

**BEFORE THE
SURFACE TRANSPORTATION BOARD
Washington, DC 20423**

In the Matter of:

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

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) **STB Ex Parte No. 664**
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**REPLY COMMENTS OF
ARKANSAS ELECTRIC COOPERATIVE CORPORATION**

Arkansas Electric Cooperative Corporation ("AECC") respectfully submits these reply comments, which respond to comments submitted by other parties regarding the proposal by the Board to revise its method for calculating the railroad industry's cost of capital.¹ As was the case in AECC's comments submitted September 26, 2007, AECC defers to the Western Coal Traffic League (WCTL) and other parties to address detailed technical issues associated with the Board's proposed reliance on the capital asset pricing model ("CAPM") method in place of the discounted cash flow ("DCF") method historically used to calculate the cost of equity component of the railroad cost of capital. However, to clarify the record before the Board, these reply comments address the following specific issues:

¹ 72 Fed. Reg. 45493 (Aug. 14, 2007), corrected Decision released August 20, 2007. AECC and its interests in this proceeding were described in AECC's comments submitted September 26, 2007.

- the concerns expressed by Kansas City Southern Railway (KCS) regarding its cost of capital;
- the theme expressed by several parties to the effect that the Board should refrain from materially reducing the estimated cost of capital;
- the ill-conceived attempt by Union Pacific Railroad (UP) to invoke the supposed concerns of the financial community regarding the Board's proposal; and,
- mischaracterizations of future rail capital needs that falsely claim support from the capacity study conducted by Cambridge Systematics (hereafter, "CS Study").

Each of these is addressed below.

I. KCS COST OF CAPITAL

KCS articulates a concern that its cost of capital is higher than that of the larger Class I railroads, and that it would be disadvantaged if it were subjected to use of an inaccurately low value in Board proceedings. AECC does not dispute the general proposition that KCS may have a higher cost of capital in comparison with the larger Class I's. Likewise, AECC does not seek to improperly disadvantage KCS through imposition of an inappropriately low value.

As outlined in AECC's comments submitted on September 26, AECC's concern relates to the likelihood that extraordinary risks associated with the foreign operations of some U.S. carriers – specifically including KCS and the former TFM – may cause some or all of the increased cost of capital such carriers may experience. A captive U.S. rail shipper should not pay a rate premium to cover extraordinary risks that may be associated with activities other than domestic rail operations that may be undertaken by corporate affiliates of its serving carrier. If there is no valid way to develop a measurement that controls for the risks associated with such activities, there may be no choice but to use risk information associated with the domestic operations of other rail carriers as a proxy.

II. "CAPM RESULTS ARE TOO LOW, SO DON'T USE THEM"

The comments of several parties urge the Board to ignore or dilute the results of the CAPM methodology it has proposed simply on the basis that the numbers it produces are lower

than the numbers produced by DCF methodology it would replace. These parties conjure up the threat that use of the lower number – even if it is accurate - will improperly discourage investment, and basically argue that the Board should keep its thumb on the scale to prevent this from happening.

This argument is nonsensical from a number of perspectives. Use of an unbiased cost of capital estimate, by definition, provides for the carrier to earn a market return, so there would not be any disincentive to invest. What the complaining parties are saying is that the Board should preserve cost of capital findings that show railroads don't earn revenue sufficient to cover their cost of capital in order to ensure that railroads continue to invest the capital needed. This line of "reasoning" is so cynical and self-serving that it basically rebuts itself. The fact that – by their own claims - the railroads are already investing the capital needed for maintenance and expansion demonstrates that the incumbent methodology is flawed and that the type of change contemplated by the Board is warranted.

III. UP: "THE SKY IS FALLING...OOPS, NEVERMIND"

The statement from UP's CFO Robert Knight asserts that the financial community has "strong concern" regarding the Board's action, and cites fluctuations in UP's stock prices surrounding the Board's announcement as being indicative of such concern. To believe Mr. Knight, however, the Board would have to ignore the written advisory of Credit Suisse, which concluded that the Board's proposed action created no concerns in the short term and that "...the rails should be able to continue to book meaningful rate increases..." in the longer term.² The Board also would need to ignore the fact that (a) UP's stock price had returned to pre-announcement levels even before UP's October release of record Q3 earnings drove a further

² STB Ex Parte No. 664, Opening Comments of National Grain and Feed Association at Appendix B (Sept. 27, 2007).

run-up of its stock price; and, (b) as of this date all 17 analysts reported by Thomson/First Call still rate UP as Hold, Buy or Strong Buy, with more now saying “buy” than did before the Board’s announcement.³

If the Board really looks at the market’s reaction to its announcement, it might reasonably conclude that Mr. Knight’s statement was ghost-written by Chicken Little. The sky will not fall on the railroads just because they are held to a cost of capital standard that is reasonably rigorous, defensible and accurate instead of ineffectual and unduly permissive. Indeed, the facts presented in Mr. Knight’s statement demonstrate how UP has been able to fund growing maintenance and expansion capital needs, as well as provide returns to its shareholders that have enabled its stock price to literally double since early 2005. Even with the Board’s proposed action, the rail industry will have every opportunity it needs to enjoy reasonable financial health.

