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BY ELECTRONIC FILING

The Honorable Vernon A. Williams
Secretary
Attn: STB Ex Parte No. 664
Surface Transportation Board
1925 K Street, N.W.
Washington, D.C. 20423

Re. Ex Parte No. 664, Methodology to be Employed in
Determining the Railroad Industry's Cost of Capital

Dear Secretary Williams:

Enclosed are copies of the powerpoint slides that the Western Coal Traffic League witnesses used at the public hearing held yesterday in the above-captioned proceeding.

Undersigned counsel has corrected a typographic error in his slide addressing the "Adjustment of AAR's 2005 Electric Utility COE to Reflect Railroad Leverage." The slide as shown and discussed yesterday stated that the AAR had calculated an average electric utility ROE for 2005 of 10.75%. The correct value, as shown on the attached slide, is 10.54%. However, all the calculations reflected the correct 10.54% figure. In other words, as stated yesterday, the 10.54% value corresponds to 8.47% if the capital structure is revised to reflect that of the railroads in 2005. The undersigned apologizes for any confusion or misunderstanding.

Please advise the undersigned if there are any questions concerning this matter.

Sincerely,



Robert D. Rosenberg
An Attorney for the
Western Coal Traffic League

Enclosures
RDR:rlh

STB Ex Parte No. 664

**METHODOLOGY TO BE EMPLOYED IN
DETERMINING**

THE RAILROAD INDUSTRY'S COST OF CAPITAL

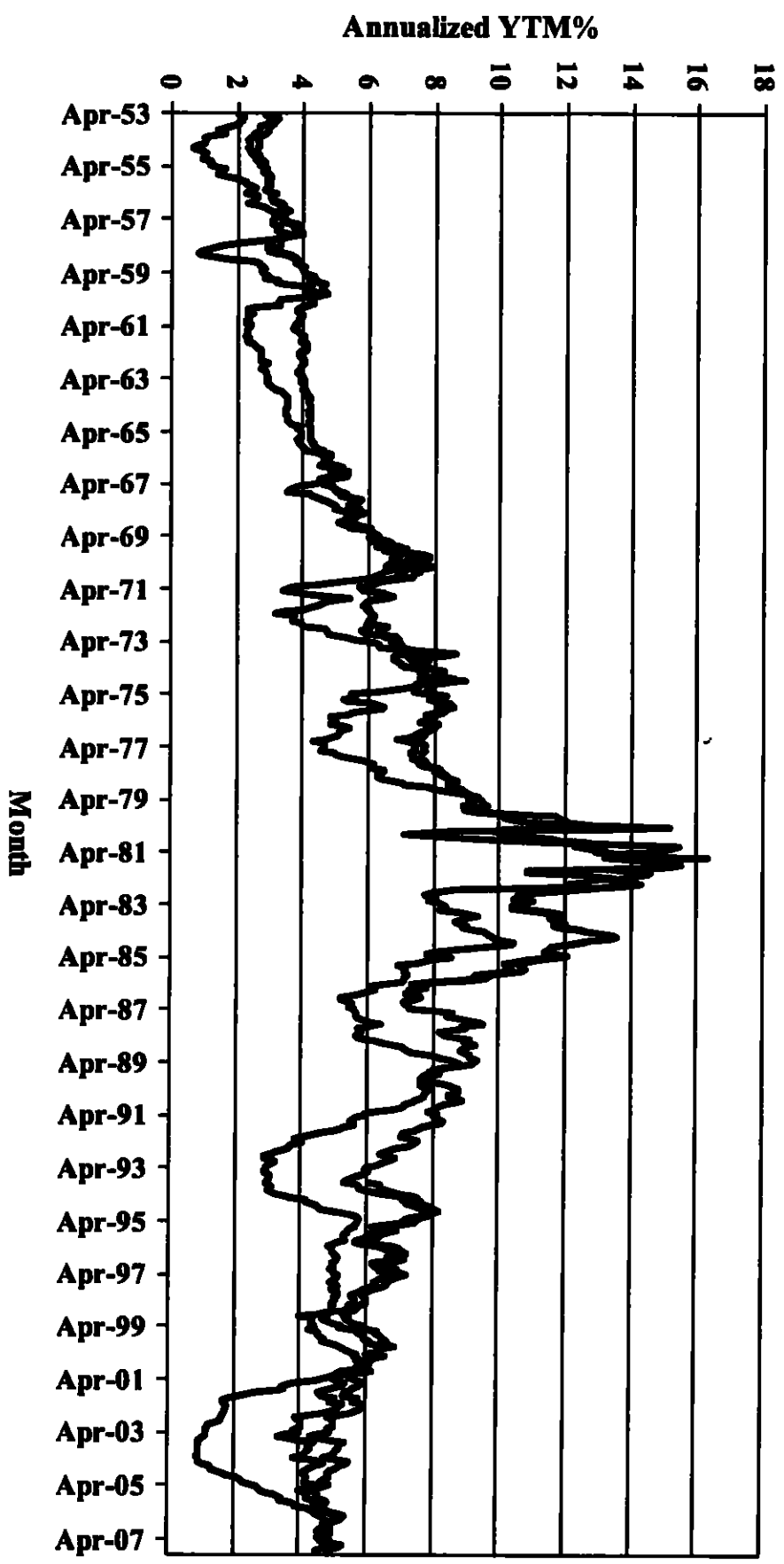
**Presented
By**

**James E. Hodder
and
Thomas D. Crowley**

December 4, 2007

Risk-Free Rate

Annualized Yields to Maturity On T-Bills and T-Bonds
(April 1953 to July 2007)



Source: Saint Louis Federal Reserve. The Treasury did not issue 20-Year Bonds from January 1, 1987 to October 1, 1993.

Market Wide Risk Premium

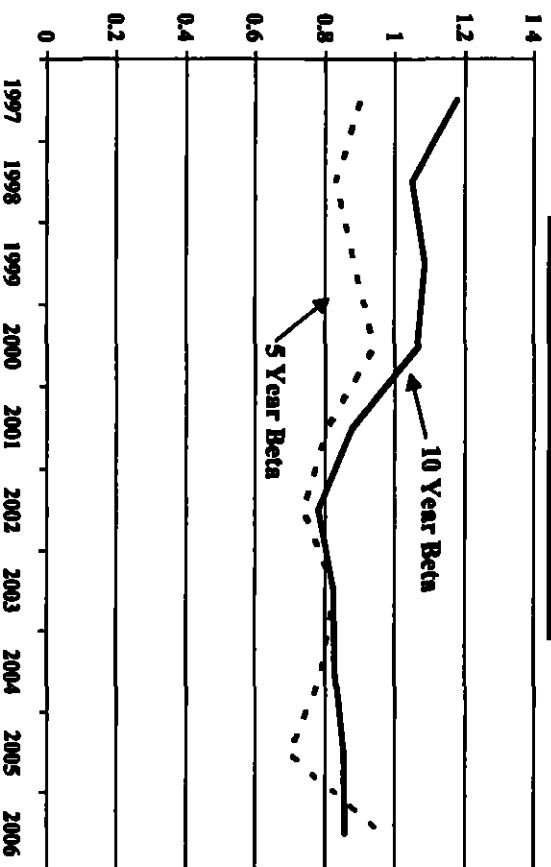
• AAR/ Hubbard & Stangle/ Ibbotson	7.1%	81 Years
• AAR/Myers/Dimson, Marsh & Staunton	6.6%	106 Years
• STB	5.2%	50 Years
• KCS/ Ward/ Morgan Stanley	4.0%	Prospective
• Welch Survey Results <u>1/</u>	7.1% and 5.5%	Prospective
• Welch Personal Perspective <u>1/</u>	2.0% to 3.0%	Prospective
• Fama and French	2.6% to 5.3%	Prospective
• Dimson, Marsh & Staunton with T-Bills	5.0%	Prospective
• Dimson, Marsh & Staunton with T-Bonds <u>2/</u>	3.8%	Prospective
• Graham and Harvey	2.4% to 4.7%	Prospective
• Brealey, Myers & Allen with T-Bills	5.0% to 8.0%	Prospective
• Brealey, Myers & Allen with T-Bonds <u>2/</u>	3.8% to 6.8%	Prospective

