

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

AEP TEXAS NORTH COMPANY	)	
	)	
v.	)	STB Docket No. 41191 (Sub-No. 1)
	)	
BNSF RAILWAY COMPANY	)	

**BNSF RAILWAY COMPANY'S
OPPOSITION TO PETITION FOR RECONSIDERATION**

BNSF Railway Company ("BNSF") hereby responds in opposition to the October 22, 2007 Petition for Reconsideration ("Petition") of the Board's September 10, 2007 decision in this matter ("Decision"), filed by complainant AEP Texas North Company ("AEP Texas"). For the reasons set forth below, AEP Texas' Petition should be denied.

I. The Board Properly Declined to Adopt AEP Texas' Method for Indexing Operating Expenses

AEP Texas claims that it was erroneous for the Board to apply in this proceeding the approach to operating cost escalation adopted in *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (served Oct. 30, 2006), which AEP Texas characterizes as an "arbitrary formula." Petition at 2. However, AEP Texas does not set out in the Petition the grounds for its claim that the approach adopted by the Board in Ex Parte No. 657 was "arbitrary." AEP Texas is a petitioner in the pending appeal of the Board's decision in Ex Parte No. 657. *See AEP Texas North Co. v. STB*, Docket No. 06-1409, Petition for Review (D.C. Cir. filed Dec. 13, 2006). AEP Texas has chosen to pursue its challenge to the supposedly arbitrary nature of the new cost escalation approach in that appeal. Instead of supporting its claim of arbitrariness here, AEP Texas argues that the Board erred in the September 10, 2007 Decision by failing to explain why

the Board chose not to adopt the approach to indexing operating expenses proposed by AEP Texas in the SAC evidence it submitted in this proceeding.

AEP Texas contends that its proposed indexing approach was designed to correct a problem with the Board's prior approach to the indexing of operating costs. According to AEP Texas, the Board's prior practice was improper because it treated productivity inconsistently when projecting future revenues and future costs. Specifically, the index used to escalate operating expenses, the RCAF-U, did not account for productivity improvements while the index used for forecasting future SARR revenues assumed productivity gains that would be passed along to shippers in the form of lower rates. AEP Texas contends that the supposed mismatch between cost and revenue indexing under the Board's prior practice resulted in a "death spiral," whereby revenues are reduced over time while operating expenses continue to escalate.

While the Board did not respond directly to AEP Texas' arguments, there was no need for it to do so. The Board had already stated clearly in a trio of cases involving eastern railroads that the "problem" AEP sought to solve with its proposal was not a problem at all but rather was an accurate reflection of how SARR operating costs and real-world revenues could be expected to diverge over time.¹

In *Eastern Reconsideration*, a decision addressing various issues on reconsideration in the three eastern cases, the Board rejected the premise of AEP Texas' argument that the productivity assumptions underlying the indices used to forecast operating costs and revenues must be the same. As the Board explained, "revenues for the railroad industry and operating expenses for a SARR could well grow at different rates." *Eastern Reconsideration* at 17.

¹ *Duke Energy Corp. v. Norfolk Southern Railway Co.*, STB Docket No. 42069; *Duke Energy Corp. v. CSX Transportation, Inc.*, STB Docket No. 42070; *Carolina Power & Light Co. v. Norfolk Southern Railway Co.*, STB Docket No. 42072 (served Oct. 20, 2004) ("*Eastern Reconsideration*").

Indeed, the revenues in a SAC analysis *should* grow at different rates from the SARR's operating expenses. The SAC test examines the real-world revenues of real-world railroads. When real-world railroad defendants pass along any productivity gains to their shippers, the revenues earned by those railroads can be expected to decline. But on the cost side, the SAC test examines the costs of a hypothetical efficient SARR. If the SARR does not experience productivity improvements, it would be unreasonable and illogical to adjust operating expenses to account for productivity. There is no reason to expect parallel growth in the SAC revenues and the SARR's operating costs.

The Board in *Eastern Reconsideration* explained the problem with AEP Texas' "death spiral" argument with an example:

For example, consider a situation where over the next 5 years a railroad is expected to replace an aging locomotive fleet with more efficient locomotives. Its revenues might be forecast to fall (in real terms) if the railroad passes some of the savings to its customers, but operating expenses would also fall because the new locomotives would be more efficient. A SARR, however, would equip itself with all those new locomotives at the outset. Having already been credited with those cost savings, the operating expenses for a SARR could remain constant (in real terms) over the next 5 years. In such circumstances, the revenues of the actual carrier and the hypothetical operating expenses of a SARR would grow at different rates, illustrating that their rates of growth need not be directly correlated.

Eastern Reconsideration at 17-18.

