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BEFORE THE
SURFACE TRANSPORTATION BOARD

CONSUMERS ENERGY COMPANY	)	
Complainant,	)	
v.	)	**Docket No. 42142**
CSX TRANSPORTATION, INC.	)	
Defendant.	)	

COMPLAINANT'S REPLY TO MOTION TO DISMISS REVENUE ADEQUACY CLAIM

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Dated: April 13, 2015

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Complainant Consumers Energy Company ("Consumers") submits its Reply to the Motion to Dismiss Revenue Adequacy Claim ("Motion") that Defendant CSX Transportation, Inc. ("CSXT") filed on March 24, 2015. As explained below, CSXT has not begun to meet the high threshold set by the Board for motions to dismiss, and its Motion therefore should be denied.

INTRODUCTION

CSXT premises its Motion primarily upon the Board's annual, industry-wide revenue adequacy decisions in the *Ex Parte No. 552* series, but those "snapshot" findings are not determinative for purposes of applying the Revenue Adequacy Constraint of the *Coal Rate Guidelines*,[1] even under CSXT's own cited precedent.

[1] *Coal Rate Guidelines -- Nationwide*, 1 I.C.C. 2d 520 (1985), *aff'd sub nom. Consolidated Rail Corp. v. United States*, 812 F.2d 1444 (3d Cir. 1987).

CSXT's contention that it cannot discern the basis for Consumers' Revenue Adequacy Claim is makeweight. The Board does not require detailed factual showings in a maximum railroad rate complaint, and Consumers presented its revenue adequacy claim in the same manner as its stand-alone cost ("SAC") claim, specifically invoking the standards of 49 U.S.C. § 10704(a)(2) and (3) and the *Coal Rate Guidelines*. This easily satisfies the Board's pleading requirements.

Under the Board's standards and procedures for litigation under the *Coal Rate Guidelines*, Consumers is not required to provide a preview of its evidence before discovery is concluded and its opening evidence is due. Nevertheless, even at this early stage there is ample, publicly available evidence that CSXT should be considered revenue adequate for purpose of the *Guidelines'* constraint, under either an *Ex Parte No. 552* analysis that employs a realistic cost of capital or a multi-factor test. Likewise, the financial and investment communities already correctly perceive CSXT to be revenue adequate on a long-term basis, which also is grounds for invoking the Revenue Adequacy Constraint against increases to captive shipper rates under the case-specific approach endorsed by the Board's predecessor,[2] and applied in prior cases.[3]

Morningstar, a leading investment research firm previously lauded both by the Board and the railroads, has determined that CSXT[4] more than earns its cost of capital and will continue to do so for the long term, *i.e.,* for at least twenty years. CSXT consistently has been able to cover its expenses and debts, make all necessary capital

[2] *See Railroad Revenue Adequacy – 1987 Determination*, 4 I.C.C. 2d 731 (1988).

[3] *CF Industries, Inc. v. Koch Pipeline Company, L.P.*, 4 S.T.B. 637, 656-62 (2009).

[4] In this Reply, references to "CSXT" also include its corporate parent, CSX Corporation.

expenditures, generate or attract needed capital, and provide a more than reasonable economic profit, thereby fulfilling the revenue adequacy criteria in the statute and the *Coal Rate Guidelines.* The massive appreciation in the price of its shares, its market capitalization of approximately $33 billion, and its use of cash generated by business activity to repurchase capital stock confirm the financial analysts' conclusions. A truly revenue inadequate firm could not achieve such financial success.

CSXT's other contentions in its Motion, such as the need to simplify this case so that only the issues that CSXT prefers to advance can be considered, and its argument that the Board should proceed only by rulemaking where the Revenue Adequacy Constraint is concerned, are entirely self-serving and unpersuasive, and serve principally to illustrate why maximum rail rate cases have gotten so expensive.

ARGUMENT

I. CSXT CANNOT MEET THE BOARD'S DEMANDING STANDARD FOR MOTIONS TO DISMISS

The Board's standard for dismissal of a claim prior to the presentation of evidence is very demanding. By statute, the Board only may dismiss a claim that "it determines does not state reasonable grounds for investigation and action." 49 U.S.C. § 11701(b). Accordingly, "[m]otions to dismiss are generally disfavored and are rarely granted." *State of Montana v. BNSF Ry. Co.*, NOR 42124 (STB served Feb. 16, 2011), at 3 (footnote omitted). Furthermore, "[i]n reviewing a motion to dismiss, all alleged facts are viewed in the light most favorable to the complainant…" *Id.* Other, recent decisions to the same effect include *Cargill, Inc. v. BNSF Ry. Co.,* NOR 42120 (STB served Jan 4, 2011); *Entergy Arkansas, Inc. v. Union Pac. R.R.*, NOR 42104 (STB served Dec. 30, 2009); and *Dairyland Power Coop. v. Union Pac. R.R.*, NOR 42105 (STB served July 25, 2008).

