

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Ex Parte No. 664

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

REPLY COMMENTS OF BNSF RAILWAY COMPANY

Pursuant to the Board's August 31, 2007 decision, BNSF Railway Company ("BNSF") hereby submits these reply comments in response to opening comments filed by other railroads, shippers, shipper associations, government entities and other interested parties in this proceeding. BNSF filed opening comments on September 27, 2007. These reply comments are supported by a reply verified statement of Mr. Thomas N. Hund, BNSF's Executive Vice President and Chief Financial Officer, who also filed a verified statement in support of BNSF's opening comments.

In its opening comments, BNSF explained why the Board's cost of capital estimates are of critical importance to the congressional goal of advancing the public interest in an adequate and financially viable railroad network. It is beyond dispute that demand for rail transportation has increased dramatically in recent years and is projected to continue to increase in the future. Major new rail infrastructure investments are needed to meet this demand. In a system that relies on private funding for railroad infrastructure, the adequacy and viability of the railroad network requires that current and future revenues and income be sufficient to justify the high level of capital expenditures that will be needed. An unrealistically low cost of capital estimate by the regulator would reduce revenues needed to justify making the infrastructure investments. More traffic would be subject to unnecessary rate regulation, producing lower regulated rates, and

potentially capping railroad revenues. As Mr. Hund notes in the attached verified statement, the prospect of inappropriate regulatory limits on the revenues that can be expected from future investments would discourage the needed infrastructure investments.

Some shipper commenters suggest that the Board need not be concerned about the impact of the cost of capital calculations on railroad revenues or on the railroads' ability to invest in railroad infrastructure. These shippers claim that the railroads are already earning adequate revenues and that the railroads' revenues are not being invested in railroad infrastructure but rather are being used to over-compensate investors. *See, e.g.,* WCTL Opening Comments at 13-14. Mr. Hund explains why the shippers' claims are wrong. As Mr. Hund points out, the level of capital spending by BNSF has been more than twice the average capital spending of the basic industry and manufacturing sector of the economy over the past 10 years. Stockholders are willing to have BNSF make further investment provided returns, including an adjustment for the riskiness of the investment, are better than the returns on other investing alternatives. Railroad revenues are clearly being used to expand capacity, and any artificial reduction in those revenues will therefore directly affect the level of infrastructure investment.

The shipper commenters generally support the Board's proposed approach to estimating the cost of equity capital, even though the Board's proposed approach would generate cost of capital estimates below those previously advocated by shippers. The shippers offer no substantive defense for the Board's unrealistically low estimates and no explanation for why the Board's approach is reasonable even though it produces results at odds with their own previous estimates of the cost of equity capital. The shippers have apparently decided to put their own short term interests in lower regulated rates ahead of a longer term view and broader public

interest in a realistic cost of capital estimate that will encourage and permit necessary investments in rail infrastructure.

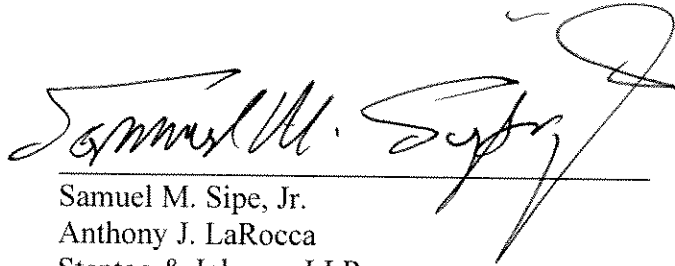
Some commenters seek to expand this proceeding beyond its original scope. The Board's August 20, 2007 Notice of Proposed Rulemaking was limited to a proposed change in the methodology for determining the cost of equity component of the industry cost of capital calculation. Some shippers urge the Board to adopt more sweeping changes in the Board's cost of capital procedures, including a vague proposal to use artificial weightings of equity and debt in the cost of capital calculation. *See* WCTL Opening Comments at 10-12. It would be an unwarranted expansion of the Board's regulatory power to second guess railroads' financial decisions regarding their capital structure. In any event, the proper weighting of debt and equity in the cost of capital calculations is an issue that is outside the scope of this rulemaking.¹ Similarly, the suggestion of Kansas City Southern Railway Company that the Board could calculate railroad-specific costs of capital rather than an industry average cost of capital is beyond the scope of this proceeding. *See* KCS Opening Comments at 10.

