

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

EX PARTE NO. 664

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

WRITTEN TESTIMONY OF

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My name is Michael K. Borrows. I am Senior Vice President and Chief Accounting Officer for The Kansas City Southern Railway Company ("KCSR"). I am pleased to submit these written comments on behalf of KCSR in response to the Surface Transportation Board's ("STB" or "Board") announced hearing on the Board's proposal to revisit and adjust the methodology it uses to calculate the railroad industry's cost of capital.

As the Board is well aware, the computation of the rail industry cost of capital is critical to a number of important STB regulatory processes, most notably the agency's rate reasonableness proceedings and revenue adequacy determinations. For such proceedings to be administered in accordance with the statute, the cost of capital calculation needs to accurately reflect the railroad's actual cost of capital. The use of an industry-wide average, composed from various inputs from the four largest Class I railroads, does not accurately measure KCSR's cost of capital or that of similarly-situated railroads.

The Board, having determined that its existing cost of capital calculation methodology does not, in the Board's view, accurately measure the cost of capital for the rail industry, has proposed changing from the discounted cash flow method ("DCF") to a capital asset pricing method ("CAPM"). In undertaking these changes, however, it is not sufficient for the Board to select the most reliable and accurate methodology to be used to compute an industry-wide average cost of capital and then apply that average to KCSR. Rather, the Board must recognize that, while an industry-wide computation may be applicable to the investment grade large railroads, it will consistently understate KCSR's actual cost of capital and, when applied to KCSR in various proceedings, will

significantly disadvantage KCSR. As KCSR has requested in its earlier comments, we would like the Board to acknowledge, and compensate as appropriate for this unintended consequence of the agency's use of an industry-wide average cost of capital.

In keeping with KCSR's previous comments in this proceeding, the focus and purpose of my testimony is not to discuss the relative merits of using certain specified inputs or methodologies for calculating cost of capital. Indeed, KCSR has joined with the rest of the rail industry in expressing concern with inherent difficulties of the Board's current proposal, and has urged the Board, if it moves forward, to focus its attention on the appropriate inputs to be used in its CAPM approach, such as the cost of debt, the proper Beta, and the market risk premium – all of which are discussed in the comments KCSR has submitted previously. Rather than focus on those issues, however, I wish to emphasize that, regardless of the methodology that the Board may choose to employ and the inputs it includes in that methodology, the use of an industry-wide average cost of capital figure will understate KCSR's actual cost of capital. This will harm KCSR and its investors, among other ways, as follows:

- Restrict KCSR's opportunity to achieve revenue adequacy by not allowing KCSR to recover its actual costs in any rate proceeding;
- Force KCSR to incur the costs of defending itself in litigation arising from meritless rate complaints that would be allowed to proceed based on flawed assumptions regarding KCSR's costs; and
- Subject KCSR to Board-prescribed rates and rate-related remedies for KCSR traffic, which remedies would not be imposed if KCSR's actual costs were properly reflected (thus depriving KCSR of commensurate revenues).

To prevent these harms from occurring, KCSR has urged the Board in this proceeding and in others to permit KCSR, and other similarly-situated, non-investment grade railroads, to – (1) substitute its individual cost of capital for the industry-wide cost

of capital in the URCS¹ formula in any rate reasonableness proceedings; and (2) use its individual cost of capital in other proceedings as a substitute for the less reliable, and potentially punitive, industry average cost where such an industry-wide figure would otherwise be used.

The four largest U.S. railroads whose economic data is used to compute the industry average cost of capital proxy are all rated “investment grade” in the market place. KCSR has already established on the record here that it does not have investment grade credit, not unlike other rails outside of the “Big Four,” and that KCSR’s cost of capital, quite naturally, will be consistently higher than the cost of capital of those investment grade railroads that represent the “industry average.” This is a product of fundamental differences between the capital markets available to investment grade railroads like the “Big Four” and those available to smaller non-investment grade operators like KCSR, which we have explained in greater length in our previously filed comments. No party of record here has disputed that KCSR’s actual cost of capital is substantially higher than the current industry average or that KCSR’s cost of capital would remain so under alternative methodologies now being considered. Furthermore, KCSR has shown – and nothing I have seen to my knowledge has disputed – that it is possible to separately compute KCSR’s cost of capital under any methodology the agency may employ.

KCSR is not seeking to manufacture an artificial distinction between itself and the carriers from which the industry average cost of capital derives; rather, KCSR seeks Board recognition of the realities of the capital markets in which KCSR and others

¹ Uniform Rail Costing System (“URCS”).

similarly situated must obtain capital. KCSR is asking the Board to correct a bias in the Board's industry-wide cost of capital assumptions which has the apparently unintended consequence of doing harm to KCSR, its investors, and other similarly-situated railroads if left unresolved. Specifically, by recognizing and addressing this important issue, the Board will preserve the integrity and appropriate fairness of its processes, and will ensure that non-investment grade railroads, such as KCSR, are not subjected to an increasing rate complaint environment and other proceedings that could be encouraged as a result of the aforementioned inequity.