1/ Welch's 1998 and 2001 surveys of financial economists Dr Welch indicated he personally believed the premium to be 2.0% to 3.0%

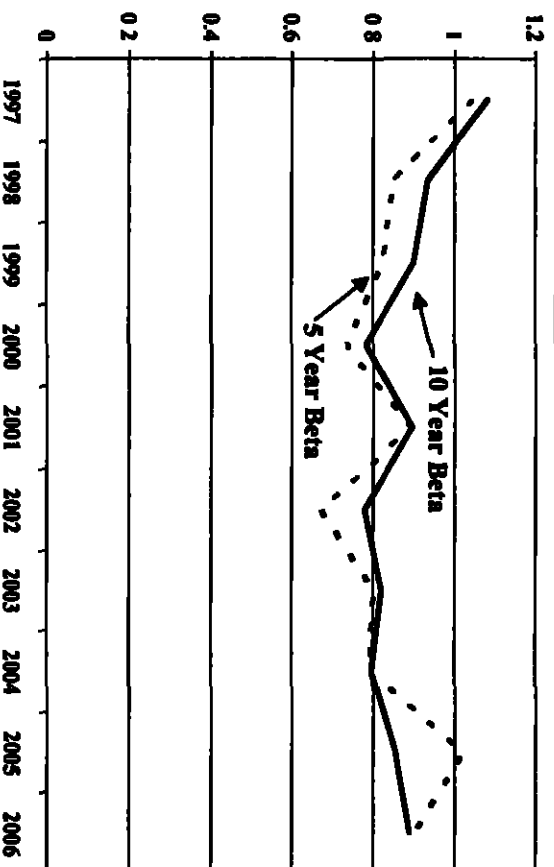
2/ Risk premium based on T-Bills adjusted by a 1.2% average difference in returns between T-Bills and Government Bonds as measured by Dimson, Marsh and Staunton and cited by Brealey, Myers and Allen

