

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB EX PARTE NO. 664

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

**STATEMENT OF ATTICUS CAPITAL LP
HEARING ON
METHODOLOGY TO BE EMPLOYED IN DETERMINING THE RAILROAD
INDUSTRY'S COST OF CAPITAL
DECEMBER 4, 2007**

Submitted by:

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November 27, 2007

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STB DOCKET NO. EP-664

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INTRODUCTION

In determining the cost of capital, we respectfully submit that the most important consideration for the Surface Transportation Board should be whether the resultant cost of equity approximates the real-world demands of equity investors. To achieve such a result through the newly-proposed Capital Asset Pricing Model ("CAPM") methodology we recommend using: (1) a risk-free rate closer to a running 10-year average of Treasury Bonds, which would be 5.2% for the relevant 10-year period; (2) a beta of at least 1.3 based on the risks inherent in a railroad investment today looking forward relative to other industries; and (3) a forward looking market risk premium of at least 5.0, as currently used at the Harvard Business School.

BACKGROUND

By notice served on October 24, 2007, the Surface Transportation Board (the "Board") announced that it would hold a public hearing on December 4, 2007, to solicit public comment on the type of methodology to be employed in determining the railroad industry's estimated cost of capital. More specifically, the Board seeks public input on the type of methodology it should use in calculating the cost of the equity component of the cost of capital.

Atticus Capital LP ("Atticus") had previously submitted written comments to the Board in this proceeding on September 26, 2007. On November 19, 2007, Atticus respectfully submitted to the Board a request to appear in person and speak at the public

hearing to convened by the Board on December 4, 2007. In accordance with the Board's notice of October 24, 2007, Atticus hereby respectfully submits to the Board a copy of its written testimony in advance of the hearing.

STATEMENT OF INTEREST

Founded in 1995, Atticus is a private investment firm that currently manages in excess of \$18 billion of assets on behalf of its clients, which include leading pension funds, educational institutions, and charitable foundations. Atticus is a long-term, value-oriented investor many of whose investments were made a number of years ago. Atticus's investment in the US railroads, currently worth in excess of \$2 billion, is one such investment.

Atticus's multi-billion dollar investment in four of America's freight railroads was made with the firm belief that the rail freight industry serves as a principal solution to the nation's present and future transportation demands. Contrary to the popular misperception of hedge funds currently in the public domain, Atticus is not an investor that buys controlling interests in companies for the purpose of selling off their assets piecemeal to make a quick profit on the theory that the individual pieces are worth more than the whole enterprise. As a long-term shareholder owner in America's freight railroads, Atticus believes that significant opportunities exist for the major freight railroads to increase value for their shareholders and customers over the long term.