Dismissal of Consumers' revenue adequacy claim cannot be granted if there are any facts which might support Consumers' assertion in its Complaint (¶5) that CSXT meets the criteria for revenue adequacy prescribed in 49 U.S.C. § 10704 (a)(2) and (3). As demonstrated *infra*, there are ample public facts under which CSXT should be found to be revenue adequate for purposes of the *Guidelines*' "first constraint," and Consumers has the right to supplement those facts with specific evidence developed for purposes of this proceeding. As such, CSXT's Motion must be denied.

CSXT argues that it cannot be found revenue adequate under the *Guidelines* because of the annual determinations made in *Ex Parte No. 522* and predecessor dockets. Motion, at 3-4, 10-13. However, as *CSXT itself* acknowledges, "[a]gency precedent does permit a party to challenge these annual findings in a particular adjudication." Motion at 13 (citing *Bituminous Coal -- Hiawatha, UT, to Moapa, NV*, 6 I.C.C. 2d 1, 7 n.24 (1989) ("*Nevada Power*"), and *Railroad Revenue Adequacy -- 1987 Determination*, 4 I.C.C. 2d 731, 731 (1988)). The actual language in the two decisions cited by CSXT is instructive. In the *1987 Determination*, the Board's predecessor ruled:

> We will also consider these findings in individual rate reasonableness proceedings conducted under 49 U.S.C. § 10701a, but will not necessarily treat these findings as determinative of revenue adequacy issues raised in those cases. Rather, we will continue to consider all probative evidence submitted in such cases pertaining to the revenue adequacy of the particular carrier(s) involved.

4 I.C.C. 2d at 731. Later, the agency explained in *Nevada Power* that "[w]e have stated that any other competent and probative evidence relative to the carrier's revenue adequacy may be submitted in individual rate reasonableness proceedings." 6 I.C.C. 2d at 7 n.24 (citing *1987 Determination*). While the complainant's revenue adequacy claims did not prevail in *Nevada Power*, the decision in that case clearly established that the annual industry-wide determinations on which CSXT now relies do not predestine findings under the Revenue Adequacy Constraint of the *Coal Rate Guidelines*.

The argument advanced by CSXT in its Motion also is contradicted by its own submissions and those of its allies in *Ex Parte No. 722*. In that proceeding, CSXT stated:

> And while consistent use of the same flawed metric allows the Board to monitor in a very rough, general way a carrier's financial health and whether it is making progress toward earning adequate revenues, it does not allow an accurate determination of when a carrier actually has earned such adequate revenues, let alone when it has attained long term revenue adequacy. *See* 49 U.S.C. § 10704(a)(2).

CSXT Opening Comments, Ex Parte No. 722, *Railroad Revenue Adequacy*, filed Sept. 5, 2014, at 5. *See also* Opening Comments of the Association of American Railroads, filed Sept. 5, 2014, at 1-2, 26-32. The railroads' positions there – unlike CSXT's claims in its Motion – echoed the holdings of the Board's predecessor in the annual revenue adequacy decision issued at the time of adoption of the *Guidelines*' Revenue Adequacy Constraint:

> [I]n rate reasonableness proceedings under Section 10701a, we do not treat the findings made under our current methodology as determinative or conclusive of the revenue adequacy of the carrier involved unless the parties present no other evidence relevant to that issue. Indeed, where the record is open in a particular case, we accept all competent, probative evidence relevant to a carrier's revenue adequacy which the parties may submit.

Railroad Revenue Adequacy – 1984 Determination, 1 I.C.C. 2d 615, 620 (1986).

Consumers and CSXT may disagree completely on whether the annual industry findings understate or overstate the railroads' revenue adequacy, but the point is clear that the annual findings are not, and never have been, preclusive of other evidence in individual rate cases.

CSXT's claim that Consumers' Complaint failed to satisfy the Board's pleading requirements with respect to the revenue adequacy claim likewise is untenable. The Board's regulations require complaining shippers to specify only whether they are proceeding under the Constrained Market Pricing ("CMP") standard or under a simplified methodology. 49 C.F.R. § 1111.1(a). By its terms, CMP includes both the Stand Alone Cost Constraint and the Revenue Adequacy Constraint. By specifying that it would be presenting evidence under both Constraints, Consumers went beyond the requirements of the Board's rules, and plainly enabled CSXT to be "fully apprised of the type of case the complainant intends to present," "determine what information it will need to present its defense," and "better formulate its answer and to more quickly prepare its discovery requests and otherwise move the case toward resolution." *Expedited Procedures for Processing Rail Rate Reasonableness, Exemption & Revocation Proceedings, Ex Parte No. 527* (STB served July 22, 1996), 1996 WL 406655 at *2.

