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September 27, 2007

VIA E-FILING

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423-0001

Re: STB Ex Parte No. 664
Methodology to be Employed in Determining the Railroad Industry's
Cost of Capital

Dear Secretary Williams:

Pursuant to the Surface Transportation Board's decisions issued on August 14, 20 and 31, 2007, in the above captioned proceeding, The Kansas City Southern Railway Company ("KCS") hereby files, via e-filing, its Opening Comments in the above captioned matter. If there are any questions concerning this e-filing, please contact me by telephone at (202) 663-7823 or by e-mail at wmullins@bakerandmiller.com.

Sincerely,


William A. Mullins

Enclosures

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Ex Parte No. 664

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

**OPENING COMMENTS OF THE KANSAS CITY
SOUTHERN RAILWAY COMPANY**

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Dated: September 27, 2007

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SURFACE TRANSPORTATION BOARD**

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**OPENING COMMENTS OF THE KANSAS CITY
SOUTHERN RAILWAY COMPANY**

In a decision served on August 20, 2007 in this proceeding (“August 20 Decision”),¹ the Board proposed to change the methodology it uses to calculate the railroad industry’s cost of capital, stating in particular its intention to replace its long-standing discounted cash flow model (“DCF”) with a capital asset pricing model (“CAPM”). Elaborating upon the application of the proposed rule change, the Board stated that, “The industry-wide cost of capital will be determined as a weighted average of individual railroad costs, using the same methodology as is used now.” August 20 Decision, slip op. at 10. Thus, although the Board’s proposed shift from DCF to CAPM would change the Board’s method for calculating the cost of capital for each of the four largest Class I railroads, the process by which the Board would derive an industry-wide cost of capital from those individual railroad costs would not change; that is, the Board still intends to use as the industry-wide cost of capital for the four largest Class I railroads. That average does not include the cost of capital of The Kansas City Southern Railway Company (“KCS”). Accordingly, an “industry-wide” cost of capital calculated using either the current or proposed methodology will not reflect KCS’s actual cost of capital, causing, among other things, KCS’s costs under the Uniform Rail Costing System (“URCS”) to be inaccurate.

¹ The Board originally published notice of this rulemaking in a decision served on August 14, 2007, but, as noted, that decision contained errors that were corrected in the August 20 Decision.

Given the importance of the cost of capital calculation in the Board's regulatory framework, the Board can and should use KCS's actual cost of capital in regulatory proceedings involving KCS. As shown herein, KCS's actual cost of capital is higher than that of the four largest Class I railroads. Substituting a so-called industry-wide cost of capital for KCS's cost of capital in rate complaints, for example, could result in findings that KCS's Revenue/Variable Cost ratio ("R/VC") exceeds 180% in some cases when it actually does not, and could result in some KCS rates being found to be unreasonably high when in fact they are not. Board reliance on the industry-wide figure could also cause the Board to find KCS to be revenue adequate when in fact KCS would not be if the agency were to apply a KCS-specific cost of capital instead. These effects threaten to impose artificial regulatory limits on KCS's pricing authority, limit KCS's ability to achieve revenue adequacy, prevent KCS from obtaining the necessary revenues to fully invest in much-needed additional capacity and infrastructure, and puts KCS at a competitive and regulatory disadvantage vis-à-vis its Class I competitors by substituting their lower costs of capital for KCS's actual cost of capital.²

KCS previously raised these issues in the Board's 'small rate complaint' proceeding. The Board deferred that issue to this proceeding.³ In line with the Board's instruction, KCS again raises these issues, and asks that the Board commit to using an accurate cost of capital calculation based on KCS's actual cost of capital in regulatory applications involving KCS, including the calculation of URCS costs.

² The Board's methodology similarly disadvantages many smaller railroads, not just KCS.

³ Simplified Standards for Rail Rate Cases, __ STB __, STB Ex Parte No. 646 (Sub-No. 1), slip op. at 103 (STB served Sept. 5, 2007) ("Simplified Standards") ("If KCS believes that the industry-average cost of capital used by this agency should be replaced with a carrier-specific cost of capital, it should advise the Board on how to address that issue in the ongoing inquiry into how to calculate the cost of capital for the railroad industry") (footnote referring to the subject cost of capital proceeding omitted).

I. THE COST OF CAPITAL IS AN IMPORTANT ELEMENT OF THE BOARD'S REGULATORY SCHEME

KCS joins in the concerns of the Association of American Railroads ("AAR") about the Board's proposed abrupt and inadequately-supported change from its historic DCF cost of equity calculation to the CAPM method. However, rather than repeating those arguments here, KCS will focus upon the fact that the Board's industry average does not accurately reflect KCS's cost of capital, and that the application of such an industry average figure puts KCS at a demonstrable regulatory disadvantage vis-à-vis its Class I competitors.