ANALYSIS

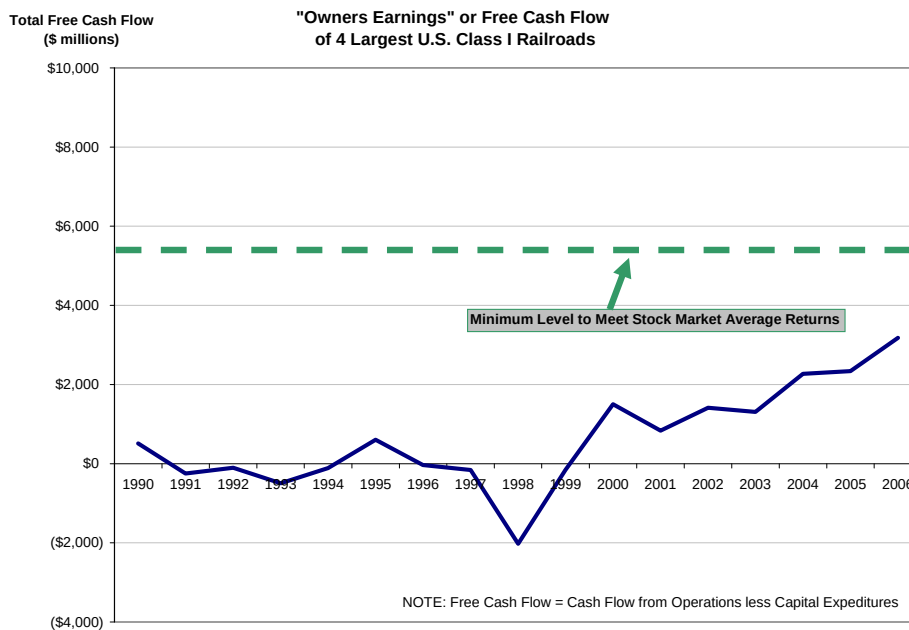
Historical Context

The American rail freight industry is at a critical juncture. After emerging from decades of decline it has, paradoxically, found itself the victim of its own success. Following the creation of the interstate highway system in the 1950s, the railroad industry experienced sustained reductions in demand which resulted in a decreased ability to meet its obligations to customers, employees, shareholders, and surrounding communities. Each time the industry completed a cycle of downsizing to address the lower level of traffic and revenue, it was confronted with further reductions in traffic and revenue, necessitating further cost cutting, layoffs, and asset dispositions. But starting with the passage of the Staggers Rail Act in 1980, that picture began gradually to change. Throughout the 1980s, the railroads used their improved profitability to rehabilitate deteriorated lines and facilities to handle new traffic. During the 1990s the railroads began attracting new traffic to their heretofore underutilized but renewed infrastructure. At first, excess capacity absorbed this increase. However, beginning approximately 10 years ago, major railroads began experiencing significant traffic congestion on their systems. At that point, the railroad industry began to realize that it would have to invest significant sums of money both to maintain the existing plant and expand capacity to handle existing and projected freight traffic flows.

Owner's Earnings

Today, due in part to truck driver shortages, rising motor fuel prices, increased highway congestion, greater concerns over the environment and energy use, and its own marketing efforts, the railroad industry has started¹ to rebound. While many observers² infer that the railroads are now making extraordinary profits based on the results reported in their earnings statements prepared in accordance with generally accepted accounting principals ("GAAP"), we believe that the industry's performance is more accurately measured by instead looking at "owners' earnings"^{3 4} which is sometimes referred to as Free Cash Flow to equity holders. As Exhibit 1 below illustrates, the four major U.S. Class 1 railroads only began generating "owners' earnings" on a consistent basis 6 years ago, and such earnings

EXHIBIT 1:



¹ The industry recovery is at its infancy, as the railroads have only recently begun to earn returns in excess of their capital expenditures.

² See "Reply Comments Of The Western Coal Traffic League," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No. 664, July 25, 2007, pp.8-9; "Comments of the National Industrial Transportation League," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No. 664, September 27, 2007, P 3, "Opening Comments of The Honorable Brian Schweitzer et al," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No 664, September 27, 2007, p. 7, "Opening Comments of the National Grain and Feed Association," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No 664, September 27, 2007, p.4.

³ Owners' earnings essentially represent the amount of money left over from a business after it pays all of its operating costs, interest, taxes, and capital expenditures. It is analogous to the real earnings a private businesswoman would bring home to her family after a year of hard work.

⁴ See Warren Buffett, Berkshire Hathaway Annual Letter to Shareholders, 1986

pale in comparison to the returns earned by the stock market as a whole. In fact, the railroad industry generates approximately one-half the income of the market.⁵ Thus, we believe that attributing great profits to the railroad industry based on GAAP financial statements distorts the reality of the situation and does not make financial sense. The railroads have recently emerged from decades of bankruptcy and financial distress and are now finally making ends meet, yet many are now considering them extremely profitable.⁶ Such a false impression could jeopardize the future operating success of the freight railroad industry.

Need for Investment

We have always believed that the customer is key and that the best run businesses should be relentless in their focus on their customers' needs. We recognize that sometimes there are tensions between the customers' desire for lower rates and their need for reliable and available service. In particular, trade associations representing large rail customers such as agricultural interests, electric utilities, and coal shippers have argued that railroad rates are too high, especially for "captive" traffic, and need to be more heavily regulated. At the same time, these groups have also complained when railroad service is too unreliable. While we believe that these concerns do need to be addressed, we believe that additional restrictive regulation, whether through specific rulemaking or changes to the methodology for determining cost of capital, would be far more harmful than helpful to all constituencies involved. Worse still would be the long-term consequences to the U.S. transportation infrastructure and overall economic competitiveness.⁷

We share the view that railroad service levels need to continue to improve. Unfortunately, while the rail industry was able to achieve significant productivity gains

⁵ The overall U.S. stock market has a Free Cash Flow yield of approximately 5.4%. Free Cash Flow is defined as cash flow from operations less capital expenditures. Free Cash Flow yield is defined as Free Cash Flow divided by market capitalization. This represents the effective return that an equity investor would be receiving through ownership of common stock. The U.S. Class I railroads would need to approximately double their current Net Income to generate a Free Cash Flow yield of 5.4%. See Exhibit 1 for a graphical representation of this.