While attributing an industry-wide cost of capital proxy to KCSR would be inappropriate, the use of a KCSR-specific cost of capital would avoid unintended consequences generated by well-intended processes of the Board. As examples:

- The use of KCSR-specific cost of capital would ensure that a rate complaint against KCSR would be assessed against an accurate 180% revenue-to-variable-cost jurisdictional threshold which is calculated based on URCS costing.
- Similarly, use of a KCSR-specific cost of capital ensures that a truly reasonable KCSR rate would not be found unreasonable should a rate reasonableness complaint proceed to that point.
- Application of KCSR-specific cost of capital ensures that the Board will find KCSR to be revenue adequate only when it truly is so.

Finally, KCSR is part of an integrated North American rail system that operates in a manner comparable to other North American rail systems with integrated operations on both sides of the U.S. border.² KCSR's cost of capital correctly reflects the scope of its overall system operations. It would be incomplete and unrealistic for the Board to ignore the risks inherent in operating an integrated rail system extending from the U.S. into

² Notably, Canadian Pacific Railway and Canadian National Railway, like the carriers whose costs are used to compute the Board's industry average, but unlike KCSR, are considered investment grade.

Mexico or Canada, and to disallow or discount the risk factors associated with such interconnecting operations outside the United States.

Thus, the Board should not exclude appropriate risk factors, as appears to be suggested by Arkansas Electric Cooperative Corporation that reflect KCSR's overall cost of capital simply because those factors may contribute to KCSR's non-investment grade credit. As the Board is aware, the market shapes KCSR's investment status, and KCSR would not intentionally make itself less attractive to investors and creditors. In fact, KCSR works diligently to improve its investment status while competing vigorously with other railroads and transportation modes. Moreover, separating or artificially discounting KCSR's entire interconnected rail operations between the U.S. and Mexico would entail a highly subjective "a la carte" approach. Such an approach could favor including some lower risk factors while excluding other appropriate higher risk factors and would result in an artificial cost of capital that ignores critical components of the marketplace where the focused outcome should be one that is market representative. In our analysis, such an approach will clearly drive an unintended consequence or outcome instituted by the Board's regulatory process, not by the realities of the international market in which KCSR operates.

Excluding the overall network costs associated with international operations from the cost of capital calculation would also create other complexities and problems as well. Such a non-representative approach would:

- Penalize a railroad for making long-term business decisions that, despite possible higher risks in the near term, can and will, in time, inure to the benefit of that railroad, its customers, investors and creditors, and indeed to the public as a whole (including KCSR's competitors who interchange with KCSR's affiliate Kansas City Southern de Mexico, S.A. de C.V., and who benefit from the investment that KCSR's parent has made there);

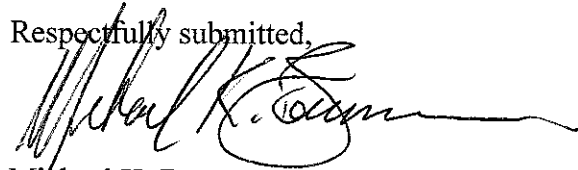
- Resurrect the theories behind so-called “acquisition premiums” that the Board has consistently discredited when they have been raised in railroad consolidation transactions requiring advance Board approval;
- Expose railroads to inconsistent regulation as various other government agencies that may have jurisdiction over cross-border transactions apply one set of standards that includes the overall network costs while the STB excludes such costs; and
- Have a chilling effect on future railroad transactions if railroads would be left to guess whether the Board might “screen” a contemplated transaction from its cost of capital calculation based on the potential risk.

As KCSR’s comments throughout this proceeding have reflected, it is important for the Board to make comprehensive decisions about the appropriate methodology used for calculating an industry cost of capital methodology, and if the Board does move toward a CAPM approach as it has proposed to do, it should ensure that the inputs used accurately reflect a railroad’s cost of capital. Once these inputs are selected and the appropriate methodology developed, then the Board needs to apply such a methodology so as to reflect the key differences of KCSR’s, or of another similarly-situated, non-investment grade railroad’s, specific cost of capital, even if the Board continues to calculate an industry-wide average for the largest investment grade carriers.

Application of KCSR’s cost of capital (or, as relevant, that of another non-investment grade railroad’s specific cost of capital) is necessary because, as KCSR has shown throughout this proceeding and in other recent proceedings before the Board, KCSR’s (or another non-investment grade railroad’s) cost of capital has been consistently higher than the Board’s industry average – regardless of which methodology is used to calculate that industry-wide average.

In closing, the application of an industry-wide average would result in clear unintended consequences as well as a bias against KCSR and other similarly-situated railroads in certain types of proceedings; including, creating an environment impairing KCSR's ability to achieve revenue adequacy. KCSR has shown that the unintended consequences that could be driven by the actions of this Board can be overcome by permitting KCSR's actual cost of capital calculation to replace the use of an industry average in those STB proceedings involving KCSR.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Michael K. Borrows", with a long horizontal flourish extending to the right.

Michael K. Borrows

November 27, 2007