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BEFORE THE
SURFACE TRANSPORTATION BOARD

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RAILROAD COST OF CAPITAL -- 2012	)))	Ex Parte No. 558 (Sub-No. 16)

REPLY STATEMENT OF THE WESTERN COAL TRAFFIC LEAGUE

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Dated: May 10, 2013

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Pursuant to the notice that the Surface Transportation Board ("STB" or "Board") served in the above-captioned proceeding on February 26, 2013, the Western Coal Traffic League ("WCTL" or "League")[1] submits its reply statement in response to the opening statement that the Association of American Railroads and its member railroads ("AAR" or "Railroads") filed on April 19, 2013.

The AAR estimated the cost of equity ("COE") at 16.39% under the Multi-Stage Discounted Cash Flow Model ("MSDCF") and 10.27% under the Capital Asset Pricing Model ("CAPM"). The MSDCF value is thus 612 basis points higher and 59.6% greater than the CAPM value. Such a large disparity in values ought to prompt inquiry into the underlying cause and consideration of which value is more probative.

[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 175 million tons of coal by rail each year. WCTL's members are: Ameren Energy Fuels and Services, Arizona Electric Power Cooperative, Inc., CLECO Corporation, Austin Energy (City of Austin, Texas), 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, Texas Municipal Power Agency, Western Fuels Association, Inc., and Wisconsin Public Service Corporation.

WCTL's review revealed a factor that contributes substantially to the disparity. The MSDCF utilizes forecasted growth in earnings per share ("EPS") as a proxy for growth in earnings and/or cashflow. When the number of shares remains constant, growth in EPS can, in theory, serve as a reasonable proxy for growth in firm-wide earnings and/or cashflow.

However, change in the number of shares distorts that relationship. In particular, reducing the shares causes EPS to increase faster than overall earnings when earnings increase. Consider a simple example where earnings and shares are both 100 in year 1, but in year 2 the earnings grow to 103 and shares decline to 97. The EPS in year 1 is 1.0 (100÷100=1.0). In year 2, the earnings grow by 3% (103÷100=1.03). However, the EPS in year 2 is 1.0619 (103÷97), which represents a 6.2% increase. The increase in EPS is double the increase in actual earnings. Relying on accurate EPS growth estimates to project cashflows under such circumstances will create a mismatch between EPS growth and growth in firm cashflows. The overstated cashflows will, in turn, yield an inflated COE when cashflows are discounted to their net present value.

The 10-Q reports for 3Q12 of CSX, NS, and UP, show that each railroad included in the composite sample significantly reduced its shares over the past year:[2]

[2] The 10-Q reports present the number of shares in different ways including (a) shares outstanding as of a date certain (which AAR witness Gray utilized in his V.S., Appendix M, pp. 4-6), and (b) weighted averages of outstanding (basic) and fully diluted shares for the applicable periods (last quarter and year-to-date). Financial reporting and analysis tend to focus on fully-diluted figures, and WCTL has measured changes in the number of shares on that basis. That said, changes across the various measures of shares tend to be very similar.

Table 1 Percentage Change in Number of Fully-Diluted Shares of the Three Railroads Included in the Composite Sample for 3Q12 Relative to 3Q11			
(1) Carrier	(2) Fully Diluted Shares (millions) for 3Q12	(3) Fully Diluted Shares (millions) for 3Q11	(4) Percentage Reduction for 3Q12/3Q11*
CSX	1,040	1,077	3.4%
NS	321.8	349	7.8%
UP	475.2	488.1	2.6%

* Column (4) value equals [column (3) value minus column (2) value] divided by column (2) value, expressed as a percentage.

The simple average of the share reductions is 4.6%. In contrast, the AAR presents a simple average of median EPS growth rates of 14.07%. Gray V.S., Appendix M, p. 1. Moreover, the problem is not limited to 2012. For example, UP's 3Q08 10-Q shows 531.4 million fully diluted shares as of 3Q07, but 511.3 million (split-adjusted) shares as of 3Q08, a 3.8% decrease. BNSF's 3Q08 10-Q shows 357.1 million fully diluted shares as of 3Q07, but 347.2 million shares as of 3Q08, a 4% decrease.

Analysts are unlikely to ignore such share reductions in projecting EPS, as EPS projections that ignore share reductions of this magnitude are likely to be inaccurate. There is thus a significant mismatch in using EPS forecasts to model changes in railroad cashflows. The reduction in shares and associated mismatch cause the MSDCF methodology to yield an inflated COE value.

Under the circumstances, the Board should rely exclusively on CAPM to estimate the COE, as it did in 2006 and 2007, at least until such time as it determines if the MSDCF methodology can be corrected. The Board should also consider restating its 2008-2011 COE values to eliminate the error in those MSDCF calculations.

The Board's previous cost of capital decisions have dismissed WCTL's MSDCF concerns, stating that such concerns must be raised through a petition to institute a rulemaking. Because this construction of its duties and discretion under the Administrative Procedure Act appear to have impeded the Board from correcting its erroneous past capital cost findings in its annual cost of capital proceedings, the time may be nigh where rail transportation consumers must seek affirmative action.

In any event, the MSDCF figure presented by the AAR for the 2012 COE is inaccurate and should not be utilized.

Respectfully submitted,

WESTERN COAL TRAFFIC LEAGUE

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Dated: May 10, 2013

CERTIFICATE OF SERVICE

I hereby certify that on this 10th day of May 2013, 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 list in Ex Parte No. 558 (Sub-No. 12), by first class mail, postage prepaid, and by email.

/s/ Robert D. Rosenberg