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October 24, 2006

By Courier

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423

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Re: Ex Parte No. 558 (Sub-No. 9), *Railroad Cost of Capital - 2005*

Dear Secretary Williams:

Enclosed for filing in the above-captioned matter are the original and ten copies of the Reply of the Association of American Railroads and Its Member Railroads to Western Coal Traffic League's Petition for Reconsideration. Also enclosed is an additional copy to be stamped and returned via our courier.

Please direct any questions regarding this matter to the undersigned counsel.
Thank you for your assistance in this matter.

Sincerely,

G. Paul Moates

cc: Louis P. Warchot

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EX PARTE NO. 558 (Sub-No. 9)

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October 24, 2006

Pursuant to 49 C.F.R. § 1115.3(d), the Association of American Railroads (“AAR”) and its members respectfully submit this Reply to the Petition filed by the Western Coal Traffic League (“WCTL”) on October 10, 2006 (“Petition”), seeking reconsideration of the Board’s Decision in this proceeding served September 20, 2006 (the “Decision”). In that Decision, the Board applied its well-established Discounted Cash Flow (“DCF”) analysis to determine the rail industry’s cost of equity and cost of capital for 2005.¹

WCTL seeks reconsideration of the Decision on the ground that it assertedly “contains material error.” Petition at 1.² But WCTL nowhere identifies any specific alleged material error in the Decision. Rather, WCTL argues that the Board erred generally by not adopting WCTL’s preferred methodology for determining the rail industry’s cost of equity – a methodology that assertedly would produce a result more to WCTL’s liking. But WCTL’s argument of its position does not establish material error by the Board.

Based on the record before it in this proceeding (consisting only of comments from AAR and WCTL), the Board correctly held that the record supports continued use of the longstanding DCF methodology, and does not support adoption of WCTL’s alternative methodology. Decision at 6. The Board recognized that there are potential alternative methods for determining the cost of equity, but held that before making such a significant change as discarding the DCF model, it would seek broader public input from other interested parties. Accordingly, the Board simultaneously issued an advance notice of proposed rulemaking (“ANPR”) in Ex Parte No. 664, *Methodology to be Employed in Determining the Railroad*

¹ The DCF model was adopted in its present form in Ex Parte No. 436, *Railroad Cost of Capital - 1982*, 367 I.C.C. 662 (1983), and has been applied consistently in the last 24 cost-of-capital proceedings. See Decision at 8 n.17; Verified Statement of Craig F. Rockey (“V.S. Rockey”) at 9 (filed March 31, 2006).

² Although WCTL’s Petition is purportedly submitted “[p]ursuant to 49 C.F.R. § 1115.2,” that provision applies to appeals from initial decisions, not entire Board actions, and contains no mention of material error. WCTL presumably intended to submit its Petition pursuant to 49 C.F.R. § 1115.3(b)(2).

Industry's Cost of Capital, in order to “provide all interested parties an opportunity to comment” on the DCF model and whether the Board should adopt an alternative method for future cost-of-capital determinations. Decision at 8.

WCTL argues that by inviting comments on the DCF methodology and its alternatives in Ex Parte No. 664, the Board effectively confessed error in the current proceeding. Petition at 3 (if “there is enough doubt or question to warrant a rulemaking as to [the DCF] methodology, then there must be enough doubt or question as to the application of that methodology to the 2005 data”). WCTL offers no precedent (and AAR is aware of none) supporting this remarkable assertion, which flies in the face of reasoned decisionmaking. The Board based its Decision on the evidence of record in this proceeding, which it found did not support any change in the Board’s established DCF methodology. The Board’s decision to invite public comments on the DCF methodology and other alternatives in Ex Parte No. 664 does not mean that the Board has prejudged the outcome of that proceeding, much less confessed error. Nor does it affect the Board’s analysis of the current record in this proceeding.

WCTL’s attempts to identify alleged errors in the Board’s Decision in this proceeding are also unpersuasive, as explained below. In short, WCTL’s Petition for Reconsideration has no merit, and should be denied.

