt activities in order to maintain our standing in debt markets. Credit ratings are dependent on a number of factors, including our debt levels, our debt/capital ratio, our ability to generate cash, and even our ability to provide returns to our shareholders. Union Pacific strives to maintain an investment-grade rating – a BBB rating from Standard & Poor's and a Baa2 from Moodys.

Our credit rating is important to us because we engage in a substantial amount of borrowing each year, and borrowing costs would increase if our ratings fell. We also believe it is important to maintain a strong position in case we need to borrow in the future, because we are a capital intensive industry that needs to invest each year to keep the railroad safe. Based on the most recent information we have, more than 60 percent of the WCTL members have higher credit ratings than Union Pacific. In addition, Union Pacific's credit ratings are lower than or equal to 73 percent of the S&P 500 companies.

III. THE BOARD MUST CONSIDER ITS RETURN ON INVESTMENT CALCULATION IN CONNECTION WITH ITS COST OF CAPITAL CALCULATION.

Union Pacific has long been concerned that the Board's measure of return on investment significantly overstates the actual return on investment in the railroad industry. This overstatement will take on greater significance if the Board adopts a methodology that produces a lower cost of capital, because it will incorrectly suggest that railroads are "revenue adequate" – that is, that they are earning returns on investment equal to the cost of capital.

The fundamental flaw in the Board's return on investment calculation is that it overstates earnings because it does not adequately account for the costs we incur when we must replace existing assets. The Board's approach measures that cost by considering historical investment in assets and treating depreciation as an expense. As a practical matter, however, in order to generate revenue, we must replace existing assets using today's dollars, and those costs exceed depreciation. The result is that our true return on investment is substantially lower than the Board's calculation makes it appear.

The disconnect between depreciation expense and costs to replace existing assets in the Board's return on investment calculation is not as much of a concern when the cost of capital exceeded the overstated return on investment. The problem will become much more serious if the Board adopts a lower cost of capital, because that will increase the likelihood that our returns (which are overstated) will appear to be adequate in comparison with the cost of capital.

We realize that the Board has said that it does not want to address the return on investment calculation in this proceeding, but we urge the Board to institute a separate proceeding to address this important issue.

I Robert M. Knight, Jr., declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this verification.

Executed on September 27, 2007

Robert M. Knight, Jr.