

**BEFORE THE
SURFACE TRANSPORTATION BOARD
Docket No. EP 664 (Sub No. 2)**

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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

**REPLY OF THE ASSOCIATION OF AMERICAN RAILROADS
TO MOTION FOR RECONSIDERATION OF THE
WESTERN COAL TRAFFIC LEAGUE**

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Pursuant to 49 C.F.R. § 1115.3(d), the Association of American Railroads ("AAR") hereby replies to the Second Petition for Reconsideration ("Pet.") filed by the Western Coal Traffic League ("WCTL"). For the reasons stated herein, the Petition should be denied.

PREFACE AND SUMMARY

WCTL has provided no basis for the Board to reconsider its April 28, 2017 Decision ("April 2017 Decision"), which denied WCTL's petition for reconsideration of a decision served on October 31, 2016 ("October 2016 Decision"). The October 2016 Decision thoroughly addressed the arguments presented by WCTL in its petition asking the agency to abolish the use of the Morningstar/Ibbotson Multi-Stage Discounted Cash Flow Model ("MSDCF") and declined to issue a Notice of Proposed Rulemaking. The Board carefully considered the evidence and arguments of the parties, and decided, in its sound and informed discretion, to continue with its existing approach to calculate the cost-of-equity component of the cost of capital as the simple average of the MSDCF model and the Capital Asset Pricing Model ("CAPM"). Similarly, the April 2017 Decision addressed WCTL's arguments and denied reconsideration.

A party may seek reconsideration of a Board decision by submitting a timely petition that (1) presents new evidence or substantially changed circumstances that would materially affect the case, or (2) demonstrates material error in the prior decision. 49 U.S.C. § 1322(c); 49 C.F.R. § 1115.3. As the Board cautioned WCTL in this very proceeding, it does not consider new issues raised for the first time on reconsideration where those issues could have and should have been presented in the earlier stages of the proceeding. *See, e.g., Tex. Mun. Power Agency v. Burlington N. & Santa Fe Ry.*, 7 S.T.B. 803, 804 (2004). In a petition alleging material error, a party must do more than simply make a general allegation; it must substantiate its claim of material error. *See Can. Pac. Ry. – Control – Dakota, Minn. & E. R.R.*, FD 35081, slip op. at 4 (STB served May 7, 2009). And “counsel’s argument is not the same as substantive testimony by expert witnesses, particularly on these kinds of highly technical finance matters.” *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry’s Cost of Capital*, Ex Parte No. 664 (Sub-No. 1), slip op. at 7 (released Jan. 28, 2009) (“MSDCF Decision”).

WCTL violates these principles in its interminable drive to lower the agency’s cost-of-capital estimate without any support in sound economics or its members’ own testimony in other fora. It raises new issues that could have and should have been presented before, and makes general allegations without substantiating its claims. Here, the Board’s explanation for rejecting WCTL’s allegations regarding the MSDCF growth estimates was neither unfounded nor contrary to agency precedent. The Board should therefore reject WCTL’s petition for reconsideration of the denial of reconsideration.

I. The Board’s Explanation Was Not “Unfounded”

In this proceeding, WCTL urged the Board to abandon the MSDCF model entirely – and rely exclusively on CAPM – because of amongst other reasons

perceived bias in the MSDCF model caused by stock buybacks. In its most recent decision, the Board rejected this argument succinctly: “WCTL has not provided adequate support for its claims that buybacks cause an overstatement.” April 2017 Decision at 9. The agency observed that “WCTL [on reconsideration] does not acknowledge or account for the offsetting effect of the buyback pulling cash flow forward in time.” *Id.*

WCTL claims this observation by the Board was “simply unfounded.” Yet no further explanation was forthcoming, leaving an accusation without substantiation. Perhaps it was because the Board’s observation was unchallengeable. Nowhere in its first petition for reconsideration did WCTL address or account for AAR’s central argument that debunked any claim of bias.

The AAR does not wish to beat a dead horse. But it bears repeating that the AAR submitted unchallenged evidence demonstrating that—if anything--modifying the MSDCF model to account for stock repurchases (which pulls distributions to shareholders forward in time) would increase (not decrease) the cost of equity estimate. Villadsen Opening V.S. at 14-18. As we explained previously, WCTL’s challenge boiled down to an allegation that the cash flow forecasts in the MSDCF model are too high. This is demonstrably false. Dr. Villadsen showed that the cash flow forecasts in the Board's MSDCF model were conservative, falling well below actual available cash flows, and that the WCTL’s proposed one-sided growth rate adjustments based on actual shares repurchased ignored the value to investors of the higher actual cash flows that were distributed via those repurchases.

