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CP's Response to the Submissions of Other Stakeholders, CTA Discussion Paper on Capital Structure and Cost of Capital, 2020

CP writes further to the submissions of CN and McMillan regarding the CTA Discussion Paper on Capital Structure and Cost of Capital, 2020. We appreciate the thought and effort that went into these responses, and thank the Agency for this opportunity to add our further input to the ongoing discussion. This is an important issue for each of us, and we all clearly have a common interest in ensuring that the regulatory cost of capital methodology is reliable, accurate and reasonably consistent.

Introduction

The parties disagree on some of the specific issues presented in the Agency discussion paper; however, there appears to be alignment, at a higher level, in terms of the purpose and desired outcome of the Agency's regulatory cost of capital methodology.

All of the respondents are aligned that the cost of capital should encapsulate a railway's entire capital structure, and the capital structure of a railway's Canadian regulated rail entity should make sense in the wider context of the whole railway. McMillan submitted studies showing that, when determining the cost of capital for one division of a company, the assets and sources of capital for the entire company must be correctly allocated. CN states quite simply that "The cost of capital should be that of the consolidated operation". CP has argued that, if debt is to be allocated from the parent entity to the regulated Canadian railway, then equity must be similarly allocated.

In the consultation letter the Agency states that its "goal is to ensure that the methodology we use to calculate cost of capital is rigorous, transparent, and fair for rail system users, including shippers, and railway companies. The methodology we use should also treat railway companies consistently."

CP agrees with this statement and notes the different histories and corporate structures of CP and CN. These differences are reflected in the accounts of each company, especially as relates to the accounts of

individual divisions within the consolidated railway company. As a result, an adjustment or allocation that makes sense for one company may not make sense for the other.

Accordingly, we provide our general response to the submissions of the other respondents as well as specific objections to points raised by Teck in its submission.

Response

This section provides a further response to certain questions raised in the Agency discussion paper, and leverages the responses of other stakeholders to develop recommendations for the Agency's consideration.

We will show that:

- The Agency's debt allocation methodology is incomplete – if the policy of allocating “general corporate activities” is pursued, then it is necessary to allocate all corporate activities, rather than allocating only debt.
- Any adjustment made to the accounts of one corporate division must consider the impact to the other divisions, and to the company as a whole.

We will then propose alternative treatments that address these issues.

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

Q.1 Should the cost of capital reflect the economic reality of the railway company at the time it is calculated, regardless of whether it is positive or negative? Please provide a rationale for your response.

CP agrees with CN, in general, that a railway requires a certain amount of working capital in order to operate its business [CN response, page 2]. A railway must be able to finance its day to day operations while it waits for receivables from its customers to be paid. This was demonstrated by the Agency's lead-lag study. Therefore it is not reasonable to include a negative working capital amount in the capital structure of the railway.

The Agency may need to provide special consideration to this issue if commercial paper and the current portion of long-term debt are included in the calculation of working capital, as discussed further below in response to question 2. In that case it may not be correct to eliminate commercial paper by forcing the net amount of working capital to zero.

Working capital, exclusive of commercial paper and the current portion of long-term debt, should be set to zero if it is negative. A negative working capital does not reflect the economic reality of the rail industry.

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

Q.2 Although commercial paper, by definition, is a short-term financial instrument, should commercial paper that is routinely rolled over be treated as a current liability or as long-term debt? Please provide a rationale for your response.

On this matter we agree with McMillan and disagree with CN: commercial paper is a current liability. As McMillan states “It may be a company’s intent to issue commercial paper as part of a continuous and longer rolling program as a short-term financing policy, but there is no certainty that they will continue the policy or be able to implement the policy.” [McMillan response, page 22, para. 3].

Commercial paper is a financing mechanism with short-term rights and obligations attached. As such it represents a claim against current assets. As well, the stated intent of one company, at a given point in time, may not be the same at a different time, and it may not be the same for other companies.

Q.3 If the CTA finds it appropriate to treat rolled over commercial paper differently, how should commercial paper that is rolled over and commercial paper that is not be identified in the railway company's annual submissions to the CTA?

Consistent with our position above, commercial paper should generally be treated as a current liability.

Q.4 How should commercial paper which is raised for general corporate purposes be allocated to regulated activities? Please provide a rationale for your response.

As explained in our initial response, CP does not normally use commercial paper to finance rail operations. Therefore it is incorrect to include CP’s commercial paper in the UCA accounts and the Canadian UCA financial statements, especially when such commercial paper was “raised for general corporate purposes”.

Q.5 Are there other short-term financing instruments (for example, an unsecured revolving credit facility or an accounts receivable securitization program) that should be treated as long-term debt rather than as a current liability? Please provide a rationale for your response.

Consistent with our position above, items that normally represent a current liability should be treated as a current liability.

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

Q.6 Should the current portion of long-term debt be treated as a current liability as per US GAAP or should it be treated as long-term debt? Please provide a rationale for your response.