In some sense this is not a new issue. The use of an industry-wide average that does not include KCS, and that does not accurately track KCS's cost of capital, has always placed KCS at a regulatory disadvantage. This would remain so regardless of whether the cost of capital is determined using a DCF or CAPM methodology. But this has been more of an academic issue in the past because KCS has not been the subject of a rate reasonableness proceeding since the adoption of the Board's rate guidelines in Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520 (1985) ("Coal Rate Guidelines"), aff'd sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3d Cir. 1987) or since the adoption of Rate Guidelines – Non-Coal Proceedings, 1 S.T.B. 1004 (1996). Furthermore, even if KCS had been the defendant in a rate complaint under either process, the Board's rules allowed for adjustments to URCS, which would have allowed KCS to account for its actual costs, including its cost of capital.

But the Board's rules have changed dramatically, and KCS faces real regulatory risks as a result. The Board has now done away with the ability to make individual adjustments in URCS for cases brought under the Coal Rate Guidelines⁴ and has adopted Simplified Standards with its

⁴ See Major Issues in Rail Rate Cases, ___ S.T.B. ___, STB Ex Parte No. 657 (Sub-No. 1) (STB served Oct. 30, 2006).

heavy reliance on URCS (which includes a cost of capital component) and its strict prohibition against making any movement-specific adjustments to URCS. As such, it is now imperative that the Board's cost of capital calculation measure KCS's cost of capital as accurately as possible so that it may be applied to regulatory proceedings involving KCS.

As the Board is well aware, the cost of capital figure is an important component of the Board's regulatory framework. One use of that figure is as a component of determining variable costs under the Board's URCS formula. In turn, URCS is used to determine whether a challenged rate is above the 180% R/VC jurisdictional threshold, which 49 U.S.C. §10707 requires be exceeded for the rate to be challenged under either the coal rate guidelines or the newly-prescribed Simplified Standards. If a rate is determined to be above the jurisdictional threshold, the cost of capital is one of the most critical elements in determining whether the challenged rate is reasonable. See West Texas Utilities Company v. The Burlington Northern and Santa Fe Railway Company, ___ S.T.B. ___, STB Docket No. 41191, slip op. at 6 (STB served Sept. 10, 2007) ("cost of capital can have a substantial impact on the analysis and the resulting level of the maximum reasonable rate"). Finally, the cost of capital is the critical component in determining whether a Class I railroad is revenue adequate. Whether or not a railroad is revenue adequate has significant implications with respect to the ability to set and increase rates.⁵ Cost of capital may also be a factor in abandonment proceedings, and can be employed in setting

⁵ Review of Rail Access and Competition Issues, 3 S.T.B. 92, 96 n.6 (1998) ("Once a carrier has become revenue adequate, ... shippers may prefer to apply the revenue adequacy constraint. Under this test, 'captive shippers should not be required to continue to pay differentially higher rates than other shippers when some or all of that differential is no longer necessary to ensure a financially sound carrier.'") (quoting Coal Rate Guidelines, Nationwide, 1 I.C.C.2d 520, 535-36).

trackage rights fees.⁶ The Board said it best when, in introducing the proposal here, it stated that the cost of capital “plays a significant role in the regulation of railroads, and it is therefore important that the cost of capital be measured as accurately and practically as possible.” August 20 Decision, slip op. at 4. KCS agrees and believes that is why the Board should – (1) allow KCS to substitute its cost of capital for the industry-wide cost of capital in the URCS formula in any rate reasonableness proceedings; and (2) permit KCS to use its cost of capital in other proceedings as a substitute for the less reliable, and potentially punitive, industry average cost where such industry-wide average would otherwise be used.

II. KCS’S COST OF CAPITAL IS SIGNIFICANTLY HIGHER THAN THE RAILROAD INDUSTRY AVERAGE

In the recently-concluded Simplified Standards proceeding, KCS addressed cost of capital in the context of a rate proceeding in which unadjusted URCS costs would be used. KCS objected to the application of unadjusted URCS in such cases, pointing out, among other issues, that URCS understates KCS’s cost of capital. See Simplified Standards, KCS Reply Comments (filed November 30, 2006)(a copy of which is attached hereto for purposes of inclusion in the record in this proceeding) and KCS Supplemental Comments (filed February 26, 2007).⁷ In its detailed discussion of the limitations and perils of the Board’s continued reliance on an industry-wide cost of capital figure in such simplified rate cases, KCS pointed out that the industry-wide cost of capital derives from the respective costs of capital of the four largest North American

⁶ See, e.g., Railroad Cost of Capital – 2006, STB Ex Parte No. 558 (Sub-No. 10), slip op. at 2-3 (STB served May 16, 2007).