As Dr. Villadsen explained, “Because the expected cash flow is discounted, cash flow that occurs early contributes more to the current stock price than cash flow that occurs later. This is important because the cash that accrues to shareholders from share buy backs occurs immediately rather than

later and therefore makes a substantial contribution to the stock price and hence the cost of equity (i.e., cash flow to shareholders is pulled forward in time).” *Id.* at 17. This evidence refuted WCTL’s unsupported claims that the cash flow forecasts and resulting cost of equity estimates were systematically optimistic due to the presence of stock repurchases. *See* Villadsen Hearing Exhibits; Tr. at 103-105; and Villadsen Opening V.S. at 17-18. WCTL offered no meaningful rejoinder to these undisputed facts. *See* WCTL Supp. Comments at 2-3 (filed Aug. 6, 2015).

WCTL readily throws unsupported accusations at the Board. In its first petition for reconsideration, WCTL besmirched the Board’s analysis as “facile” and “evasive.” Now it finds the reasoning “illogical” and “unfounded.” But refuting AAR’s witness proved impossible for WCTL. Indeed, WCTL never refuted the testimony submitted by the AAR – which the STB relied upon as sound – testimony that dispelled any notion that an adjustment to the MSDCF model was needed. The STB should therefore reject WCTL’s halfhearted attempt to claim otherwise, again.

II. The Board’s Decision was not “Contrary to Agency Precedent”

Switching gears, we turn to the apparent genesis of this second petition for reconsideration. In what WCTL describes as a “related aspect of the problem,” it claims the Board’s decision is contrary to precedent. Pet. at 3. WCTL unearthed two decades-old decisions by the Interstate Commerce Commission (“ICC”) it now claims are inconsistent – *R.R. Cost of Capital-1983*, 1 I.C.C.2d 643, 654-55 (1984) and *R.R. Cost of Capital – 1991*, 8 I.C.C.2d 402, 415 & n.14 (1992) – and filed its second petition to inject its latest theory into the record. However, WCTL’s new legal theory is both waived and wrong.

First, this argument is plainly waived. As indicated in the docket title, WCTL petitioned the Board to abolish the use of the MSDCF, not adjust it. In the

April 2017 Decision, the Board found that it need not address WCTL's alternative arguments regarding other MSDCF models or adjustments that were raised for the first time on reconsideration. April 2017 Decision at 6 & n.8 (*citing* Tex. Mun. Power Agency, 7 S.T.B. at 804). At some point, endless litigation must give way to administrative finality and repose. WCTL did not raise its latest theory of how ICC precedent required an adjustment to the current model on opening, or rebuttal, or at the hearing, or in the supplemental evidence after the hearing, or in the first petition for reconsideration. Surely it is too late now.

Second, WCTL's theory fails on the merits.¹ The lynchpin of its newest argument is a perceived inconsistency with how the ICC treated earnings per share (EPS) dilution when a railroad issued new shares in 1983 and again in 1991. Back in the day, the ICC was using a simple single-stage Gordon Growth Model to estimate the cost of equity. The formula for that method was expressed as $K = [D(i)/P(o)] + g$, where:

K = cost of equity

$D(i)$ = expected dividends

$P(o)$ = current stock price

g = expected growth rate

When a company issued new stock, the ICC would make an adjustment to reflect the dilution in dividends per share from the new issuance. "[W]hen a company sells additional stock, the existing shareholders experience a dilution of earnings

¹ The Board should dismiss this waived argument without reaching the merits for two reasons. First, holding WCTL to known procedural requirements will encourage other parties to follow the Board's rules. Otherwise, parties will continue to raise new arguments far too late in the proceedings under the belief that tardiness will be overlooked and the merits examined regardless. Second, a court called on to review this decision may set aside any claims of waiver if the issue was fully addressed by the agency, again incentivizing parties to ignore the prohibition against raising new arguments that could have been presented earlier in the proceeding.

per share, and a corresponding downward pressure on the price per share.” *R.R. Cost of Capital-1983*, 1 I.C.C.2d 643, 654-55 (1984). As the Gordon Growth Model estimated the cost of equity from stock prices, an adjustment was needed. This modification resulted in the modified formula $K = (D(i)/[P(o) \times (1-f)]) + g$, where f equals flotation costs. *Id.*

WCTL then leaps to the conclusion that the Board committed material error by not adjusting the growth rate forecasts in the Morningstar/Ibbotson model to reflect stock buybacks. “Buy backs are the functional opposite of new issuances,” claims WCTL, such that if an increase to the Gordon Growth Model due to new issuances of stock was needed, “it follows ineluctably” that the Board must decrease the cost of equity estimate produced by the Morningstar/Ibbotson model due to stock buybacks. Pet. at 4.