⁶ See "Reply Comments Of The Western Coal Traffic League," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No. 664, July 25, 2007, pp.8-9; "Comments of the National Industrial Transportation League," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No. 664, September 27, 2007, P 3, "Opening Comments of The Honorable Brian Schweitzer et al," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No 664, September 27, 2007, p. 7, "Opening Comments of the National Grain and Feed Association," In the Matter of Methodology to be Employed in Determining the Railroad Industry's Cost of Capital, STB Ex Parte No 664, September 27, 2007, p.4.

⁷ The Board need only look back a few short years after the absorption of the Southern Pacific Railroad into the Union Pacific System and the breakup and acquisition of Conrail by CSX Transportation and Norfolk Southern Railway. The issue upper most in the minds of customers of those railroads then was not rates or competitive service but the very ability of the railroad network to meet their needs on any sort of reliable basis. In some parts of the country, the railroad system had reached a capacity crisis equal to a service gridlock. In fact, congestion was so bad on some parts of the Union Pacific Railroad that many referred to it as a "service meltdown."

during the 1980s and 1990s through work rule changes and by utilizing existing capacity, additional productivity gains going forward will require substantial capital investment.⁸ The capital required for such investments will need to come from outside investors, yet we are convinced that a cost of equity below 12% will not only prevent such investment but will drive long-term investors away from the industry.⁹ This is even more evident when viewed in the context of the relative returns of other assets (see attached Slide 4, “Market Spectrum of Risk vs. Return”). We struggle to think of a rational investor who would commit long-term equity capital to the railroad industry for the proposed 8.4% when such an investor could instead invest in corporate bank debt or bonds for less risk and a higher return.

If railroad returns are below that demanded by equity investors, the result, of course, would be that needed capital investments would not be made, service would suffer, and all stakeholders would be worse off.

The Cost of Equity

In determining the cost of capital (whether using Discounted Cash Flow (“DCF”) or CAPM), we believe that the most important element to consider is whether the resultant cost of equity approximates the real-world demands of equity investors.

If the Board determines that the CAPM should be used, then we would recommend using a risk-free rate closer to a running 10-year average for Treasury Bonds, which would be 5.2% for the relevant 10-year period.¹⁰

Beta, as a measure of systematic risk, should approximate the real world view of investors. While beta can be calculated innumerable ways each justified with long academic dissertations, in our professional judgment the railroads are at least as risky, if not riskier, than the overall market due to macro economic, regulatory, catastrophic liability, labor, and legislative risks. Consequently, in our expert opinion, market participants would incorporate the relative risk of the railroads with a beta of at least 1.3 as of today looking forward. In our view, we believe that it is especially important to employ a forward-looking beta because any historical measure, as determined through a historical regression analysis, fails to capture the realities of an investor making a decision today. Lastly, the market risk premium should also be forward looking and we believe that the number should be at least 5.0.¹¹ The end results of such a calculation would be a cost of equity of 12-15%.

⁸ According to a study prepared at the behest of the Association of American Railroads, the Class I railroad freight industry estimates that it will need about \$135 billion in private funded facility investment over the next 30 years just to meet the freight needs for its shippers. “National Rail Freight Infrastructure Capacity and Investment Study,” Cambridge Systematics, September 2007.

⁹ Some groups of shippers assert that railroads can generate sufficient capital for necessary infrastructure investments through some combination of productivity gains, unspecified capacity increases, tax credits, or public/private partnerships. We believe these claims to be largely illusory and unsubstantiated from a financial perspective.

¹⁰ Source: Bloomberg; St. Louis Federal Reserve, FRED – Economic Data, 1996-2005

¹¹ For example, the Harvard Business School currently teaches the use of a market-risk-premium of 5.0 in its Masters of Business Administration and Executive Education programs.

Historical vs. Book Value of Capital

We firmly believe that a discussion of cost of capital is inextricably linked to return on investment and invested capital. While we respect the Board's decision to exclude the cost of capital from this discussion, we feel that this is an extremely important issue to address given the large disparity between the estimated historical book capital and the replacement cost of that book capital. While we understand the potential complexity of calculating replacement cost, we firmly agree with Warren Buffett, now the largest shareholder of Burlington Northern Santa Fe, who has repeatedly stated: "It is better to be approximately right than precisely wrong."¹²

While GAAP accounting has the perception of fine-tuned accuracy, most professional investors understand that it has a number of limitations. One of the largest drawbacks of GAAP accounting is its recording of historical book capital for long-dated assets. Interestingly, if an investor such as Warren Buffett were to buy all of the assets of a railroad today and leave everything exactly the way it was, under GAAP purchase accounting treatment the book equity would be written up to the value paid for the business. As a result, simply by virtue of the railroad's assets changing hands, the exact same railroad would have its book equity double, triple, or quadruple, thereby drastically changing the determination of ROI and revenue adequacy. This does not make economic sense, and, as financial experts, we strongly suggest a movement away from the use of historical cost and towards the use of replacement cost of railroad assets.

