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BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 664

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

REPLY COMMENTS

NATIONAL GRAIN AND FEED ASSOCIATION

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National Grain and Feed Association ("NGFA"), which filed Opening Comments in this proceeding, hereby submits its reply to the comments filed by the Association of American Railroads ("AAR") on behalf of the railroad industry and to the opening comments of individual railroads.

In the Notice of August 14, 2007, the Board stated that it proposes to revise its methods for calculating the railroad industry's cost of capital by computing the cost of equity using a Capital Asset Pricing Model ("CAPM") to replace the Discounted Cash Flow ("DCF") model, mainly because DCF has been discredited, and CAPM is now regarded as decidedly preferable, in the eyes of most objective, neutral economists.

It is not surprising that the central theme of the AAR and individual railroad opening comments is that CAPM should be rejected and DCF be retained because the change proposed by the Board will result in a more rapid attainment of revenue adequacy by railroads, which apparently is looked upon by the carriers as an undesirable event. See AAR Opening Comments at 2. The carriers' companion argument is that, because the proposed change in the method of calculating cost of capital will provide railroads with less insulation from relief where their rates are challenged as unreasonably high, their financial health and that of "the American economy as whole" will be harmed (*Ibid* at p 3) and railroad investors will be unhappy (e.g., Opening Comments of Union Pacific Railroad Company at 4) if the Board adopts its proposal.

It may be true that the selection of a particular method of calculating the railroad industry's cost of capital will influence the outcome of rate reasonableness challenges and determinations of when railroads have attained revenue adequacy. But selecting a method of calculating cost of capital for policy reasons, as the railroads propose, is the

wrong thing to do. If CAPM is regarded as economically preferable to DCF, then the Board should adopt CAPM as the method by which the Board's statutory responsibilities can best be fulfilled. The Board should not allow its judgment to be affected by accusations that a departure from the discredited DCF model would be a form of "reregulation" (see Union Pacific Opening Comments at 4). It is important that the Board make an objective decision and not the politically motivated choice urged by the railroad industry, because the stakeholders here are not just railroad investors but also those who pay the railroad's freight charges

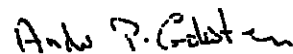
NGFA does not mean to suggest that the rail industry's comments should be avoided merely as a matter of principle, but also because they are badly flawed. For example, before accepting as in any manner persuasive the AAR's indication of alarm because the proposed new cost of capital methodology would have resulted in "several of the major U.S. railroads [having] been found revenue-adequate for one or more years," (AAR Opening Comments at 2), the Board might pause to ask itself and AAR why the attainment of revenue adequacy is looked upon by the railroad industry with disdain. Most industries would be happy to achieve "revenue adequacy," and most companies would proudly proclaim that fact to their investors as evidence of a job well done. In fact, the railroad industry has been proclaiming ever since passage of the Staggers Act that its goal is to achieve revenue adequacy.

The Board's Notice, which suggests that railroads may not have been found "revenue adequate" until now because an unrealistic measure of cost of capital has been employed, would seem to argue not in favor of the railroads' position, but against it. That is, if railroads have not been found "revenue adequate" because an inaccurate or

outdated cost of capital measurement has been employed by the Board, then shippers may have been paying more money in freight rates than they should have been, and it is the Board's duty to set that situation right.

NGFA believes that sound public policy requires the Board to resolve the issues in this case objectively. The Board's proposal has been advanced because the Board perceives that proposal as being economically sound and preferable to the model previously employed. If that is the correct conclusion, as it appears to be, then it should be adopted.

Respectfully submitted,



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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing Reply Comments of National Grain and Feed Association has, this 29th day of October 2007, been served upon all parties of record, by first-class mail, postage prepaid.

Andrew P. Goldstein

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