

Ex Parte No. 664
Railroad Cost of Capital

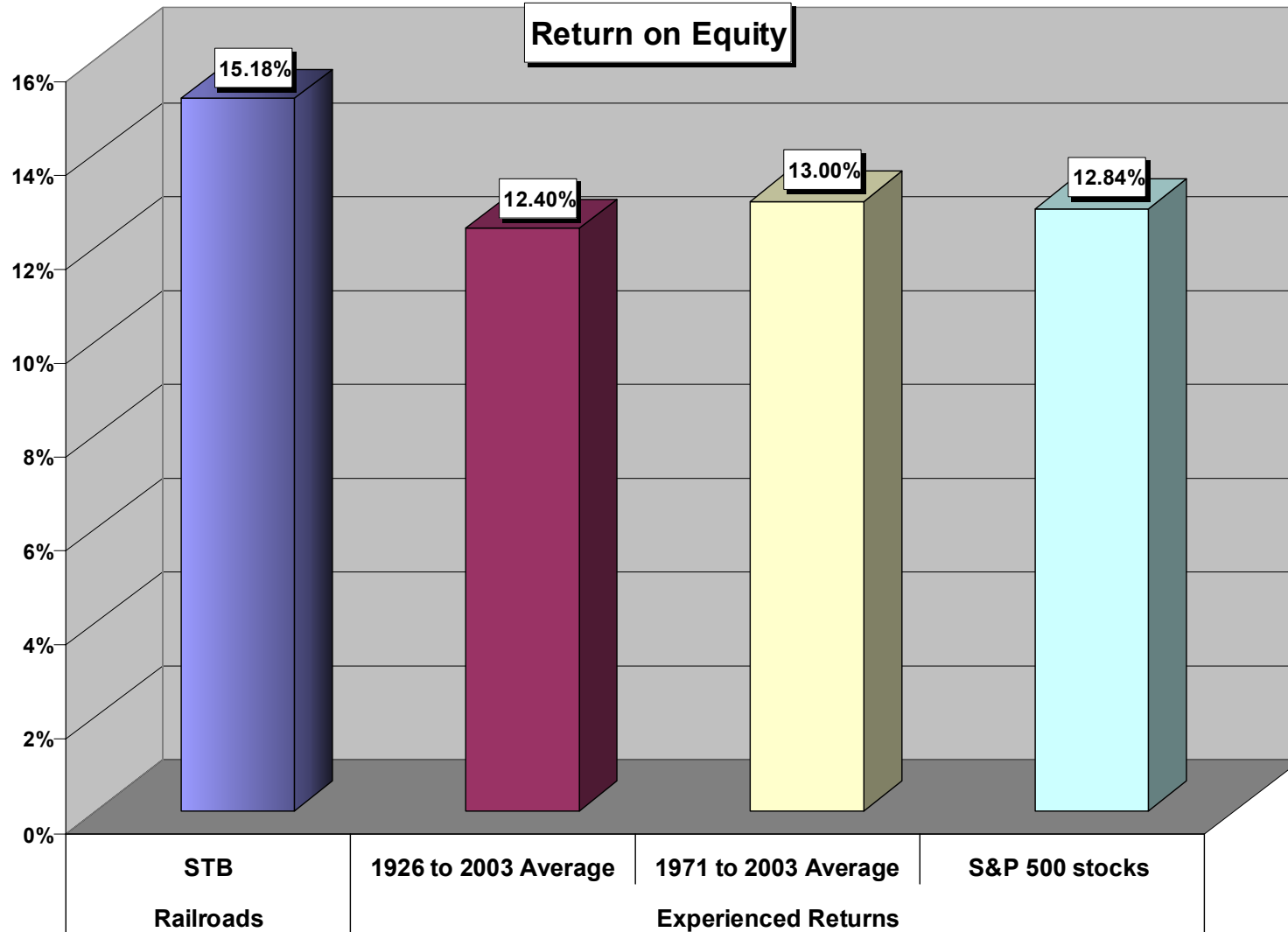
Charles W. King

Snavelly King Majoros O'Connor & Lee, Inc.