AEP Texas contends that *Eastern Reconsideration* does not apply because the "circumstances presented here are quite different." Petition at 5. AEP Texas seeks to distinguish the eastern cases on grounds that AEP Texas presented a different approach to linking the treatment of productivity in the revenue and cost escalation. According to AEP Texas, it proposed an approach that "recognized on the expense side only those improvements that the

EIA index projects would be passed through to shippers on the revenue side.” Petition at 5-6.

But it is clear from AEP Texas’ own description of its approach that AEP Texas simply proposed an alternative solution to a “problem” that the Board already correctly determined does not exist. The Board made it clear in *Eastern Reconsideration* that there is no reason to believe that SARR operating costs would reflect the same productivity changes that might affect the future revenues of real-world railroads. AEP Texas’ assumptions relating to the operating cost escalation of the SARR were inconsistent with the Board’s clear rejection of the linkage between SARR operating costs and SARR revenues in *Eastern Reconsideration*. It was not material error for the Board to decline to reiterate its reasoning on the issue in response to AEP Texas’ evidence.

II. The Board’s Use of Its 2005 Cost of Capital Determination in the SAC Calculations Was Not Material Error

AEP Texas makes two arguments with respect to the Board’s computation of cost of capital in this proceeding. Its first argument is that the Board should not have used the cost of capital calculated for 2005 in the SAC calculations. AEP Texas’ position appears to be that the Board should have used something other than the Board’s actual 2005 cost of capital calculation as an input in the DCF calculations for the year 2005, although AEP Texas never specifies the alternative number that the Board supposedly should have used, and it further argues that the Board should have excluded the actual 2005 cost of capital calculation from the multi-year average used to estimate the SARR’s future cost of equity. The premise of AEP Texas’ argument is that AEP Texas presented a valid objection to the accuracy of the Board’s 2005 cost of capital calculation and the Board subsequently agreed with AEP Texas’ objections in *Methodology to Be Employed in Determining the Railroad Industry’s Cost of Capital*, STB Ex Parte No. 664 (served Aug. 14, 2007)(“EP 664 Notice”).

AEP Texas' argument is based on a flawed reading of the *EP 664 Notice*. AEP Texas contends that the Board concluded that the methodology used to calculate cost of capital since the early 1980s was "defective." Petition at 7. In fact, the Board has been clear that its decision to reevaluate its methodology for calculating the cost of equity capital is not based on a determination that its prior method was defective or that calculations made under that prior method are invalid. To the contrary, in rejecting a petition to reconsider its 2005 cost of capital determination, the Board stated: "[o]ur decision to conduct a broader rulemaking is not an admission that the existing approach is flawed, but instead a prudent exercise of our regulatory responsibility to explore whether there are superior alternatives available" *Cost of Capital – 2005*, STB Ex Parte No. 558 (Sub-No. 9), slip op. at 3-4 n.2 (served Feb. 12, 2007).

Similarly, in the *EP 664 Notice*, the Board noted that "modern finance practices have changed since the last time the agency reviewed its cost of capital methodology" and articulated its desire to "modernize our approach" to calculating the cost of equity. *EP 664 Notice* at 4-5. Contrary to AEP Texas' claim, it was not a fundamental flaw in the 2005 calculation that led the Board to initiate a proceeding to consider new methodologies for the future, but rather the broader record of developments in finance practices that the Board concluded might justify changes for future year calculations.

In the Decision, the Board disagreed with AEP Texas' claim that the Board's 2005 cost of capital determination was erroneous. Instead, the Board held that the 2005 calculation was final and valid and should therefore be used in the calculation of the multi-year average. As the Board stated: "our 2005 cost of capital determination is final and should not be excluded here. Although we are currently evaluating how best to compute the cost of capital in the future,

whatever change we may adopt would not be applied retroactively to the 2005 determination.”

Decision at 108. AEP Texas presents no valid reason for the Board to reconsider this conclusion.

III. The Board Should Not Modify the Cost of Capital Used in this Case Based on a Recalculation of Historical Cost of Capital Determinations

AEP Texas’ second argument with respect to cost of capital is that the *EP 664 Notice* is a “changed circumstance” that justifies reconsideration of all cost of capital inputs used in this case. AEP Texas argues that the *EP 664 Notice* requires “that the Board restate the cost of capital for each of the prior years in the TNR average (*i.e.*, 1997-2005) using the formula ultimately adopted in *Ex Parte No. 664*.” Petition at 11. As a preliminary matter, the Board’s initiation of a rulemaking proceeding to investigate changes to an established methodology cannot reasonably be considered a changed circumstance under 49 C.F.R. § 1115.3. Issuance of the notice did nothing more than indicate that the Board was contemplating a change to its procedures; the Notice did not and could not predetermine what change, if any, would be made at the conclusion of the process.

