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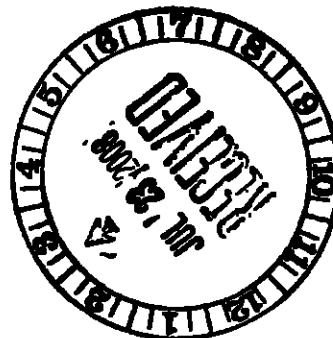
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July 23, 2008

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By Courier

Vernon A Williams
Secretary
Surface Transportation Board
395 E Street, S W
Washington, D C 20005



Re STB Ex Parte No 558 (Sub-No 11),
Railroad Cost of Capital – 2007

Dear Secretary Williams

Pursuant to the Decision released on April 23, 2008, in the above-referenced proceeding, please find enclosed for filing an original and ten (10) copies of the Rebuttal Comments of the Association of American Railroads and Its Member Railroads.

If you have any questions, please contact the undersigned counsel

Sincerely,

Richard E Young

*Counsel for the Association of
American Railroads and Member Railroads*

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Enclosures

cc All parties on service list

July 23, 2008

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

RAILROAD COST OF
CAPITAL — 2007

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) Ex Parte No. 558 (Sub- No 11)
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**REBUTTAL COMMENTS OF THE ASSOCIATION OF AMERICAN
RAILROADS
AND ITS MEMBER RAILROADS**

By order served April 23, 2008, the Board instituted this proceeding to determine the railroad industry's cost of capital for the year 2007. In its order, the Board directed that "[c]omments should focus on the various cost of capital components using the same methodology followed in *Cost 06*."¹ Ex Parte No. 558 (Sub-No 11), *Railroad Cost of Capital – 2007*, Decision released April 23, 2008, at 2 ("April 23 Order")

On May 22, 2008, in response to the April 23 Order, the railroads, through the Association of American Railroads ("AAR"), submitted their calculation of the 2007 cost of capital using the same methodology followed in *Cost 06*. The AAR calculated the railroads' overall cost of capital for 2007 at 11.33 percent, including a cost of common equity of 12.68 percent and a cost of debt of 6.17 percent.

Only two parties filed reply comments in this proceeding: (1) the Western Coal Traffic League ("WCTL"), and (2) The People of The State of California and the

¹ Ex Parte No. 558 (Sub-No 10), *Railroad Cost of Capital—2006* (served April 15, 2008) ("*Cost 06*")

California Public Utilities Commission ("CPUC") In these Rebuttal Comments, the AAR responds to the issues raised by those parties For the reasons stated herein, the criticisms of the AAR's calculations by the WCTL and the CPUC are without merit and should be rejected

The only issue in this proceeding is whether the AAR has properly implemented the Board's existing rules and methodology for determining the cost of capital Plainly, the AAR has done so The changes that the WCTL and CPUC advocate are substantively without merit Indeed, the Board has already considered and rejected the CPUC's proposed change in the Ex Parte No 664 proceeding (in which the CPUC chose not to participate), and should not revisit it here

There is similarly no merit in the WCTL's alternative request that the Board treat its reply comments as a petition for rulemaking in Ex Parte No 664 *See* WCTL Reply at 8 n.9. The WCTL's various arguments and evidence provide no justification for instituting a rulemaking proceeding Rather than devote its time and resources (and those of the parties) to another rulemaking, the Board should simply reject the WCTL's proposed changes

Finally, even leaving aside their lack of substantive merit, the arguments raised by both the WCTL and the CPUC are procedurally improper in this proceeding Although they purport only to be "correcting" or criticizing the AAR's methodology, in reality the WCTL and the CPUC are proposing that the Board adopt new methods for calculating certain components of the cost of capital In its January 2008 decision in Ex Parte No 664, however, the Board made clear that such proposals are not proper in the annual cost of capital calculation proceedings Specifically, the Board stated that although it was

willing to entertain petitions in the future for modifications of the Capital Asset Pricing Model ("CAPM") that it was adopting, it would *only* do so in an Ex Parte No 664 sub-numbered proceeding.

