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Ms. Marcia Jones
Chief Strategy Officer
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RE: CN SUBMISSION - CONSULTATION ON THE METHODOLOGY TO DETERMINE NET RAIL INVESTMENT AND CAPITAL STRUCTURE FOR THE CALCULATION OF COST OF CAPITAL RATES

Dear Ms. Jones,

Please find enclosed CN's response to the initial submissions of stakeholders pursuant to the Agency's Discussion Paper on the methodology to determine net rail investment and capital structure for the calculation of cost of capital rate.

We remain available should the Agency require more information.

Yours truly,

Eric Harvey
Senior Counsel - Regulatory

Canadian National Railway Company's response to the initial submissions of stakeholders pursuant to the Agency's Discussion Paper on the Methodology to Determine Net Rail Investment and Capital Structure for the Calculation of Cost of Capital Rate

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Thank you for providing the opportunity to respond to the initial submissions of stakeholders concerning the questions and issues raised in the **"Consultation on Cost of Capital Rates"** dated September 25, 2020 and the ensuing **"Discussion Paper on the Methodology to Determine Net Rail Investment and Capital Structure for the Calculation of Cost of Capital Rates"**. After our introductory remarks, we submit our comments following the same structure established in the Discussion Paper.

Introduction

The introductory comments submitted by Dr. Gould in his report included within the McMillan submission dated as of November 24, 2020 give an excellent framework for understanding and identifying the different presentations of the same balance sheet for cost of capital (COC) purposes. In essence, there are two different presentations:

1. The "Gross Method" where current liabilities (CL) and accumulated deferred taxes (ADT) are presented on the liabilities side of the balance sheet; and
2. The "Net Method" where CL and ADT are netted out of the assets side of the balance sheet, leaving only investor supplied capital on the liabilities side.

Canadian National Railway Company (CN) has long been a proponent of the Net Method of presentation.

- Firstly, this method focuses on the returns required by investors, which are the crux of COC determinations. It allows for an easier comparison with the return on invested capital (ROIC) presented in a company's financial statements and is well understood by the investor community.
- Secondly, as demonstrated by Dr. Gould, the weighted average cost of capital (WACC) of the Net Method is the same for the entire company as for each of its operating divisions, a position that CN has advocated for in calling for the COC determination of the entire company, rather than just the Canadian operations.
- Thirdly, the Net Method allocates the general-purpose debt among the different divisions of a company based on the assets in each division, a position also proposed by CN and supported by Canadian Pacific Railway (CP) in its submission.

It is important to note, as the Gould report demonstrates, that when properly applied, all methods lead to the exact same dollar returns to investors, thereby concluding that there is no inherent monetary advantage of one method versus another. However, some methods are simpler, and less prone to misapplication. For example, no allocation of general-purpose debt is required if we evaluate the WACC for an entire company. In contrast, evaluating the WACC for only one division of a company runs the risk of introducing an error or disagreement about the distribution of general-purpose debt based on disputed, mis-aligned or mis-interpreted measures.

It is also important to note that if we adopt the Gross Method for an individual division, the Net Method will still need to be evaluated for all divisions, because the general-purpose debt distribution is always carried out based on the percentage of assets of the Net Method, even in the Gross Method. Therefore, given that the Net Method is still needed even if we adopt the Gross Method, then a <u>fourth</u> advantage of the Net Method is to reduce the bureaucratic burden of COC determination because we will need to evaluate only the Net Method rather than both the Net and Gross methods.

CN finds it necessary to remind all stakeholders involved in this discussion that, contrary to some apparent misconception, <u>CN is not a regulated utility</u>. Economic regulation of CN's operations in Canada

are limited to dispute cases about rate and service issues (including final offer arbitration), long-haul interswitching rates, mandatory interswitching, and the maximum revenue entitlement (MRE) for the export movements of Western regulated grain. Unlike a regulated utility whose rates are set by allowing a certain guaranteed return on a certain rate base, CN is free to set its transportation rates[1] and is exposed to many market risks[2]. It is in this non-utility context that CN must compete for investors' capital, not only from investors in the Canadian market, but also from worldwide investors. Therefore, the returns that CN must provide have to be commensurate with investors' expectations from companies with similar risk profiles, which are higher than for regulated utilities.