ARGUMENT

I. WCTL HAS FAILED TO IDENTIFY ANY SPECIFIC MATERIAL ERROR IN THE BOARD’S DECISION.

Although WCTL asserts broadly (at 1) that the Board’s Decision “contains material error,” its Petition is remarkably vague in describing what portion or portions of the Decision actually amounted to “material error” within the meaning of 49 C.F.R. § 1115.3.

WCTL asserts that the Board’s Decision, its methodology and its reasoning were “inadequate,”

“inconsistent,” not “fair or complete,” “spurious,” “absurd, or at least suspect,” “baffling,” and “nonsensical.” Petition at 2, 3, 4, 5, 6. Despite this parade of adjectives, however, WCTL’s Petition fails to identify any specific material error in the Decision, other than the Board’s alleged failure (*id.* at 1-2) to “correct the error in the cost of capital calculation for 2005 that WCTL demonstrated” in its previous filing of its Reply Comments (filed April 28, 2006) (“WCTL Reply”). *See also* Petition at 6-7 (requesting that the Board “remedy the material error in its Decision ... by addressing the error in the calculation in the railroad cost of capital for 2005”).

In effect, WCTL alleges that the Board committed material error by not adopting WCTL’s preferred methodology in this proceeding, known as the Capital Asset Pricing Model (“CAPM”). *See* WCTL Reply at 7-10; Verified Statement of Thomas D. Crowley (filed April 28, 2006) (“V.S. Crowley”) at 10-18. But WCTL’s mere reassertion of its previously-stated position does not establish “material error.”

II. THE BOARD HAS BROAD DISCRETION TO REVIEW ITS DCF METHODOLOGY IN A SEPARATE RULEMAKING PROCEEDING.

Administrative agencies have broad discretion in deciding whether to address particular issues by rulemaking or adjudication.³ In its Decision, the Board noted that the record

³ *See infra* at 6 n.8; *see generally Vermont Yankee Nuclear Power Corp. v. NRDC*, 435 U.S. 519, 543-544 (1978) (agencies ‘should be free to fashion their own rules of procedure and to pursue methods of inquiry capable of permitting them to discharge their multitudinous duties,’”) (*quoting FCC v. Schreiber*, 381 U.S. 279, 290 (1965), and *FCC v. Pottsville Broadcasting Co.*, 309 U.S. 134, 143 (1940)); *FPC v. Transcontinental Gas Pipe Line Corp.*, 423 U.S. 326, 333 (1976) (agency should normally be allowed to “exercise its administrative discretion in deciding how, in light of internal organization considerations, it may best proceed to develop the needed evidence and how its prior decision should be modified in light of such evidence as develops”); *Aberdeen & Rockfish R. Co. v. SCRAP*, 422 U.S. 289, 322 (1975) (upholding approval of rate increase where ICC structured its proceedings so that general rate increase proceeding was not the forum for full environmental consideration of rates on recyclable materials; emphasizing that ICC was giving more extensive attention to environmental consequences “in another proceeding ... which [is] more appropriate to the task”); *Association of Businesses Advocating Tariff Equity v. Hanzlik*, 779 F.2d 697, 701 (D.C.Cir.1985) (it is “too well-established to be seriously

before it did not support a change in the Board's established DCF methodology in this case,⁴ but decided to seek further comment on this issue, including possible alternative methodologies, in a separate proceeding. *Id.* The Board explained that the issue of how to determine the cost of equity had proved complex and controversial in past proceedings, in which the issue had been carefully studied.⁵ The Board properly determined that it would consider further comments on this issue in a separate rulemaking, in order to "provide all interested parties an opportunity to comment" on the DCF model and alternative methods for future cost-of-capital determinations. Decision at 8; see Ex Parte No. 664, *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital* (served September 20, 2006). This explanation fully justified the Board's decision to review its DCF methodology in a separate rulemaking.

