

**PETITION OF THE WESTERN)
COAL TRAFFIC LEAGUE TO)
INSTITUTE A RULEMAKING)
PROCEEDING TO ABOLISH THE) EP 664 (Sub-No. 2)
USE OF THE MULTI-STAGE)
DISCOUNTED CASH FLOW)
MODEL IN DETERMINING THE)
RAILROAD INDUSTRY’S COST OF)
EQUITY CAPITAL)**

WESTERN COAL TRAFFIC LEAGUE

Dated: May 11, 2017

Its Attorneys

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

PETITION OF THE WESTERN	)	
COAL TRAFFIC LEAGUE TO	)	
INSTITUTE A RULEMAKING	)	
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**WESTERN COAL TRAFFIC LEAGUE
SECOND PETITION FOR RECONSIDERATION**

Pursuant to 49 U.S.C. § 722(c) and 49 C.F.R. § 1115.3(b), the Western Coal Traffic League (“WCTL”) respectfully petitions the Surface Transportation Board (“Board” or “STB”) for reconsideration of the decision it served in the above proceeding on April 28, 2017, denying the petition for reconsideration WCTL filed on November 21, 2016, seeking reconsideration of the decision that the Board served on October 31, 2016.

WCTL seeks further reconsideration on the grounds that the Board’s failure to adjust the cost of equity (“COE”) calculated under its Multi-Stage Discounted Cash Flow model (“MSDCF”) to account for the effect of stock buybacks on earnings per share (“EPS”) constitutes material error. WCTL previously showed how buybacks cause the EPS growth used in the MSDCF to exceed actual growth in firm-wide earnings, but the Board still has not responded meaningfully to WCTL’s concerns. Moreover, what the Board has said about buybacks is illogical and contrary to agency precedent involving new issuances.

WCTL’s earlier petition for reconsideration showed that the Board’s focus on buybacks as a distribution to shareholders did not explain away the buyback problem because dividends, like buybacks, also distribute cash to shareholders, but without altering the number of shares or the related EPS growth rate used in the MSDCF.¹ The Board’s response that “WCTL does not acknowledge or account for the offsetting effect of the buyback pulling cash flow forward in time”² is simply unfounded.

The Board further states that “even if” buybacks increase EPS growth by reducing shares, “that effect would be offset by the additional distribution of cash flow at the time of the buyback.”³ The Board’s observation that buybacks represent a distribution to shareholders is no answer at all. Again, dividends also distribute cash. Beyond that, WCTL has previously noted that the MSDCF that the Board intentionally selected focuses on the cash that is *available* for distribution, rather than the cash that is *actually* distributed through dividends and buybacks.⁴ “The Morningstar/Ibbotson model does not explicitly account for stock options and stock buybacks because it focuses on a broader measure of free cash flow that is potentially available to equity investors,” and it “does not assume that these cash flows are actually paid out to equity investors.”⁵

¹ WCTL Pet. for Reconsideration, EP 664 (Sub-No. 2), filed Nov. 21, 2016, at 13.

² Decision, EP 664 (Sub-No. 2) (STB served Apr. 28, 2017), at 9.

³ *Id.* (citing the AAR’s expert).

⁴ *E.g.*, WCTL Reply Statement in *Railroad Cost of Capital–2015*, EP 558 (Sub-No. 19), filed May 11, 2016, at 3.

⁵ *Use of a Multi-Stage Discounted Cash Flow Model in Determining the Railroad Industry Cost of Capital*, EP 664 (Sub-No. 1) (STB served Jan. 28, 2009), at 12. WCTL

It is manifestly inconsistent for the Board to assert that both (a) the level of actual distributions to shareholders does not matter because the MSDCF defines cashflow broadly, and (b) its MSDCF has no EPS problem because the buybacks distribute cash to shareholders. The Board cannot have it both ways. Again, the problem remains that buybacks, unlike dividend distributions, reduce the number of shares and thereby increase the EPS, which the MSDCF uses to grow firm-wide cashflows.

A related aspect of the problem is that the Board's attempt to dismiss the change in the number of outstanding shares is contrary to agency precedent. Specifically, the Board's predecessor, the Interstate Commerce Commission ("ICC"), recognized the need to increase the COE under its discounted cash flow model ("DCF") to account for the EPS dilution that occurs when new shares are issued. If the DCF-based COE is increased when new shares are floated to account for EPS dilution, then the same logic and basic fairness require that the COE be decreased when buybacks reduce the shares outstanding in order to account for the resulting concentration or increase in EPS.