II. AMPLE GROUNDS EXIST FOR FINDING THAT CSXT IS REVENUE ADEQUATE FOR PURPOSES OF THE *COAL RATE GUIDELINES*

As explained *supra*, dismissal of Consumers' revenue adequacy claim only could be considered if there were no reasonable grounds on which CSXT could be found to be revenue adequate for purposes of the governing statute and the *Guidelines*. In fact, there are numerous grounds for such a finding.[5]

First, under the Board's annual "snapshot" methodology, CSXT has missed the targeted return on investment only by very modest amounts in recent years, *e.g.*, 18 basis points in 2010, 3 basis points in 2011, and 31 basis points in 2012. Since the Board's cost of capital ("COC") determinations are not precise, it is well within standard statistical ranges of accuracy that CSXT in fact *did* earn a return at the COC level, even under the Board's broad, rough measure. Moreover, if the Board were to adopt the reforms to the equity portion of the COC proposed by the Western Coal Traffic League and other parties in *Ex Parte No. 664 (Sub-No. 2*), then CSXT would have met the Board's numeric threshold in all or at least most of the recent years. Likewise, if the Board heeds the recommendations of parties to *Ex Parte No. 722* and the Senate Finance Committee[6] to return to reliance on multiple financial indicators in making the annual

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[5] In addressing this issue, Consumers is not conceding that it was required to do so in its Complaint, or that it is appropriate to argue or consider the weight of the evidence at this stage. Consumers reserves the right to submit other information regarding CSXT's revenue adequacy in its actual evidentiary presentation.

[6] *The Current Financial State of the Class I Freight Rail Industry,* Report of Office of Oversight and Investigations, U.S. Senate Committee on Commerce, Science and Transportation, Sep. 15, 2010; *Update on the Financial State of the Class I Freight Rail Industry,* Report of the Office of Oversight and Investigations, U.S. Senate Committee on Commerce, Science and Transportation, Nov. 21, 2013.

industry determinations, CSXT would be found revenue adequate under the annual determination formula for many years. *See, e.g.*, Opening Comments of WCTL, *et al.*, Ex Parte No. 722, filed Sept. 5, 2014, Verified Statement of Dr. Harvey A. Levine ("Levine VS"), Table No. 1. This approach, which more closely conforms to the revenue adequacy criteria prescribed in 49 U.S.C. § 10704(a)(2) and (3) and complies with the treatment of revenue adequacy in the *Coal Rate Guidelines*, (1 I.C.C. 2d at 534-37), confirms that CSXT earns revenues sufficient to "cover total operating expenses, including depreciation and obsolescence," generate at least a "reasonable and economic profit or return," "provide a flow of net income plus depreciation adequate to support prudent capital outlays" (and would support further outlays, if CSXT would make them), "assure the repayment of a reasonable level of debt," "permit the raising of needed equity capital," "cover the effects of inflation," and "attract and retain capital in amounts adequate to provide a sound transportation system in the United States."

Second, there is strong evidence that the financial community views CSXT as earning more than its cost of capital, not just currently, but consistently on a long-term, prospective basis. For example, the Morningstar analysis for CSXT, attached as Exhibit A, finds that CSXT benefits from a "wide moat" that will enable it to out-earn its cost of capital under circumstances that are likely to persist for the next twenty years or more:

> While the rails don't outearn their cost of capital by much, our wide moat rating stems from our confidence that rails will leverage cost and efficient scale competitive advantages to generate positive economic profits for the benefit of share owners with near certainty 10 years from now, and more likely than not 20 years from now; by our methodology, this defines a wide economic moat.

The Morningstar assessment is direct and compelling evidence that in the view of the financial investment community, CSXT is and will continue to be an attractive candidate for investment capital, earning more than its own cost of capital and meeting the statutory test of revenue adequacy on a long-term basis, as contemplated under the *Coal Rate Guidelines*' Revenue Adequacy Constraint.

The Morningstar analysis also touts the progress that CSXT has made over the past decade:

> CSX's margin gains of the past decade are nothing short of astounding. The firm lagged its peers after the rail renaissance began in 2004, but surprisingly strong profitability during the recession marked the end of its perceived second-class status. Historically, CSX's closest comparative peer, Norfolk Southern, earned at least 5 percentage points better annual margin, but CSX achieved record improvements in operating ratio (operating expenses/revenue) during 2009-12 and more than closed the performance gap. The Eastern railroad started its margin improvement trajectory during the early days of the modern railroad renaissance and advanced its OR to around 71% (29% EBIT margin) during 2010-13 from more than 90% in 2003.