WCTL argues that the Board's "regular practice" when issuing decisions "in the face of uncertainty or challenge" has been to make its decisions "subject to revision based on the outcome of other proceedings," or to hold its proceedings in abeyance pending revisions of the applicable rules.⁶ In light of the Board's "established practice" in these cases, WCTL argues that "it is incumbent upon the Board to explain why it is deviating from that practice here and not

questioned that agencies are empowered to order their own proceedings and control their own dockets"); *Natural Resources Defense Council, Inc. v. SEC*, 606 F.2d 1031, 1056 (D.C.Cir.1979) ("An agency is allowed to be master of its own house, lest effective agency decisionmaking not occur in *any* proceeding") (emphasis in original); *GTE Service Corp. v. FCC*, 782 F.2d 263, 273 (D.C. Cir. 1986) ("[T]his court has upheld in the strongest terms the discretion of regulatory agencies to control the disposition of their caseload") citing *Nader v. FCC*, 520 F.2d 182, 195 (D.C.Cir.1975).

⁴ Decision at 6 ("[a]t this time there is not enough evidence that our longstanding DCF model must be replaced"); *id.* at 8 (declining to "discard the DCF method ... based on the limited record here").

⁵ *Id.* at 6-8 (noting that there are "thousands of articles and treatises by members of the financial, economic, and regulatory communities" addressing the issue of how to compute the cost of common equity, and no consensus on the issue among investors or regulators); *id.* at 7 ("[a]fter considerable public discourse, this agency settled upon the DCF model to derive the cost-of-equity component, ... and that is the method used by the [agency] for over 20 years").

⁶ Petition at 2, citing Ex Parte No. 582 (Sub-No. 1), *Major Rail Consolidation Procedures* (served Mar. 31, 2000), and Ex Parte No. 657 (Sub-No. 1), *Major Issues in Rail Rate Cases* (served Feb. 27, 2006), recon. denied (served Apr. 14, 2006).

conditioning its determination of the 2005 industry cost of capital on the outcome in its new rulemaking proceeding” in Ex Parte 664. Petition at 3. The proceedings cited by WCTL, however, did not involve the Board’s “established practice,” but involved exceptional circumstances that do not establish a general rule. Moreover, there is no substantial “uncertainty” regarding the Board’s Decision, as shown below.

In Ex Parte No. 582, the Board addressed a proposed Class I rail merger that it believed could trigger “the final round of restructuring of the North American railroad industry.”⁷ The Board stated that its then-current merger rules were “simply not appropriate” for such a series of transactions, and found that reviewing these transactions while attempting to revise its rules “could irreparably damage the entire industry, to the detriment of the interests of shippers, rail employees, and the national economy and defense.” *Id.* Therefore, the Board adopted a 15-month moratorium on major rail merger activity while it considered and adopted new merger rules in Ex Parte No. 582 (Sub-No. 1). The Board acknowledged that its action was “unprecedented,” but stated that “these are not ordinary circumstances, and we see no way of adequately protecting the public interest short of the steps we have outlined here.” *Id.* at 10.

Contrary to WCTL’s assertion, the unprecedented procedures followed in Ex Parte No. 582 were not illustrative of the Board’s “established practice.” At the time, WCTL obviously did not consider the moratorium adopted in Ex Parte No. 582 to be routine, because WCTL sought to overturn the Board’s decision (without success) in *Western Coal Traffic League v. STB*, 216 F.3d 1168 (D.C. Cir. 2000).

In Ex Parte No. 657 (Sub-No. 1), *Major Issues in Rail Rate Cases* (served Feb. 27, 2006), the Board addressed an unusual situation in which it found (at 9) that “the parties have exposed a flaw with the rate prescription method used in the past,” but the Board was “not

⁷ Ex Parte No. 582, *Public Views On Major Rail Consolidations*, at 2 (served March 17, 2000), *aff’d sub nom. Western Coal Traffic League v. STB*, 216 F.3d 1168 (D.C. Cir. 2000).

satisfied with the solutions proposed by the parties in the pending cases.” *Id.* at 3 (served April 14, 2006). In these circumstances, the Board concluded that the best approach was to initiate a rulemaking proceeding to address these recurring stand-alone cost (“SAC”) issues. *Id.* at 3-4. The Board elected to propose its own alternatives for public comment, “so that they would be tested through the notice and comment process before being applied to a pending case.” *Id.* The Board noted the “well-established principle of administrative law that ‘the choice between rulemaking and adjudication lies in the first instance within the [agency’s] discretion.’”⁸