The ICC addressed the issue of EPS dilution when CSX floated new shares to the public in 1983 and BN did so in 1991. *Railroad Cost of Capital–1983*, 1 I.C.C.2d 643, 654-55 (1984); *Railroad Cost of Capital–1991*, 8 I.C.C.2d 402, 415 & n.14 (1992). In both decisions, the ICC agreed with the AAR to increase the COE to account for the costs associated with issuing additional shares.

filed comments filed in that proceeding on April 14, 2008, that offered a MSDCF that defined cashflows as dividends plus buybacks less proceeds from new issuances.

The 1983 additive covered not only the direct floatation costs (commissions and other out-of-pocket costs paid to float the additional shares), but also an additional additive to reflect the dilution (reduced EPS) resulting from the issuance of the additional CSX shares. *Railroad Cost of Capital–1983*, 1 I.C.C.2d at 654 n.42. The ICC explained that “when a company sells additional stock, the existing shareholders experience a dilution of earnings per share, and a corresponding downward pressure on the price per share.” *Id.* at 655 (footnote omitted). The ICC’s footnote showed how issuing 10% more shares reduces EPS by 9%. *Id.* at n.46. The ICC’s EPS dilution example is an exact counterpart to WCTL’s examples of how buybacks increase EPS.

The ICC additive used the same adjustment to the DCF formula in 1991 to incorporate an additive to account for the dilution associated with the BN issuance. “In addition, the stock price suffered a dilution of 0.87% as a result of the addition of new shares.” *Railroad Cost of Capital–1991*, 8 I.C.C.2d at 415 (footnote omitted). The footnote explained that “[w]hen new shares of stock are issued, the existing shareholders’ ownership in a company are diluted since they now own a lesser percentage of the company. This dilution effect is usually considered as a cost, along with flotation charges.” *Id.* at n.14.

Buybacks are the functional opposite of new issuances: buybacks reduce the number of outstanding shares and increase the EPS, just as new issuances increase shares and reduce the EPS. Therefore, if it was appropriate, as the ICC found at the AAR’s urging, to *increase* the DCF-based COE to reflect the issuance of new shares and associated EPS dilution, then it follows ineluctably that the Board must *decrease* the

COE to reflect the reduction in outstanding shares caused by net buybacks to account for the resulting EPS concentration, assuming that a DCF method is utilized at all.

Refusing to reduce the cost of equity or adjust the growth rate to reflect buybacks, when the cost of equity was previously increased to reflect new issuances, causes an asymmetrical and unfair distortion in the COE. The error is made severe because there have been only two small, one-time issuances, both over 25 years ago, whereas the buybacks have been sustained and substantial over the past decade, thereby compounding their impact on EPS, and they show no sign of ceasing. WCTL's comments on the 2015 cost of capital, at 6-8, for example, showed how buybacks in that year accounted for 2.95% of the EPS growth, more than half of the total average forecasted simple average EPS growth of 5.49%.

Failing to adjust for buybacks is fundamentally inconsistent and constitutes material error. Accordingly, the Board must either adjust for buybacks or, better yet, cease using the MSDCF altogether.⁶ The Board should also restate past values to correct the material error resulting from the failure to adjust the COE values under MSDCF to reflect the impact of the buybacks.

⁶ The Board's professed inability to understand WCTL's trailing adjustment to correct for error (Apr. 28, 2017 Decision at 6 n.8) rings hollow. The Board employs a forecast error adjustment for the RCAF and a trailing productivity adjustment for the RCAF-A and RCAF-5. It also recently proposed and utilized, on its own initiative, a linking factor to adjust for the change in measured productivity resulting from use of a different methodology to measure waybill mileage. *Railroad Cost Recovery Procedures—Productivity Adjustment*, EP 290 (Sub-No. 4) (STB served Feb. 24, 2017). The Board is well-acquainted with means to adjust for bias and error.

Respectfully submitted,

WESTERN COAL TRAFFIC LEAGUE

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CERTIFICATE OF SERVICE

I hereby certify that on this 11th day of May 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