As aptly summarized in the Gould Report of the McMillan submission, the annual cost of capital rate determination is for specific statutory and regulatory applications:

- *As a component in the volume-related composite price index calculation that establishes the maximum revenue entitlement for the movement of Western grain by rail.*
- *For use in the development of interswitching costs and rates.*
- *For other regulatory purposes requiring cost determinations, such as technical costing assistance in Final Offer Arbitration proceedings between a shipper and a railway.*

The third point is an *ad hoc* dispute resolution arbitration procedure, whereby the arbitrator must choose between two competing offers, and is therefore not a regulatory rate setting *per se*. Its frequency varies greatly from year to year. Therefore, only the first two points can be described as rate setting activities by a regulator.

In its 2019 fiscal year, CN's revenue from regulated Canadian grain movements represented only 7.1% of its total $14.2B of freight revenues[3]. Adding 2.2% for non-regulated Canadian grain (i.e. grain for Canadian domestic consumption, grain moving east of Thunder Bay and Armstrong, ON, grain moving in containers, and grain exports to the U.S.) total Canadian grain movements represented only 9.3% of CN freight revenues. This is less than half of the 20% claimed by the Western Grain Elevator Association (WGEA) in its letter supporting the McMillan submission.

CN's revenue from regulated interswitching activities is about 0.3% of its freight revenues[4]. Therefore, total CN revenue from regulated activities accounts for only 7.4% of CN's freight revenues. The other 92.6% of CN's revenues are not regulated. As such, CN should not be categorized as a regulated utility.

If all of CN's activities were regulated like a utility with the COC and calculation methods ascribed by the Agency, CN would face significant financial shortfalls and would be running yearly deficits as it did for

[1] Even under the MRE, CN is free to set each of its individual transportation rates subject only to the maximum total annual revenue.
[2] See the section entitled *Business risks* of CN's annual report for a description of major risk factors. The *2019 Full Year Financial Statements* and *Management's Discussion and Analysis* are available on https://www.cn.ca/en/investors/financial-results/.
[3] *Idem* This US GAAP revenue measure of regulated grain movements differs from the Agency's determination of MRE because the latter is not a GAAP measure (for example, MRE excludes amounts earned as a performance penalty, demurrage, storage of loaded rail cars, staging of rail cars in transit, and additional car switching) and is determined on a crop year basis, not a fiscal calendar year basis.
[4] CN interswitching revenues are offset by interswitching expenses of 0.2% of freight revenues. Therefore, on a net basis, regulated interswitching revenues represent only 0.1% of CN's freight revenues.

decades before its privatization. This is not a theoretical argument. There are decades of history to prove it. We can further illustrate our point with a simple example using the cost of equity.

Using the Agency's CAPM method, analyzing the price of CN shares trading on the TSX and the NYSE, the Agency determined in its Decision LET-R-30-2020 that the cost of CN common equity rate adjusted to include an allowance for income tax is 9.72%. That rate was determined using the price of CN shares on the two public exchanges.

During 2019, the volume-weighted adjusted closing price of CN on the TSX (the same that was used by the Agency's CAPM method) was $117.31. Presumably, equity investors would expect a return of at least 9.72% on the share price they paid, i.e. 9.72% * $117.31 = $11.40 per share. This would be provided by dividends, share buy-backs, retained earnings for future investments, and discounting future revenues. The Agency applies this equity cost rate to the book value of equity, which is five times less than the market value by Dr. Gould's estimate. If CN were a regulated utility, and the Agency allowed CN to earn only five times less, i.e. only $2.28 per share, this would not even cover the $2.30 per share dividend paid in 2020, let alone generate enough funds to support CN's ability to finance $3.9B of capital investments in 2019. Applying a regulated utility financial model to CN would cripple CN's ability to continually reinvest in its plant and equipment. These investments protect the safety and fluidity of the network, as well as increase capacity, improve service, innovate, help compete with Class-1 peers and other transportation modes (trucks, vessels and pipelines), in addition to providing the returns expected by its shareholders. These investments are critical to ensuring the competitiveness of Canada's supply chains, supporting Canada's economic growth, and enabling Canadian trade.

