

BEFORE THE
SURFACE TRANSPORTATION BOARD

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

Ex Parte No. 664

SUMMARY OF HEARING TESTIMONY OF
THE WESTERN COAL TRAFFIC LEAGUE

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TRAFFIC LEAGUE

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Dated: February 12, 2007

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In accordance with the Board's Notice in the above-captioned proceeding served January 12, 2007, the notice of intent to participate that the Western Coal Traffic League ("WCTL") filed February 5, 2007, and the Board's Decision in the above-captioned proceeding served February 9, 2007, WCTL provides this summary of testimony that its representatives, Robert D. Rosenberg and Dr. James E. Hodder, will present at the Board's hearing scheduled for February 15, 2007:

1. The cost of equity ("COE") component of the railroad industry cost of capital ("COC") can properly be calculated in different ways, including the Discounted Cash Flow ("DCF") model and the Capital Asset Pricing Model ("CAPM") and its variants.

2. One advantage of the CAPM approach is that it explicitly addresses inflation and risk, two key determinants of the cost of capital that are only implicit in the DCF model. In contrast, the DCF model implicitly derives the cost of capital from the price of the asset.

3. The one-stage DCF model that the Board currently uses to calculate the COE assumes that earnings will grow at the projected growth rate in perpetuity. The Board's model produces unrealistic and implausible results, especially for 2005, because of its exclusive reliance on the underlying analyst projections for earnings growth that are

more than double the projected rate of growth in the economy as a whole. The underlying assumption that earnings will grow at that rate in perpetuity is not plausible or even sustainable.

4. The Board should instead use a multi-stage DCF model (one that reflects that railroad earnings growth will in time revert to the rate of growth in the general economy) or a CAPM-based approach to calculate the railroad industry cost of capital. Both approaches, properly employed, should yield similar results, and both approaches should be considered and any differences reconciled.

5. In particular, when one method yields a sharp increase in the cost of capital from one year to the next, as the Board's one-stage DCF methodology did in 2005, the increase should be reviewed to determine if it makes economic and financial sense, *i.e.*, if there was any significant change in underlying inflation or the risk associated with railroading. If there were no such changes (and no such changes are apparent for 2005), that factor is a reason to question the reliance on a model that yields the sharp increase and to place more emphasis on some other approach.

6. The sharp increase in the analyst forecasts of earnings growth in 2005, and thus the associated increase in the railroad industry cost of capital for 2005 as calculated by the Board, appear to result instead from the sharp increase in railroad earnings in recent years. An increase in railroad earnings, as opposed to an increase in inflation or underlying risk, should not necessarily translate into an increased cost of capital. Indeed, doing so produces the anomalous result that the railroads' cost of capital increases simply because they are earning more. (What is not at all anomalous is that the increased earnings growth would produce an increase in railroad stock prices, which is what the DCF model predicts, and which is what has occurred.) Moreover, insofar as

rate regulation is based on the industry cost of capital, the result is that the railroads should be allowed to charge more because they are earning more. Such a perverse outcome does not constitute sound regulatory policy.

7. Use of the analysts' 2005 projections of earnings growth in the DCF model is suspect for additional reasons. In some of the months, there are large spreads between the growth rates projected by different analysts for the same railroads, and in a number of instances, the truncated average for a railroad reflects a small number of forecasts, in some cases only a single forecast. There are also wide spreads among the averages for the same carrier in different months. These factors undermine the reliability and credibility of the data.

8. The Board's 2005 COC calculation reflects a heavy weight for equity, the most expensive portion of the COC, due to the higher railroad stock prices (which, as noted, reflect the recent increase in earnings). The Board should address the current excessive weighting in equity by (a) treating operating leases as an asset and not an expense, (b) using a multi-year average for the capital structure, and (c) determining a more reasonable (lower equity-weighted) capital structure.

Respectfully submitted,

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