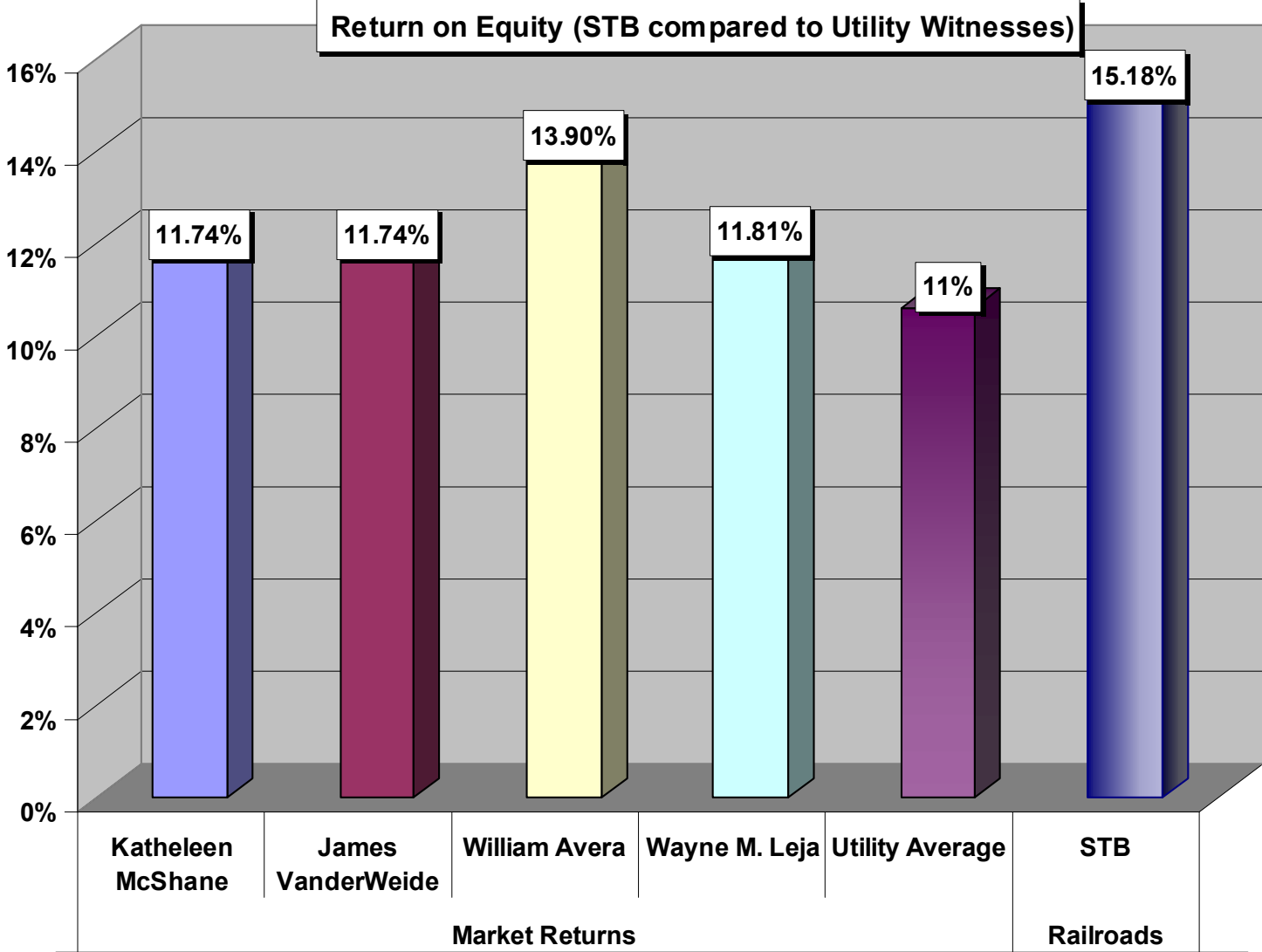
1111 14th Street NW, Washington DC 20005

February 15th, 2007

The 15.18% Return on Equity Found by the Board is Unrealistically and Unreasonably High