This calls for great caution when applying a regulated utility model to CN as a whole, in order to regulate the small portion of CN's activities that are still regulated.

Issue 1: Should a negative working capital be allowed in the calculation of net rail investment?

In the theoretical models of Dr. Gould, it should not matter which presentation of working capital is chosen. However, in the Agency's model, the COC is not calculated with the December 31st regulatory balance sheet (RBS) as presented in CN's annual report to Transport Canada. The Agency's model requires many adjustments to the RBS, such as the removal of certain accumulated depreciation amounts, donations and grants, used track materials, and the adjustment of working capital to the average of the twelve monthly estimates (which therefore is not equal to the amount on December 31st as per the rest of the RBS). All these adjustments have a direct impact on the value of shareholder's equity since it is the only entry that is affected in order to keep the RBS in balance. It is therefore imperative to make sure that the adjustments make sense from an operational point of view, and not only from a theoretical accounting point of view.

From Agency Determination No. R-2017-198:

> *[47] The 1985 Decision discussed the definition of working capital. The Decision stated that a consensus was reached among the parties that working capital for rail regulatory purposes should be <u>defined differently from the classical accounting definition</u> of the term. The parties agreed to use instead the term current working assets, comprising cash and the materials and*

> *supplies required to support the day-to-day operations of the railway company.* [Emphasis added]

Moreover, the Discussion Paper states:

> "*net rail investment includes an amount for working capital which is comprised of the cash, as well as the materials and supplies required by the railway company to maintain day-to-day operations*". [Emphasis added]

Two points are clear from the Agency's statements:

1. working capital for rail regulatory purposes should be defined differently from the accounting definition of the term;
2. working capital is required to support the day-to-day operations of the railway company.

As highlighted in detail in CN's original submission, negative working capital is not a realistic measure to support the day-to-day operations of a railway. And since working capital for rail regulatory purposes should be defined differently from the accounting definition, we need to examine and adjust accordingly the accounting treatment that led to this negative amount that is operationally impossible.

In CN's case, the negative working capital stems mainly from an accounting elective presentation of a large position in commercial paper, that is routinely rolled over, as a short-term liability. Had CN elected to present this commercial paper position as a long-term debt (LTD), as accounting rules also permit, then CN would not encounter this problem of a negative accounting working capital.

From the operational point of view, and to satisfy the Agency's definition of working capital as the assets required for day-to-day operation of a railway, a negative working capital should not be allowed.

Issue 2: Should commercial paper be included in the calculation of working capital?

From the differences in CN and CP's submissions, it is clear that the answer to the above question depends on the particular situation of each railway.

CP states in its submission that:

> *CP's use of commercial paper is primarily to provide a short-term financing instrument in order to meet immediate cash needs when funds from operations and other sources are not immediately available.*

If this is the case that CP's use of commercial paper is primarily for short-term financing needs, then CP should treat its commercial paper as a current liability since it must reserve cash to retire its commercial paper upon maturity.

CN's case is different. CN has been drawing continuously on the commercial paper market, as conditions over the recent years have been more favourable than drawing on long-term financing sources. It would be financially irresponsible for the CN management to forego the opportunity of readily available – to

CN – low-interest, short-term commercial paper, and replace it with higher interest long-term debt[5]. This strategy will change with changing market conditions. As CN management determines the amounts and types of debts to assume, CN management is in the best position to determine whether commercial paper is used for short term liquidity or longer-term financing.

If the Agency finds it undesirable to leave this decision to the railways' good judgment or prefers to have a uniform treatment for all railways – and CN fully understands such regulatory concerns – then including commercial paper in LTD for calculating working capital is the most desirable option. It does not lead to a negative working capital for CN, which is not operationally feasible, as explained above, and it would have minimal impact on CP's working capital. As CP points out in its submission, their commercial paper "*outstanding balance regularly fluctuates from month to month between zero and several hundred million dollars*". Hence CP's position is insignificant compared to CN's billion dollars position, and the Agency's method of averaging twelve monthly figures (including the months where CP's balance is zero) will further reduce its impact.

