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BEFORE THE
SURFACE TRANSPORTATION BOARD

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| RAILROAD COST OF CAPITAL -- 2013 | ) ) | Ex Parte No. 558 (Sub-No. 17) |

**REPLY STATEMENT OF THE WESTERN COAL TRAFFIC LEAGUE**

WESTERN COAL TRAFFIC LEAGUE

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Dated: May 12, 2014

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Pursuant to the notice that the Surface Transportation Board ("STB" or "Board") served in the above-captioned proceeding on February 28, 2014, the Western Coal Traffic League ("WCTL" or "League")[1] submits its reply statement in response to the opening statement that the Association of American Railroads and its member railroads ("AAR" or "Railroads") filed on April 21, 2014.

The League has no technical disagreement with the AAR's mathematical calculations for the 2013 determination. However, the League has concerns regarding two matters: the relationship of the 2013 determination to the pending rulemaking proceeding in EP 664 (Sub-No. 2), and the inclusion of Kansas City Southern ("KSU") within the composite sample.

First, the determination of the railroad cost of capital for 2013 should be deferred or conditioned upon the outcome of the rulemaking proceeding in EP 664 (Sub-

[1] WCTL is a voluntary association, whose regular membership consists entirely of shippers of coal mined west of the Mississippi River that is transported by rail. WCTL members currently ship and receive in excess of 125 million tons of coal by rail each year. WCTL's members are: Ameren Energy Fuels and Services, Arizona Electric Power Cooperative, Inc., Austin Energy (City of Austin, Texas), CLECO Corporation, CPS Energy, Entergy Services, Inc., Kansas City Power & Light Company, Lower Colorado River Authority, MidAmerican Energy Company, Minnesota Power, Nebraska Public Power District, Omaha Public Power District, Texas Municipal Power Agency, Western Fuels Association, Inc., and Wisconsin Public Service Corporation.

No. 2), *Petition of the Western Coal Traffic League to Institute a Rulemaking Proceeding to Abolish the Use of the Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry's Cost of Capital*.

The League filed its petition for the Board to institute the EP 664 (Sub-No. 2) rulemaking on August 27, 2013, in the same month that the Board served its determination of the railroad cost of capital for 2012. *Railroad Cost of Capital-2012*, EP 558 (Sub-No. 16) (STB served Aug. 2, 2013). In its 2012 determination, the Board said that the League's challenges to the Multi-Stage Discounted Cash Flow methodology ("MSDCF") should be presented in a petition for rulemaking. The League did just that in promptly submitting its petition in EP 664 (Sub-No 2). The Board granted the League's petition, over the AAR's objection, in its EP 664 (Sub-No. 2) decision served December 20, 2013, thereby recognizing at least some merit to the League's concerns.

Eight months have transpired since the League filed its petition, and the concerns that the League raised are no less pressing. CSX, NS, and UP continue to engage in significant buybacks. For example, UP's November 21, 2013 press release and 8-K filing, http://www.up.com/investors/attachments/secfiling/2013/upc8k_112113.pdf, reported early renewal of its share repurchase program to allow UP to repurchase an additional 13% of its shares over the next four years (2014-2017). Buybacks of 13% over four years equate to a compound average rate of 3.1% per year. NS's 2013 annual report, http://www.nscorp.com/content/dam/nscorp/get-to-know-ns/investor-relations/annual-reports/annual-report-2013.pdf, reported remaining authority to repurchase 38.3 million shares, or 12.4%, of 309.7 million shares outstanding during 2014-2017 (pp. K1, K32), corresponding to 2.96% per year. Analysts logically take stock repurchases into account in forecasting growth in earnings per share, as buybacks increase earnings per share. Yet the Board's MSDCF methodology assumes that the number of shares remains constant in measuring the growth in future cashflows for the firm as a whole.

The Board should not proceed with the 2013 determination while it is reviewing the soundness of the underlying methodology, especially when the agency refuses to consider challenges to the underlying methodology in its annual proceedings.

