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October 29, 2007

VIA E-FILING

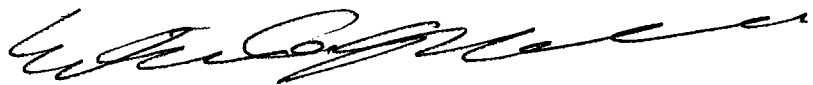
The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
395 E Street, S.W.
Washington, DC 20423-0001

Re: STB Ex Parte No. 664
Methodology to be Employed in Determining the Railroad Industry's
Cost of Capital

Dear Secretary Williams:

Pursuant to the Surface Transportation Board's decisions issued on August 14, 20 and 31, 2007, in the above captioned proceeding, The Kansas City Southern Railway Company ("KCS") hereby files, via e-filing, its Reply Comments in the above captioned matter. If there are any questions concerning this e-filing, please contact me by telephone at (202) 663-7823 or by e-mail at wmullins@bakerandmiller.com.

Sincerely,



William A. Mullins

Enclosures

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Ex Parte No. 664

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

**REPLY COMMENTS OF THE KANSAS CITY
SOUTHERN RAILWAY COMPANY**

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**Attorneys for The Kansas City
Southern Railway Company**

Dated: October 29, 2007

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Ex Parte No. 664

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

**REPLY COMMENTS OF THE KANSAS CITY
SOUTHERN RAILWAY COMPANY**

In a decision served on August 20, 2007 in this proceeding ("August 20 Decision"),¹ the Board proposed to change the methodology it uses to calculate the railroad industry's cost of capital, stating in particular its intention to replace its long-standing discounted cash flow model ("DCF") with a capital asset pricing model ("CAPM"). Elaborating upon the application of the proposed rule change, the Board stated that, "The industry-wide cost of capital will be determined as a weighted average of individual railroad costs, using the same methodology as is used now." August 20 Decision, slip op. at 10. That average does not include the cost of capital of The Kansas City Southern Railway Company ("KCS").

SUMMARY

KCS's opening comments in this proceeding responded to the Board's directive in the Simplified Standards proceeding² that, "If KCS believes that the industry-average cost of capital used by this agency should be replaced with a carrier-specific cost of capital, it should advise the

¹ The Board originally published notice of this rulemaking in a decision served on August 14, 2007. Errors in that decision were corrected in the August 20 Decision.

² Simplified Standards for Rail Rate Cases, __ STB __, STB Ex Parte No. 646 (Sub-No. 1) (STB served Sept. 5, 2007) ("Simplified Standards"), petition for reconsideration pending; petitions for review pending sub nom. CSX Transportation, Inc. v. STB and USA, D. C. Cir. No. 07-1369 (and consolidated cases).

Board on how to address that issue in the ongoing inquiry into how to calculate the cost of capital for the railroad industry.” Accordingly, KCS’s opening comments showed that, even assuming a methodology similar to the Board’s proposal, a cost of capital calculated for KCS was markedly different than that of the railroads whose costs of capital are used to compute the industry average. While KCS does not endorse any of the particular inputs or conclusions used by the Board in its decisions thus far in this matter about the industry average cost of capital, KCS’s evidence here has demonstrated that even using such a methodology, KCS’s cost of capital is different than the supposed industry average, and that using the industry average in regulatory applications involving KCS creates an unfairness and inaccuracy – essentially a regulatory competitive disadvantage – against KCS.

Upon review of the other opening comments in this proceeding, KCS concludes that there is an insufficient record in this proceeding to go beyond the foregoing conclusion and to determine whether the “industry average” cost of capital is fairly representative of the costs of other carriers whose costs are included in determining that average, or of similar investment grade carriers. Moreover, given the multitude of disputes about inputs used to determine the industry average, using the industry average may avoid unnecessary disputes in cases where it is applied to investment grade carriers. Nevertheless, it is patently clear is that using the “industry average” cost of capital in regulatory applications involving KCS is inaccurate and unfair. The Board should hold in this proceeding that KCS’s cost of capital, not the industry average, will be used in regulatory applications involving KCS.

DISCUSSION

On September 27, 2007, KCS filed its Opening comments in response to the Board’s proposal. KCS requested that regardless of the methodology the Board chooses to use to

determine the cost of capital, the Board should not apply an “industry-wide” average cost of capital in cases and proceedings involving KCS. Instead, the Board should (1) allow KCS to substitute its cost of capital for the industry-wide cost of capital in the URCS formula in any rate reasonableness proceedings; and (2) permit KCS to use its cost of capital in other proceedings as a substitute for the less reliable, and potentially punitive, industry average cost where such industry-wide average would otherwise be used.