While we appreciate that calculating replacement cost has a number of complexities, other regulatory bodies have found solutions to these problems. One notable example is the Australian Competition and Consumer Commission which uses a "depreciated optimized replacement cost" methodology for regulation of energy transmission assets.¹⁴ The commission's method provides for the written-down replacement cost of the assets which better approximates the true economic capital being employed and hence provides for proper incentive for their regulated utilities to invest for the future.

As a solution to the practical challenges of assessing market values for railroad assets, we suggest that the industry conduct such an assessment once every 10 years with inflation adjustments during the interim years. This would be similar to the way that the United States conducts its population census. As with the census, it would be impractical to conduct such an effort annually, but if we avoid making such an effort altogether, the industry runs the risk of arriving at misleading and potentially damaging conclusions.

As the Board noted, we agree that the use of a replacement value for assets should be accompanied by an inflation-adjusted cost of capital. We believe that this can be calculated using the above suggested methodologies for cost of equity and subtracting the market's view of future 10-year inflation as implied by the U.S. Treasury

¹² Warren Buffett, Berkshire Hathaway Annual Letter to Shareholders, 1993; Warren Buffett, "Fuzzy Math and Stock Options," Washington Post, July 6, 2004

¹⁴ Independent Pricing and Regulatory Tribunal of New South Wales (IPART), Pricing for Electricity Networks and Retail Supply, 2 volumes, June 1999

Inflation-Protected Securities ("TIPS"). The TIPS market represents a very liquid and transparent market that provides for long-dated market views of inflation.

In all cases, we believe that any use of a market-based cost of equity methodology, such as CAPM, should be made in conjunction with a market-based value of assets in calculating return on investment.

CONCLUSION

In conclusion, we urge the Board either to retain the use of the DCF methodology in determining the railroad industry's cost of capital or use more market-based assumptions with the CAPM approach such that the cost of equity is at least 12%. We appreciate the opportunity to appear before the Board to offer our views in this proceeding.

Respectfully submitted,



Timothy R. Barakett
Chairman and CEO



Heath L. Watkin
Managing Director

November 27, 2007

STB Ex Parte No. 664 Hearing

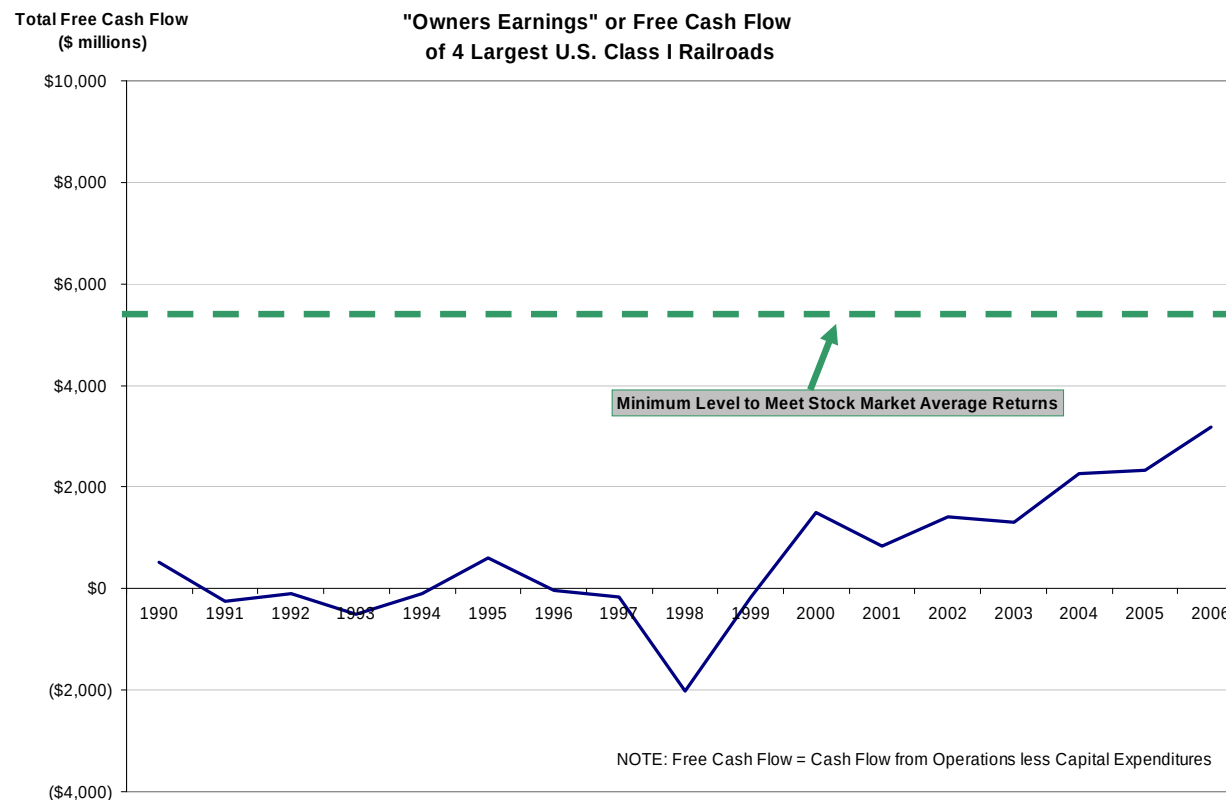
Oral Presentation Slides for
Atticus Capital LP