In evaluating CSXT's Motion to Dismiss, it must be assumed that Consumers' eventual evidentiary presentation will demonstrate what Consumers alleges in its Complaint: that CSXT meets the financial criteria set out in 49 U.S.C. § 10704(a)(2) and (3). Consumers need not show any such supporting facts here; its pleading is sufficient to defeat CSXT's Motion. However, even the cursory look at the public record offered in this Reply shows that there are ample grounds to find that CSXT meets the criteria for application of the Revenue Adequacy Constraint. While CSXT's parent has had no need to raise equity capital in recent years, investors plainly do not view and do not treat CSXT and its parent as generating revenues that are insufficient to sustain and operate a thriving enterprise.

III. CSXT'S CUMULATIVE SHORTFALL CLAIM SHOWS ONLY THAT THE BOARD'S SNAPSHOT DETERMINATIONS ARE FLAWED

Along with the Board's annual industry snapshots, CSXT's Motion rests on the claim that CSXT has experienced a cumulative, present-value revenue (or earnings) shortfall starting in 1999 of some $30 billion, which it suggests precludes any consideration of the *Guidelines*' Revenue Adequacy Constraint. The calculation is presented on page 12 of its Motion, but CSXT references the calculation or its elements throughout the document (*e.g.*, pp. 1, 3-4, 9-11, 13-14, 17).[7]

CSXT's calculation is entirely fallacious. There is no $30 billion shortfall that CSXT owes to anyone over this period. It is, at most, the sum of a set of artificial annual shortfalls of measured revenues as compared to an industry cost of capital calculation, which by the end of the period disappears within the statistical range of accuracy. Moreover, CSXT's alleged cumulative value shortfall calculation is very dependent on the choice of interest rate. If one were to use a risk-free rate such as the one-year treasury, the "shortfall" is reduced to under $13 billion, less than half the figure urged by CSXT.

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[7] CSXT also repeatedly claims that revenue adequacy should be measured against replacement costs. *E.g*,, Motion at 5-7, 9, 14. However, the Board and its predecessor have repeatedly rejected the use of replacement costs for this purpose. *See, e.g., Assoc. of Am. R.R. -- Pet. Regarding Methodology for Determining R.R. Revenue Adequacy*, *Ex Parte No. 679* (STB served Oct. 24, 2008). CSXT's admonitions against "entangling this dispute with the ongoing proceeding in *R.R. Revenue Adequacy*" and engaging in "an improper collateral attack on prior agency rulemakings" (Motion at 2, 14 n.18) are better directed at itself.

CSXT's alleged cumulative shortfall has not undermined its viability, or prevented it from meeting the revenue adequacy criteria specified in 49 U.S.C. § 10704(a)(2) and (3). CSXT has plainly not careened into bankruptcy. By any reasonable measure, CSXT is robust today, and its financial condition is continually improving. There is no serious question whether CSXT has satisfied the retrospective criteria described in 49 U.S.C. § 10704(a)(2). If there is an open issue at all, it is whether it has earned "a reasonable and economic profit or return (or both) on capital employed in the business" that is sufficient to "attract and retain capital." In that regard, the Morningstar analysis confirms that CSXT is producing an economic profit or return that exceeds its cost of capital.

The facts are that CSXT has provided an admirable return to its equity investors. At the end of 1999, the first year considered under CSXT's "shortfall" analysis, CSXT had a split-adjusted price per share of $5.23 per share and 1.312 billion (post-split) shares outstanding, for a market capitalization of $6.86 billion.[8] As of the end of 2013, the last year included in CSXT's table, CSXT's shares traded at a price of $28.77, and CSXT's market cap, with 1.009 billion shares outstanding, was $29.03 billion (and is over $33 billion today). In other words, over the period that CSXT supposedly was accruing a revenue shortfall of over $30 billion, it provided stockholders with 450% appreciation in the price of their shares, and its market cap increased by $22 billion, more than 300%. By comparison, the S&P 500 index rose from an end-of-year value of 1,469 in 1999 to 1,848 in 2013, an increase of only 26%. A "buy and hold"

[8] The data is taken from Yahoo Finance Charts and excludes any retention of dividends.

equity investor in CSXT would not have experienced any loss of return on his investment in CSXT over this period and such returns were more than adequate to attract investment. Indeed, CSXT itself repurchased a substantial quantity of its own shares during the period in question, and continues to do so. To the extent that CSXT's shortfall chart shows anything at all, it is that the STB's annual revenue adequacy snapshot methodology does not accurately depict CSXT's true financial condition.