Recent experience has shown that the most useful way for the agency to review such petitions – while also completing our annual cost-of-capital determinations in a timely fashion – is to maintain separate proceedings one (STB Ex Parte No 558 sub-numbered proceedings "558 proceedings") for the annual estimate and another (STB Ex Parte No 664 sub-numbered proceedings "664 proceedings") for petitions to advocate changes to the cost-of-capital model. Use of 664 proceedings will enable all stakeholders to have a meaningful opportunity to comment on any proposed changes to the CAPM methodology we are adopting here. In contrast, *the annual 558 proceedings are best suited to a mechanical application of the standards adopted here, rather than to debate about changes in the standards, which can lead to protracted litigation that will delay the release of a cost-of-capital figure for a wide variety of regulatory functions. While in the past we have entertained challenges to the agency's model in the 558 proceedings, we will no longer do so. As such, future requests to change the assumptions that form the elements of our CAPM model must be brought (in the form of a petition for rulemaking) in a 664 proceeding, not in the annual 558 proceedings, in which we calculate the cost of capital for a particular year*²

The Board reiterated this policy in its April 23 Order, which required the parties to use the same methodology followed in *Cost 06* – which, of course, was the CAPM methodology adopted in the *Ex Parte No 664 Decision*. See April 23 Order at 2

Because the WCTL and the CPUC are advocating precisely the types of changes that, under the *Ex Parte No 664 Decision*, the Board will not consider in a 558 proceeding, their arguments should be rejected

² See Ex Parte No 664, *Methodology To Be Employed in Determining the Railroad Industry's Cost of Capital*, Decision released January 17, 2008 ("*Ex Parte No 664 Decision*"), at 18 (emphasis added)

ARGUMENT

I. THE WCTL'S CRITICISMS OF THE AAR'S CALCULATIONS ARE SUBSTANTIVELY WITHOUT MERIT AND PROCEDURALLY IMPROPER.

In its Reply Comments, the WCTL takes issue with AAR's calculations in two areas (1) the Beta calculation used in the CAPM, and (2) the calculation of flotation costs for debt. See Reply Comments of the WCTL ("WCTL Reply"), at 2. The WCTL proposes to use what it terms a "narrow and very technical refinement" to the Beta calculation methodology employed by the Board and the parties in *Cost 06*. *Id.* at 7. Yet the WCTL acknowledges, as it must, that its disagreement with AAR on the Beta calculation "has a significant impact", if adopted, the WCTL's proposed change would reduce the railroads' 2007 cost of equity from 12.68 percent to 11.7 percent. *Id.* at 2. With respect to flotation costs, the WCTL proposes a "minor" adjustment that would reduce the railroads' 2007 cost of debt from 6.17 percent to 6.15 percent. *Id.* at 2-3. If they were both adopted by the Board, the WCTL's two proposed "corrections" would reduce the 2007 railroad cost of capital calculation from the 11.33 percent calculated by the AAR to 10.55 percent. *Id.* at 3.

The Board should reject the WCTL's proposed "corrections." In addition, the WCTL's proposed methodology change regarding Beta is based on a flawed premise and simply represents an attempt to preserve the use of 2002 data for the purpose of reducing the Beta calculation. With respect to its second proposal, the WCTL's current criticism of the AAR's method of calculating flotation costs is inconsistent with its failure to challenge the very same method when the AAR used it in Ex Parte No. 558 (Sub-No. 10) to calculate such costs for 2006. In any event, the changes advocated by WCTL are procedurally improper in this proceeding.

A. The Beta Calculation Issue

The WCTL's attempt to seek a change in the methodology used to calculate Beta is both substantively wrong and self-serving. The WCTL contends that adoption of its proposed methodology for calculating Beta is necessary because the current methodology only provides a "snapshot" of the Beta value at the end of 2007, rather than an "average" Beta value for all of 2007. *See* WCTL Reply at 4-7. The WCTL's criticism of the current methodology is misplaced, because it is based on a predicate that is factually wrong. Contrary to the WCTL's assertion, the current Beta value calculated by the AAR under the Board's rules is not a mere "end-of-year snapshot" based on the last week or the last day of 2007. *See id.* at 6. That Beta value is based on 260 market data observations (*i.e.*, the five most current years of weekly market data). Because its premise is therefore erroneous, the WCTL's proposal must necessarily fail.