⁷ KCS’s Reply Comments in the Simplified Standards proceeding emphasize the difficulties and harms that would flow to KCS in the event that the Board were, in so-called “small rate cases,” to rely on an industry average cost of capital.

railroads – BNSF, CSX, NS, and UP⁸ – which are far larger than KCS and which enjoy more favorable costs of equity and debt than KCS does.⁹ KCS argued then, as it does now, that use of unadjusted URCS is flawed in two major respects – (1) URCS seriously understates the operating costs of railroads KCS’s size and smaller, and (2) URCS’ use of an industry-wide cost of capital figure harmed carriers such as KCS – and many smaller carriers - who are not investment grade credits and whose costs of capital are significantly higher than the so-called industry average that is based solely on the costs of the “Big Four” who are investment grade credits.

With respect to the first point, the Board considered but then rejected KCS’s argument regarding the failure of URCS to appropriately account for switching and shorthaul operating costs, although it may have misunderstood KCS’s argument.¹⁰ With respect to the second point, the Board appears to have given the matter only passing consideration, instead deferring further action on the matter to this proceeding. Rather than dismiss KCS’s industry-wide cost of capital

⁸ See, e.g., Railroad Cost of Capital – 2005, STB Ex Parte 558 (Sub-No. 9), slip op. at 2 (STB served Sept. 20, 2006) (“Consistent with previous cost-of-capital proceedings, AAR determined the cost-of-capital rate for a ‘composite railroad’ based on the criteria developed in Railroad Cost of Capital - 1984, 1 I.C.C.2d 989 (1985). The following railroad holding companies met these criteria: Burlington Northern Santa Fe Corporation (BNSF), CSX Corporation (CSX), Norfolk Southern Corporation (NSC), and Union Pacific Corporation (UPC)”) (footnotes omitted).

⁹ See Verified Statement of Nelson Walsh, Vice Chairman of the Investment Banking Group, Morgan Stanley, attached as Exhibit 1 (“V.S. Nelson”) for a discussion of the fact that KCS is considered a non-investment grade railroad while the four largest railroads are considered investment grade.

¹⁰ KCS did not argue in the Simplified Standard proceeding that the Board collects or uses incorrect *data* in calculating URCS or that URCS does not capture KCS’s costs, as the Board seemed to understand it. Rather, KCS pointed out that, notwithstanding the fact that URCS may capture KCS’s costs, URCS does not attribute appropriate weight to certain individual URCS cost inputs so that URCS is skewed toward longer-haul movements and understates switching and local service costs, such as those that are prevalent on KCS and similarly situated railroads. It is not the cost data itself but rather the weight given those costs in the overall calculation of URCS costs that ends up understating KCS’s true costs.

argument, the Board recommended that KCS “should advise the Board on how to address that issue in the ongoing inquiry into how to calculate the cost of capital for the railroad industry.” Simplified Standards, slip op. at 103. Accordingly, KCS has accepted the Board’s invitation to re-present the issue here, even though this rulemaking, as currently constituted, focuses upon how the industry-wide cost of capital should be calculated rather than the use of that cost of capital in any particular proceeding.¹¹

Thus, the Board already has undisputed evidence that KCS’s cost of capital is not accurately reflected in the industry-wide calculation. No party in the Simplified Standards proceeding took issue with KCS’s evidence and expert witness testimony on the subject. Mr. Nelson’s verified statement attached hereto further reinforces the point that KCS’s cost of capital is higher than that of other Class I railroads, and, by extension, is higher than the so-called “industry-wide” cost of capital. As the attached verified statement shows, KCS’s 2007 weighted average cost of capital using the Board’s proposed CAPM methodology is 9.0%,¹² which, when compared to the industry-wide average cost of capital set forth in the August 20 Decision, is the highest in the industry and consistently higher than the industry-wide average. Mr. Nelson’s statement also further demonstrates why the industry average cost of capital derived solely from investment grade railroads is an unsuitable surrogate for the actual cost of capital for non-investment grade railroads like KCS. Because there is a substantial difference between the industry-wide cost of capital under the proposed CAPM method on the one hand and the

¹¹ Indeed, what little discussion of the industry-wide cost of capital and its implications on URCS there is in the Simplified Standards decision arises few times and is discussed but once in the appendix of the decision.