Key Points

- Substantial capital investments in the U.S. Class I railroads are needed to meet the nation's present and future transportation demands
- The capital required for such investments needs to come from outside investors, but the proposed cost-of-equity when applied to a historical cost of invested capital threatens to drive long-term investors away from the railroads
- Atticus has investments worth over \$2 billion in the U.S. Class I railroads
- Contrary to a common view of hedge-funds, we are long-term investors who believe the cost of equity must approximate the real world demands of equity investors

Railroad Free Cash Flow

- The railroads are not generating excessive profits
- They are beginning to earn positive returns for the first time in many years
- The railroads would need to double their recent GAAP earnings with no additional capital in order to match comparable market returns



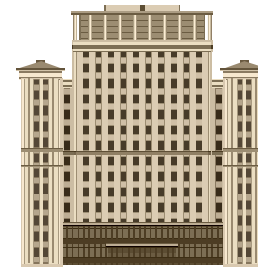
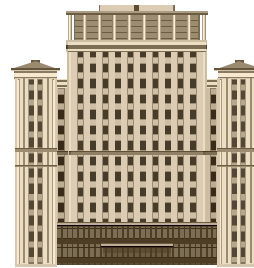
Market Spectrum of Risk vs. Return

A cost-of-equity below 12% does not adequately compensate investors for the risk of investing in the railroads and will discourage investment

Low Risk High Risk									
Type:	Cash	Investment Grade Bonds	High-Yield Bank Debt	High-Yield Bonds	Large-Cap Equity	Railroads	Small Company Stocks	Private Equity	Venture Capital
Example:	Savings account	Alcoa Bond	LBO term loan	American Airlines	GE	Class Is	priceline.com	Bain Capital	Kleiner Perkins
Current Expected Return	4%	6%	8-9%	9-11%	10-12%	12-15%	15-20%	25-30%	30%+
Historical Range (1926-2005)	0-15%	-10 to +40%	-20 to +25%	-35 to +45%	-40 to +55%	-100 to +40%	-60% to +145%	-60 to +244%	-100 to +721%
<i>Major categories of risk:</i>									
Loss of capital	None	Very Low	Low	Moderate	Moderate/High	Moderate/High	High	High/Very High	Very High
Liquidity	High	Moderate	Low	Low	High	High	Moderate	Very Low	Very Low
Legislative	Low	Low	Low	Low	Low	High	Low	Moderate	Low
Inflation	Low	High	Moderate	Low	Low	Low	Low	Low	Low
Interest Rates	Low	High	High	High	Moderate	Moderate	Low	High/Very High	Low
Catastrophic Risk Liability	None	None	None	None	Very low	Very high	Very low	Low	Low

Historical vs. Replacement Cost

“It is better to be approximately right, than specifically wrong.”
-- Warren Buffett



	My Great-Grandfather's Hotel	Marriott in next city over
Year Built	1920	1990
Inflation since year built	1000%	60%
Number of Rooms	100	100
Original Cost	\$10,000,000	\$100,000,000
Additional Invested Capital Since Year Built	\$25,000,000	\$5,000,000
Cumulative Depreciation	\$20,000,000	\$43,500,000
Net Book Value	\$15,000,000	\$61,500,000
Room rate based on Book Value and 8% Return	\$32.88	\$134.79
Multiple	1.0x	4.1x