In its *Ex Parte No. 664 Decision*, the Board determined "to calculate the beta for the railroad industry [using] a portfolio of weekly, merger-adjusted stock return data for the prior five years" in its regression equation. *Ex Parte No. 664 Decision* at 11. In adopting a five-year estimation period for the Beta calculation (instead of the ten-year period originally proposed), the Board found that "using weekly data [instead of monthly data] can address our concern over statistical noise, and that a five-year period is more common and *will provide a more forward-looking estimate that will better and more quickly reflect the changing nature of the rail industry*." *Id.* at 10 (emphasis added).

Accordingly, under the CAPM methodology adopted by the Board in *Ex Parte No. 664* and used in *Cost 06*, Beta is calculated based upon 5 years of market return data.

(the current year plus the four prior years on a 5-year rolling basis)³ The five-year market return data is then inputted into the standard regression equation established by the Board to determine the Beta value for this five-year period. *See Cost 06* at 7, 14-15. To update the Beta calculation under the Board's methodology for each subsequent annual cost of capital proceeding, "[52 weeks] of new market data would be added to the data set and the oldest [52 weeks] of observations would be removed."⁴

This is exactly the approach that the AAR followed in this proceeding. To calculate Beta, the AAR added 52 weeks of new market data to the data set (*id.*, 2007) and dropped the oldest 52 weeks of market data (*id.*, 2002) to calculate the five-year market data input (2003-2007) into the regression equation.⁵ The resulting Beta calculation thus includes five years of data (reflecting 260 weekly observations of market return data for the latest rolling 5-year period 2003-2007) under the 5-year timeframe established by the Board in *Ex Parte No. 664*. In other words, the AAR's Beta calculation method uses a data set that includes all 52 weeks of 2007, plus four more years of weekly data, for a total of 260 observations. This approach provides the "more forward-looking estimate" that "will better and more quickly reflect the changing nature of the rail industry," as the Board required in its *Ex Parte No. 664 Decision*.

³ In its January 17, 2008 decision instituting the *Ex Parte No. 558* (Sub-No. 10) proceeding, the Board directed that "Parties will calculate beta using a portfolio of weekly, merger-adjusted railroad stock returns for the prior 5 years." Decision released January 17, 2008, in *Ex Parte No. 558* (Sub-No. 10), at 2.

⁴ *See Ex Parte No. 664, Methodology To Be Employed In Determining the Railroad Industry's Cost of Capital*. Decision served August 20, 2007, at 10-11.

⁵ *See, e.g.*, Comments of AAR submitted May 22, 2008, in *Ex Parte No. 558* (Sub-No. 11), Verified Statement of John T. Gray, at 25 ("2008 Gray V S") ("The raw regression data used in the AAR calculation [of Beta] consists of weekly observations from the first week of 2003 through the last week of 2007").

In view of the patently erroneous premise of its position, it is apparent that the WCTL is asking the Board to change the methodology for calculating Beta. In fact, the WCTL specifically acknowledges that the methodology employed by the AAR in this proceeding was used by "both the Board and the parties" in *Cost 06*. WCTL Reply at 5.⁶ The WCTL seeks to sidestep this reality by describing its proposal as "a narrow and very technical refinement in how CAPM is applied." WCTL Reply at 7. Even a cursory examination of the WCTL's proposal, however, shows that the "refinement" proposed by the WCTL would significantly affect the method of calculating Beta and, as the WCTL itself concedes, the cost of capital that the Board determines in this proceeding.