WCTL also did not consider the Board’s action in Ex Parte No. 657 (Sub-No. 1), to be part of the Board’s “established practice” at the time, because WCTL and other shippers sought reconsideration of the Board’s decision to institute a rulemaking, alleging “material error.” The Board rejected WCTL’s position, citing the unique circumstances described above. *Id.* The other cases cited by WCTL also involved unusual circumstances in which the parties agreed that extraordinary relief was warranted, either as a result of changed circumstances⁹ or pending appeal.¹⁰

The cases cited by WCTL demonstrate that in certain extraordinary factual circumstances, the Board occasionally has held pending proceedings in abeyance in order to

⁸ *Id.* at 2, citing *NLRB v. Bell Aerospace Co.*, 416 U.S. 267, 294 (1974), *NLRB v. Wyman-Gordon Co.*, 394 U.S. 759, 765-66 (1969); *SEC v. Chenery Corp.*, 332 U.S. 194, 201 (1947); and *American Hosp. Ass’n v. NLRB*, 499 U.S. 606 (1991).

⁹ In Docket No. 41185, *Arizona Pub. Serv. Co. v. Atchison, T. & S.F. Ry.* (served May 12, 2003), the parties *agreed* that circumstances had changed since the Board’s prior decision, because it was clear that the origin coal mine would exhaust its coal reserves sooner than anticipated. The Board therefore reopened the proceeding and lifted its prior rate prescription, but exercised its power to prevent irreparable harm under 49 U.S.C. § 721(b)(4), by ordering the carrier to charge no more than the previously-prescribed rate, subject to a subsequent accounting upon completion of the reopening. In this case, in contrast, there is no agreement between the parties regarding changed circumstances, and WCTL has not sought to invoke the Board’s powers under § 721(b)(4).

¹⁰ In Docket No. 41185, *Arizona Pub. Serv. Co. v. Atchison, T. & S.F. Ry.* (served Sep. 3, 1997), the parties agreed to a partial stay and related relief pending appeal, subject to a make-whole agreement at the conclusion of the appeal.

complete related proceedings. In both Ex Parte No. 582, and Ex Parte No. 657 (Sub-No. 1), the Board held that its existing rules were either flawed or wholly inappropriate for the proceedings at hand. In both cases, the Board acted to correct the flaws in its existing rules before completing the pending cases. But the Board's actions in these cases were unusual, not part of the Board's "established practice" (as illustrated by WCTL's opposition in both cases).

Moreover, in the cases cited by WCTL, the Board simply declined to make a substantive decision until it completed a formal proceeding in which the Board actually proposed specific changes to its rules. In this case, in contrast, WCTL insists the Board must set aside an existing decision and materially change the substantive result (*i.e.*, adopt a different cost of capital) when the STB has not even proposed an alternative calculation but merely offered interested parties the opportunity to comment on the existing methodology and possible alternatives. Thus, the cases cited by WCTL do not support the result it seeks.

In this case, the Board has not found that its existing cost of capital methodology is "flawed" or otherwise inappropriate. To the contrary, the Board has found that the record evidence in this case supports the continued application of the current methodology – the same methodology that the Board has applied consistently for more than 20 years. Decision at 7. The Board has acknowledged that there are other potential methods for calculating the cost of capital, and has decided to initiate a rulemaking proceeding in order to "provide all interested parties an opportunity to comment" on the current DCF model and other alternative methods for future cost-of-capital determinations. *Id.* at 8. But the Board has determined that in the absence of compelling evidence that its current methodology is flawed, it will continue to follow that methodology, as it has in the last 24 cost-of-capital proceedings. *Id.* In so doing, the Board is not "deviating" from its "established practice," as WCTL has alleged. To the contrary, the Board is adhering to its well-established precedent.

III. THE BOARD'S REQUEST FOR COMMENTS IN EX PARTE NO. 664 DOES NOT DEMONSTRATE MATERIAL ERROR IN THIS PROCEEDING.

WCTL argues that by inviting comments on the DCF methodology and its alternatives in Ex Parte No. 664, the Board effectively admitted error in the current proceeding. Petition at 3 (if “there is enough doubt or question to warrant a rulemaking as to [the DCF] methodology, then there must be enough doubt or question as to the application of that methodology to the 2005 data”). WCTL offers no precedent supporting this remarkable assertion, and AAR is aware of none.

