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BEFORE THE
SURFACE TRANSPORTATION BOARD

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RAILROAD COST OF CAPITAL --	)	EP 558 (Sub-No. 21)
2017	)	

PETITION OF THE WESTERN COAL	)	
TRAFFIC LEAGUE TO INSTITUTE A	)	
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**REPLY STATEMENT AND PETITION TO REOPEN
OF THE WESTERN COAL TRAFFIC LEAGUE**

WESTERN COAL TRAFFIC LEAGUE

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Dated: May 11, 2018

Its Attorneys

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**REPLY STATEMENT AND PETITION TO REOPEN
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Pursuant to notice that the Surface Transportation Board (“STB” or “Board”) served in EP 558 (Sub-No. 21) on February 8, 2018, the Western Coal Traffic League (“WCTL”)¹ submits its reply statement in response to the opening statement that the Association of American Railroads (“AAR” or “Railroads”) filed on April 20, 2018. WCTL also submits this filing pursuant to 49 U.S.C. § 1322 as a petition to reopen the decisions that the Board served in EP 664 (Sub-No. 2) on October 31, 2016, April 28,

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, Western Fuels Association, Inc., and Wisconsin Public Service Corporation.

2017, and August 14, 2017, refusing to revisit its cost of capital methodology, based on material error in light of new evidence and substantially changed circumstances.

WCTL accepts that the AAR generally followed the Board's prescribed methodology for estimating the cost of capital ("COC") for the railroad industry for 2017 at 10.52%. However, the fidelity of the AAR's calculations should not be the end of the matter, as the credibility of the results must also be considered, not swept aside.

The 10.52% COC for 2017 represents a very substantial increase of 18.7% (166 basis points) from the Board's 8.86% COC for 2016. The increase is largely attributable to the application of the MSDCF. The MSDCF cost of equity ("COE") was 10.44% in 2016, but is calculated at 13.33% for 2017, an increase of 27.7% or 289 basis points. The CAPM COE of 10.74% for 2017 shows a modest increase of only 55 basis points.

The Board's 2016 decision in EP 664 (Sub-No. 2) dismissed WCTL's concerns about the substantial gap between the MSDCF and CAPM values because "in the last two years the gap between the two estimates was fairly narrow." STB decision served Oct. 31, 2016, at 12. The Board further stated:

Indeed, it would hardly be surprising if the two approaches cross in the near future, and MSDCF may prove the lower of the two estimates, as past experience shows that, over time, one cost of capital model will produce higher outcomes for a period of years, and then lower outcomes over a subsequent period of years.

Id. (footnote omitted). The Board's footnote referenced a chart that the D.C. Circuit found unpersuasive. The reality is that the MSDCF COE has now exceeded the CAPM

COE for twenty consecutive years, utilizing the data Dr. Stangle submitted in EP 664 (Sub-No. 1) for 1998-2006 values. The average disparity has increased since the Board adopted its hybrid methodology. Both history and the 2017 values refute the Board's conclusions.

Unrealistic growth rates are the primary cause of the flawed MSDCF COE. The Stage Two growth rate was 7.47% in 2016, but 13.53% in 2017, an increase of 81%. Because the MSDCF has no transition mechanism, the Stage Two growth rate effectively applies for eleven years of the MSDCF, through the first day of Stage Three.² The calculation to reach Stage Three is effectively 1.1353^{11} or 4.04. The MSDCF thus projects that railroad earnings will quadruple from the 2017 starting level by January 1, 2028. Quadrupling of railroad overall earnings (not merely earnings per share) in such a short period, on top of the increase that already occurred in 2017, and without any subsequent retrenchment, is highly unlikely.

The AAR's sponsoring witness, John T. Gray, cognizant of the inexplicable gap between the CAPM and MSDCF equity costs, nonetheless seeks to explain it by the baseless assertion that the MSDCF is not too high and that "[i]n all probability, the CAPM is too low because it [unlike the MSDCF] has no way to account for the lower corporate tax rate." Gray V.S. at 49. In fact, the MSDCF and CAPM both reflect the

² The math is more complicated, as individual growth rates apply for Stage One and cashflow is redefined for Stage Three (as discussed *infra*), but the simple average is a conservative estimate.

Tax Cut and Jobs Act, but the MSDCF does so improperly because of the way that it is constructed.

While the tax cut does not take effect until 2018, it impacted deferred taxes in 2017 because deferred taxes are valued based on expected future tax rates. The recent tax cut reduced the value of the deferred tax liabilities, and the reduction is accounted for as income. Income and deferred taxes are both key inputs in the MSDCF. Mr. Gray's Appendix K shows massive increase in net income for all four railroads in 2017, but much of the increase comes from the reduction in deferred taxes.

The cut in the statutory tax rate from 35% to 21% is a one-time event. Even if the analysts (half of which are not identified) properly anticipated the tax cut in their earnings forecasts, they did so by including the impact in average growth rates estimated for three to five years. Because Stage Two "*is not a transition stage*" (Gray V.S. at 43) (original emphasis), the MSDCF projects that the events of the first five years will repeat over the next five years plus the first day of the eleventh year. Investors and the market know otherwise. The MSDCF simply produces an overstated cost of equity.