More important, even if the Board were to adopt the proposed change in the methodology used to calculate the railroad industry cost of capital identified in the *EP 664 Notice*, that decision would not be a changed circumstances that affects in any way the Board’s SAC calculations in this case. As the Board made clear in its Decision with respect to the 2005 cost of capital, “whatever change we may adopt would not be applied retroactively.” Decision at 108. Any change in cost of capital practices that may result from the *EP 664 Notice* will only affect the cost of capital calculations for future years and would have no impact at all on the historical year cost of capital calculations that were used as the basis for the Board’s decision in this case.

AEP Texas argues that restatement of the historical cost of capital figures is nevertheless required because the *EP 664 Notice* demonstrates that the prior year calculations based on the

DCF methodology were flawed. But as explained in the prior section, the premise of this argument is wrong. The Board did not find in *EP 664* that the prior methodology was flawed or that any of the historical cost of capital calculations are erroneous. The Board's stated objective in that proceeding was to modernize its approach to cost of capital calculations for future years. The Board made it clear that it intends to apply any new methodology it adopts only to future year cost of capital determinations. The Board also made clear that final cost of capital decisions for past years will remain final. Decision at 108.

Moreover, it would be unsound regulatory practice to permit a party to relitigate separately determined cost of capital decisions in the context of a SAC case. AEP Texas ignores the long established practice in SAC cases regarding the cost of capital assumptions used in the DCF analysis. SAC cost of capital calculations are a routine application of the separate cost of capital determinations made annually in Ex Parte No. 558. The parties do not submit evidence in SAC cases relating to alternative annual cost of capital figures. The validity of the cost of capital inputs calculated in separate proceedings is not an issue in SAC cases. SAC cases are already burdensome and complicated, and litigation burdens would be needlessly expanded if decisions relating to the industry cost of capital reached in separate proceedings could be relitigated in a SAC case.

IV. The Board Properly Rejected AEP Texas' Debt Amortization Approach

Finally, AEP Texas challenges the Board's rejection of its debt amortization evidence. In its previously submitted SAC evidence, AEP Texas urged the Board to abandon its long-standing practice of amortizing debt over a 20-year period. As an alternative, AEP Texas proposed debt amortization periods that substantially exceed 20 years. The Board properly concluded that AEP Texas did not present evidence that justified its proposed departure from precedent.

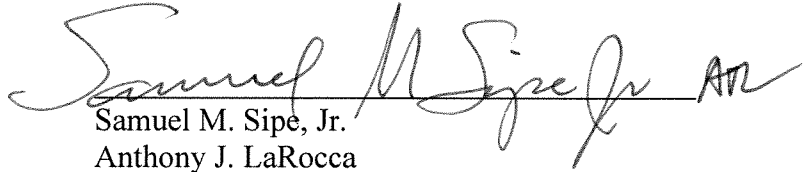
AEP Texas offers nothing new in support of its request for reconsideration. AEP Texas simply reiterates the same argument that the Board already rejected. Once again, AEP Texas argues that it demonstrated the feasibility of its proposed long-term debt amortization assumptions because “some railroads do use longer term financing (over 30 years in some cases).” Petition at 14. But at most, AEP Texas’ evidence shows that on some occasions, under some circumstances, and at some unspecified costs, railroads are able to incur debt for periods longer than 20 years. The Board was correct to conclude that this evidence does not establish the feasibility of the specific debt amortization assumptions posited by AEP Texas. The fact that railroads *may* obtain some debt financing over long periods under some circumstances does not mean that AEP Texas would be able to obtain *all* of its financing under different circumstances and conditions without any increase in financing costs.

Moreover, the evidence showed that long-term amortization is the exception rather than the rule: “although some debt may be issued for longer than 20 years, most debt is amortized over considerably less than 20 years. Therefore, we follow the long-standing precedent for amortizing the SARR debt over a 20-year period.” Decision at 107. AEP Texas gave the Board no reason to depart from precedent. The Board therefore properly rejected AEP Texas’ debt amortization approach.

V. Conclusion

For all the foregoing reasons, AEP Texas’ Petition for Reconsideration should be denied.

Respectfully submitted,

A handwritten signature in cursive script, reading "Samuel M. Sipe, Jr." followed by a large, stylized "A" or "An".

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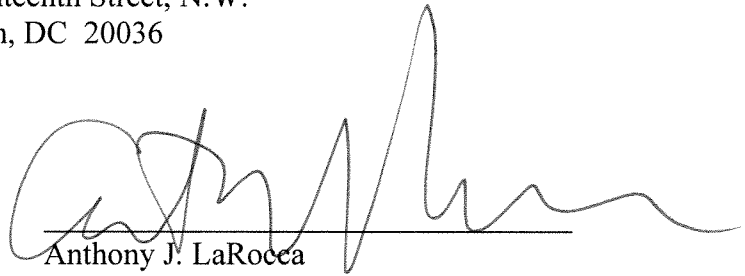
Attorneys for BNSF Railway Company

November 13, 2007

CERTIFICATE OF SERVICE

I hereby certify that this 13th day of November, 2007, I served a copy of BNSF's
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