IV. CSXT'S SIMPLIFICATION ARGUMENT SHOULD BE SUMMARILY REJECTED

CSXT also argues that Consumers' revenue adequacy claim should be dismissed in order to "simplify" this proceeding. Motion at 14-16. CSXT's notion of simplification is so one-sided that it offends common notions of regulatory fairness.

Revenue adequacy is part of the CMP methodology under the *Coal Rate Guidelines*, and shippers clearly are free to proceed under the Revenue Adequacy Constraint and the SAC Constraint simultaneously.[9] CSXT may prefer not to have to defend against a claim under the Revenue Adequacy Constraint, but it is not entitled to dictate Consumers' remedial options.

It is especially repugnant for CSXT to assert that Consumers' revenue adequacy claim should be dismissed so that more attention can be paid to CSXT's arguments regarding (1) market dominance; (2) its new, Uber-like theory of "congestion pricing;" and (3) issues concerning the cross-subsidy of light density lines. Motion at 14-

[9] *See, e.g., West Texas Utilities Company v. Burlington Northern Railroad Co.*, 1 S.T.B. 638, 655 (1996); *Nevada Power,* 6 I.C.C. 2d at 16-17; *Arkansas Power & Light Company v. Burlington Northern Railroad Company, et al.,* 3 I.C.C. 2d 757, 765-77 (1987); *Coal Rate Guidelines*, 1 I.C.C. 2d at 547-48.

16. The ability of a railroad to make rate cases more complicated, protracted and expensive is not a reason to preclude a shipper from advancing a grounded claim under the *Coal Rate Guidelines*. The evidence will show that after more than a year of obstinate refusal to entertain any concession on rate levels during the parties' contract negotiations, CSXT responded to Consumers' request for the establishment of a common carrier rate by *increasing* its demand to a level approximating 450% of the variable cost of service. CSXT may be entitled under the law to attempt to show that its pricing nevertheless was "constrained" by some imaginary "effective competition for the transportation of coal to Campbell."[10] But it has no basis to assert that the Board should dismiss a well-pleaded claim by Consumers in order to provide CSXT with a larger stage. Likewise, the facts that Consumers' SAC analysis will account for operating conditions in the Chicago area, and must meet the "cross-subsidy" tests adopted by the Board in *PPL Montana* and *Otter Tail*,[11] simply reflect the realities of modern rate litigation under the *Coal Rate Guidelines*. They provide no justification for curtailing Consumers' rights and remedies under those *Guidelines*.

CSXT also posits that other railroads and shippers "likely" will seek to intervene in Consumers' rate case. Motion at 15. This assertion is speculative and self-serving. The revenue adequacy claim against Norfolk Southern in the *SMEPA* litigation did not result in any interventions, or a motion to dismiss the claim. But the fact that other railroads and shippers may have an interest hardly provides a reason to bar a

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[10] CSXT Answer, at 4.

[11] *See* Motion at 15, nn. 20 and 21.

captive shipper from seeking reasonable rates under an established component of the *Coal Rate Guidelines*.

V. THE PENDENCY OF *EX PARTE NO. 722* IS NO REASON TO BLOCK CONSUMERS' REVENUE ADEQUACY CLAIM

CSXT's final argument for dismissal is that the given the pendency of *Ex Parte No. 722*, the "proper parameters" of a revenue adequacy claim under the *Guidelines* should not be addressed in this individual rate case. Motion at 16.

The outcome-oriented nature of CSXT's argument is easily discerned. The Board's first notice in *Ex Parte No. 722* came more than fifteen (15) months ago,[12] and thus far the Board has limited the proceeding to an airing of positions and views of interested parties on certain questions posed by the Board. No public hearing has been scheduled, and the Board has not advanced any proposed rule, policy or guideline. In contrast, the Revenue Adequacy Constraint has been part of the *Coal Rate Guidelines* for the past thirty years, has been invoked by parties such as Nevada Power, Arkansas Power & Light and SMEPA, and was interpreted and applied by the Board in actual litigation under CMP for years prior to the initiation of *Ex Parte No. 722*.[13] Consumers' invocation of the Constraint in this case not novel, and its consideration is firmly legitimized by the Board's previous actions in promulgating genuinely *new* regulatory standards in

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[12] *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*, EP 664 (Sub-No. 2) (STB served Dec. 20, 2013), at 2 ("In the near future, the Board intends to institute a proceeding on railroad "revenue adequacy.").

