

BEFORE THE
SURFACE TRANSPORTATION BOARD

STB Ex Parte 664

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

HEARING TESTIMONY

of

THE NATIONAL INDUSTRIAL TRANSPORTATION LEAGUE

The National Industrial Transportation League is pleased to comment on the methodology to be employed in determining the railroad industry's cost of capital. The calculation of this figure affects some of the most basic components of the Board's responsibility, and a correct determination is critical for the Board to achieve its Congressional mandate.

The League strongly supports the Board's proposal. While the nation's financial markets have been indicating that the industry's financial position was becoming stronger and that several carriers were achieving or close to achieving returns at their cost of capital, the results of the Board's methodology portrays an industry that is in ill-health and financially stagnant. In fact, the Board's most recent cost of capital determination showed that a number of carriers were further from achieving revenue adequacy in 2005 than they had been in previous years.

The League believes that the Board has made a careful and thorough review of both the techniques used by other federal agencies as well as the academic literature, in coming to its

conclusion that the DCF model should be abandoned and that the CAPM procedures should be adopted. Reliance on the analyses performed by the Federal Reserve Board is very sound.

The Board's CAPM proposal appears to much more closely mirror the judgment of the nation's financial community with respect to the financial health of the nation's rail carriers. Although only the Norfolk Southern was deemed to be "revenue adequate" under the Board's current procedures in 2005, under the proposed procedures the Norfolk Southern, BNSF, CN and CP would all have been deemed "revenue adequate in that year. These are the very same carriers that many observers in the financial industry have identified as particularly sound financially.

The comments in this proceeding show that the Board is clearly justified in adopting the CAPM methodology to replace the DCF methodology. In fact, Congress expected that the Board would periodically have to update its methodology, and ordered the Board to do so: Section 10704(a)(2) states that the Board shall maintain "and revise as necessary standards and procedures for establishing" adequate revenue levels for rail carriers.

The comments in this proceeding indicate that there is wide agreement on the need for change, and even agreement on some of the elements of the Board's CAPM proposal. For example, the Norfolk Southern notes that CAPM is not an unreasonable choice, and in fact looks at its own cost of capital from a CAPM perspective. AAR witness Hubbard states that he well understands the STB's reluctance to continue its use a single-stage DCF model, and AAR witness Myers notes that CAPM is a "very useful" methodology that is widely used in practice by corporations that estimate or update their cost of capital."

In its Comments, the AAR argues that the Board should consider a "range" of estimates of the cost of equity, and adopt a point estimate for each year within the middle to upper portion

of that range. But such an approach would enmesh the Board in continuing disputes both as to the extent of the range and as to where within the range the Board should prescribe the cost of equity. Twenty-five years ago, the Board rejected an approach that developed a range of numbers for determining revenue adequacy. There is no principled way of determining just where in the "range" the cost of equity should be set.

Moreover, the Board should not "shade" its cost of capital determination to achieve a particular result. While factors such as the need for funds for expanded future investment may be appropriate for policymakers to consider in other settings, the Board's determination of the industry's cost of capital should be neutral, particularly in view of the wide use made of the cost of capital figure in a variety of regulatory settings.

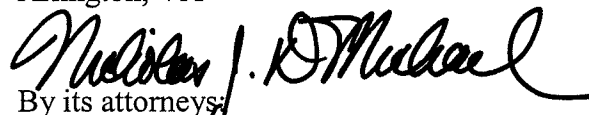
Finally, the League believes that the Board's key technical choices regarding CAPM are sound and supported by the Comments submitted in this proceeding. The AAR's major disagreement with the Board's approach appears to be in the calculation of the market risk premium. The Board has used a market risk premium of 5.2 percent for 2005, based upon data over a 50-year period. The AAR argues that the period is too short, an error that allegedly biases the value downward. However, an examination of the data provided by the AAR's own experts indicates equity risk premiums have been dropping consistently for the last twenty five years. Extension of the equity risk premium period all the way back to 1926 would encompass very different financial conditions than those that exist today, including one-time events as the Great Depression and World War II. It is significant that KCS' witness, from the Investment Banking Group at Morgan Stanley, calculated the current cost of capital for KCS using a market risk premium of only 4.0 percent, or well below the Board's market risk premium of 5.2 percent.

Finally, the League believes that the Board should reject the use of replacement cost to determine the investment base. Use of replacement cost would enmesh the Board in a large number of extremely difficult judgments, including: how to determine what existing investment would actually be replaced; how to calculate the cost of replacing the investment that would be replaced; how to calculate the use of existing investment for less intensive uses; how to calculate the real cost of capital; etc. The Board's use of the existing investment base is sound.

The League appreciates this opportunity to present its views to the Board.

Respectfully submitted,

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A handwritten signature in black ink, appearing to read "Nicholas J. DiMichael".

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Dated: November 27, 2007