The WCTL's proposal seeks to retain the use of 2002 data for an additional year in this 2007 proceeding by requiring that: (1) Beta values for each of the weekly market observations for the year 2007 also be determined as part of the CAPM methodology under a regression analysis, and (2) each of these Beta values themselves also be based on a regression analysis using five prior years of data.⁷ Thus, although the Beta calculation in the instant proceeding is supposed to be predicated on five years of market

⁶ The WCTL attempts to explain away its failure to raise this issue in Ex Parte No. 558 (Sub-No. 10) by asserting that "there is no indication that there was any conscious decision to select an end-of-the-year instead of an average value for the year." WCTL Reply at 5-6. Leaving aside its erroneous characterization of the AAR's calculation of Beta as an "end-of-the-year Beta value," the WCTL's explanation is nonsense. The AAR calculated Beta for 2006 using the same approach that it used for 2007, and explained that approach in its submissions in Ex Parte No. 558 (Sub-No. 10). In the comments that it submitted last February in Ex Parte No. 558 (Sub-No. 10), the WCTL showed that it had closely reviewed the time period used in the AAR's Beta calculation, one of the WCTL's criticisms of that calculation was that the AAR had "start[ed] with a base that is outside of the five-year period from 2001-2005," effectively "includ[ing] an extra week in [the] analysis." Reply Statement of WCTL filed February 15, 2008, in Ex Parte No. 558 (Sub-No. 10), at 3. Given its scrutiny of the AAR's calculation, WCTL cannot plausibly argue that the "snapshot" issue somehow escaped its attention in February, but "came to light" only a few months later. Indeed, the WCTL acknowledges that it is making its proposal now because its proposal "would have made little difference for 2006", whereas there was a wide spread [difference] in 2007." WCTL Reply at 6.

⁷ Even though never mentioned in the text of the WCTL's proposal, the calculations in the exhibits attached to the testimony of WCTL's witnesses make clear that each weekly Beta value determination would itself be based on five years of data. See WCTL Reply, Crowley/Tapp V S, Exhs. 4-7.

data commencing in 2003, under the WCTL's proposed method the weekly Beta values calculated would include *six* years of data commencing in 2002.⁸ The 52 regression analyses performed for 2007 would then be averaged to get an "average beta value" for 2007 instead of the Beta calculation currently used (which the WCTL incorrectly terms the "end of the year snapshot") WCTL Reply at 5-7.

This is clearly a change in methodology. Rather than run a single regression analysis using the five most recent years of market data to calculate a single Beta value for the period 2003-2007 (as is provided for in the *Ex Parte No. 664 Decision*, and as was done in *Cost 06*), the WCTL would add two additional steps to the CAPM calculation. As previously indicated, the WCTL would (1) require an averaging of 52 regression analyses to arrive at a Beta value for the study year and (2) require the use of "market data" prior to the five-year period adopted by the Board for the study year.

The fact that the WCTL's proposal is a change in methodology is further evidenced by the "significant impact" that it would have on the final calculation of the cost of capital. See WCTL Reply at 2. As the WCTL acknowledges, its proposal would reduce the Beta to 0.963 from the 1.1025 calculated by the AAR, and would reduce a cost of equity from the AAR's figure of 12.68 percent to 11.70 percent. *Id.* Given this effect, WCTL's proposal is clearly not the "narrow and technical refinement" that it describes. *Id.* at 7. The WCTL tacitly concedes as much when it requests that the Board alternatively treat its comments as a petition for rulemaking. *Id.* 8 n. 9.

⁸ The WCTL's proposed methodology change would involve averaging 52 five-year Beta calculations. For example, Regression 1 would use week 1 of 2007 plus the prior 259 weeks for the 260-week data set, including 51 weeks of data from 2002. Regression 2 would use 2 weeks from 2007, plus the previous 258 weeks of data (including 50 weeks of data from 2002). Regression 3 would use 3 weeks of data from 2007 plus the previous 257 weeks of data (including 49 weeks from 2002). Only Regression 52 would include all 52 weeks of data from 2007, and no data from 2002, in the data set.