IV. CS STUDY

The rail parties make numerous references to the CS Study to conjure up the image of huge capital needs associated with substantial projected volume increases. The figure of \$148 billion is repeated so often that one is tempted to accept the proposition that the rail network is facing a substantial capital deficit, and that shippers and the Board better get used to the idea of higher rates. After all, even though one might quibble with a few assumptions, the work of a reputable firm like Cambridge Systematics couldn’t be used to defend a position that’s too far removed from reality, right?

Wrong.

Even a cursory reading of the CS Study reveals the ways that the rail parties have misrepresented its results. For starters, the \$148 billion includes \$13 billion for smaller railroads – the amount applicable to the Class I’s is \$135 billion. While this number is still large, the rail

³ See <http://finance.yahoo.com/q/ao?s=UNP> .

parties never mention the CS Study's conclusion that "(t)he Class I freight railroads anticipate that they will be able to meet most of this increase in investment through growth and productivity gains."⁴ The CS Study specifically highlights the fact that even at current rates, new traffic would make a contribution to cover the costs of the facilities it uses (as does current traffic) and estimates that more than half (\$70 billion of the \$135 billion for the Class I's) likely would be funded in this manner.

Likewise, the \$135 billion figure omits any consideration of the effect of productivity improvements on capacity requirements.⁵ It completely ignores ongoing initiatives, such as field testing of ECP brakes and increasing train lengths, as well as time-tested approaches like voluntary paired-track agreements, that could materially improve network capacity without the types of investments contemplated in the CS Study.⁶

The railroads must think the Board has a short memory, because it was only 6 months ago that the railroads described to the Board the essential role of productivity improvements in the provision of capacity increases. At the public hearing in Ex Parte 671, Rail Capacity and Infrastructure Requirements, conducted in April 2007, the Class I railroads described to the Board how an option like Positive Train Control ("PTC") may provide substantial increases in the effective capacity of the existing network for a small fraction of the investment cost figures the railroads now are waving around. It might be useful for the railroads to show the CS Study to the financial community to justify investment in PTC as a cost-effective way for the railroads

⁴ CS Study at pp. 8-2.

⁵ Ironically, the \$148 billion figure cited so prominently by the rail parties includes the cost of providing shortlines with the capability to efficiently move 286,000 lb. GWR cars, but reflects none of the productivity improvements for the Class I's that would flow directly from such an investment.

⁶ The CS Study does present a "preliminary estimate" that productivity improvements at the rate of 0.5 percent per year could offset \$26 billion of the contemplated investment requirements. However, this rate of productivity increase, which was supplied by the railroads, appears low in comparison with historical experience and expected future improvements, and is not mentioned by the rail parties in their arguments to the Board.

to increase capacity. It is not useful for the railroads to bluff the Board with scare stories based on information that omits consideration of known viable options.

There are several additional aspects of the CS Study methodology that should cause the railroads to refrain from the types of uses they have made of the \$148 billion figure. For example, for line segments with Centralized Traffic Control the only option for increasing capacity examined in the CS Study is the addition of tracks at a cost of \$3.8-4.4 million per mile. However, the railroads are well aware that many of the segments they now operate formerly contained more than the current number of tracks, and that restoration of additional tracks in such circumstances typically costs much less than assumed in the CS Study. Likewise, the railroads surely are aware of opportunities to change classification and blocking plans to permit more direct and efficient handling as volume increases.

Overall, the CS Study documents the results of an academic exercise in which current operations are simply “scaled up” to reflect projected future volumes. Indeed, the CS Study explicitly assumes “...that the future demand for rail freight transportation will be met by using current technology and existing rail corridors.”⁷ It does not purport to address the ways the network can be expected to evolve to efficiently handle volume increases, and certainly does not support the railroad proposition that capital needs should lead the Board to refrain from actions that ensure the validity of its procedures and the proper discharge of its statutory authority.

⁷ CS Study at pp. 7-4.

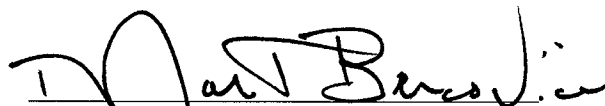
AECC appreciates this opportunity to reply to the opening comments of other parties regarding the Board's proposals.

Respectfully submitted,

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A handwritten signature in black ink, appearing to read "Martin W. Bercovici", written over a horizontal line.

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