¹² As discussed below, this figure was derived using Morgan Stanley’s standard methodology for determining a weighted average cost of capital, including the use of a Barra predicted Beta rather than a historical Beta.

corresponding KCS cost of capital on the other, KCS respectfully submits that the application of industry-wide figures to KCS would be arbitrary, capricious, and completely at odds with the Board's stated goal to measure cost of capital "as accurately and practically as possible."

III. APPLYING THE WRONG COST OF CAPITAL HAS SIGNIFICANT LEGAL AND RATE IMPLICATIONS

As KCS had shown in the Simplified Standards proceeding and as discussed above, KCS's cost of capital is significantly higher than the industry average. As a result, the Board's reliance on an industry-wide cost of capital figure that is calculated using an average of the cost of capital for the four largest Class I railroads unfairly prejudices KCS. Because the Board's new rate complaint methodology understates KCS's cost of capital, KCS could (1) be subjected to rate complaints for rates deemed above the 180% R/VC ratio when application of KCS's true cost of capital would establish that such rates are below this jurisdictional threshold; (2) have its rates found unreasonable when a more accurate cost of capital calculation would show precisely the opposite; and (3) be unfairly characterized as revenue adequate, when it actually would not be so characterized under an even-handed application of the Board's standards. In such situations, the Board would be violating its statutory obligations toward KCS.

This is a particular problem with respect to revenue adequacy. In such determinations, the rail industry's cost of capital is the only benchmark of whether a railroad is earning a sufficient return on its assets to achieve revenue adequacy. Indeed, the Board is mandated by statute to promote the long-term revenue adequacy of all railroads and its regulations (including its methodology for determining cost of capital) must be consistent with that goal.¹³ As such, KCS must be given a meaningful opportunity to have its revenue adequacy accurately measured,

¹³ Standards for Railroad Revenue Adequacy, 364 I.C.C. 803 (1981)(Staggers Act mandates that the ICC should seek to promote the ability of railroads to earn adequate revenues).

and when found not to be revenue adequate, must be given the adequate opportunity to achieve revenue adequacy.¹⁴ Reliance on faulty revenue adequacy standards based on unfair cost of capital assumptions would improperly characterize KCS as revenue adequate when it actually was not, if judged under an even-handed application of the Board’s standards. Such a characterization would deny KCS the pricing flexibility it needs to achieve long-term revenue adequacy. This, in turn, would disadvantage KCS against its Class I competitors because the “industry-wide average” cost of capital is not an accurate representation of KCS’s actual cost of capital.

This is not hyperbole. Using the Board's stated revised figures for what the industry-wide cost of capital would have been for the past nine years using the CAPM methodology rather than the DCF model, and then comparing that with the Board's calculation of KCS's return on investment (“ROI” – which is used to determine revenue adequacy, i.e. if ROI is higher than the cost of capital then a railroad is revenue adequate), the results are as follows:

Year	Current DCF	2-Stage DCF	CAPM	KCS ROI
1997	9.7	7.4	10.5	3.6
1998	11.6	6.8	8.8	9.1
1999	10.7	7.0	9.3	6.4
2000	10.8	8.1	9.2	6.3
2001	10.1	6.8	8.1	7.0
2002	9.6	6.2	7.2	6.5

¹⁴ 49 U.S.C. 10101(3); MidAmerican Energy Co. v. Surface Transp. Bd., 169 F.3d 1099 (8th Cir. 1999) (the Interstate Commerce Act “protects both shippers and carriers. It guarantees that shippers will receive rail service at reasonable rates, and it allows carriers to provide such service in a manner that achieves revenue adequacy”); Potomac Electric Power Company v. Consolidated Rail Corporation, 367 I.C.C. 532, 540 (1983), aff’d sub nom. Potomac Electric Power Co. v. Interstate Commerce Com., 744 F.2d 185 (D.C. Cir. 1984) (“our task was to develop a regulatory framework which would provide effective rate constraints on market dominant traffic yet still permit railroads to become revenue adequate”); Cost Standards for Railroad Rates, 364 I.C.C. 898, 904 (1981), aff’d sub nom. Water Transport Association v. Interstate Commerce Com., 684 F.2d 81 (D.C. Cir. 1982) (“rail carriers are to be left as free as possible to achieve revenue adequacy through internally determined price structures”)

2003	9.4	6.0	6.7	3.7
2004	10.1	6.2	7.1	8.3
2005	12.2	6.7	7.5	5.89

Under this approach, KCS would have been considered revenue adequate for 2004 but not for any other year. However, given that KCS's cost of capital has consistently been higher than that of the Big Four carriers, it is likely that KCS would not have been revenue adequate for any year during the Board's study period.

