

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	)	
RULEMAKING PROCEEDING TO	)	
ABOLISH THE USE OF THE MULTI-	)	EP 664 (Sub-No. 2)
STAGE DISCOUNTED CASH FLOW	)	
MODEL IN DETERMINING THE	)	
RAILROAD INDUSTRY'S COST OF	)	
EQUITY CAPITAL	)	

**PETITION FOR LEAVE TO SUBMIT SURREPLY
AND SURREPLY OF THE WESTERN COAL TRAFFIC LEAGUE**

WESTERN COAL TRAFFIC LEAGUE

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Dated: June 14, 2018

Its Attorneys

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The Western Coal Traffic League (“WCTL”) respectfully petitions for leave to submit this surreply in the above-captioned proceedings to respond to the Rebuttal Comments that the Association of American Railroads (“AAR”) filed on June 1, 2018. The AAR introduces new distortions and diversions in attempting to defend the MSDCF, and good cause exists for allowing WCTL to respond briefly in the interests of fairness and a more complete record.

First, the AAR attempts to make the MSDCF Stage Two Growth Rate for 2017 of 13.55%, which quadruples cash flow over eleven years and one day (*i.e.*, by the start of Stage Three), appear realistic. AAR at 6-7. The AAR contrasts the 13.55% growth rate with those for the preceding nine years, but the 2017 growth rate is still the highest of the last five. The Stage Two Growth Rates were higher in 2008, 2011, and 2012, but those were the years with the greatest MSDCF-CAPM disparity, which the

Board erroneously concluded had disappeared in EP 664 (Sub-No. 2) (STB served Oct. 31, 2016), at 12, as discussed in WCTL's Reply filed May 11, 2018, at 2-3.

The AAR then attempts to make the quadrupling appear plausible by noting that railroad after-tax ordinary income quadrupled from 1970 to 1980, doubled from 1995 to 2005, and tripled from 2005 to 2015. AAR at 7. But the only quadrupling was from 1970 to 1980, when inflation was rampant and the CPI more than doubled.¹ Furthermore, the quadrupling assumed by the 2017 growth rates comes on top of the substantial increase that already occurred in 2017. For example, UP more than doubled its net income (as distinguished from cashflow, as discussed *infra*), and CSX's tripled. The AAR's machinations do not provide any basis for finding that the 13.55% growth rate will prove realistic for net railroad earnings for the next ten years.²

Second, the AAR does not dispute that the tax cut drives the high earnings growth forecasts. Instead, the AAR faults WCTL for failing to note that the 2017 tax change did not alter 2017 cashflow (for MSDCF purposes) because the increased earnings were offset by the decrease in deferred taxes, which were negative. AAR at 9.

¹ From January 1970 to December 1980, the CPI increased by more than 128%. <https://data.bls.gov/cgi-bin/cpicalc.pl?cost1=100.00&year1=197001&year2=198012>. In contrast, the CPI increased by less than 22% from January 2007 to December 2017. <https://data.bls.gov/cgi-bin/cpicalc.pl?cost1=100.00&year1=200701&year2=201712>.

² Earnings per share will grow faster due to large buybacks. CSX is buying back at least \$5 billion of its shares between the first quarters of 2018 and 2019, amounting to almost 9% of its shares. <https://www.csx.com/index.cfm/investors/news-releases/?rptyr=2013&article=2331857>. On May 31, 2018, UP announced it plans to buy back \$20 billion of its shares during 2018-2020, which amounts to 18% of its market cap. https://www.up.com/cs/groups/public/@uprr/@investor/documents/investordocuments/pdf_up_18invday_rob_knight.pdf (slide 11 on page 6).

In fact, WCTL specifically noted that deferred taxes were negative in 2017 due to the tax cut. WCTL Reply at 4.

The problem is that the MSDCF utilizes projected earnings as its growth rate, but applies that growth rate to defined cashflow, not earnings, in its first two stages. That approach might be appropriate if earnings and cash flow were closely correlated. But the AAR's observation that the tax cut increased 2017 earnings, but not cashflow, demonstrates that earnings growth is a poor proxy for cashflow growth. The tax cut thus reveals the major disconnect between the growth proxy and the cash flow definition in the MSDCF. That disconnect is yet another reason not to utilize the MSDCF, even if the earnings forecast were credible as applied.

The AAR then reverses direction to observe that the cash flow is defined as earnings in the third stage and claims the shift appropriately reflects the tax cut. AAR at 9-10. But the tax cut is a one-time event, and the increase is already reflected in the initial (year 1) terminal cash flow.³ The MSDCF assumes that that the tax cut benefits will be repeated at least twice more, once in the first stage, and again in the second stage.⁴ The MSDCF is thus designed to overstate the impact of one-time events such as the tax cut, even if the five-year forecasts prove accurate for the first five years.

Third, the AAR reasserts that “the effect of the tax cut on the cost of capital will be seen in CAPM only over time.” AAR at 8. However, the risk-free rate, the beta,

³ For example, CSX's initial cashflow is \$1.1 billion for the first two stages, but \$2.5 million for the third. Gray VS, Appendix O.

⁴ To the extent the I/B/E/S forecasts include any three-year forecasts, the benefits could be felt three more times.

and the market-risk premium (“MRP”) for 2017 are all changed from 2016 and all reflect investor expectations of future events, of which the tax cut is one. The impact of the tax cut on the MRP is limited because it “utilizes all available historical stock market data” (*id.*), but that limitation is one that the Board imposes with the AAR’s strong support.

WCTL included within its Reply ample evidence regarding prospective and non-historical MRPs, some of which explicitly account for the tax cut. Some of those MRPs showed modest decreases, none showed a significant increase, and all were substantially below the AAR’s historical MRP.⁵ The AAR’s insistence on using an overstated historical MRP does not begin to provide an adequate foundation for concluding either that (a) the CAPM is incapable of reflecting the recent changes in the tax rate, or (b) the tax cut has caused any sort of increase in the cost of capital.

Indeed, one purpose of the tax cut was to reduce the before-tax cost of capital. The AAR’s thesis that the tax cut instead increased the after-tax cost of capital (beyond that calculated in the CAPM itself) is illogical and devoid of factual support.

In short, the AAR has done nothing more than restate its preference for a poorly-specified MSDCF, a hobbled CAPM, and anomalous results that favor its interests. Those are insufficient grounds for ignoring additional evidence of the material

⁵ The Damodaran implied MRP, in particular, represents a MSDCF analysis for the market as a whole, and was considered in the Duff & Phelps analysis. KPMG finds that the implied MRP is “the most appropriate methodology” to reflect the impact of recent events because the historical MRP “does not allow for the incorporation of the most recent market developments.”

<https://assets.kpmg.com/content/dam/kpmg/nl/pdf/2018/advisory/equity-market-risk-premium-research-summary.pdf> at 5, 6.

error inherent in the Board's methodology for estimating the cost of equity, or for criticizing WCTL for bringing that evidence to the Board's attention.

Respectfully submitted,

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Its Attorneys

CERTIFICATE OF SERVICE

I hereby certify that on this 14th day of June 2018, I have caused true and accurate copies of the foregoing Petition For Leave To Submit Surreply And Surreply 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