[13] *CF Industries, supra; Nevada Power*, 6 I.C.C. 2d at 16; *Arkansas Power & Light Company*, 3 I.C.C. 2d at 765-77.

individual adjudications, including the very same *PPL Montana/Otter Tail* cross-subsidy tests referenced in CSXT's Motion, and its "limit price" approach to qualitative market dominance developed in *M&G Polymers USA, LLC v. CSX Transp., Inc.*, NOR 42123 (STB served Sept. 27, 2012). The pendency of *Ex Parte No. 722* provides no reason to dismiss Consumers' claim under the Revenue Adequacy Constraint.

CONCLUSION

For the reasons stated above, CSXT's Motion to Dismiss Consumers' Revenue Adequacy Claim should be denied.

Respectfully submitted,

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Dated: April 13, 2015

CERTIFICATE OF SERVICE

I hereby certify that this 13th day of April, 2015, I caused a copy of the foregoing Complainant's Reply to Motion to Dismiss Revenue Adequacy Claim to be served by hand delivery and electronic mail on the following counsel for Defendant CSX Transportation, Inc.:

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EXHIBIT A

MORNINGSTAR INVESTMENT RESEARCH

CSX CORPORATION ANALYST REPORT

CSX Corp CSX |

Long run, we expect CSX to continue to improve its operating ratio, despite secular coal weakness.

by
Keith Schoonmaker, CFA

Sector Director

Authors can be reached at Analyst Feedback

Morningstar's Editorial Policies

Analyst Note 01/14/2015

CSX delivered record fourth-quarter revenue, operating income, and earnings per share despite its mediocre 71.8% operating ratio. We won't be surprised if CP, CN, and UP beat this OR by 8-10 percentage points, and consider CSX in the "improved, yet still improving" bucket. Results are near our projections, so we expect no material changes to our fair value estimate and we maintain our wide moat rating.

Demand remains strong, even in coal and crude, but we still believe intermodal is the long runway for volume growth at CSX and elsewhere. Freight already moving on trucks can move cheaper, greener, and with available capacity on the rails. Domestic intermodal units grew an impressive 9% over the prior-year period, even as cheaper fuel decreased the cost of both truck and rail shipping. Overall coal carloads improved 11%, driven chiefly by 22% greater domestic tonnage as utilities replenished stockpiles. Export coal tons declined 7% due to the weak global market; management projects a 25% export decline in 2015 even though it also expects flat coal volume overall. CSX's crude traffic moves eastward from the Bakken and constitutes just 2% of total volume, but of late receives a lot of headlines due to cheap oil. The rail reported no diminution in crude flows during the quarter, and indicated crude customers are signaling 2015 volume also will not decline. We maintain that CSX will attain a 65% OR within four years, now that the major coal dropoff seems to have passed. Lower surcharges improve the OR mathematically because fuel is a 100% OR pass-through. More economically material, the firm continues to improve its cost structure, and took a $39 million charge as part of a management workforce reduction program that will begin in earnest during 2015. Details are vague, but CSX expects this to generate $50 million of annual cost reduction. Long run, we still model a slight decline in coal volume after this year, and we bake in no significant crude expansion.

Investment Thesis 10/15/2014

CSX's margin gains of the past decade are nothing short of astounding. The firm lagged its peers after the rail renaissance began in 2004, but surprisingly strong profitability during the recession marked the end of its perceived second-class status. Historically, CSX's closest comparative peer, Norfolk Southern, earned at least 5 percentage points better annual margin, but CSX achieved record improvements in operating ratio (operating expenses/revenue) during 2009-12 and more than closed the performance gap. The Eastern railroad started its margin improvement trajectory during the early days of the modern railroad renaissance and advanced its OR to around 71% (29% EBIT margin) during 2010-13 from more than 90% in 2003.

Management's long-run mid-60s OR target seems attainable to us, for we believe much-improved profitability is here to stay at CSX. However, given CSX's coal-rich mix (31.6% of consolidated 2011 revenue, down to 24.1% in 2013), the rail will continue to be hard hit by plunging coal demand during the next several years; we think CSX can size its network to match demand. Case in point: While coal volume declined a steep 16% in 2012, CSX slightly bettered its prior-year OR. Autos and

Morningstar's Take CSX

Analyst

Price 04-08-2015	**Fair Value Estimate**	**Uncertainty**
33.31 USD	35 USD	Medium
Consider Buy	**Consider Sell**	**Economic Moat**
24.5 USD	47.25 USD	Wide
Stewardship Rating		
Standard		

Bulls Say

- CSX has improved operations significantly during the past few years. On-time originations and arrivals, safety, dwell time in terminals, and velocity have steadily increased during recent quarters.
- CSX is doing what it takes to improve its operating ratio. Starting with trimming more than one fifth of its management in 2003, the firm has driven down labor expense to about 26% of revenue from 39% in 2002.
- Compared with trucking, shipping by rail is less expensive for long distances, is 4 times more fuel-efficient per ton-mile, and does not contribute to freeway congestion.

