

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

ENTERED
Office of Proceedings
June 14, 2017
Part of
Public Record

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 EQUITY CAPITAL	)))))))))	EP 664 (Sub-No. 2)
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**WESTERN COAL TRAFFIC LEAGUE
MOTION FOR LEAVE AND RESPONSE TO REPLY TO
SECOND PETITION FOR RECONSIDERATION**

WESTERN COAL TRAFFIC LEAGUE

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Dated: June 14, 2017

Its Attorneys

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**WESTERN COAL TRAFFIC LEAGUE
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The Western Coal Traffic League (“WCTL”) respectfully seeks leave to respond briefly to the Reply that the Association of American Railroads (“AAR”) filed on May 31, 2017 (“Reply”), in response to the Second Petition for Reconsideration that WCTL filed on May 11, 2017, in the above-captioned proceeding. While the AAR surely intends otherwise, the Board should understand that the AAR’s assertions only confirm WCTL’s showing of how buybacks taint the cost of equity under the MSDCF.

The AAR’S Reply states at page 7 that “[t]he value of a firm is not inherently affected by a new stock issuance.” If so, then the value of a firm should also not be affected by buybacks. Therein lies the problem.

Buybacks increase earnings per share as the same firm-wide earnings (key to the firm’s inherent value) are allocated over fewer shares, just as the ICC found that new issuances dilute earnings per share by allocating the same earnings over more shares.

Maintaining the same value of the firm while using higher earnings per share to grow higher future cash flows necessarily increases the cost of equity since the MSDCF defines the cost of equity as the discount rate where the present value of those future cashflows equals the market value.

The AAR attempts to evade this reality by claiming that buybacks represent “cash flow that occurs early” that thus “contributes more to [*i.e.*, increases] the stock price.” Reply at 3-4. The AAR’s evasion fails for three reasons. First, the inherent value of the firm is, as noted above, not affected by buybacks, just as the AAR asserts the inherent value is not affected by new issuances.¹ Second, the Board selected its MSDCF in order to focus on the cash flow *available* for distribution and render irrelevant actual distributions. Third, any dollars distributed to shareholders through buybacks can instead be distributed, just as early, to shareholders through dividends, but without altering earnings per share and thereby distorting the MSDCF. The problem is thus not the distributions *per se*, or when they occur, but the fact that buybacks, unlike dividends, reduce the number of outstanding shares and in turn cause earnings per share to change more than firm-wide earnings on a relative basis because of the reduced denominator.

¹ Indeed, the present value calculation already accounts for the effect of time, as the MSDCF discounts future cashflow to equal the present value of equity. The AAR’s claim that its historical evidence was “unchallenged” (Reply at 3) is another of its unfounded assertions. WCTL has previously explained that the AAR’s comparison of later cash flows to earlier forecasts improperly conflated *ex ante* expectations with *ex post* performance and that the inaccuracy of growth projections provides another reason to avoid relying on the MSDCF. Also, railroads do not uniformly exceed forecasts or even increase their cash flow. For example, Appendix K of the AAR’s submission for the 2015 cost of capital shows that the combined cash flow for the four carriers did not grow at all from 2011 to 2015, but actually *decreased* during that period by over 10%.

The AAR's final attempted evasion is to posit that the MSDCF avoids any problem by utilizing the equity market capitalization, whereas the Gordon Growth Model relies on the price per share. Reply at 5-7. Any superiority of the MSDCF in this regard is illusory. The Gordon Growth Model is at least internally consistent, *i.e.*, it relies on earnings *per share*, dividends *per share*, and market price *per share*. In contrast, the MSDCF uses earnings *per share* to grow *firm-wide* cashflows, which creates a mismatch when there are buybacks. The MSDCF does compare firm-wide cashflows with the firm-wide market value, but the overstatement in the firm-wide cashflows resulting from the buybacks still yields an overstated cost of equity when compared to the market value.²

In short, the AAR's attempted evasions only confirm that buybacks present a fundamental problem that undermines the viability of the MSDCF (apart from its other defects). The buyback problem must be fixed or, preferably, the MSDCF discarded.

Respectfully submitted,

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² While buybacks do not change the firm's inherent value (reflected in the market capitalization), each remaining share may be worth more as it represents a greater slice of that inherent value. Increasing the price per share serves to offset the increased earnings per share under the Gordon Growth Model, but not under the MSDCF, which uses the market capitalization (increased price of shares times the reduced number of shares).

CERTIFICATE OF SERVICE

I hereby certify that on this 14th day of June 2017, I have caused true and accurate copies of the foregoing filing to be served upon all parties on the service list in in EP 664 (Sub-No. 2), by first class mail, postage prepaid, or by more expeditious means.

/s/ Robert D. Rosenberg