Dr. Gould's concerns over the ability to access the commercial paper market are understandable. This is the reason why the rules of FASB-ASC 470-10-45-12 to 20 insist on having a contractual, non-retractable ability to back-stop the commercial paper with longer term financing as a *sine-qua-non* condition before allowing the reclassification of some short-term obligations as long-term liabilities, as explained in detail in CN's original submission. As to the situation of a financial crisis where all debt markets freeze, this is a once in a lifetime situation and one cannot base any decision on the remote possibility of occurrence of such a black swan event. In such a situation, many other factors on which the COC determination depends would also be upended, such as stock market returns and government bond yields, etc. It is not reasonable to expect CN to maintain a billion dollars cash reserve to retire its commercial paper, just in case another financial crisis may come, on top of the back-stop credit facility it already has with the banks, just in case the banks may be failing too. Cash reserves to cover commercial paper positions have not been needed even in the most recent black swan events of the COVID-19 pandemic and the 2008 financial crisis, where CN maintained its access to the commercial paper market[6]. Therefore, CN's demonstrated ability to access the commercial paper market even in times of crisis should alleviate such concerns.

Finally, CN agrees with CP's position:

> *Furthermore, as cash is a fungible commodity, it would be impossible to distinguish an instance of commercial paper being rolled forward from an instance where old commercial paper is retired, and new commercial paper in a similar amount is issued for a new purpose.*

CN would add that any decision about which commercial paper is rolled forward and which is not would be totally arbitrary. Only the total position counts at the end of each reporting period. The total monthly position would count in calculating the monthly working capital for regulatory purposes. Finally, the average of the twelve monthly working capital estimates would be used in determining the railway capital structure.

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[5] As per CN's audited 2019 financial statement, weighted average interest rate for commercial paper was 1.77% for 2019, whereas 10- and 30-years notes issued in February 2019 had interest rates about twice as high of 3.00% and 3.60%, respectively.

[6] Per its revolving credit facility, CN could issue up to $2B of commercial paper.

Issue 3: Should the current portion of long-term debt be identified as a current liability or as long-term debt?

CP's assertion that "*the current portion of long-term debt is a current liability under US GAAP*" ignores the fact that U.S. Generally Accepted Accounting Principles (GAAP) does indeed allow the classification of short-term obligations as long-term debt (LTD), depending on a company's demonstration of its intent and ability to refinance such instruments on a long-term basis, as explained at length in CN's original submission.

CN fully agrees with Dr. Gould's statement that:

> *In measuring a company's capital structure for the calculation of cost of capital rates, the Agency should consider the current portion of long-term debt as part of long-term debt.*

CN illustrated its position in its original submission using a 5-year bond example, and Dr. Gould illustrated the same point using a 10-year bond example. The issue becomes evident when illustrated by a company that starts with equal amounts of debt and equity, the debt is a 2-year bond of $X, equal to share capital, and is renewed every time it comes to maturity. As illustrated below, if one follows the basic GAAP rules and ignores the allowable alternative, every other year the bond would switch between being classified as either current liability or long-term debt.

Example: 2-yr bond		**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**
Capital Structure	**Equity**	50%	100%	50%	100%	50%
	LTD	50%		50%		50%
Current Liabilities		0$	X$	0$	X$	0$
LTD Liabilities		X$	0$	X$	0$	X$
Shareholder Equity		X$	X$	X$	X$	X$

CN submits that it would be misleading to present either to a regulator or to investors that the company holding the 2-yr bond in the above illustration was 100% financed by equity investors in years 2 and 4 in order to calculate its COC. As a matter of fact, in its Code of Professional Ethics under Rule 203 – Accounting Principles, the American Institute of Certified Public Accountants (AICPA) would require a departure from GAAP in such a case in order to avoid such a material misstatement.

Issue 4: How to apportion general purpose long-term debt of a railway company between its Canadian rail entities and non-regulated entities?

In its original submission, CN supplied the data to clearly prove beyond any doubt that the Agency's stated "*reasonable expectation that there will be a relationship between investments in assets and revenues earned",* is in fact a flawed assumption. The same number of revenue ton miles (RTMs) require different investment levels in different geographies and jurisdictions. Additionally, the same number of

RTMs generate different levels of revenue in different economic regions. Consequently, RTMs are not an appropriately good measure or proxy, neither for investments and their related financing needs; nor are RTMs an adequate proxy for revenues.