Bears Say

- Although coal and grain historically have been normally relatively robust cargo, 2009 demonstrated that railroads cannot escape the broader economy's cyclicality.
- Coal never recovered from the recession, and demand continues to slide due to cheap natural gas substitution and reduced international steelmaking. Uncertainty surrounding the magnitude of coal volume declines has pressured CSX's stock for several quarters.
- Unlike trucking firms, railroads must purchase and maintain their roads. We project high capital expenditures will consume about 18% of CSX's annual revenue.

Competitors CSX

More...

Name	Price	% Chg	TTM Sales $ mil
CSX Corp	**$33.31**	**-0.72**	**12,669**
Union Pacific Corp	$108.17	0.35	23,988
East Japan Railway Co	$19.53	-76.82	22,747
Central Japan Railway Company ADR	$18.96	-0.18	13,791
Central Japan Railway Company	$200.00	5.96	13,791
Canadian National Railway Co	$66.43	0.30	9,380

intermodal growth, plus continued OR improvement, should help salvage earnings despite coal losses.

CSX's competitive advantages are inseparable from the geography of its track. Its Eastern U.S. network stretches a bit farther in latitude than that of Norfolk Southern, reaching into Florida and New England. The location of all its assets enables CSX to attract a diverse mix of commodities. CSX made meteoric progress in its operations during the past decade, improving safety, shortening terminal dwell time, and increasing on-time arrivals. In almost every measure of operating performance, CSX moved the needle significantly. Along with better-run operations, the company materially improved its pricing, expanding consolidated yield at a 6% compound annual rate since 2004. Given this progress, there's now less room for improvement, but we expect pricing power to persevere in excess of 2%-3% annual railroad cost inflation.

Economic Moat 10/15/2014

CSX's wide economic moat is based on cost advantages and efficient scale. While barges, ships, aircraft, and trucks also haul freight, railroads are the low-cost option by far where no waterway connects the origin and destination, especially for freight with low value per unit weight. Moreover, railroads claim quadruple the fuel efficiency of trucking per ton-mile of freight and through greater railcar capacity and train length make more effective use of manpower despite the need for train yard personnel. Even for goods that can be shipped by truck, we estimate Eastern railroads charge 10%-20% less than truckers to transport containers on the same lane.

The network of track and assets Class I rails have in place is impossible to replicate. CSX spans the densely populated Eastern U.S., capturing about half of the rail volume in the region. Its rights of way and installed track form a nearly impenetrable barrier to entry. We think there will be no new railroads built, although line extensions by existing railroads (including restoring abandoned lines) may take place in select areas as the economy recovers. Efficient scale followed industry consolidation escalated by the 1980 Staggers Act that permitted extensive rail line sales, abandonment, and combination. North America had more than 40 Class I rails in 1980; today, there are just eight (a Class I generated at least $452.7 million of 2012 operating revenue; six are publicly traded). Staggers also allowed private contracts and rate setting. On all but the busiest lanes (like Wyoming's coal-rich Powder River Basin), generally a single railroad serves an end-of-the-line shipper, and only two railroads operate in most regions in North America. Indeed, we opine that absent government intervention, the rational number of competitors on the continent would be two, via additional consolidation, since in most regions customers already have only two capable providers. The steep barrier to entry formed by the need to obtain contiguous rights of way on which to lay continuously welded steel rail spanning one third of a huge continent fends off would-be entrants. Railroads may build spurs or restore abandoned lines, but we anticipate that because of massive barriers to entry, no new main lines will be built.

Barriers to entry are powerful for railroads, but running a railroad requires massive reinvestment. CSX's still-sizable annual capital expenditures typically amount to 16%-20% of revenue. While the rails don't outearn their cost of capital by much, our wide moat rating stems from our confidence that rails will leverage cost and efficient scale competitive advantages to generate positive economic profits for the benefit of share owners with near certainty 10 years from now, and more likely than not 20 years from now; by our methodology, this defines a wide economic moat.