Beta Estimates

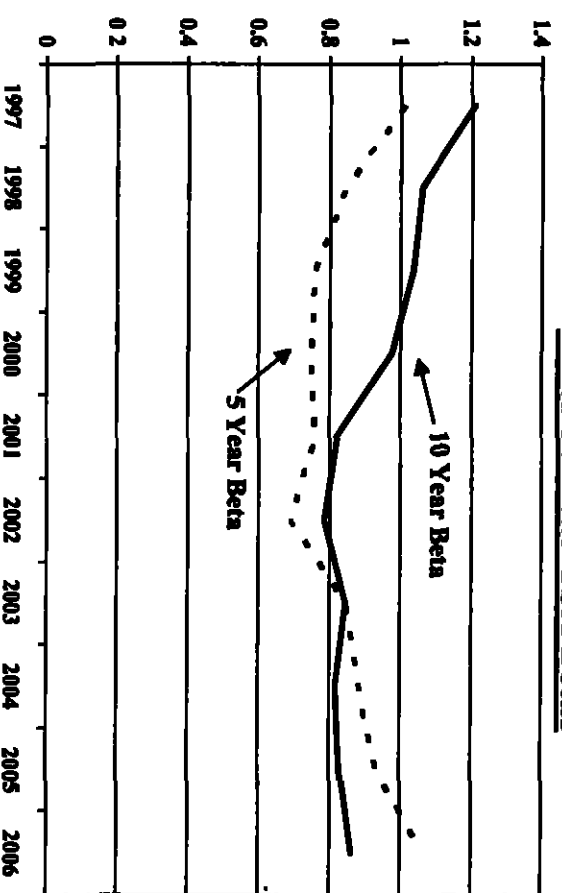
5 and 10 Year BNSF Betas



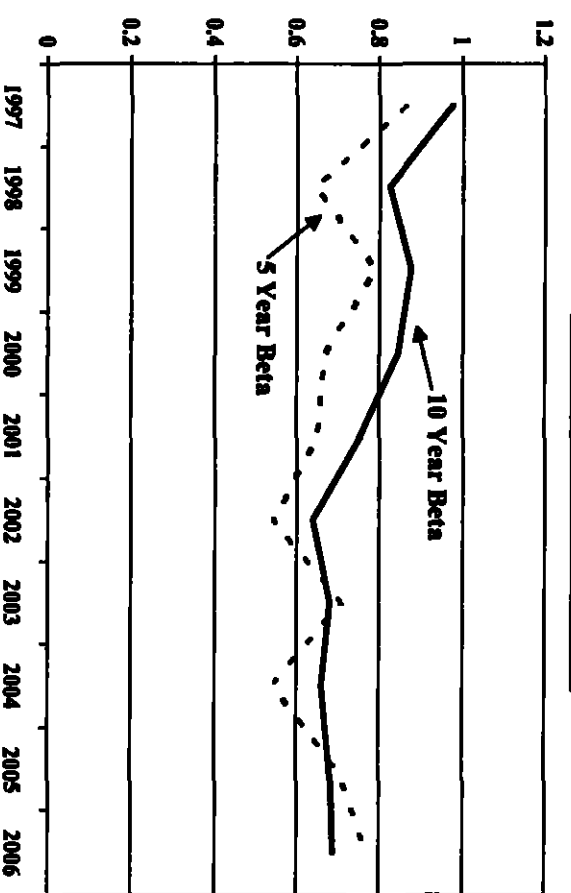
5 and 10 Year NS Betas



5 and 10 Year CSX Betas

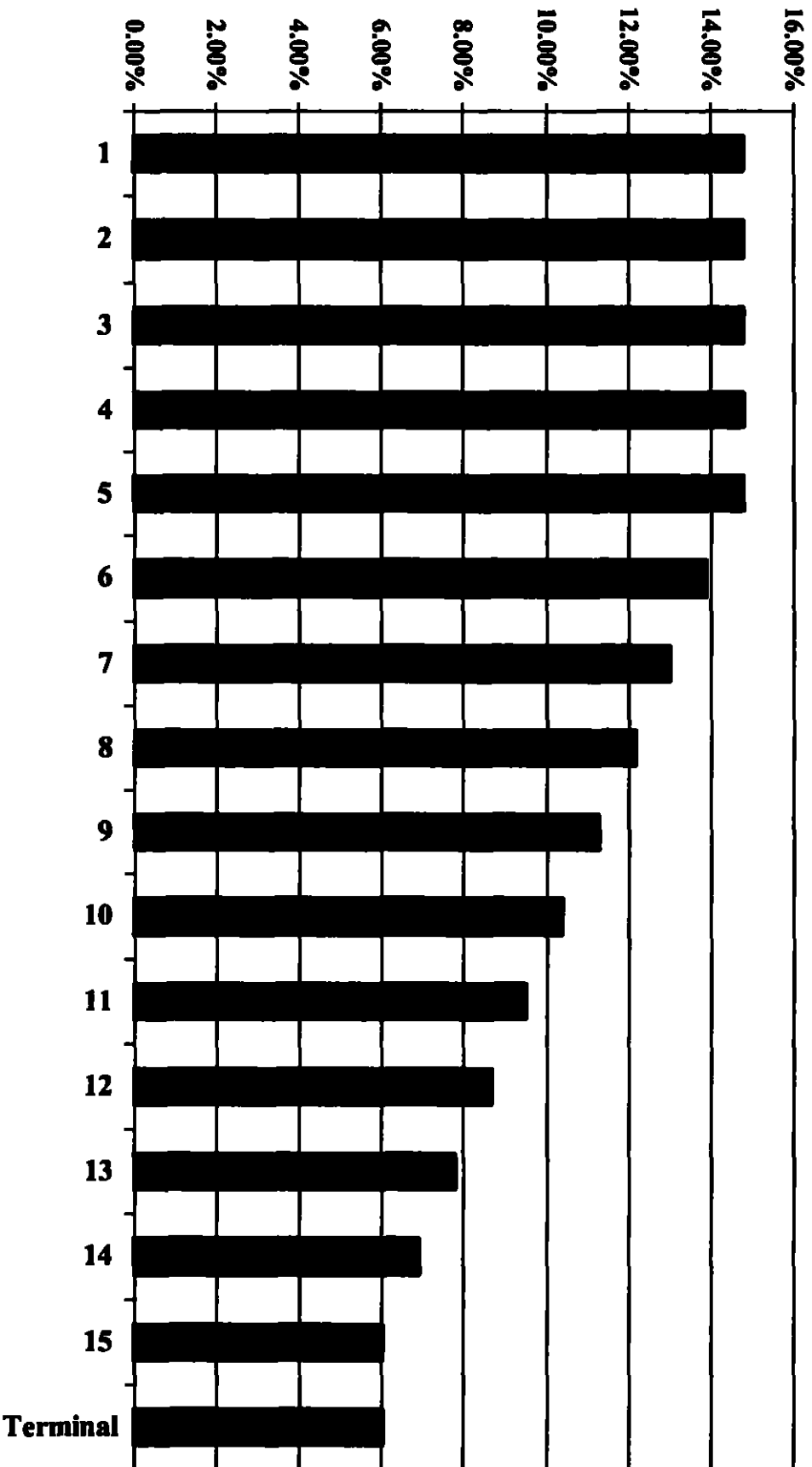


5 and 10 Year UP Betas