WCTL's assertion is incompatible with reasoned decisionmaking. An agency that invites public comment on a proposed change to its procedures must be prepared to consider all sides of the issue, including the position that no change is warranted.¹¹ If an agency's willingness to receive comments on its procedures is deemed to be an admission that those procedures are flawed, then the agency in effect has prejudged the issue merely by initiating the proceeding. No principle of administrative law or logic requires such an approach.

In this case, the Board based its Decision on the evidence of record in this proceeding, which did not support any change in the Board's established DCF methodology. The Board's decision to invite public comments on the DCF methodology and other alternatives in Ex Parte No. 664 does not mean that the Board has prejudged the outcome of that proceeding, nor does it affect the Board's analysis of the current record in this proceeding.

The Board's Decision noted (at 7) that the agency has used the DCF model consistently for more than 20 years to determine the rail industry's cost of equity. The Board

¹¹ The Board has conducted a number of rulemaking proceedings in which it considered all of the evidence of record and ultimately concluded that no change in its existing rules was required or justified. *See, e.g.,* Ex Parte No. 282 (Sub-No. 15), *Railroad Consolidation Procedures: Class Exemption for Transactions Subject to the Statutory Consolidation Provision* (served Nov. 24, 1999); Ex Parte No. 282 (Sub-No. 19), *New Procedures in Rail Acquisitions, Mergers and Consolidations* (served Nov. 24, 1999); Ex Parte No. 346 (Sub-No. 28), *Rail General Exemption Authority: Export Corn and Export Soybeans* (served Nov. 24, 1999).

acknowledged WCTL's criticisms of its methodology, but based on the limited record before it (consisting only of comments from AAR and WCTL), the Board held that "[a]t this time there is not enough evidence that our longstanding DCF model must be replaced." *Id.* at 6.

The Board determined that alternative methodologies should be explored in more depth, but held that before making such a significant change as discarding the DCF model, it would "seek broader public input from other interested shippers, as well as from transportation experts, Wall Street analysts, financial experts and academics" on the longstanding DCF approach, on WCTL's preferred approach, and "on any other available recognized methods for determining the cost of capital." *Id.* at 8. The Board's decision to initiate a separate rulemaking proceeding was not an admission of error, nor does it indicate that the Board's current cost-of-capital procedures are flawed.

IV. WCTL'S RESULT-ORIENTED ARGUMENTS MISCONCEIVE THE NATURE OF THIS PROCEEDING.

In its Reply, WCTL argued at length that the AAR's calculations, using the Board's well-established DCF methodology, resulted in a cost of capital that is "entirely too high," and that entailed "a massive increase in the cost of equity and the resulting overall cost of capital." WCTL Reply at 2. WCTL noted (at 1) that the Board had rejected its previous submissions alleging that the cost of capital was "too high," and urged the Board to adopt the cost of capital figures produced by its CAPM methodology, "instead of the much higher figures proposed by the AAR." *Id.* at 2; *see id.* at 1 (Board's cost of capital is "unrealistically high"); *id.* at 3 (referring to the "massive increase" and the "massive change" that would result from the Board's established methodology, and the "even larger" increase after taxes); .

WCTL's Reply plainly stated that increases of this size were "not acceptable" to WCTL, especially "when the cost of capital is used for such purposes as to determine the revenue adequacy of individual railroads, [and] to adjudicate the reasonableness of the common

carrier rates paid on individual movements.” *Id.* at 5. WCTL stated that the “cost of capital should not be allowed to increase,” especially when such an increase allegedly resulted “just because the railroads have been able to increase their rates, revenues, and earnings.” *Id.* In other words, WCTL stated, the Board should not allow railroads to conduct any calculation of the cost of capital that would “allow them to charge still higher rates.” *Id.* at 6. “Such an *outcome*,” WCTL stated, “is the antithesis of meaningful economic rate regulation.” *Id.* (emphasis added). WCTL urged the Board to apply its preferred methodology, “and see if it produces more reasonable and appropriate *results*.” *Id.* at 9 (emphasis added).