Given this fact, application of the industry-wide average cost of capital in any regulatory proceeding will consistently understate KCS's actual cost of capital and impose regulatory remedies on KCS that are inaccurate and unfair. Use of an industry-wide figure would enable shippers to seek "redress" against KCS rates that are not unreasonable, result in Board decisions that unfairly award damages to such complainants, require KCS to defend itself against rate complaints that would not satisfy the requisite jurisdictional threshold, and put artificial regulatory caps on KCS's ability to earn revenues adequate to achieve long-term revenue adequacy. Such consequences would be contrary to the Board's statutory mandates and the Rail Transportation Policy. They also would create a regulatory disadvantage for KCS vis-à-vis its competitors.

IV. THE BOARD CAN CALCULATE AND APPLY RAILROAD-SPECIFIC COSTS OF CAPITAL

As noted, the railroad industry cost of capital determination bears upon a variety of regulatory matters including Board determinations of rate reasonableness and an individual railroad's revenue adequacy. KCS raised this issue in Simplified Standards but the Board invited KCS to address the issue in this proceeding and requested KCS's suggestion on how to calculate and apply a carrier specific cost of capital. As Morgan Stanley witness Nelson shows, calculating a carrier-specific weighted cost of capital under the CAPM methodology is not

difficult if the Board and the interested parties can agree upon the inputs to be used in the calculation.¹⁵ Unfortunately, selecting among the many possible inputs that could be used entails a more thorough discussion and analysis than available within the context of these opening comments. In general, there appear to be three main inputs upon which academics, the Board, and industry experts disagree. These are: (1) the cost of debt; (2) the proper Beta; and (3) the market risk premium. In this case, Morgan Stanley used the current cost of debt for KCS if KCS were to issue a 10-year bond today and derived a figure of 7.0%. The Barra predicted Beta as the Beta figure,¹⁶ and the market risk premium was calculated using Morgan Stanley's standard assumption for market risk premium plus a mid-cap premium as identified Ibbotson Associates' Stocks, Bonds, Bills, and Inflation ("SBBI") Yearbook. As previously noted, using these inputs, Morgan Stanley was able to calculate a weighted cost of capital for KCS as of the third quarter for 2007 of 9.0%.

Of course one of the key elements is the use of the proper Beta. The determination of this value has significant consequences. Unfortunately, there is no consensus on what the correct Beta should be, and the various alternative approaches can lead to substantial variations in the cost of equity estimates. There are a wide range of railroad Betas offered by reputable third party firms, such as Bloomberg, Ibbotson Associates, Thomason/Worldscope, and Value Line. They differ due to the manner in which certain factors are calculated and used. These factors

¹⁵ On this sole point, KCS would be in agreement with the statement of Dr. James E. Hodder submitted in Ex Parte No. 664 on December 8, 2006 that "[t]he CAPM approach is also not difficult to implement." Of course the difficulty is not in the methodology itself, but rather in determining what the proper inputs should be.

¹⁶ Although Morgan Stanley applied a Barra predicted Beta, rather than a historical Beta (which KCS understands the Board is proposing to do) KCS believes that the 2007 cost of capital Morgan Stanley derived for KCS would not have differed significantly if it had instead used a historical Beta.

include the following: (1) the period over which the Beta is estimated;¹⁷ (2) the frequency of the data, e.g. daily, weekly, and monthly; (3) and the proxy used to measure overall market performance. Which of the various reasonable alternatives is used can lead to dramatic variations in the estimates of the cost of capital.

Indeed, market Betas can differ whether one uses a 5-year, 3-year, or 10-year time period in connection with a 90-day T-bill rate, a 1-year Treasury Bond, a 10-year Treasury bond, a 20-year Treasury bond, or a predictive Beta as Mr. Nelson did. Interestingly enough, regardless of which process is utilized, the relative Betas among the four largest Class I railroads tend to be approximately the same. This is due, in part, to the relative stability of the capital markets available to investment grade companies such as the Big Four. However, as Mr. Nelson show, the same cannot be said for KCS. Using the same calculation methods, KCS's Betas are significantly higher than those of the Big Four. V.S. Nelson at 4. In the end, if the Board chooses to proceed with a CAPM methodology, the Board will need to carefully choose among the different alternative methods or to develop, based on public comment, its own valid estimation method. In either case, the method the Board ultimately selects should measure KCS's Beta as accurately as possible.