Here we disagree with both McMillan and CN, who argue that the current portion of long-term debt should be a long-term liability. As we explained in our initial response to this question, the current portion of long-term debt represents a claim on current assets. As such it works to reduce available working capital. The current portion of long term debt is a current liability.

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

Q.7 To the degree that general corporate activities affect the Canadian rail entity, how should the CTA allocate a portion of those activities to the Canadian rail entity? Please provide a rationale for your response.

CP disagrees with the Agency's decision to allocate general purpose debt to CP's regulated rail entity. However, assuming that the Agency is resolute in its intent to allocate general corporate activities, we will address two areas of concern when considering the inclusion of general activities:

- First, if the Agency chooses to allocate general corporate activities to the Canadian regulated rail entity, it must include all general purpose activities, including general purpose debt, equity, assets and working capital, and not debt alone.
- Second, in order to avoid unintentional distortion when allocating general purpose activities, the Agency must ensure that the adjustments made lead to a capital structure that is reasonable for the Canadian regulated rail entity as well as for the consolidated company and its other divisions.

We will then propose alternate approaches for the Agency to consider when looking at the inclusion of general purpose activities within the Cost of Capital calculation.

Concern #1: Consideration of All General Purpose Activities

In response to this question McMillan presented a hypothetical calculation of the weighted average cost of capital and earnings for a company with two divisions. [McMillan response, page 43, Table 3]. This calculation pointed out the need to begin with the entire balance sheet and allocate all balance sheet amounts using a consistent methodology.

CP agrees. In order to appropriately allocate activities from the consolidated company to the regulated rail entity, the Agency must take the entire balance sheet into consideration. It must allocate general purpose debt, equity, assets and working capital. If not then the methodology will produce distortions and systematic bias in the results.

The accounting method that the Agency applied to add the general purpose debt to CP's regulated balance sheet in the April 2020 cost of capital decision LET-R-29-2020 (the "2020 Decision") has resulted in an unrealistic capital structure. Under the current methodology we expect that CP's regulatory balance sheet will likely show near-zero equity, or even negative equity, in the foreseeable future. This is an absurd result for a company that has more than 30% equity on its US-GAAP consolidated balance sheet.

Much of the general purpose debt that was allocated to CP's balance sheet was raised in order to finance share buy-backs. In normal circumstances, when a company completes a share buy-back program, it will remove the purchased shares from its balance sheet, and its equity will decrease accordingly. However, in the case of CP, it was the CP parent company that originally issued the public shares. Thus, the share-capital resides on the balance sheet of the parent company and not that of the Canadian regulated rail entity. The regulated rail entity has no share-capital issued through public shares, yet the 2020 Decision methodology effectively has the regulated rail entity issuing debt to buy-back the shares of another company, without equally allocating equity of such company.

When the Agency added the general purpose debt to CP's regulated balance sheet, it reduced equity in order to maintain balance in the balance sheet. However, this step was incorrect. Shares that were subject to the buy-back program cannot be removed from the Canadian regulated rail entity's balance sheet because those shares reside on the balance sheet of the parent company. Instead, the Agency has eliminated equity generated through rail operations.

Furthermore, CP had already applied a balanced approach to its UCA ledger, and further adjustments were not required. CP eliminates non-rail equity amounting to several billion dollars when it prepares its regulatory balance sheet each year, even before the Agency's revised treatment of corporate debt is considered. These equity balances are eliminated because they represent non-rail transactions pursuant to the UCA accounting principles. These balances occur due to a variety of transactions including transfers of cash to the parent company to finance share buy-backs and payment of dividends on behalf of other CP subsidiaries.

All of these transactions provide a general corporate benefit by financing dividend payments to shareholders including employees, and financing share buy-backs done by the parent company, thus maximizing earnings and share-value. Therefore, much of these equity balances should be considered as "general purpose equity" in the same sense that the Agency has defined general purpose debt in the 2020 cost of capital decision. According to the Agency's finding in that decision pertaining to UCA 1203.05, many of these transactions should be considered rail-related, as they provide a general corporate benefit.

CP did not previously include non-rail debt in its balance sheet (as per its prior understanding of the meaning of that term), and conversely, did not include substantial amounts of equity that had previously been deemed non-rail. As the Agency has revised its stance on what types of debt are considered rail-related, certain types of equity related transactions are also rail-related, and should be included in CP's capital structure.

Concern #2: Consideration of the Impact to the Consolidated Company and Other Divisions

In response to the Agency's question seven CN states:

There is only one entity that issues equity on the market, and that is the consolidated corporation, not the Canadian nor the U.S. operations. Similarly, there is only one entity that issues debt instruments on the market, and that is again the consolidated corporation. Therefore, there is only one cost of capital and that is for the consolidated corporation, and that unique cost of capital should then be the same for both Canadian and U.S. operations.