WCTL’s Reply left no doubt that its analysis was focused squarely and solely on the “outcome” of the Board’s cost of capital determination. Indeed, WCTL indicated that the principal virtue of the CAPM methodology was that it produced results that were more favorable to shippers than the “much higher figures” that would result from the Board’s established methodology. *Id.* at 2.

WCTL’s outcome-based arguments fundamentally misconstrue the purpose of the Board’s statutorily-mandated determination of the current cost of capital. As the Board has stated, it is one of the Board’s “regulatory responsibilities” to “determine annually the railroad industry’s cost of capital.” Decision at 1. Notably, it is *not* the Board’s duty in this proceeding to determine what the rail industry’s cost of capital *ought* to be, nor is the Board empowered to decide in this proceeding that the “cost of capital should not be allowed to increase,” as WCTL has suggested. Rather, it is the Board’s duty to determine objectively the rail industry’s actual, current cost of capital, based on the available data and the Board’s long-established precedent

and procedures.¹² The Board should reject WCTL's invitation to put a thumb on the scale in this proceeding, solely to achieve an "outcome" that is "acceptable" to WCTL.

In its Petition for Reconsideration, WCTL continues to focus primary attention on the *results*, rather than the merits, of the Board's cost of capital determination. WCTL argues that the "pivotal error" in the Decision is that it increases the cost of capital "just because the covered railroads are enjoying increased earnings and stock prices in the short-term." Petition at 3-4. WCTL asserts that allowing regulated carriers to "charge more" when, and "just because, their earnings and stock prices increase" is "absurd, or at least suspect," and is "inherently defective on its face." *Id.*

In focusing on its desired result, WCTL has oversimplified and misstated the effect of rail stock prices on the cost of capital. The Board's DCF methodology does not increase the cost of capital or allow carriers to raise rates "just because" of increased earnings and stock prices. Rather, changes in rail stock prices influence the cost of equity and the cost of capital in several different (and partially offsetting) ways.

First, as WCTL has acknowledged, an increase in rail stock prices tends to increase the equity portion of the industry's capital structure, which in turn tends to increase the cost of capital (because equity is currently more costly than debt). WCTL Reply at 4; *see* AAR Rebuttal Comments (filed May 19, 2006), at 3-4 (noting that the rail industry's capital structure "fluctuates from year to year based upon the amount of debt and equity outstanding ... and the

¹² As noted in the decision adopting the original revenue adequacy standards, "[w]e must ascertain theoretically and practically sound standards for measuring a railroad's relative financial condition. We cannot set standards based on a belief that we should find a certain number of carriers revenue adequate or inadequate -- our standards must rest on their own inherent financial integrity." *Standards for Railroad Revenue Adequacy*, 364 I.C.C. 803, 822 (1981) (Commissioner Clapp, concurring in part), *modified*, 3 I.C.C.2d 261 (1986), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 855 F.2d 78 (3d Cir. 1988).

value placed on each by the market”).¹³ The determination of the rail industry’s current capital structure is a straightforward arithmetic calculation based on the value of outstanding debt and common equity (as none of the rail carriers included in the analysis had any preferred equity outstanding at the end of 2005). *See* V.S. Rockey at 27-28.

WCTL’s Reply states (at 3) that the equity component of the rail industry’s capital structure “increased substantially” from 61.5 percent in 2004 to 69.6 percent in 2005, and asserted that the “underlying cause” of this change was a “dramatic increase in railroad earnings and associated stock prices.” *Id.* at 3-4. But WCTL’s proposed CAPM methodology would not change the arithmetic effect of rail stock prices on the industry’s capital structure. WCTL’s proposed approach assumes that the other elements of the AAR’s calculations, including its calculation of the industry’s capital structure, would be accepted. *Id.* at 10. WCTL specifically acknowledges that its calculated cost of equity using CAPM, and its resulting cost of capital figure, “does not entail any adjustment to the capital structure, especially the *run-up in the percentage of equity* attributable to the *run-up in [rail] stock prices*.” *Id.* (emphasis added). Thus, even if WCTL’s approach were adopted, it would not alter the fundamental relationship between rail stock prices and the industry’s capital structure. As described above, this fundamental relationship will tend to cause an increase in the cost of capital when rail stocks rise. Even though WCTL alleges that this result is the “pivotal error” in the Decision, its proposed methodology would do nothing to alter it.