Similar problems arise in determining the appropriate cost of debt and the market risk premium. Each requires a subjective judgment about which variable to use, as well as with respect to what additional factors should be included. For example, the market risk premium ("MRP") varies depending upon the market index used, the period over which market returns are

¹⁷ As KCS understands the Board's proposal, the agency would employ a historical Beta, rather than a predicted Beta, and that such a historical Beta would derive from relevant monthly data over a period of ten years. Although KCS would not object to the use of a historical Beta, KCS maintains that this Beta should be computed from five year's of data, rather than ten. KCS specifically endorses AAR's position on this subject.

measured, and the use of arithmetic or geometric mean returns over that period. As noted in Professor Hubbard's December 8, 2006 testimony submitted by AAR, the "choice of the appropriate market risk premium has been the subject of much debate in financial economics" (V.S. Hubbard at ¶ 26 at pg. 10). Depending upon which historical period is used for averaging stock prices can have a significant impact on the ultimate MRP, according to Professor Hubbard.

The complexities associated with applying a CAPM methodology are not new for the Board, and yet, notwithstanding these complexities, the Board has still proposed doing away with the DCF method in favor of a CAPM approach. KCS believes such a course of action is not desirable; however, if the Board continues to pursue it, KCS believes that the public interest would best be served if the Board were to review the opening comments, narrow the issues to focus on what standards and inputs should be used for the cost of debt, the Beta, and the MRP, and then solicit further comments on these discrete issues. Then, if the Board proceeds with adopting CAPM, whatever measurements are selected for the various inputs should be applied to all of the Class I's, e.g. if the Board decides to use the Beta as calculated by Bloomberg, then each railroad's individual Bloomberg calculated Beta should be used in determining each railroad's cost of capital. If this were to occur, the Board could in fact calculate a cost of capital specific to each railroad and apply it – rather than use an industry-wide composite average of UP, BNSF, NS, and CSX – in the various regulatory proceedings.

Finally, there is another integrally related issue to the selection of the appropriate inputs to be used in CAPM model, specifically, the value of the asset base used in determining a railroad's ROI, which the cost of capital is compared against in making revenue adequacy determinations. As the Board knows, there are two critical elements in determining whether a railroad is revenue adequate: (1) determining a railroad's ROI, which itself is dependent upon

how the Board calculates a railroad's asset base; and (2) determining the cost of capital. If a railroad's ROI is higher than the cost of capital, the Board will find that railroad revenue adequate. As such, determining the proper asset base is in some sense the flip side of the coin of determining the proper way to calculate the cost of capital. The Board should not adopt changes to its cost of capital methodology without also looking at the flip-side of the coin regarding the determination of how to value the asset base. The two processes go hand in hand, and changes to one should not be done without examining the need to change the other as well.

At a time when the railroads' will need substantial revenues in order to invest in capacity for the future,¹⁸ it is essential that the Board not adopt policies that would artificially constrain the rail industry's ability to achieve revenue adequacy. As such, if the Board is going to adopt changes in its cost of capital methodology then it should consider adopting market-based values when determining the asset base used in determining a railroad's return on investment rather than relying upon historic book value. KCS recommends that the Board should immediately begin a proceeding to address the proper asset valuation for ROI purposes. KCS believes that the Board will conclude that it should no longer use book values or historic values for determining ROI if it adopts CAPM for determining the cost of capital. As such, the Board should propose and solicit comments on adopting the replacement cost new less depreciation method or similar current-value method for determining a railroad's asset base for revenue adequacy purposes.¹⁹

¹⁸ Indeed, there is going to be even a greater burden placed on the rail system in the future which will require substantial investment by the railroads simply to maintain the system, yet alone grow it. National Rail Freight Infrastructure Capacity and Investment Study, Cambridge Systematics, (Sept. 20, 2007) (about \$148 billion must be invested to expand the nation's freight rail infrastructure over the next three decades to make sure that adequate rail capacity exists to meet future demand).

¹⁹ See, e.g., RAPB Final Report on Railroad Accounting Principles (September 1987), Vol. 2, at 60 (“[C]urrent market valuation is preferable to historic valuation.”); Standards For Railroad

CONCLUSION

As has been shown above, KCS's cost of capital is significantly higher than an "industry average" drawn from the economic data of the four largest railroads in North America. This is because there are fundamental differences between the capital markets available to investment grade railroads like the "Big Four" and those available to non-investment grade credits like KCS. Non-investment grade markets are more volatile (as has been demonstrated lately by the sub-prime mortgage markets), demand higher premiums, and are not always available. This means that KCS's cost of capital will likely always be higher than that of Big Four. Unfortunately, the industry average cost of capital has various applications in the Board's regulation of railroads, all of which unfairly prejudice KCS because they draw upon on a costing system that understates KCS's actual costs. Without an appropriate remedy to compensate for this shortcoming in the Board's costing processes, KCS may be subject to otherwise meritless litigation (including, most prominently, rate challenges) and its efforts to achieve revenue adequacy would be disproportionately thwarted vis-à-vis its Class I competitors.