Given the lack of merit in its criticisms of the AAR's approach, and the substantial change that it proposes, the ulterior motive underlying the WCTL's proposed alternative is transparent. WCTL simply seeks to lower the value of Beta by incorporating data from 2002 (the year the "Tech Bubble" burst). Although the WCTL seeks to mask its motive by failing to mention the use of 2002 data at all in its reply comments, such use is made clear in the exhibits to the testimony of WCTL's witnesses Crowley and Fapp. *Compare id.* at 3-8 with Verified Statement of Thomas L. Crowley and Daniel L. Fapp ("Crowley/Fapp V S"), Exhs. 3-8.

The Board should not countenance such gamesmanship. The WCTL had ample opportunity to propose its alternative method of calculating Beta in the two public hearings and extensive rounds of comments which the Board ordered in the Ex Parte 664 rulemaking, but it failed to do so.⁹ That failure is particularly striking in view of the fact that in the Ex Parte No. 664 proceeding, the AAR's witnesses repeatedly referenced the 2002 Tech Bubble period as unrepresentative of historical and current railroad Beta values and specifically noted that the Beta value would change significantly after data from the Tech Bubble period were superseded by five years of more current data.¹⁰ The WCTL did not complain then, and the Board should not entertain its request for a change in this approach in the instant 558 proceeding.

⁹ The history of the Ex Parte 664 proceeding is set forth in the *Ex Parte No. 664 Decision*, at 1 ("we have held two public hearings and reviewed five rounds of written testimony and exhibits to explore this subject fully")

¹⁰ See written testimony of Stewart C. Myers on behalf of the AAR, filed in Ex Parte No. 664 on November 27, 2007, at 2, see also written testimony of R. Glenn Hubbard and Bruce E. Stangle filed in Ex Parte No. 664 on behalf of the AAR on October 29, 2007, at 6-7, written testimony of Stewart C. Myers on behalf of the AAR, filed in Ex Parte No. 664 on October 29, 2007, at 6-7.

B. The Flotation Cost Issue

The WCTL's proposed "correction" of the AAR's method of calculating flotation costs is equally flawed. The WCTL asserts that the "actual" interest rates for the debt instruments for 2007, rather than the rates "implicitly assumed" by the AAR, should be used in the calculation of flotation costs – and, therefore, that flotation costs and the cost of debt should be lower than those calculated by the AAR. WCTL Reply at 2, 8. However, like its proposed adjustment of the Beta calculation, the WCTL's proposed "correction" of flotation costs should be rejected.

The AAR's methodology for calculating flotation costs for 2007 was the same methodology that it used for calculating those costs for 2006 in the Ex Parte No. 558 (Sub-No. 10) proceeding.¹¹ In its *Cost 06* decision, the Board approved the AAR's calculation of flotation costs of 0.159% (rounded to 0.16%) as "reasonable." *Cost 06* at 5. That figure is precisely the same as the flotation costs calculated by the AAR for 2007. See WCTL Reply at 2.

The WCTL does not dispute that the AAR calculated flotation costs in accordance with the methodology established by the Board. The WCTL has not previously challenged the AAR's method of calculating flotation costs, and it offers no reason that would justify changing that method now. The Board should reject the proposed change out of hand.

¹¹ Compare 2008 Gray V S at 18-20 & App. I with Comments of AAR submitted June 25, 2007, Verified Statement of John T. Gray, at 25-27 & App. 27.

II. THE CPUC'S ARGUMENT THAT THE BOARD SHOULD ADOPT A LOWER "EQUITY RISK PREMIUM" IS WITHOUT MERIT.

The CPUC argues that the equity risk premium of 7.13 used by the AAR – which is the risk premium published by Ibbotson Associates – is “excessive” because it “overstates the actual return experienced by investors.” CPUC Comments at 2. Thus, the CPUC argues, the Board should “reduce the equity risk premium to levels consistent with the expectations of the financial community.” *Id.* Although the CPUC does not propose a specific alternative risk premium, it asserts that the Board should use a geometric mean (rather than the arithmetic mean reflected by the Ibbotson Associates figure), and cites the position of Professor Jay Ritter that “the equity risk premium is only 0.7%.” In round numbers, 1%.” *Id.* at 3-4.