Second, it is undisputed that if dividends are constant, an increase in rail stock prices will tend to cause a decrease in the rail industry’s calculated dividend yield, and thus *decrease* the cost of equity. Again, this follows directly from the arithmetic relationship

¹³ The AAR’s Rebuttal also noted that “rising interest rates over the past two years, which tend to reduce the market value of outstanding debt, have also contributed to the shift in the capital structure in favor of equity.” *Id.*

described in the AAR's testimony. *See* V.S. Rockey at 9. WCTL admits (in a footnote) that an "increase in the stock prices causes a decrease in the average current dividend yield, the other cost of equity component, because the divided yield is expressed as a percentage of the stock price." WCTL Reply at 4 n.6.¹⁴

Thus, WCTL admits that increased rail stock prices will tend to decrease the rail industry's dividend yield, and the cost of equity. But WCTL fails to acknowledge that this decrease in the cost of equity will partially offset the effect of changes in the industry's capital structure, as described above. WCTL ignores this offsetting factor in describing the alleged "pivotal error" in the Board's methodology.

WCTL argues that the use of analysts' earnings forecasts distorts the expected growth rate and the cost of capital for the rail industry. As the Board correctly noted, however, WCTL has offered no evidence that the Board's approach has systematically produced inaccurate growth rate predictions. Decision at 7.

WCTL asserts that an increase in rail profits and stock prices "fuels investor expectations that the growth in earnings will continue in the future," WCTL Reply at 4, unrealistically inflating the expected growth rate for the industry. WCTL asserts that "simply because the railroads are making greater revenues and profits, investment analysts expect the growth in [railroad] revenues and earnings to continue." *Id.* at 5. WCTL offers no support for this bare assertion. In fact, the expected composite growth rate used in the Board's current methodology is, by definition, *forward-looking*, because it measures investor expectations for rail industry growth over the next five years. Thus, current stock prices should have relatively little, if any, effect on investor expectations for the future.

¹⁴ WCTL adds that this effect "would be offset or reversed if the Railroads used their increased earnings to increase their dividends." *Id.* But WCTL does not attempt to reconcile this suggestion with the rail industry's need for continued investment to offer improved service to shippers. *See id.* at 10.

Some rail analysts, and some investors, may emphasize current rail stock prices, but other analysts are aware that railroads' future financial performance will be influenced by many other factors. In effect, WCTL simply seeks to substitute its own unsubstantiated judgment and opinions for those of the analysts. But the purpose of the composite growth estimate is to gauge the *investor expectations* that effectively drive the cost of equity, *not* WCTL's expectations. WCTL offers no reason to believe that its expectations are more relevant than those of actual investors and analysts.¹⁵

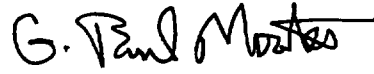
¹⁵Moreover, the fact that actual results may or may not agree with analysts' forecasts does not prove that the use of forecasts is wrong. Ex Parte No. 466, *Railroad Cost of Capital – 1986*, 3 I.C.C.2d 948, 955 (1987) (“Investors make their decisions ... [based] on the best data that they have at the time [and] do not have the benefit of knowing what the actual future performance of the stock market will be. Thus, they must rely on either past performance or estimates of future performance.... It is not unrealistic to assume that investors place a great deal of weight on forecasts”).

CONCLUSION

For the foregoing reasons, the Petition for Reconsideration filed by WCTL has no merit, and should be denied.

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*Counsel for the Association of American Railroads
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October 24, 2006

CERTIFICATE OF SERVICE

I hereby certify this 24th day of October, 2006 that I have served copies of the foregoing on all parties of record in this proceeding.

David N. Smith