

**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
DAVID A. BOOR
VICE PRESIDENT TAX & TREASURER
CSX CORPORATION**

Dated: November 27, 2007

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My name is David A. Boor. I am Vice President Tax & Treasurer of CSX Corporation, the parent company of CSX Transportation, Inc. ("CSXT").

CSXT believes that this proceeding addresses one of the most important topics the Board will examine this decade. The Board's cost of capital assessment directly affects its determination of whether an individual railroad is revenue adequate. In light of recent regulatory decisions affecting maximum rate regulation standards, it is essential that the Board contemporaneously consider the appropriate investment base to which the cost of capital should be applied in conjunction with its assessment of how cost of capital should be determined. The results of these and future proceedings will dramatically affect the ability of

the rail industry to attract capital and make new investment, whether for growth or even to replace existing capacity.

In the past, the industry generally has not been able to earn its cost of capital on a sustained basis, irrespective of the manner of its calculation. As calls for reconsideration of revenue adequacy standards now surface, it is imperative that the Board resolve these questions carefully, and factually. And these issues must be addressed in a manner that provides clarity as to when regulatory oversight would curtail privately negotiated rate setting. The cost of capital standards we discuss today are relevant primarily because of these broader economic issues.

CSXT joins in and fully supports the presentation by the Association of American Railroads and its economic witnesses, Professors Myers, Stangle and Hubbard. In light of this expert economic testimony regarding underlying cost of capital assumptions, CSXT will primarily address the broader issue of why it is essential – prior to implementing any change in the cost of capital computation – that the Board carefully consider how that computation will be applied.

First, there are many broad considerations relevant to this topic for which no disagreement should exist. The submissions and written testimony to the Board in this proceeding, as well as to Congress in support of the recently introduced tax credit legislation (S.1125/H.R.2116) for expanded rail

infrastructure capacity, evidence the public policy benefits of rail transportation to the nation's commerce, its security and to the environment. With growing congestion on our highways and the need to rebuild many portions of our highway system, the benefits of a strong private rail system have never been clearer. On average, railroads can transport a ton of freight over 400 miles on a gallon of diesel fuel. That kind of efficiency directly addresses pressing environmental and energy concerns. Private and public sectors as well as federal and state governmental agencies recognize that private investment in freight rail transportation is critical to sustaining the nation's growth.

In addition, it should be broadly acknowledged that the goal of the Staggers Act – to rejuvenate and preserve a privately funded rail system – has been overwhelmingly successful. The purpose and promise of the Staggers Act was to establish a revenue adequate private network, rebuilt from a financially struggling industry. The market freedoms of the Staggers Act have resulted in a rail freight transportation network that is the envy of the world. The Staggers Act has delivered demonstrated savings to shippers, through increasingly more efficient rail operations. The impact of privately-driven investments and financial returns has been dramatic. Of all the transportation modes in the nation, only the freight rail system is built and maintained with private capital. Highways, airports, waterways . . . all are primarily taxpayer-funded.

To secure private investment in rail transportation, in track, bridges, tunnels, signal systems, information technology, rail cars and in locomotives, the economic requirements are also clear. We, as a company funded by profit oriented shareholders, and you, as a Board with oversight for revenue adequacy, must provide an environment where there is an opportunity to profit from the risk of investing in long-lived assets whose cost cannot be significantly defrayed by redeploying the assets to any other significant use. The railroad industry is one of the most capital intensive industries in the world. In order for freight shipment by rail to be affordable for shippers, it is important that this investment can be recovered over an extended period of time. For an industry whose assets, with periodic reinvestment, last 30, 50 or even 100 years, predictability in the regulatory system is essential.

The nation faces a need for continued investment in rail assets. CSXT's network is geographically located in some of the fastest growing markets in the country. U.S. demographics and population patterns are changing. By 2020, the U.S. Census Bureau predicts that the population of the states of Georgia and Florida will equal that of the states of New York and New Jersey. The transportation demands to support those populations will be tremendous and the capital investment CSXT will need to make to meet that demand is significant. In recent years CSX has redeployed on average approximately 80% of its after-tax cash from operations, back into rail investment. Importantly, it is out of these cash flows that we also pay dividends and repay debt.