Multi-Stage DCF Model

Annual Dividend Growth Rates Assuming A 10 Year Phase-In Period
(Based on 2006 Truncated IBES Data and a 6% Long-Term Growth Factor)



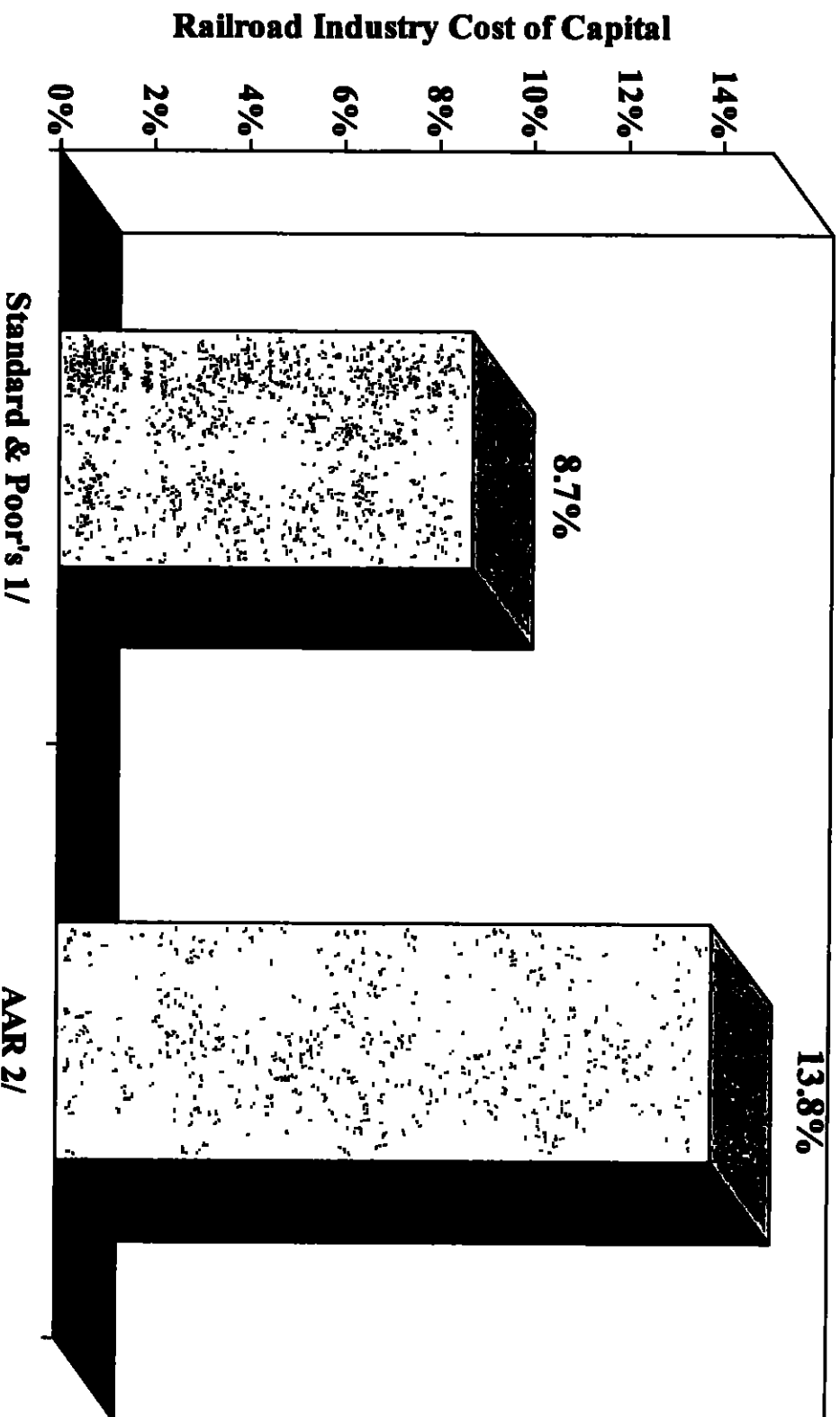
Average of Multi-Stage DCF and CAPM Results