CN fully agrees with CP's position that:

> "*the proposal to somehow allocate corporate level debt to the Canadian rail operation is itself fundamentally flawed.*"

That is why CN advocated the determination of COC for the entire company, rather than for the Canadian rail operating division alone. As Dr. Gould demonstrated in his opening remarks, the COC is the same for the entire company as for each of its operating divisions when using the Net Method, and thus there is no need for allocating debt to evaluate the COC of a particular division.

It is inconsistent for the Agency to refuse the use of the WACC of the entire company after determining the cost of equity based on the entire company (there are only shares for the entire company on the stock market – there are no individual shares for the Canadian operating division), and also determining the average cost of debt using the consolidated debt schedule of the entire company. Currently, there is a disconnect in the Agency's COC calculation:

- the cost of equity is determined based on the consolidated entity;
- the amount of equity is determined by the regulatory balance sheet of Canadian operations after numerous adjustments;
- the average cost of debt is determined based on the consolidated entity debt schedule;
- the amount of debt is determined by an allocation based on RTM measures that are non-representative of neither investments nor revenues.

It would be more logical and consistent to determine the COC for the consolidated entity.

With the above *caveat*, CN also agrees with CP's position that:

> "*To the extent that a debt allocation methodology is required, the ratio of Canadian rail properties to total corporate properties should be used*".

Where CN and CP positions differ is that CP prefers using Net Book Value (NBV) of properties, i.e. the depreciated value of assets, whereas CN prefers using Gross Book Value (GBV), i.e. the original cost of assets. However, CP concedes that "*an allocation based on gross book-values would also be preferable to one based on RTMs.*"

CN's preference for GBV is based on the fact that bonds issued to finance properties remain due at their face value even though the equipment they helped finance will depreciate over the bond duration. CN's preference can be illustrated with a simple example. Suppose a company issued one 20-year $800M bond, to finance the $400M purchase of a U.S. property (including land) and to finance the $400M purchase of Canadian equipment with a 20-year life. At the first year, the total $800M would be allocated 50/50 evenly to the U.S. and Canadian operations based on either GBV or NBV. Throughout the life of the bond, the allocation will remain evenly split 50/50 based on GBV. However, based on NBV, the allocation will be increasingly tilted to the U.S., as the NBV of the Canadian properties would have decreased faster than the NBV of U.S. properties, because land does not depreciate. In the last year of the bond, the allocation may be almost 100% to the U.S., as the Canadian equipment may be fully

depreciated with an NBV of almost zero. The purpose of the bond has not changed, it was used to finance 50/50 properties in the two jurisdictions, and only the GBV allocation method will reflect this fact throughout the duration of the bond.

Finally, CN agrees with CP that:

> "*Money is a fungible commodity – one dollar is identical to the next … any "reporting" or "tracking" … is not possible … and subject to significant issues of interpretation.*"

Dr. Gould states that "*It is not correct to allocate debt to the regulated balance sheet based on the debt-to-equity ratio of the consolidated balance sheet*", without offering any reason or evidence as to why this is not correct. Quite the contrary, CN believes that the debt-to-equity ratio as an indication of leverage, and hence investment risk, is an excellent measure almost universally used by investors in their decisions to buy a company's both shares and bonds. One must keep in mind that investors buy shares and bonds of the entire company, and not of one of its operating divisions. Hence the risk profile that determines its WACC, and that investors consider, is that of the entire company. It sounds logical then that we ascribe to its dominant and major operating division the same leverage and risk profile that investors consider when investing, and not apply a different leverage and risk profile.

From CN's 2019 Annual Report, freight revenues from the rail and related transportation business represented 95% of CN's total revenues. The other 5% of revenues were derived from non-rail logistics services that support the company's rail business including vessels and docks, transloading and distribution, automotive logistics, and freight forwarding and transportation management. Therefore, 100% of CN revenues were from rail freight and supporting services. CN understands that the case could be different if, for example, CN had one division with risk comparable to a low risk regulated utility, and another, say, that was as high risk as a speculative oil prospecting operation. The regulator may want in this case to isolate a lower WACC for the regulated utility division to reflect a lower risk profile. However, this is definitely not the case for CN where 100% of its revenues are from rail freight and supporting services.