Having recently brought this matter to the Board's attention in a separate proceeding, the Board instructed that KCS "should advise the Board on how to address that issue in the ongoing inquiry into how to calculate the cost of capital for the railroad industry." In accordance with that recommendation, KCS has now done just that. For the reasons set forth above, KCS respectfully requests that the Board –(1) allow KCS to substitute its cost of capital for the industry-wide cost of capital in the URCS formula in any rate reasonableness proceedings; and (2) permit KCS to use its cost of capital in other proceedings as a substitute for the less reliable, and potentially punitive, industry average cost where such industry-wide average would

Revenue Adequacy, 364 I.C.C. 803, 818 (1981) (noting that replacement costs may better mirror the "true economic costs associated with an investment.").

otherwise be used. Permitting KCS to substitute its own cost of capital for that of the industry average would be far preferable and more in line with the Board's objectives here than would be an industry-wide figure that included KCS in the average.

Respectfully submitted,

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Attorneys for The Kansas City
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EXHIBIT 1

VERIFIED STATEMENT OF NELSON WALSH

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**OPENING COMMENTS OF THE KANSAS CITY
SOUTHERN RAILWAY COMPANY**

VERIFIED STATEMENT OF NELSON WALSH

My name is Nelson Walsh. I am a Vice Chairman of the Investment Banking Group at Morgan Stanley and have been with Morgan Stanley's Investment Banking division for over twenty years focusing on various companies in the transportation and industrial sectors. Over the course of my career, I have had significant investment banking transactional experience including in connection with equity and fixed income transactions for most of the major airlines, railroads and logistics companies including Kansas City Southern and a number of the other U.S. Class I railroads. In addition, I have extensive experience in mergers and acquisitions for a broad cross section of companies in a variety of industries. I am a graduate of Williams College and Columbia Business School.

The purpose of my verified statement is to provide a calculation of the weighted average cost of capital ("WACC") for Kansas City Southern ("KCS"), provide a comparison of the estimated beta levels for KCS and the four large U.S. Class I railroads (Burlington Northern, CSX, Norfolk Southern and Union Pacific) and, lastly, comment on the differences in the non-investment grade debt markets that KCS has access to compared to the investment grade markets that the four large U.S. Class I railroads participate in.

1) Weighted Average Cost of Capital Calculation for KCS

A carrier specific weighted cost of capital calculation using the capital asset pricing model ("CAPM") methodology depends to a large extent on selecting the most appropriate inputs. The main inputs underlying a WACC calculation are: (1) the measure of the cost of debt; (2) the beta; (3) a determination of the market risk premium; (4) the risk-free rate; and (5) the weighting of debt/ equity as a part of the capital structure.

For purposes of determining the WACC for KCS, we have calculated these inputs as follows: (1) We estimated the cost of debt for KCS when issuing a 10 year bond today and derived a yield of 7.0%. (2) The beta estimate of 1.425 is the estimated (predicted) beta as provided for KCS by financial data provider MSCI Barra¹. (3) The market risk premium is calculated using Morgan Stanley's estimation of the market risk premium of 4.0%, which is supported by various academic studies. (4) We have used the current yield of 4.6% for the 10-year United States Treasury Bill as the estimate for the risk free rate. This is a customary methodology which we use in other cost of capital analyses. (5) The debt included in the capital structure for the WACC calculation is the gross financial debt of KCS as of 06/30/2007. The equity portion is calculated as the fully diluted number of shares multiplied with the current stock price.

Further, The 2006 Stocks, Bonds, Bill and Inflation Valuation Yearbook published by Ibbotson Associates, Inc. ("Ibbotson") based on historical data identifies the return in excess of that predicted by the Capital Asset Pricing Model ("CAPM") for Micro-Cap (between \$0.0 - \$0.6 billion in market capitalization), Low-Cap (between \$0.6 - \$1.9 billion in market capitalization) and Mid-Cap (between \$1.9 - \$7.8 billion in market capitalization) companies. As KCS's market capitalization is within the range for the Mid-Cap companies as identified by Ibbotson, we have used Ibbotson's excess return over CAPM of 0.97% for Mid-Cap companies, to adjust the cost of equity for KCS as follows:

$$C_e = R_f + [\text{Beta} * R_m] + \text{Mid-Cap Excess Return over CAPM}$$

where:

C_e = Cost of equity

R_f = Risk free rate

R_m = Market risk premium

¹ MSCI Barra is a leading provider of financial products and services. MSCI Barra is headquartered in New York, with research and commercial offices around the world. Morgan Stanley is the majority shareholder of MSCI Barra, and Capital Group International, Inc. is the minority shareholder.