KCS made this request because KCS pointed out that substituting the so-called industry-wide cost of capital for KCS’s cost of capital in rate complaints would result in findings that KCS’s Revenue/Variable Cost ratio (“R/VC”) exceeds 180% in some cases when it actually did not, and would result in some KCS rates being found to be unreasonably high when in fact they were not. KCS also argued that the Board’s reliance on the industry-wide figure would cause the Board to find KCS to be revenue adequate when in fact KCS would not be if the agency were to apply a KCS-specific cost of capital instead. A review of the Opening comments shows that no party took issue with KCS’s comments regarding the consequences of applying an industry-wide cost of capital to a proceeding involving KCS, even though KCS had argued the same point in the Simplified Standards proceeding.

The regulatory consequences that KCS would face are a direct result of the fact that the industry-wide cost of capital, regardless of how it is calculated, understates KCS’s true cost of capital. KCS proved in its Opening comments, as it had in the recently-conducted Simplified Standards proceeding, that because the industry-wide cost of capital derives from the respective costs of capital of the four largest North American railroads, all of whom are investment grade companies and enjoy more favorable costs of equity and debt than KCS does, that KCS’s cost of capital is consistently higher than the industry-wide calculation. No party in the Simplified

Standards proceeding took issue with KCS's evidence and expert witness testimony on that point. Likewise, no party in its Opening comments took issue with this point.

To address the Board's specific direction to KCS in Simplified Standards, KCS's witness Nelson did show that calculating a carrier-specific weighted cost of capital under the CAPM methodology was possible, assuming that the Board and the interested parties could all agree upon the inputs to be used in the calculation. But the inputs and approach used by Mr. Nelson were not intended to be the only means by which to calculate CAPM. Indeed, KCS noted that there is widespread disagreement among academics and industry experts as to what the proper inputs should be, especially regarding (1) the cost of debt; (2) the proper Beta; and (3) the market risk premium. To address this issue, KCS suggested the Board review the opening comments, narrow the issues to focus on what standards and inputs should be used for the cost of debt, the Beta, and the MRP, and then solicit further comments on these discrete issues. The Board will need to carefully choose among the different alternative methods to develop and validate its own estimation methodology.

While KCS also suggested that the Board's methodology, once validated, could be applied to each railroad individually, KCS believes that the record in this proceeding is not adequate for the Board to go that far. Calculation and application of each of the investment grade railroads' cost of capital might create unforeseen difficulties and complexities. Given those complexities, it may be appropriate to use an industry-wide composite average of those four railroads in the various regulatory proceedings instead of their individual cost of capital regardless of which methodology is used. The record here simply contains inadequate information as to the pluses and minuses of using industry average for those carriers whose capital costs are included in the industry-average calculation and for which it may be

representative. In any event, the industry average used by the Board is not representative of KCS's cost of capital.

The Arkansas Electric Cooperative Corporation ("AECC") was the only party to even briefly comment on one aspect involving KCS's proposal. AECC did not take issue with using KCS's specific cost of capital, but instead, believes that the Board should be careful in interpreting stock price data for U.S. carriers that control or are integrated with foreign operations "as with KCS and the former TFM." Although AECC did not clearly articulate the reason for its belief, AECC's comments do not refute the fact that the Board's so-called industry average cost of capital is not representative of KCS's cost of capital, and that applying that "industry average" in regulatory applications involving KCS is unfair and demonstrably inaccurate.

CONCLUSION

As was shown in its opening comments, KCS's cost of capital is significantly higher than an "industry-wide average" drawn from the economic data of the four largest railroads in North America. This is because there are fundamental differences between the capital markets available to investment grade railroads like the "Big Four" and those available to non-investment grade companies like KCS. As a result, application of the industry average cost of capital to KCS in various Board proceedings would unfairly prejudice KCS. No party refutes KCS's evidence on this point.

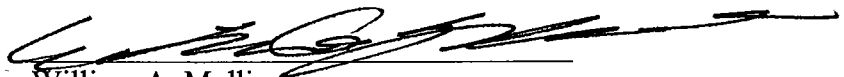
To remedy this potential harm, KCS requested that the Board – (1) allow KCS to substitute its cost of capital for the industry-wide cost of capital in the URCS formula in any rate reasonableness proceedings; and (2) permit KCS to use its cost of capital in other proceedings as

a substitute for the less reliable, and potentially punitive, industry average cost where such industry-wide average would otherwise be used. No party took issue with this proposed remedy.

Accordingly, KCS requests that if the Board adopts changes to its cost of capital methodology, it should permit KCS to substitute its own cost of capital (calculated in accordance with the Board's methodology) for that of the industry average in the various Board regulatory proceedings.

Respectfully submitted,

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Attorneys for The Kansas City
Southern Railway Company

Dated: October 29, 2007

CERTIFICATE OF SERVICE

I have this day served a copy of the foregoing Reply Comments Of The Kansas City Southern Railway Company upon all other parties of record by depositing a copy in the U.S. mail in a properly addressed envelope with adequate first-class postage thereon prepaid, or by other, more expeditious means.

Dated: October 29, 2007


William A. Mullins

Attorney for The Kansas City
Southern Railway Company