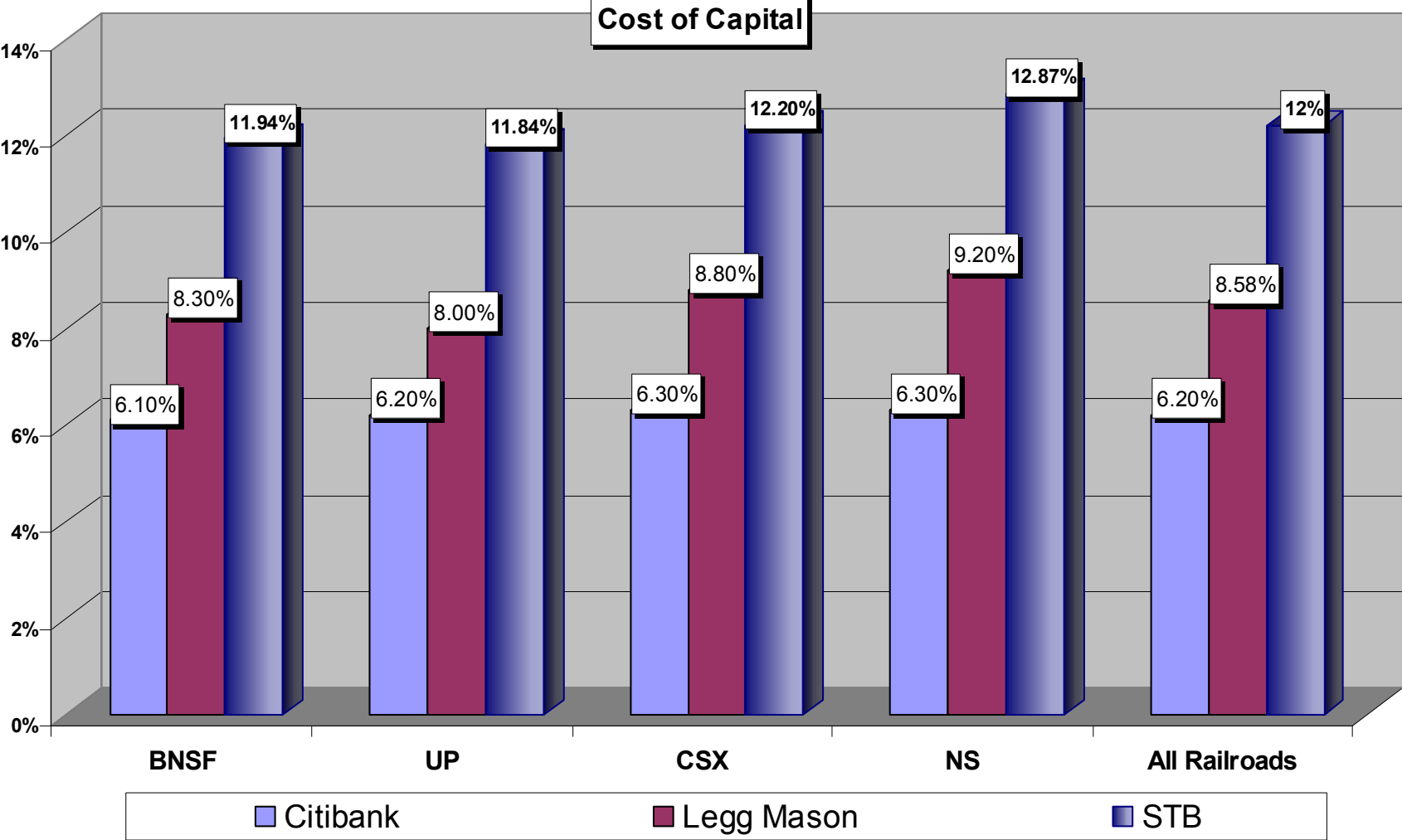
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