WCTL has noted this flaw in the MSDCF repeatedly. For example, WCTL addressed the overstatement caused by high growth rates in its EP 664 (Sub-No. 2) petition dated March 5, 2013, as did Dr. James E. Hodder in his accompanying Verified Statement at 3-6. Dr. Hodder also explained how the cashflow redefinition for Stage Three further increases cashflow by removing depreciation, deferred taxes, and capital expenditures. The problem is exacerbated for 2017 because the tax cut created negative deferred taxes for the year, so much so that deferred taxes reduce total 2013-2017

cashflow for CSX, NS, and UP. Stage Three thus recognizes how the reduced deferred taxes increased 2017 income, but not how those deferred taxes reduced cashflow. The treatment lacks basic coherence.

Mr. Gray’s claim that “the CAPM ... has no way to account for the lower corporate tax rate” (Gray V.S. at 49) is also incorrect as the tax cut reaches each component of the CAPM. The risk-free rate reflects interest rates, inflation, and the trade-off between stocks and bonds, all of which are changed by the tax cut. Beta can also change since some firms benefit more from the tax cut than others. The market risk premium will also be affected. Indeed, the risk-free rate and market risk premium both increased during 2017, whereas the railroad beta decreased slightly.

It is illogical to argue that a tax cut increases the cost of equity so significantly. The tax cut was intended to lower the cost of capital on a before-tax basis to foster investment.³ The Board, by design, calculates the cost of capital on an after-tax basis and applies separate tax adjustments for URCS, SAC, etc.

The tax cut has also not created any substantial increase in non-historical market risk premiums. For example, Professor Damodaran’s implied premium at the start of 2018 stood at 5.08%.⁴ Duff & Phelps cut its recommended ERP to 5.0% effective

³ E.g., Scott A. Hodge, “The Jobs and Wage Effects of a Corporate Rate Cut” (Tax Found. Oct. 25, 2017), <https://taxfoundation.org/jobs-wage-effects-corporate-rate-cut/>.

⁴ Aswath Damodaran, *Equity Risk Premiums (ERP): Determinants, Estimation & Implications – The 2018 Edition*, N.Y. Univ. – Stern School of Bus. (Mar. 14, 2018), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3140837 at 68, 87.

September 5, 2017, taking into account the potential tax cut.⁵ KPMG recommends a 5.5% MRP as of December 31, 2017, after the tax cut.⁶ The Pablo Fernandez survey for values to be used in 2018 shows an MRP of 5.4%, compared to 5.7% for 2017 and 5.5% for 2016.⁷ If the tax cut actually increased the cost of capital, there ought to be pervasive evidence to that effect, but there is none.

The perpetuation of the MSDCF-CAPM disparity in 2017, as set forth in the filing of the AAR, is proof that the MSDCF is distorted by high growth rates, as WCTL has long contended. The comparative 2017 equity costs constitute new evidence, not previously available, that the gap between the MSDCF and the CAPM has not disappeared, as the Board erroneously concluded two years ago, and that the flaws in the Board's MSDCF methodology persist. The tax cut also constitutes a changed

⁵ Duff & Phelps, *Duff & Phelps' U.S. Equity Risk Premium Recommendation Decreased from 5.5% to 5.0%, Effective Sept. 5, 2017* (Oct. 30, 2017), <https://www.duffandphelps.com/-/media/assets/pdfs/publications/valuation/coc/duff-and-phelps-decreases-us-erp-recommendation-to-5-percent-oct-2017.ashx> at 1, 6, 9. Duff & Phelps notes that "Long-term research indicates that the ERP is cyclical." *Id.* at 2, citing Cochrane, J. H. (2011), "Presidential Address: Discount Rates," *The Journal of Finance*, 66:1047–1108, available at: <http://onlinelibrary.wiley.com/doi/10.1111/j.1540-6261.2011.01671.x/full>. Use of a long-term historical trend prevents the recognition of that cyclicity.

⁶ KPMG, *Equity Market Risk Premium – Research Summary* (Jan. 24, 2018) <https://assets.kpmg.com/content/dam/kpmg/nl/pdf/2018/advisory/equity-market-risk-premium-research-summary.pdf>.

⁷ Pablo Fernandez, *Market Risk Premium & Risk-Free Rate used for 59 countries in 2018: a survey* (Apr. 4, 2018), https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID3155709_code12696.pdf?abstractid=3155709&mirid=1 at 7. The survey is taken in March (article at 1), and the 2018 survey provides a better fit for comparison to an end-of-year value calculated by the Board. Furthermore, the later timing and associated reduction further confirms that the tax cut has not resulted in an increased cost of capital.

circumstance as well as new evidence of the MSDCF's unsuitability as a tool for estimating the railroad industry cost of equity.

The MSDCF should not be used to determine the 2017 cost of capital. The Board should reopen its decisions in EP 664 (Sub-No. 2) to correct material error in its cost equity methodology, and it should not adopt a cost of capital for 2017 until it has done so.

Respectfully submitted,

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Dated: May 11, 2018

Its Attorneys

CERTIFICATE OF SERVICE

I hereby certify that on this 11th day of May 2018, 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 lists in EP 558 (Sub-No. 21) and EP 664 (Sub-No. 2) by first class mail, postage prepaid, or by more expeditious means.

/s/ Robert D. Rosenberg