WCTL is manufacturing conflict where none exists. The agency no longer uses the simplistic Gordon Growth Model to estimate the cost of equity. It switched to the Morningstar / Ibbotson model, in part because “it does not limit future cash flows to dividend payments alone, but incorporates a wider array of cash flows for equity investors.” *MSDCF Decision* at 4. Thus, unlike the Gordon Growth Model – which equated *stock price* with a projected dividend stream – the cost of equity derived from the Morningstar / Ibbotson model “is the discount rate that equates a firm’s *market value* to the present value of the stream of cash flows that could affect investors.” *Id.* at 5 (emphasis added). The critical distinction is that the older model derived the cost of equity estimate from stock prices and dividend yields, whereas the Morningstar / Ibbotson model rests on the market value of the railroad and total cash flow.

As a result, WCTL offered no evidence or expert testimony that the STB would or should make the same adjustment from the 1980s to the model used today. Indeed, it appears on its face that the impact from any dilution in stock

value from a new issuance of shares is already baked into the Morningstar / Ibbotson model. The value of a firm is not inherently affected by a new stock issuance, just as the value of a \$100 bill is not affected if it is exchanged for two \$50 bills. And if a stock issuance does affect the market capitalization of a firm, it would be because investors perceive a shift in the expected total cash flows from the infusion of cash, which is also baked into the Morningstar / Ibbotson model.

As a result, it does not “follow ineluctably” that an adjustment made by the ICC 30-years ago to account for new stock issuances now compels a *different* adjustment to a *different* model to address *different* market phenomena. And, as discussed above, the AAR provided compelling expert testimony that no adjustment to the Morningstar / Ibbotson model was needed to address stock repurchases. Given that record, there is simply no basis for the Board to reverse course based on two dated and seemingly irrelevant ICC decisions. This new argument lacks economic support, rests on flawed assumptions, was obviously waived, and should fail.

CONCLUSION

The Board choose to use the Morningstar / Ibbotson model for good reason. The model “is a commercially accepted multi-stage DCF model, developed by disinterested, respected third parties, that was created for use by the financial community in evaluating publicly traded equities and in making real-world investment decisions.” *MSDCF Decision* at 4. The Board saw “no need to construct a railroad-only multi-stage DCF model for the cost of equity when a reputable independent vendor provides a suitable model for our purposes.” *Id.* at 7.

This was wise. If the Board replaced the Morningstar / Ibbotson model with one of its own design, it would need to consider issues other than those

cherry-picked by WCTL. More fundamentally, AAR submitted testimony that debunked WCTL's accusation that stock repurchases were biasing the cost-of-equity estimates. WCTL clearly did not "acknowledge or account for the offsetting effect of the buyback pulling cash flow forward in time." April 2017 Decision at 9. Nothing in WCTL's second petition for reconsideration can or could change the fact that "WCTL had not provided adequate support for its claim that buybacks caused a distortion." *Id.*

This proceeding has become an odyssey. The April 2017 Decision marked the third time in 8 years that the Board has examined its cost-of-capital methodology and concluded that it should use the simple average of the MSDCF and CAPM. WCTL has railed against that decision, urging a different methodology to produce a lower cost of equity more to its liking. WCTL has also attempted to challenge the methodology in numerous annual cost-of-capital determination proceedings (including the 2016 determination this year), despite the Board's admonition against raising such a challenge within the annual Ex Parte No. 558 sub-numbered proceeding.² The Board should not allow the cost-of-capital process to degenerate into vexatious, never-ending litigation. The Board should deny this second petition for reconsideration – and instruct WCTL that it may not file a third petition for reconsideration – to permit this epic journey to end.

² See Decision at 3-4, 6 n.9; Ex Parte No. 558 (Sub-No. 19), *Railroad Cost of Capital – 2015*, Decision served Aug. 3, 2016, at 2-3 & n.4, 9-10.

Respectfully submitted,

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