238356

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May 11, 2015
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Public Record

BEFORE THE
SURFACE TRANSPORTATION BOARD

RAILROAD COST OF CAPITAL -- 2014	))	Ex Parte No. 558 (Sub-No. 18)

REPLY STATEMENT OF THE WESTERN COAL TRAFFIC LEAGUE

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William L. Slover
Robert D. Rosenberg
Slover & Loftus LLP
1224 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 347-7170

Its Attorneys

Of Counsel:

Slover & Loftus LLP
1224 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 347-7170

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Pursuant to notice that the Surface Transportation Board ("STB" or "Board") served in the above-captioned proceeding on February 19, 2015, 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 ("AAR" or "Railroads") filed on April 20, 2015.

The AAR's mathematical calculations for the 2014 determination appear technically accurate. However, the technical accuracy is of little import given the infirmities in the underlying methodology. While the Board is, in theory, reviewing its methodology for calculating the cost of equity ("COE") portion of the cost of capital ("COC") in EP 664 (Sub-No. 2), that proceeding has been languishing, as a hearing is now scheduled to be held nearly twenty-three months after the League filed its petition. The instant proceeding provides an appropriate forum to consider what would constitute a

[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 Missouri, 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.

more appropriate COC methodology, what results it might yield, and whether the difference is significant.

First, the continued presence of KSU, a relatively small carrier, in the industry sample, and the exclusion of BNSF, the largest carrier by some obvious measures, remains problematic. The sample is not representative, especially as KSU derives much of its revenue from its Mexico subsidiary. KSU's inclusion is particularly troublesome for the MSDCF because the model uses the simple average of the carriers' growth rates to determine the growth rate for the second stage. KSU's 15.45% growth rate is the highest of the four carriers in the sample, yet KSU has substantially smaller revenues, cashflow, and market capitalization, *e.g.,* KSU's market capitalization is one-eighth of UNP's. KSU should not receive equal weight in the second stage growth rate.[2]

Second, there is every reason to think that the earnings per share ("EPS") growth rates for CSX, NSC, and UNP reflect their substantial stock buyback programs, thereby tainting use of those growth rates in the MSDCF. According to gurufocus.com, buybacks by CSX, NSC, and UP have averaged 2.7%, 3.8%, and 2.7% per year over the past three years. Using EPS growth rates to project growth in firm-wide cashflows creates a mismatch in the presence of substantial stock buybacks. Dividing the growth rates for the three carriers (10.1%, 11.9%, and 13.25%) by their average buyback rates (the type of adjustment that the AAR suggested in EP 664 (Sub-No. 2)) results in adjusted firm-wide

[2] Also, the AAR's IBES growth rates for each carrier include a forecast from an "undisclosed" source. AAR App. L, pp. 2-5. While the "undisclosed" estimate has little impact on the 2014 calculations, it undermines transparency and confidence in the result.

growth rates of 7.2%, 7.8%, and 10.3%, respectively.[3] Rerunning the AAR's MSDCF calculations using these adjusted growth rates, and retaining KSU's unchanged growth rate, yields an average MSDCF COE of 11.11%, as contrasted with the 12.30% calculated by the AAR. (The calculations are shown in electronic workpapers that are being submitted and are available to other parties upon request.) In other words, if the MSDCF were otherwise sound (and it is not), the buyback problem alone inflates the resulting MSDCF COE by more than 10%.

In EP 664 (Sub-No. 2), the AAR claimed that buybacks did not pose a problem for the MSDCF model because they represented a distribution to shareholders similar to dividends and that including buybacks in the calculation (as both an adjustment to growth rates as shown above and an additional cashflow distribution) made no material difference in the outcome. However, the MSDCF already model purports to capture all available cashflow, regardless of whether distributed through dividends or buybacks or retained. The AAR's rationale thus relies, at best, upon a double-count of cashflows.

Third, the AAR uses the CAPM to calculate a COE of 11.82% based on a risk-free rate of 3.07%, a market risk premium of 7.00%, and a beta of 1.2503. The AAR thus posits an expected market-wide return for equities in excess of 10%. A figure that high lacks credibility. For example, Duff & Phelps, which now publishes and maintains the Ibbotson MSDCF model, recommends a risk-free rate of 4% (based on a "normalized," meaning increased, 20-year Treasury return) and a market-risk premium of

[3] For CSX, 1.101 (10.1%) divided by 1.027 (2.7%) equals 7.2% (1.072). For NS, 1.119/1.038=1.078. For UNP, 1.1325/2.7=1.103.

5%. http://www.duffandphelps.com/ expertise/Pages/Cost_of_Capital.aspx. Using the Duff & Phelps recommendations and the same beta yields a CAPM COE of 10.25% (4% + (5% x 1.2503)). Substituting the actual 3.07% 20-year Treasury yield used by the AAR results in a more plausible expected market return of 8.07%, and a railroad industry CAPM COE of 9.32% (3.07% + (5% x 1.2503)). The unrealistic inputs thus inflate the CAPM COE by 15% to 27%.

Combining the modestly corrected MSDCF (11.11%) and CAPM (10.25%) results in a COE of 10.68%, not the 12.06% calculated by the AAR. The resulting overall COC is 9.50%, as contrasted with the 10.65% calculated by the AAR.

WCTL's purpose here is not to support a DCF-type approach, much less the particular MSDCF utilized by the AAR and the Board, nor is it to suggest that the CAPM need only incorporate the Duff & Phelps recommended risk-free rate and equity risk premium. WCTL's purpose is instead to demonstrate that the COC and COE values proposed by the AAR are deeply flawed and substantially overstated. They should not be adopted. The Board should instead devote its efforts to resolving EP 664 (Sub-No. 2) before determining the cost of capital for 2014, or at the very least make the 2014 finding subject to revision based on the outcome of EP 664 (Sub-No. 2). To continue with the agency's current course is to engage in substantial error, just as it did in determining the COE and COC for 2013 and earlier years.

Respectfully submitted,

WESTERN COAL TRAFFIC LEAGUE

Of Counsel:

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1224 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 347-7170

William L. Slover
/s/ Robert D. Rosenberg
Slover & Loftus LLP
1224 Seventeenth Street, N.W.
Washington, D.C. 20036
(202) 347-7170

Dated: May 11, 2015

Its Attorneys

CERTIFICATE OF SERVICE

I hereby certify that on this 11th day of May 2015, 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. 18), by first class mail, postage prepaid, and by email.

/s/ Robert D. Rosenberg