The WACC is calculated as follows:

$$\text{WACC} = E/(E + D) * C_e + D/(E + D) * C_d * (1 - \text{Tax})$$

where:

C_d = Cost of debt

E = Equity

D = Debt

Our calculations using the above mentioned methodology yield a current WACC for KCS of 9.0%.

2) Substantial Difference in the Beta of KCS (systematic, non-diversifiable risk) versus larger U.S. Class I Railroads

The arithmetic average of the daily estimated (predicted) beta for KCS as provided by MSCI Barra for the last twelve months (from 09/25/06 to 09/24/07) is 1.353. Using the same data provider, the market-capitalization-weighted average of the daily estimated (predicted) beta values over the same time period for the four large U.S. Class I railroads is 0.937. Thus, the MSCI Barra estimated (predicted) beta for KCS over this time period was, on average, higher than the market capitalization weighted average of the four large U.S. Class I railroads by 0.335.

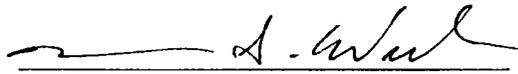
3) KCS has a Materially Different Credit Profile than the Four Large U.S. Class I Railroads

KCS is a non-investment grade railroad while the four large U.S. Class I railroads all have investment grade credit ratings. KCS's corporate rating is B2 by Moody's and B+ by Standard & Poor's. Amongst the four large U.S. Class I railroads the corporate rating forecast by Moody's and Standard & Poor's respectively is for Burlington Northern Santa Fe Baa1 and BBB, for CSX Baa3 and BBB-, for Norfolk Southern Baa1 and BBB, and for Union Pacific Baa2 and BBB. KCS has experienced higher absolute borrowing costs as compared to the other four large U.S. Class I railroads due to the difference in relative credit profiles. There are numerous structural differences between the investment grade and non-investment grade markets which impact issuance terms and absolute cost of borrowing. For instance, the size of the market and the investor base is significantly larger for investment grade issuers compared to non-investment grade companies and the largest investment grade investors are proscribed by their charters from investing in issuers of credit ratings lower than BBB-. Lenders in non-investment grade markets typically are provided more comprehensive bondholder protection and covenant packages as well as call protection. Based on historical data, during economic downturns, non-investment grade issuers see

steeper rises in borrowing costs than their investment grade counterparts, while investment grade issuers are more sensitive to movements in Treasury rates.

VERIFICATION

I, Nelson Walsh, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified to file this Verified Statement. Executed this 27th day of September, 2007.

A handwritten signature in black ink, appearing to read "N. Walsh", is written over a horizontal line.

Nelson Walsh

Attachment A

Weighted Average Cost of Capital Calculation - KSU

Stock Price (\$) as of 09/24/2007	32.61
Diluted shares outstanding (MM) ⁽¹⁾	97.7
Market Value (\$MM) of equity	3,187.0
Gross Debt (\$MM) as of 06/30/2007	1,647.6
Total Firm Value	4,834.6
Equity / Firm Value	65.9%
Debt / Firm Value	34.1%
Cost of Debt	
Estimated Cost of Debt	7.00%
Tax Rate	35.0%
After-tax Cost of Debt	4.55%
Cost of Equity	
Risk Free Rate (10-yr UST)	4.63%
Barra Predicted Beta (U.S.)	1.43
Mid Cap Excess Return over CAPM ⁽²⁾	0.97%
Market Risk Premium	4.00%
Cost of Equity	11.30%
WACC	9.00%

Notes

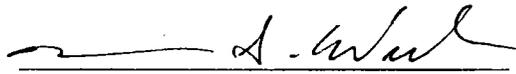
1. Includes dilution from convertible preferred securities outstanding

2. Based on historical data as identified by 2006 Stocks, Bonds, Bill and Inflation Yearbook published by Ibbotson Associates Inc.

steeper rises in borrowing costs than their investment grade counterparts, while investment grade issuers are more sensitive to movements in Treasury rates.

VERIFICATION

I, Nelson Walsh, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified to file this Verified Statement. Executed this 27th day of September, 2007.

A handwritten signature in black ink, appearing to read "N. Walsh", is written over a horizontal line.

Nelson Walsh

CERTIFICATE OF SERVICE

I have this day served a copy of the foregoing Opening Comments Of The Kansas City Southern Railway Company upon all other parties of record by depositing a copy in the U.S. mail in a properly addressed envelope with adequate first-class postage thereon prepaid, or by other, more expeditious means.

Dated: September 27, 2007



William A. Mullins

Attorney for The Kansas City
Southern Railway Company