The CPUC's position is without merit, and its attempt to propose an alternative equity risk premium at this juncture, and in this proceeding, is wholly inappropriate. The issue of what market risk premium should be used in the CAPM was extensively briefed and argued by the participating parties in *Ex Parte No. 664*. After reviewing the parties' arguments, the Board concluded that “basing the equity-risk premium on returns dating from 1926 is the superior and more standard approach,” and thus adopted the Morningstar/Ibbotson approach, rather than the approach of using the 50-year time period (and a 5.2% risk premium) originally proposed by the Board in its Notice of Proposed Rulemaking. *Ex Parte No. 664 Decision* at 8-9. The Board acknowledged that several parties had argued for a lower equity risk premium, but found that the approach of using data from 1926 was followed not only by Morningstar/Ibbotson, but also by “most commercial vendors of cost-of-capital information.” *Id.* Consistent with the Board's

decision, the AAR used Morningstar/Ibbotson data to calculate the risk premium for 2006 and 2007 – as the CPUC implicitly recognizes. See CPUC Comments at 1.

The CPUC's proposed alternative for calculating risk premium is illogical and contrary to economic reality. If, as the CPUC suggests, the market risk premium is only 0.7 percent to 1.0 percent, the cost of common equity is 5.68 to 6.01 percent.¹² These figures are obviously wrong. Even the higher cost-of-equity figure of 6.01 percent is approximately the same as the cost of railroad *debt* before flotation costs, as calculated by the AAR.¹³ The 6.01 percent figure also is less than 50 percent of the cost of common equity capital calculated by the AAR for 2007, and scarcely half of the cost of common equity capital determined by the Board for 2006.¹⁴ Finally, a risk premium of 0.7 to 1.0 percent is far lower than the 5.2 percent figure that the Board determined to be inadequate in the *Ex Parte No. 664 Decision*. For these reasons, the CPUC's proposal for a lower risk premium defies common sense, is patently unreliable, and should be rejected.

In any event, the CPUC is in no position to complain in this proceeding about the Board's decision to use the Morningstar/Ibbotson data as the risk premium. The CPUC does not dispute that the AAR correctly calculated the risk premium in accordance with the Board's *Ex Parte No. 664 Decision*. The CPUC had full opportunity to participate in the *Ex Parte No. 664* proceeding, but for whatever reason did not do so. Although the

¹² If a market risk premium of 0.7 percent is used, the cost of common equity using the Board's methodology is approximately 5.68 percent ($\text{CAPM} = \text{Risk Free Rate} + \text{Beta} (\text{Market Risk Premium}) = 4.91\% + 1.1025(0.7\%) = 5.68175\%$). If an equity risk premium of 1 percent is used, the calculation becomes approximately 6.01 percent ($4.91\% + 1.1025(1.0\%) = 6.0125\%$).

¹³ See 2008 Gray V.S. at 2, 20 (calculating 2007 cost of debt capital as 6.17 percent, including 0.159% in flotation costs).

¹⁴ See 2008 Gray V.S. at 2, 29 (calculating 2007 cost of common equity capital as 12.68 percent), *Cost 06* at 7 (determining 2006 cost of common equity to be 11.13 percent).

Board has stated that parties may petition for modification of its approach of using Morningstar/Ibbotson data, it has made clear that any such petitions may be submitted only in a 664 proceeding – not in an annual cost-of-capital calculation proceeding *Ex Parte No 664 Decision* at 9, 18

CONCLUSION

For the reasons stated herein and in the AAR's initial comments, the Board should determine that the railroads' cost of capital for 2007 is 11.33 percent

Respectfully submitted,

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and Member Railroads

July 23, 2008

CERTIFICATE OF SERVICE

I hereby certify that on this 23rd day of July, 2008, I served by first class mail, postage prepaid, a copy of the foregoing on the parties listed in the official service list in this proceeding



Richard Bryan