In his response to the Agency's Q.8, Dr. Gould does not appear to make the distinction that CN is not a regulated company. As explained in CN's introduction above, only approximately 7.4% of CN's freight revenues are regulated, in the sense that revenues from their activities are subject to statutory limitations. The Agency has no statutory authority to determine the amount of debt that CN can or cannot raise. CN management determines the amount of debt that CN is willing to issue depending on market conditions, financial needs, desired returns, and the maintenance of CN's top credit rating. The regulatory balance sheet (RBS) is "regulatory" in the sense that it is made following the UCA prescription, not that all of its accounts or activities are subject to regulatory review or fiat. CN's capital structure is solely determined by CN management and is subject only to market constraints, with no regulatory oversight.

Issue 5: Treatment of debt not issued by a railway company

Keeping aside for a moment the fact that the BC Notes are a special-purpose debt assumed by CN in a specific acquisition situation that warrants the special treatment as detailed in CN's original submission, CN does not agree with CP's blanket statement that "*Debt issued by a company other than the Class-I*

railroad should not be included in the determination of the regulatory cost of capital." Using the CP example of a Class-1 acquiring a shortline, if the assets are consolidated into the Class-1 but not the debt instruments, this would result in an unwarranted increase in shareholder's equity. Moreover, while the interest rate on the acquired debt is most likely higher than what a Class-1 would pay on its own debt, it is nonetheless this higher amount that the Class-1 must earn for the remainder of the bond duration in order to be able to meet its financial obligation to pay the interests due. CN considers it very relevant to be able to earn the higher interest rate to pay the bondholders. Average debt rate costs would eventually revert to the Class-1 level only after maturity of the higher interest debt instruments.

In the specific case of the BC Notes, both submissions made by CP and Dr. Gould do not address the real issues of these BC Notes. The Agency's consultation papers were not very explicit about the specific special circumstances of these BC Notes. Reading the detailed initial CN submission will clarify the real issues surrounding these BC Notes.

To summarize, the real issues of the BC Notes are NOT that they were issued by another railway company. CN assumed many debt instruments issued by other railway companies that CN acquired, and CN has always presented these instruments at their face value as required by the Agency. These BC Notes are different in that:

1. they were issued by a company on the verge of bankruptcy with no assets to back them up;
2. they were issued as a creditor arrangement between BC Rail and its parent British Columbia Railway Company (BCRC) before the CN acquisition, and not to finance any rail operation;
3. they were discounted by 99.4% when assumed, compared to typical discounts of less than 1%;
4. they bear 0% interest, compared to 2004 typical rates of 5.5 to 6.5% for A-rated 30-year bonds; and
5. they mature in 90 years, compared to typical 5 to 10-year and a maximum of 30-year bonds.

It is CN's position that such special debt instruments that were issued as a special financial arrangement, and not for any rail operations, fall outside the realms of UCA and normal Agency costing procedures, therefore warranting special treatment. The Agency model of calculating the capital structure by "*equating the book value of the net rail investment to the book value of the sources of capital*" does not work when the book value of net rail investment is very small and the book value of the sources of capital (at face value) is very large.

The only certainty is that CN must earn the 5.75% imputed interest rate on the discounted value every year in order to be able to repay the face value of $842M in 2094. CN showed in its original submission that the total LTD that CN acquired with BC Rail was only $13 million, $5 million of which represented the fair market value of the 90-yr notes. CN equally showed that these are the same amounts also declared by BCRC independently in its 2004 Annual Report.

The Agency's requirement for CN to record the $842M of face value, and with zero return on this face value, does not allow CN to meet its future financial obligation. This is entirely contrary to the central purpose of COC determination, which is to allow for the earnings required to meet financial obligations.

CN respectfully reiterates its request to allow the continuation of treating this special purpose debt at its discount value, as was Agency practice from 2004 until 2019, before the Agency's recent reversal in 2020.