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

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Office of Proceedings

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Public Record

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

Dear Secretary Williams

AK Steel Corporation ("AK Steel") respectfully submits an original and ten copies of these letter reply comments in the above-referenced proceeding. AK Steel replies in support of the comments filed by the Western Coal Traffic League ("WCTL") on September 27, 2007.

A Identity and Interest

AK Steel is a major steel producer engaged in the production of flat-rolled carbon, stainless, and electrical steels at seven major steelmaking and finishing plants in Indiana, Kentucky, Ohio and Pennsylvania. These steels are produced primarily for use in the domestic automotive, appliance, industrial machinery and equipment, and construction markets.

AK Steel relies on the railroads to transport a large majority of its freight. The freight consists of inbound movements of raw materials, inter-plant movements of in-process products, and outbound movements of finished products. AK Steel ships annually over 6 million tons of steel products on an annual basis to numerous customers primarily in the Midwestern and Eastern United States, and to foreign customers. As part of the manufacturing process, AK Steel also ships to its facilities large amounts of raw

materials, including iron ore, coal, coke, limestone, carbon and stainless steel scrap, and other materials. AK Steel also routinely purchases between 10% and 15% of our carbon steel slab requirements from other steel producers to supplement the production from its own steelmaking facilities. Altogether, AK ships over 15 million tons of raw, in-process, and finished materials and products. Due to the size, weight, and other characteristics of AK Steel's freight, most of AK Steel's traffic must be shipped by rail as it is not amenable to shipment by motor carrier or other transportation modes.

AK Steel has a significant interest in moving its inbound and outbound materials and products efficiently and cost effectively. AK Steel in many instances is captive to a single railroad for its transportation requirements, and it is subject to monopoly railroad power and market dominant railroad pricing. AK Steel's rail transportation costs remain a very substantial component of its overall cost of doing business, and these costs have been growing significantly in recent years. These significant expenses ultimately have a considerable impact on AK Steel's ability to compete in the marketplace.

AK Steel has a substantial interest in this proceeding. Every year the STB is required by statute to determine the railroad industry's cost of capital. The annual cost of capital determination is used to determine railroad "revenue adequacy" and it is used for regulatory costing purposes. Therefore, it is imperative that the STB utilize an accurate and credible methodology for determining railroad cost of capital.

B. AK Steel's Reply Comments

AK Steel agrees with WCTL that the application of the Board's single-stage Discounted Cash Flow ("DCF") model used for determining the railroad industry's cost of capital is clearly flawed. One need only look at the STB's cost of capital decisions for the past three years (2003-2005), and the Association of American Railroad's ("AAR") proposed cost of capital figure for 2006, to see the distorted results of the current DCF model:

Railroad Cost of Capital Under DCF (2003-2006)

<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006 (AAR Proposed)</u>
9.4%	10.1%	12.2%	13.8%

If the DCF formula were utilized for calculating railroad cost of capital for 2006, the result would be a 47% increase (from 9.4% in 2003 to 13.8% in 2006) in the railroad cost of capital in only four years! The effect of such an increase in the railroads' cost of capital is to dramatically increase the STB's "jurisdictional threshold" (180% of variable costs) – which is the statutory floor set for rates that the STB can review for purposes of obtaining maximum relief. Similarly, this explosion in the cost of capital has an even greater effect on "stand-alone" cost maximum rate calculations. Additionally, at these unreasonable high cost of capital levels, the railroads will likely continue to be considered "revenue inadequate," which will further undermine the ability of railroad customers to obtain maximum rate relief, and hinder their ability to effectively negotiate with the railroads reasonable rates and terms of service.

The financial state of the railroad industry is robust, and the railroads are all enjoying record volumes, revenues, and profits. Railroad stock prices are thriving, and numerous astute private investors, including Warren Buffet's Berkshire Hathaway fund, have been purchasing, and increasing, their financial stakes in the Nation's railroads. AK Steel also understands that the investment community in various reports has confirmed that the railroad industry's cost of capital is far below those that have been published by the STB under its existing DCF approach.

These factors all support the clear conclusion that the railroads are doing far better economically than the STB's annual cost of capital determination is suggesting. It simply does not make sense that, as the industry is becoming more and more profitable, the railroads are effectively heading further and further away from becoming "revenue adequate." This clear disconnect should be corrected immediately, to help ensure that railroads are not able to unreasonably exploit their market dominant position in the marketplace over their customers.

AK Steel also strongly agrees with the STB's August 20, 2007 Notice that there is "compelling evidence that [its] current DCF approach" is flawed and requires replacing. Notice at 4. Also, failure to make this important change would be an affront on several of the mandates of the Nation's rail transportation policy to:

- (i) "maintain reasonable rates where there is an absence of effective competition."
- (ii) "encourage honest and efficient management of railroads,"

(iii) "prohibit predatory pricing and practices;" and

(iv) "ensure the availability of accurate cost information in regulatory proceedings"

49 U.S.C. § 10101(6), (9), (12), and (13)

AK Steel respectfully submits that the Board should replace the DCF approach to determining the railroad industry's cost of capital with the Capital Asset Pricing Model ("CAPM") in the manner proposed by WCTL. See WCTL Comments at 4-12. As noted in the Board's Notice, the CAPM approach "provides an alternative to DCF that commands greater respect in the regulatory and academic community and dominates the private sector" (Notice at 6), and it should provide a reasonable and reliable methodology for determining the railroad industry's cost of capital.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "John H. LeSeur". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

John H. LeSeur
An Attorney for AK Steel Corporation