Consultation on methodology for determining CN's and CP's Capital Structure under the MRE

CN's submission - 14 October 2016

Issue 1: Items to be included in the capital structure

Based on the Agency Decision, and following generally accepted accounting principles, Agency staff wishes to receive feedback, for consideration by the Agency Members, on a definition of the Balance Sheet Approach for determining the capital structure for CP and CN as comprising the following items:

1. *That the Net Rail Investment comprises the following components:*

(i) *The net book values of property assets identified in the Uniform Classification of Accounts (UCA) accounts 102-195 (full list in Appendix I of this document);*

(ii) *The pension asset (UCA account 197) as defined in Agency Decision No. 97-R-2012;*

(iii) *The working capital allowance; and*

(iv) *Deferred charges and other assets.*

2. *That the Capital Structure comprises the following components:*

(i) *The long-term debt;*

(ii) *The deferred taxes, investment tax credits and deferred downsizing costs; and*

(iii) *The shareholders' equity.*

3. *That the net cash balance cannot be applied to reduce long-term debt*

1. Net Rail Investment

1.(i) Property Assets CN submits that the Net Rail Investment should also include the net book values of property assets identified in the Uniform Classification of Accounts (UCA) accounts 101 for Land. Land is an important asset for the corporation and its operations. CN routinely buys land properties for developing its network (siding extensions, spurs to serve new customers, even entire shortlines, etc.) or sells land properties of lines no longer foreseen as economically viable. These additions and retirements of land do impact the amounts of investments that have to be financed and therefore should be taken into account in determining the Net Rail Investment for the purpose of calculating the cost of capital (CoC).

1.(ii) The Pension Asset (UCA account 197) as defined in Agency Decision No. 97-R-2012 is calculated on a cash basis which is non-compliant with US GAAP. For the Transport Canada 2015 annual report, the Agency changed the accounting method for Pension Asset from cash basis to US GAAP, see decision LET-R-53-2014. For consistency with the annual report, pension asset (and liability) should be reported on a US GAAP basis for the CoC calculations.

1.(iii) The Working Capital Allowance CN submits that the working capital allowance should be equal to (Current Assets) minus (Current Liabilities). More on this subject can be found in the discussion of issue #2 below.

1.(iv) Deferred Charges and Other Assets These currently comprise both deferred charges and long term investments in rail operations. CN agrees that long-term prepaid expenses, such as locomotives' warranties, should remain in the determination of net rail investments.

2. Capital Structure

2.(ii) The Deferred Taxes, Investment Tax Credits And Deferred Downsizing Costs CN has always been of the opinion that its capital structure has only two sources of financing: long term debt and shareholders' equity. The deferred taxes, investment tax credits and deferred downsizing costs are adjustments required by accounting rules and not a source of financing. Corporations can go to the markets to raise funds by issuing debt instruments or equity shares. Corporations cannot raise funds by issuing "deferred taxes" or "deferred downsizing costs". These are all non-cash items that are required only for accounting purposes and have no real bearings on the company's financing. These accounting artifices are only required because of the Agency's insistence on using "book values", another accounting device that has no bearings on required financing or investors returns. Financing and returns are all driven by market values. Equipments and investments are not bought or sold at book values but at market values. Investors who buy the company's shares or bonds expect returns on the market value of their investment, not its book value. CN challenges the pertinence of the Agency's cost of capital method where the CAPM model is used to estimate the expected market returns on CN stock as traded on the TSX and the NYSE, and then uses this market return as applied to the book value of equity which is less than half the market value. Since these deferred costs are only accounting devices and not real funds obtained from a financing source outside the corporation, any amounts they represent on the balance sheet are ultimately financed by investors and therefore should attract the returns expected by these investors in the same proportion as debt and equity.

Investment Tax Credits CN questions the treatment of investment tax credits (ITC) that current Agency rules put in liabilities. CN is of the opinion that investment tax credits should go against the property investments that generated these credits to begin with. Investment tax credits should be afforded the same treatment as Donations & Grants (D&G) which go against property investments to reduce their value for CoC purposes. Unlike other liabilities (bonds, equity, or deferred costs) ITC do not represent an amount that is owed or has to be paid to anyone in the future. Like D&G, ITC should be used to reduce the value of properties in the determination of the Net Rail Investments for CoC calculation purposes.

2.(iii) The Shareholders' Equity As expressed before, CN is of the opinion that shareholders' equity should be evaluated using market value and not book value. The Agency agrees partially since its prescribed method of determining the rate to be applied to the equity portion of the cost of capital uses the Capital Asset Pricing Model (CAPM) as applied to the trading of CNR shares on the TSX and CNI shares on the NYSE. Where CN differs with the Agency is in determining the weights to be used for this market rate of return. CN argues that since the rate of return is determined using the market value of CN shares, the market values of such shares should be used in weighing the different sources of capital. It makes no sense to determine thru CAPM analysis that investors expect 6% return on $80 shares as traded on the market, and then turn around and apply that 6% return on, say, $20 book value of shares.

The long-standing argument that it is very difficult to almost impossible to determine the market value of assets is both true and irrelevant. We do not need to determine the market value of assets. The CoC weights in the current Agency method are determined based on the value of liabilities, bonds and equity, and not assets. Both of these liabilities have easily determined market values, and, as a matter of fact, the Agency's prescribed methodology uses the market value of equity to determine shareholders required return on equity.

3. The Net Cash Balance

CN agrees that the net cash balance should not be applied to reduce long-term debt. Long term debt is well identified on the company's books and requires the returns expected by bondholders, and any cash balance (net of short term liabilities as explained above) is part of the working capital that should attract the cost of capital returns required by investors. CN ordinarily carries no large amounts of excess cash, only what is prudently required for day to day operations, and thus form part of working capital.

Issue 2: Methodology to determine the working capital allowance

There have indeed been significant changes to CN operations both qualitative and quantitative since the last determination of working capital allowance in 1992 (which CN believes was based on 1985 or 1986 data). While it is generally accepted in North American regulatory circles that a lead-lag study is the most accurate way of properly gauging the amount of working capital required for the operations of a regulated utility, it is also the method that requires the most resources and effort, and that is why it has not been reproduced since 1992 for the prescribed railways in Canada. Moreover, CN is not a regulated utility. Regulated grain movements represent less than 10% of its Canadian operations traffic. It would be inappropriate to apply a method developed for regulated utilities to an almost unregulated company.

CN proposes instead to use the simpler and more classical definition of working capital: net short term assets, or current assets minus current liabilities. This is an acceptable measure of the short term working capital required to operate the business on a day to day basis, and hence to cover the time period between when services are rendered and expenses paid by CN, and when revenue is ultimately collected from customers who received these services. To dampen the volatility that may be present in such an estimate made only with a snapshot taken at the conclusion of a fiscal year, as opposed to an average over an entire year, a multi-year rolling average of 2 or 3 years could be used.

By subtracting Current Liabilities, this simple definition removes from consideration supplier-financed or other short-term-liabilities-financed assets or inventory. Cash that would still be available in working capital conceptually belongs to the investors (bondholders and shareholders), and as such should attract the returns required by them. CN is of the opinion that any vendor supplied finance is ultimately baked into the price of goods and services that CN buys, and therefore all financing costs are ultimately borne by investors.

With this new and simple definition, the working capital allowance could be updated every year. The working capital allowance would thus follow the business cycles as customers and/or CN take longer or shorter time to pay their invoices.