U.S. Department of Transportation
Office of the Secretary of Transportation

General Counsel

400 Seventh St., S.W.
Washington, D.C. 20590

November 26, 2007

Vernon A. Williams, Secretary
Surface Transportation Board
395 E Street, S.W.
Washington, D.C. 20423

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

Dear Secretary Williams:

Submitted herewith pursuant to the Decision served October 24, 2007, is the Written Testimony of the United States Department of Transportation for the public hearing in the above-referenced proceeding.

Respectfully,

Paul Samuel Smith

PAUL SAMUEL SMITH
Senior Trial Attorney

(202) 366-9280

Enclosure

**Before the**
**Surface Transportation Board**
**Washington, D.C.**

**Ex Parte No. 664**

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

## Hearing Statement of the United States Department of Transportation

This proceeding concerns an issue of substantial importance, for the cost of capital as estimated by the Board determines whether a railroad is "revenue adequate," and that in turn has direct implications for the rail rates that captive shippers pay and the investments that railroads make. Most forecasts indicate that freight rail investments will have to exceed current record levels to meet the freight demands in this country. This investment will only occur if railroads are expected to earn their cost of capital.

It is clear that there is a need to adopt a methodology that produces consistent and realistic estimates of the cost of capital. Such a methodology will reassure investors that the railroad industry is free to earn the revenues that will attract the funding required for much-needed capital investment. A consistent methodology will also assure that regulatory protections function properly to prevent captive shippers as a whole from paying more than they should. An unrealistically high estimate of the cost of capital skews regulatory oversight in favor of the carriers by unduly deferring rail pricing constraints. In contrast, an unrealistically low estimate favors shippers by prematurely triggering these restrictions.

Fortunately, if one considers the entire record -- and not just the result-oriented support or opposition for models that yield higher or lower estimates -- one finds a view broadly shared among both carrier and shipper representatives: that no single methodology has a monopoly on producing reasonable, real-world estimates. To the contrary, parties concur that different methodologies, employing sound inputs and assumptions, ought to produce cost of capital estimates within a fairly narrow range. That is as it should be, for assessments of the value of equity would not ordinarily be expected to vary appreciably. As DOT noted in its reply comments by gathering estimates submitted by different parties, the railroad industry cost of equity seems to range between 10% and 12%.

It is striking, then, that the Capital Asset Pricing Model (CAPM) proposed in the Notice of Proposed Rulemaking produced estimates not only so at variance with the current Discounted Cash Flow (DCF) methodology's recent results, but also so much lower even than those yielded by the models previously tendered by *any* party, whether shipper, railroad, or unaffiliated with either camp.

However, evidence provided by the WCTL and AAR demonstrates that even reputable financial firms with extensive knowledge of theory and the economy underlying the railroad industry can have disparities in their views to produce an estimate of the cost of equity. WCTL Reply Verified Statement of Crowley and Fapp at 13; AAR Verified Statement of Hubbard and Stangle at Exhibit 3a. Furthermore, in the past the ICC and the STB rejected the CAPM because it relied on too many assumptions, both theoretical and practical. These assumptions remain and account to a large extent for the differences in the record. DOT suggests that the inputs and assumptions used in the models considered or proposed by the STB be re-examined.

Unfortunately, years of research on the CAPM have not created a consistent set of assumptions. As a result, the Department also urges the Board to include other methodologies such as multi-stage DCF, in addition to the results obtained from CAPM.

Finally, DOT recommends that the STB address in greater detail the regulatory implications of revenue adequacy. This encompasses at least two related regulatory issues. The first is the amount of time that a railroad must be "revenue adequate" before restrictions on its pricing flexibility are imposed. The second is the nature and extent of these restrictions. Expectations of revenue adequacy for some carriers are near, and reducing the uncertainty of how captive rate regulation will be changed will reduce risk and lower the industry's cost of capital.