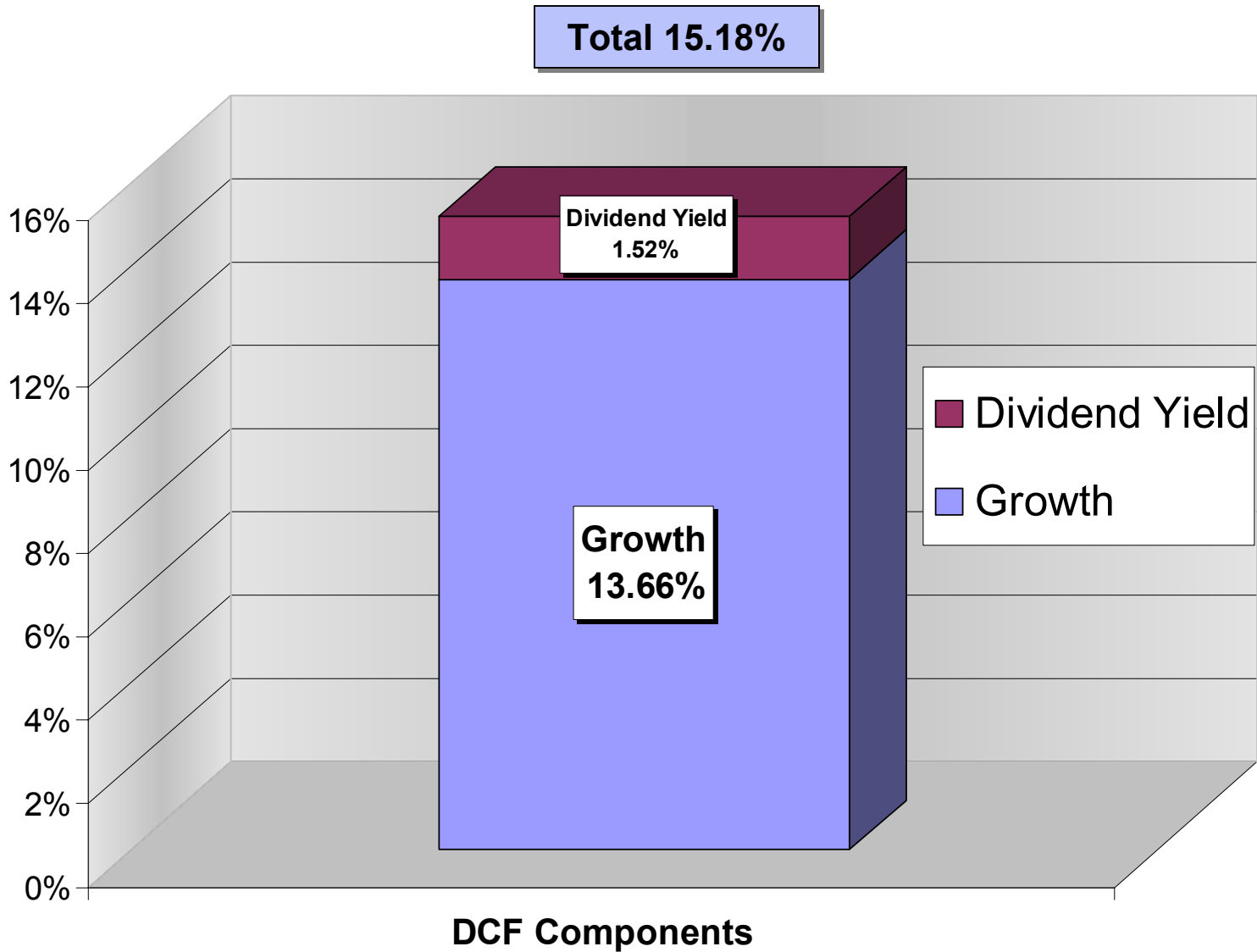
Beta and Safety