Estimates of the Railroad Industry Cost of Equity

		Multi-Stage DCF	STB CAPM
		Railroad Industry	Railroad Industry
<u>Year</u>	<u>Cost of Equity</u>	<u>Cost of Equity</u>	<u>Cost of Equity</u>
(1)	(2)	(3)	
1. 1997	9.4%	11.9%	
2. 1998	8.9%	10.2%	
3. 1999	9.0%	10.7%	
4. 2000	10.6%	10.7%	
5. 2001	8.6%	9.2%	
6. 2002	8.2%	8.3%	
7. 2003	8.6%	8.0%	
8. 2004	8.7%	8.2%	
9. 2005	8.8%	8.4%	
10. 2006	8.7%	9.0%	

Departure From Established Standards

Estimates Of The 2006 Railroad Industry Cost of Capital



1/ Weighted average of railroad company costs of capital as reported in Standard & Poor's Stock Reports

2/ AAR filing in Ex Parte No. 558 (Sub-No. 10), Railroad Cost of Capital – 2006

Adjustment of AAR's 2005 Electric Utility COE to Reflect Railroad Leverage

1. AAR Derives 2005 Electric Utility COE of 10.75%, reflecting Equity/Cap Ratio of 46.73%
2. Using the STB's proposed 4.251% risk free rate and 5.2% equity risk premium, the implied levered beta is 1.2094: $\text{COE} = \text{Risk-free rate} + (\text{levered beta}) (\text{Equity Risk Premium}) = 4.251\% + (1.2094 \times 5.2\%) = 10.75\%$
3. The 1.2094 levered beta corresponds to an unlevered beta of 0.5652, derived as follows:
 - a. Levered beta = $(1 + D/E)$ times unlevered beta
 - b. Equity is 46.73% of total cap, so debt is 53.27%, and D/E is $53.27\% / 46.73\%$ or 1.14
 - c. $1.2904 = 2.14$ times unlevered beta, so unlevered beta equals $1.2904 / 2.14$ or 0.5652
4. Applying the railroads' capital structure, the resulting COE for the electric utilities is 8.47%, equivalent to what the STB calculated as the railroad COE for 2005. The derivation is as follows:
 - a. Railroad capital structure is 30.4% debt and 69.6% equity, and so D/E is 0.4368
 - b. Levered beta = $(1 + D/E)$ times unlevered beta = $(1 + 0.4368)$ times 0.5652 = 0.8121
 - c. $\text{COE} = \text{risk-free rate} + (\text{Levered beta}) (\text{ERP}) = 4.251\% + (0.8121 \times 5.2\%) = 8.47\%$