Valuation 10/15/2014

We increased our fair value estimate to $35 per share from $34 to account for the time value of money since our last update and to incorporate year-to-date actual volume, revenue per car, and expenses through the end of September. We model CSX's top line to increase 4% in 2014. We project carloads to increase about 5% above the prior-year level. We model utility coal tonnage to increase about 10% and export coal to contract about 15% to 37 million tons in 2014 (mid-30 million tons, per management guidance), leading to about 1% growth in total coal volume this year. By the end of our five-year discrete Stage 1 projection period, we estimate that total volume will expand about 1.5% per year despite further coal contraction, as population growth, auto recovery, homebuilding recovery, and intermodal share gains fuel continued modest volume demand. We also model most rates to improve 2%-3% annually--slightly in excess of rail inflation. In coal, however, we model a slight decline in 2014 rates as we believe export coal will need to stay priced to move in a demanding (read: supercheap prices, even though midyear CSX indicates it cannot price export moves lower) international market, and we believe the competing mode of trucking can constrain intermodal yield changes to 0%-2% per year. We forecast an operating ratio of 71.0% in 2014--a slight deterioration from 70.6% in 2012 and 71.1% in 2013 as the rail continues to adjust to dynamic coal demand and as the firm suffered an extremely harsh first quarter (75.5% OR). By 2017, we think the rail can achieve a 65% OR. In April 2013, management reviewed with the board the prior OR target of 65% by 2015, which was set before the firm felt the full brunt of coal-to-gas utility switching; the current target is a mid-60s OR over the long term. We anticipate no degradation in the rail's ability to control most of its costs over the long run (even fuel is mostly covered by surcharges). Our valuation is constrained by the heavy cash demanded for reinvestment in the railroad: We project that about 18% of revenue will be spent annually on capital investment, including the unfunded but mandated positive train control implementation during the next few years.

Risk 10/15/2014

CSX is exposed to the health of the U.S. economy and to both domestic utility and international metallurgical and steam coal demand. Low natural gas prices and increased Environmental Protection Agency regulations have put a material portion of the domestic utility coal franchise at risk of disappearing, and export coal demand is lower than in past years as a result of less steelmaking in Asia. The rail is relying on its intermodal franchise to expand volume. The firm has improved rapidly, and we no longer believe it has greater operating risk than other railroads. Outside of normal operations, CSX has assets in locations susceptible to hurricane damage, but natural disaster risk is inevitable in railroading, given its outdoor nature and expanse. Threat of increased regulation ebbed somewhat because the 2010 election resulted in a Republican-controlled House, but regulation can constrain rail profitability in more modes than simply price controls. For example, the Federal Railroad Administration estimates the 2008 legal mandate to install positive train control systems (by 2015) will cost the Class I railroads north of $13 billion to implement and maintain for the next 20 years; CSX estimates it will spend $300 million on PTC during 2014 out of $2.3 billion in total capital expenditures, and $0.5 billion more on PTC in the future. The Association of American Railroads claims PTC will prevent few accidents and provide little economic return to shareholders. We consider legislators lacking long-term or broad national freight transportation perspective to be one of the greatest risks railroads face.

Management 03/24/2015

Since Michael Ward took the reins as CEO in January 2003, CSX has generated truly impressive results. This success was achieved during a period when all railroads realized excellent performance, but we believe Ward has accomplished a lot, particularly in driving operating ratio improvement. Railroads pay executive suites well, and CSX is no exception. Ward's $12.4 million in total 2013 compensation consisted of $1.2 million in salary, $9.2 million in stock awards, and $2.0 million in nonequity incentive plan compensation. His compensation in both 2011 and 2012 was around $8 million.

COO Oscar Munoz, 56, served as CFO from 2003 to 2012, during CSX's tremendous margin improvement. Solid leadership in operations has been instrumental in CSX's success. Before the 2004 arrival of Tony Ingram, CSX had 10 COOs in the prior decade. Ingram retired in 2009; before his stability, each new COO's changing initiatives and operating philosophies made CSX's failure to run as well as other railroads no surprise. CSX paid Munoz $3.9 million in total during 2013, and beyond Ward and Munoz, paid total compensation between $2.7 million and $4.1 million to three additional named executive officers. In mid-February 2015, CSX named Munoz president in addition to COO (Ward remains CEO and chairman), and appointed Cindy Sanborn, 50, executive vice president of operations. To us this action clarifies the succession plan for CSX's C-suite.

We consider CSX to be a prudent steward of shareholder capital as a result of continued investment in maintaining the rail network and growing intermodal capacity, as well as the return of cash to shareholders via an increasing dividend (doubled from 2008 to 2012) and sizable share repurchases at market prices below our fair value estimate.

Overview

Profile:

CSX is a $12 billion railroad operating in the Eastern United States. On its 20,800 miles of track, CSX hauls shipments of coal products (24% of consolidated revenue), chemicals (16%), intermodal traffic (14%), and a diverse mix of other merchandise.