CSXT annually incurs significant expenditures to replace and sustain its existing network. As a result of significant damage from Hurricane Katrina, CSXT is able to make particularly clear today how much replacement costs for the existing network vary from historical costs – let alone depreciated historical costs. For example, a major bridge over Bay St. Louis had to be substantially rebuilt by CSXT as a result of Hurricane Katrina at a cost of over \$75 million. Now undoubtedly, this \$75 million was affected by the need to complete construction within urgent timeframes and under adverse conditions; however, it is also the case that large portions of that structure were undamaged. The original cost of that bridge when placed in service in 1967 was less than \$5 million.

A second bridge over the West Pascagoula River provides another example. Rebuilt following Hurricane Katrina for almost \$15 million, that bridge was built in 1903 and expanded in 1917 for a total original cost of less than \$130 thousand.

There are over 15,000 active bridges, tunnels, and overpasses on the CSXT network.

The above examples highlight a collateral consequence of using historical costs instead of replacement costs as part of the revenue adequacy

determination. The Board's proposal to change the regulatory cost of capital methodology without considering the investment base to which cost of capital is applied will lead inevitably to constrained capital spending at a time when the U.S. is facing a transportation capacity crisis. Now, the argument will surely be made that the Board has always used book value in its revenue adequacy determinations. That is true. It is also true that for the last quarter century the Board has accepted the DCF methodology in determining railroad cost of capital. And now, as the Board proposes a new methodology based upon CAPM, it is incumbent on the Board to evaluate the primary drivers of the revenue adequacy framework holistically.

It may also be argued that railroads will be able to "recover" their appreciated costs after new investments are made, but this argument has an insidious failure in its logic. Just as historical costs fail to adequately capture how investment costs grow over time, so too do today's cash flows sometimes appear "rich" in comparison with the historical costs of investment. This is a very important point that is easy to misunderstand. If ROIC compares today's returns to a historical cost investment base, it inherently compares inflated dollars to depreciated dollars. Of course, the railroads had to pay historical cost and then wait 10 or 20 or 30 years to get today's return from that earlier investment, so the time cost of money is real.

At the time any investment is made, a company makes a forecast of future cash flows that could be earned over the life of that investment. Those cash flows grow over time from inflation and from volume growth, as well as from productivity savings where applicable. Future years' increasingly higher cash flows are then discounted for inflation and risk, as reflected by the cost of capital, to determine the total economic value of making an investment. Consider a project that earns precisely the cost of capital over the life of the investment. If the annual return is measured solely in one of the later years of the investment, it will be inherently overstated. Cash flows in the later years of the investment will, solely by the compounding of inflation, be significantly higher than the depreciated investment base. This mismatch for the time value of money is particularly exacerbated in the rail industry because railroads invest significantly more in capital additions than other industries. Additionally, the asset lives of rail assets, especially with some periodic reinvestment, can be exceptionally long.

For all these reasons, the Board simply cannot confine its attention to the relative merits of CAPM versus DCF. If it is to reexamine its formulae, it must do so with an eye to sound public policy outcomes. That means reexamining both the cost of capital and the determination of the cost of the asset base against which it is applied.

Accordingly, CSXT makes the following suggestions for the Board's consideration:

- Upon receipt of a timely petition in accordance with the Board's August 14, 2007 Notice of Proposed Rulemaking in this proceeding, the Board should combine or coordinate its cost of capital reexamination with a reexamination or new proceeding regarding replacement cost determinations. The rail industry should be challenged to identify a workable solution for incorporating replacement costs. CSXT believes workable solutions can be developed. On a matter as vitally important as this, sufficient time to thoughtfully develop such a solution should also be provided.
- Despite broad use of CAPM for non-regulatory purposes, a strong case can still be made for retaining DCF as the Board's regulatory standard. Certainly until such time as a coordinated review of cost of capital and asset replacement cost can be collectively resolved, the DCF methodology and existing framework should continue.

Conclusion

The Board's proposal to alter its quarter-century-long policy on railroad cost of capital would be a sea change in regulatory policy. The consequences of such a policy change would be dramatic. If the Board concludes that such a radical change is necessary, CSXT respectfully requests that the Board also contemporaneously address replacement cost as the carrier's investment base. An economically unjustified half-correction could severely restrict carriers' abilities to re-invest in their networks at a time when the nation's transportation infrastructure is strained and more – not less – transportation capacity is needed.