

OPENING STATEMENT of  
CHARLES D. NOTTINGHAM, CHAIRMAN  
COST OF CAPITAL HEARING  
DECEMBER 4, 2007

Good morning and welcome. Today we will hear further testimony on the methodology that the Board should use to determine the railroad industry's cost of capital. We are required by statute to make an annual determination of the revenue adequacy of the railroads, and the cost of capital is an integral part of that inquiry. The cost of capital also plays a key role in various other agency functions, including our rate cases. Therefore, this proceeding and the resolution of the issues presented is a high priority of the agency.

The focus of this hearing is narrow. While parties have raised a number of ancillary points, the key issue and subject of this hearing is the most suitable method for calculating the cost of equity of the railroads. The cost of equity is the return that investors require of the railroads. But, unlike the cost of debt, the true cost of equity never reveals itself. We must therefore use economic and financial tools to estimate this component of the cost of capital.

For over 25 years, this agency has used a relatively simple discounted dividend model to estimate the cost of equity. This approach served the agency well by offering a transparent means of calculating the cost of equity, without requiring protracted litigation every year. This approach was used without any objection for over twenty years. But in our proceeding to calculate the 2005 cost of capital, a trade association of interested shippers filed comments suggesting that a simple discounted dividend model may have outlived its usefulness. They asked that we replace the established approach with a more modern approach that the agency had rejected in the early 1980s. That model is called the Capital Asset Pricing Model, or CAPM for short, which the shippers claimed had grown in acceptance in the financial community since the early 1980s when it was last examined by this agency.

The shippers' testimony was insufficient to support such a significant departure from agency precedent at that time. Therefore, we used our established approach for the 2005 cost of capital determination, but instituted this broader rulemaking proceeding to explore this complex issue in far greater depth. We held a hearing last January, where we heard from interested parties, finance experts, and other agencies such as the Federal Reserve on standard finance practices. The Board also instructed our staff to meet with other agencies that conduct a similar analysis in their industries.

Based on that large record, we asked for comment on whether we should replace the existing approach with a specified CAPM approach.

The public comments reveal a welcome degree of consensus. All parties agree that the Board should set aside its current approach in favor of the more modern techniques. Now we are no longer debating the merits of the simple discounted

dividend model we have been using, but rather can turn our attention solely to the merits of the modern approaches to replace it.

The second point of agreement is more surprising. Although we had proposed to use just a CAPM model, we are hearing from all parties that we should also use a multi-stage discounted cash flow model. The argument, as I understand it, is that both models are accepted modern approaches, each has different strengths and weaknesses, and that by taking an average of the cost of equity produced by each, we would develop a more reliable, less volatile, and ultimately superior estimate.

Naturally, the parties are not in complete agreement on how we should apply either the CAPM or multi-stage discounted cash flow models. While there are some minor disagreements, I see a number of key areas in dispute that I would like the witnesses to address today, including:

- How far back we should look to determine the market premium for the CAPM model.
- How far back we should look to determine the riskiness of the railroad industry as compared to the entire stock market, sometimes just called the “beta.”
- Whether the multi-stage DCF model should look at cash flows rather than dividends.
- How long the various stages of the DCF model should be and the corresponding growth rates within each period.

In sum, the record has revealed broad agreement that we should modernize our approach. But the record also clearly illustrates how delicate a matter it is to get the CAPM or multi-stage DCF models to function properly. But our task, if not simple, is at least straightforward: we seek a suitable replacement method that is transparent, conforms with modern practices, and is appropriate for our regulatory purposes.

Just a few procedural notes regarding the testimony itself. As usual, we will hear from all the speakers on a Panel prior to questions from the Commissioners. Speakers, please note that the timing lights are in front of me on the dais. You will see a yellow light when you have one minute remaining, and a red light when your time has expired. Please do your best to keep to the time you have been allotted. I assure you that we have read all of your submissions, and there is no need to read them here. After hearing from the entire panel, we will rotate with questions from each Board Member until we have exhausted the questions. Additionally, just a reminder to please turn off your cell phones.

I look forward to hearing the testimony of the parties. I would now like to turn to Vice Chairman Buttrey for his opening remarks.