In sum, BNSF urges the Board to reexamine the methodology it proposed in the August 20, 2007 Notice and to adopt an approach that produces a realistic estimate of the railroad industry's cost of capital, consistent with the need to encourage investment in the rail infrastructure. An unrealistically low cost of capital estimate, as proposed by the Board, might please shippers in the short term but it would have serious, adverse consequences over the long

¹ The Board expressly excluded from this proceeding the shippers' specific proposal to treat operating leases as debt, finding that the shippers had not provided evidence that would justify consideration in this rulemaking of changes in the Board's existing approach. For similar reasons, the Board excluded from this rulemaking the railroads' proposal that the Board consider a replacement cost analysis in the revenue adequacy calculations. As Mr. Hund explains in the attached verified statement, this is an issue that the Board will need to address in a future rulemaking proceeding.

term. If the Board adopts the CAPM model as the basis for estimating the railroad industry's cost of equity capital, the Board must use inputs to that model that produce a cost of equity capital that promotes the public interest in adequate rail infrastructure investment.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Samuel M. Sipe, Jr.", is written over a horizontal line.

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October 29, 2007

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

REPLY VERIFIED STATEMENT OF THOMAS N. HUND

My name is Thomas N. Hund. I am Executive Vice President and Chief Financial Officer of BNSF Railway Company. My offices are located at 2500 Lou Menk Drive, Fort Worth, Texas 76131. I previously submitted a verified statement in this proceeding on September 27, 2007.

As I indicated in my prior verified statement, the proper determination of the rail industry cost of capital is a matter of extreme importance to BNSF. The Board's cost of capital determinations have real-world consequences for the adequacy and quality of the transportation network in the United States. The regulatory cost of capital calculations that are under consideration could eventually serve as a cap on what the Board will permit railroads to earn if railroads are determined in the future to be revenue adequate. Even now, those calculations play an important role in the Board's setting of maximum reasonable rates. Therefore, if the cost of capital found by the Board is set too low, there is a strong likelihood that railroad revenues will be adversely affected, that capital investment will be restricted, that railroads (and their owners) will find capital investment an unattractive use for available funds, and as a result, that the railroad industry will fail to meet future demand for its transportation product, adversely impacting the entire U.S. transportation network—public and private.

The Board is charged with ensuring that carriers' revenues are adequate to "support prudent capital outlays, assure the repayment of a reasonable level of debt, permit the raising of needed equity capital, and cover the effects of inflation; and attract and retain capital in amounts adequate to provide a sound transportation system in the United States."¹ BNSF is committed to continuing to make capital expenditures, some of which may have a useful life of up to 20 to 50 years or more, *if the return justifies these long term investments*. But investment decisions are made on the basis of anticipated returns, including a risk component. If anticipated returns are too low to justify the investment, the investment is not made lest value be destroyed. Like any publicly held company, BNSF has an obligation to its owners. Investors expect a return on their investment, and BNSF must make investment decisions in a manner that respects its obligation to its owners. Capital expenditures needed to support future growth may not be justified if the Board prevents BNSF from earning a reasonable return by setting a cost of capital for regulatory purposes which imposes an artificial and illogical restriction on rates charged to its customers.