There is precedent for the Board to defer its annual determination while it reviews its methodology. When the League raised its concerns about the Board's earlier single-stage discounted cash flow methodology ("SSDCF"), the Board initiated a new rulemaking in EP 664, *Methodology to be Employed in Determining the Railroad Industry's Cost of Capital*, and did not make the cost of capital determinations for 2006 or 2007 until the EP 664 rulemaking was completed. In particular, the EP 664 decision was served on January 17, 2008, and the decision in *Railroad Cost of Capital-2006*, EP 558 (Sub-No. 10), was served on April 15, 2008. The Board should follow the same practice here.

Second, the League has concerns about the appropriateness of including KSU in the composite sample for the 2013 determination. The AAR included KSU in the composite sample on the grounds that KSU met the stated criteria in 2013: Kansas City Southern is a Class I railroad, at least 50% of KSU's assets are devoted to railroading, KSU now has investment grade debt, and KSU is publicly traded and listed on the New York Stock Exchange.

KSU meets the criteria, but only for 2013 and not for past years. The Board's prior SSDCF methodology utilized input data (price, dividend, and growth rate) only for the current year. In contrast, the Board's MSDCF and CAPM methodologies both utilize data from the previous four years (2009-2012), when KSU did not qualify for inclusion. The MSDCF uses the past four years (2009-2012) as well as the current year (2013) to determine the average ratio of cash flow to revenue for application to the revenue for the current year. Similarly, the CAPM measures beta over a five-year period (2009-2013).

Both cost of equity calculations thus rely on data from periods where KSU did not meet the criteria for inclusion in the composite sample. Indeed, 80% of the data used to construct the MSDCF average ratio of cash flow to revenue and the CAPM beta is taken from periods where KSU did not meet the Board's established criteria. Careful consideration should be given as to whether inclusion of KSU in the composite sample is appropriate under such circumstances.

Even if KSU is included in the composite sample, questions arise concerning how it is included, especially in the MSDCF. Specifically, the second-stage of the MSDCF model uses a growth rate reflecting the simple (unweighted) average of the carriers included in the composite sample. *See* AAR Appendix O, p. 1. Consequently, KSU's 16.7% first stage growth rate (the highest of the four carriers) counts just as much as CSX's 8.15% first stage growth rate or UP's 14.27% first stage growth rate. However, KSU's initial cash flow ($45.77 million) is only 3.9% of CSX's $1,185.82 initial cash flow and 1.5% of UP's $3,075.63 initial cash flow. Similarly, KSU's equity market capitalization as of January 3, 2014, is only about one-half of CSX's and a little more than one-sixth of UP's. Ibbotson/Morningstar's apparent use of the simple average may be appropriate when a larger number of diverse firms are considered, but that does not mean that the approach is appropriate when only four firms are considered.

KSU's inclusion appears to have very modest effect on the calculations for the 2013 cost of capital. KSU slightly increases the overall beta in the CAPM. Gray V.S. at 35. KSU's impact on MSDCF is mixed as KSU has the highest growth rate, but the lowest individual cost of equity. AAR Appendix O. KSU's cost of debt is slightly higher. Gray V.S. at 11. However, the small effect in one year does not preclude a larger effect in another year. Moreover, there is some irony in utilizing a composite sample that includes KSU, but excludes BNSF, when BNSF is roughly the same size as UP and had the lowest cost of capital of the four railroads prior to its exclusion.

Accordingly, the Board should defer determination of the 2013 cost of capital until the conclusion of the rulemaking proceeding in EP 664 (Sub-No. 2). The Board should also consider whether it is appropriate to include KSU in the composite sample when the Board's cost of capital methodologies utilize data from periods where KSU was not eligible for inclusion in the composite sample.

Respectfully submitted,

WESTERN COAL TRAFFIC LEAGUE

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Dated: May 12, 2014

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CERTIFICATE OF SERVICE

I hereby certify that on this 12th day of May 2014, I have caused true and accurate copies of the foregoing Reply Statement of the Western Coal Traffic League to be served upon all parties on the service list in Ex Parte No. 558 (Sub-No. 17), by first class mail, postage prepaid, and by email.

/s/ Robert D. Rosenberg