	Beta	Safety
BNSF	0.95	2.00
CSX	1.00	3.00
NS	1.05	3.00
UP	0.90	1.00
Average, 4 Railroads	0.98	2.25
All Stocks	1.00	3.00

The 12.2% Composite Cost of Capital Exceeds Estimates of the Railroads' Capital Costs Developed by Independent Investment Analysts



Discounted Cash Flow (DCF) Components



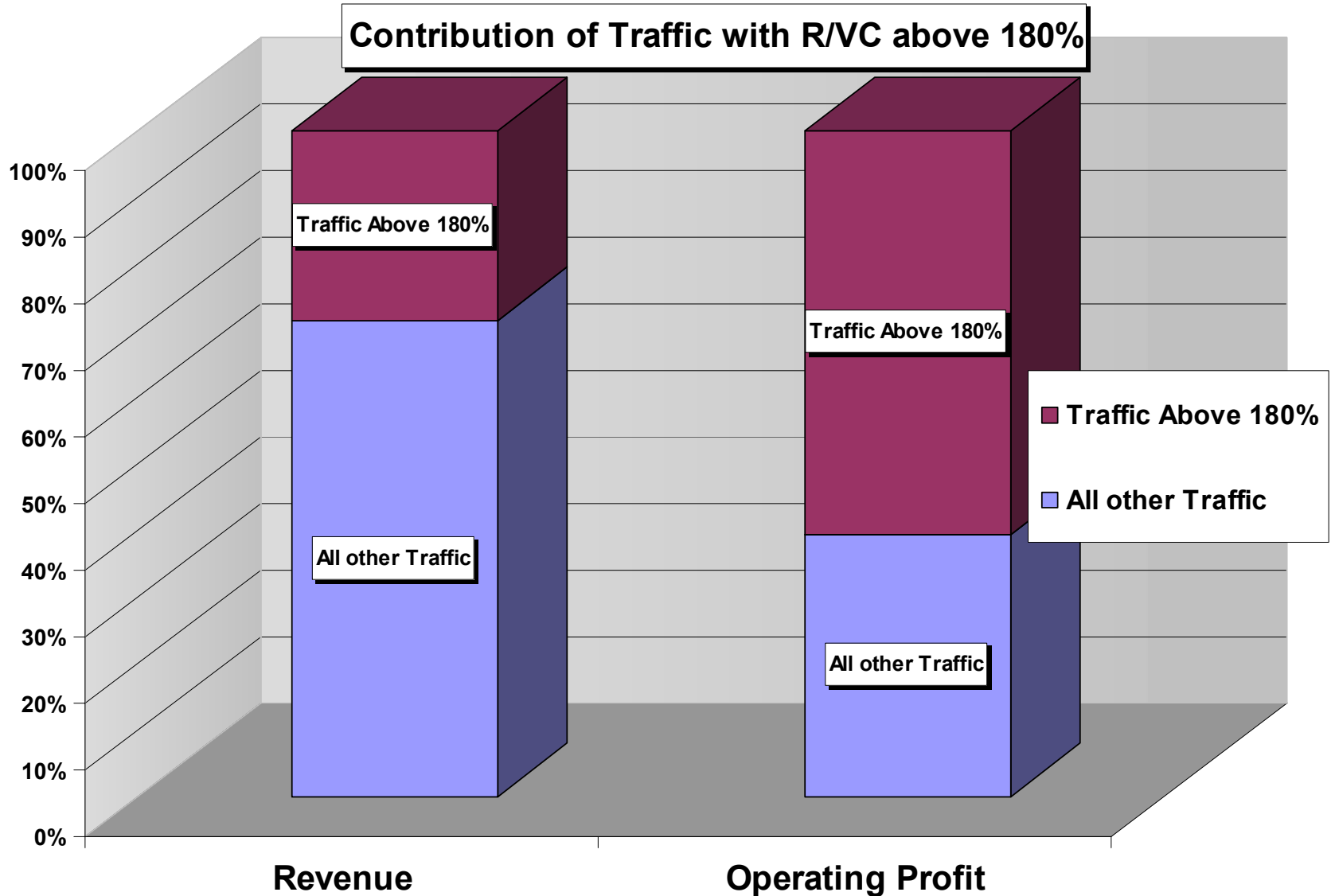
Reasons for high railroad earnings growth forecasts

- ❑ Motor carrier problems
- ❑ More “headroom” for price increases
- ❑ Growth in long-haul Intermodal
- ❑ Improved train scheduling
- ❑ Weak regulatory constraints

Federal Energy Regulatory Commission (FERC) Two-step Earnings Growth Formulation

Term	Rate	Weighting	Composite
Short-Term	13.66%	0.6667	9.11%
Long-term	4.50%	0.3333	1.50%
Total			10.61%

Contribution of Traffic with Revenue to Variable Cost Ratio (R/VC) Above 180%



Source: Snavelly King Estimates

Circularity Issues

Circularity Issues

- ❑ Weak regulatory constraints lead to:
 - ❑ High earnings forecasts
 - ❑ High market valuation

Both lead to high cost of capital estimates

Solution for Circularity

- ❑ Use FERC 2-step procedure

- ❑ Use book value, not market value

Recommendations and Results

- ❑ Continue to use the DCF formulation to determine the cost of capital for the railroads
 - ❑ Adopt the two step procedure used by FERC for identifying the growth factor in the DCF formula
 - ❑ Use the book value of debt and equity in determining the capital structures of the railroads
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❑ **Results for 2005:**

- ❑ **Equity Return 12.13%**
- ❑ **Total return 8.99%**

Snavely King Majoros O'Connor & Lee, Inc.

- ❑ Charles W. King. is President of the economic and management consulting firm of Snavely King Majoros O'Connor & Lee, Inc.
- ❑ Snavely King was founded by the late Carl M. Snavely, Jr. and Charles King in 1970 to conduct research on a consulting basis into the rates, revenues, costs and economic performance of regulated firms and industries.
- ❑ The firm has a professional staff of 12 economists, accountants, engineers and cost analysts. Most of its work involves the development, preparation and presentation of expert witness testimony before federal and state regulatory agencies.
- ❑ Mr. King has testified as an expert witness on economic and other issues in more than 300 proceedings in the US and Canada.
- ❑ In addition to this appearance before the STB, Mr. King has testified as an expert witness on cost of capital in 14 regulatory proceedings in nine states, since January 2000.