Some commenters suggest that the major railroads are already earning sufficient returns, and they point to a selection of financial indicators such as stock buy-backs and dividend payments in support of their argument. They apparently hope to convince the Board that an understatement of the railroad industry's cost of capital would not have any adverse consequences. But these commenters' short-term interests ignore the long-term objective of having a financially viable railroad industry that is able to make the investments necessary to meet expanding demand. The appropriate question this raises for the Board is whether the railroads are earning returns sufficient to attract and retain debt and equity capital to support prudent capital outlays. If BNSF is persistently denied the opportunity to earn a reasonable

¹ 49 U.S.C. 10704 (a) (2) (A), (B)

return, its ability to make the future investments needed to satisfy an expanding economy will be reduced. Some commenters argue that stock repurchases and dividends indicate that the railroads are earning adequate, if not excessive, returns. Decisions to repurchase stock or to pay dividends often reflect a determination by a company that using available cash to provide an immediate return to owners is a more appropriate choice *because* the returns that would be earned by reinvesting that cash in the business are too low.

These commenters also suggest that the railroads' dividend and stock repurchase practices are evidence that the railroads are over-compensating their owners while neglecting prudent capital outlays. This suggestion is incorrect. Over the past ten years, BNSF has invested an average of 17.4% of revenues in infrastructure, plant and equipment through capital expenditures. This level of capital spending is substantially higher than the average capital spending of basic industry and manufacturing sectors over the past ten years of 6.3%² of revenues. Over the same period, BNSF has devoted only 4.6% of revenues to stock repurchases net of shares issued. Also, BNSF's dividend yield, 1.2% as of the end of the second quarter, is below the average S&P 500 dividend yield.

Some of the commenters appear to see this proceeding as a back-door opportunity to reduce rail rates through introduction of an artificially low cost of equity capital. If they are successful, serious damage could result to the Nation's transportation infrastructure.

It is also my belief that the Board, having revisited the method for determining the cost of equity capital, will need to revisit its current approach to assessing railroad revenue adequacy. The Board is charged with promoting a sound transportation system in the United States, *i.e.*, a viable and financially healthy railroad industry that has sufficient capacity to meet expanding

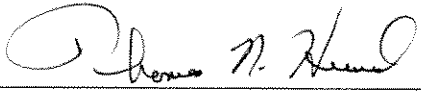
² Based on public data compiled by FactSet Research Systems, Inc.

transportation needs. The Board's current revenue adequacy calculations examine the railroads' return on the book value of their assets. But providing a return on the book value of assets equal to the cost of capital will not ensure that those assets are replaced or that necessary infrastructure investments will be made when they are needed. To promote necessary infrastructure investment, the Board must ensure that railroads can earn a return on their infrastructure investments at least equal to the cost of capital based on a more appropriate measure, such as a version of replacement cost. BNSF understands that the Board does not intend to address how to compute the asset base in the current cost of capital proceeding, but this is an issue directly linked to the Board's responsibility to "maintain and revise as necessary standards and procedures for establishing revenue levels for rail carriers,"³ and as such, this is a matter that the Board will need to address in a future proceeding.

³ 49 U.S.C. 10704 (a) (2)

I, Thomas N. Hund, declare under penalty of perjury, that the foregoing statement is true and correct and that I am qualified and authorized to file this statement.

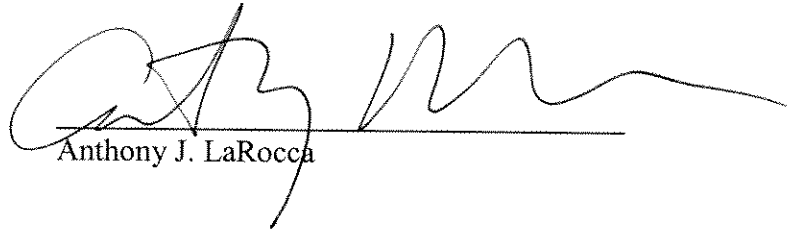
Executed on October 29, 2007



Thomas N. Hund

CERTIFICATE OF SERVICE

I, Anthony J. LaRocca, hereby certify that on October 29, 2007, I caused a copy of BNSF Railway Company's Reply Comments to be served by first-class mail upon all persons identified in the Board's service list for STB Ex Parte No. 664.



Anthony J. LaRocca