This issue is directly relevant to the 2020 Decision, wherein the Agency allocated significant amounts of "general purpose debt" to the balance sheet of CP's regulated rail entity, resulting in a capital structure that does not resemble the rest of the company. The debt-to-equity ratio of the regulated rail entity is now multiple times higher than that of the consolidated corporation and the remaining divisions.

McMillan states:

The Agency relies on the UCA as the framework for regulatory accounting in cost of capital determinations. Using the railways consolidated statements to allocate debt requires resolving differences in accounting rules between United States Generally Accepted Accounting Principles (GAAP) and the UCA, and reconciling differences between the parent company's balance sheet and the regulatory balance sheet. [McMillan response, page 29, para. 3 & 4].

Elsewhere in its submission, McMillan presents a series of studies showing that the capital structure of a corporate division should be determined by correctly allocating the assets, liabilities and equity of the consolidated company to its divisions [see McMillan response at page 17 & 18, as well as Tables 3 to 6]. These submissions highlight the key challenge that the Agency faces with respect to the issue of allocating "general corporate activities" to the regulated rail entity.

The challenge that confronts the Agency is the fact that it only has UCA accounting information for the regulated rail entity. The accounts of the consolidated company and its other divisions are not available under the UCA accounting standard.

This means that the top-down approach espoused by McMillan does not apply in the context of determining a cost of capital for the Canadian railway operations. The Agency is not able to begin at the level of the consolidated company, and then allocate assets and sources of capital down to the divisions. It must take an approach that is quite the opposite. The Agency must begin with the ledger of the

Canadian regulated rail entity. If the Agency then determines that certain elements from the consolidated company and its other divisions must be allocated to the Canadian railway, it must push those elements down to the Canadian regulated rail entity without reference to how this may impact the balance sheet of the consolidated company and the other divisions.

This unfortunate situation is the opposite of an approach that is “rigorous, transparent and fair”, for two key reasons:

First, it leads to an artificial bias in the type of adjustments that are considered. For example, while it is fairly easy to point to “general purpose debt” as one distinct element of the US-GAAP consolidated balance sheet that may be allocated, it is more difficult to decide which components of the consolidated company’s assets and equity accounts provide a general corporate benefit sufficient that they should be allocated to the regulated rail entity. Indeed, the Agency has not attempted to do so thus far. There is a bias in the types of allocations that are considered which is systematically punitive to the cost of capital of the regulated rail entity.

Second, it is not possible for the Agency to determine whether its debt allocation methodology is objectively correct, in terms of its impact to the accounts of the company and its other divisions. For example, when a significant amount of debt is allocated to the regulated rail entity, the Agency reduces the equity of the regulated rail entity accordingly in order to maintain balance on the balance sheet. The allocation exercise does not create or destroy debt and equity – rather it re-allocates it among the corporate divisions. The capital structure of the regulated rail entity becomes heavily debt weighted, and the capital structures of the other divisions become more equity weighted.

In order to ensure that the approach is rigorous, transparent and fair, the Agency must be able to assess the resulting capital structures and implied cost of capital for the remaining divisions so that it can then determine whether the differences between the cost of capital for the regulated rail entity and the remainder of the company are reasonable. Since the Agency is not able to perform this assessment, it cannot know whether its methodology is unintentionally creating significant distortions in the capital structure of the regulated rail entity and, potentially treating CN and CP inconsistently.

In the 2020 cost of capital decision, the Agency provided the following explanations for its view that general purpose debt, and share buy-back debt specifically, are rail related because

[...] The fact that these transactions are managed through a treasury function does not eliminate their impact on the Canadian rail entity or relieve the requirement to properly account for those impacts.

[...] There is a general corporate benefit derived from buying back shares issued. The issuance of debt in lieu of issuing more shares to fund rail-related investments lowers the company’s cost of capital, as the cost rate of debt issuance is lower than the cost of common equity rate that is expected from investors. [LET-R-29-2020 at para. 14 and 16]

CP understands, therefore, that the Agency’s intent is that the regulated cost of capital should more closely reflect general corporate activities to the extent that such activities affect the Canadian regulated rail entity. Accordingly, the regulatory balance sheet should also more closely reflect the balance sheet of the consolidated company. However, CP’s regulatory capital structure does not resemble the consolidated corporate capital structure.

If the Agency had used the consolidated capital structure in the cost of capital determination, and applied the cost rates used in the letter decision, the resulting cost of capital would be 6.46%. This methodology yields a cost of capital more than 30% higher than the 4.79% determined in the 2020 cost of capital decision.

CP's Capital Structure, US GAAP			
	Book Value (\$)	Capital Structure (%)	CTA Cost Rates
Deferred Liabilities	4.8B	24%	0.00%
Debt	8.2B	41%	5.34%
Total Liabilities	13.0B	64%	
Total Shareholder Equity	7.1B	35%	12.19%
Cost of Capital			6.46%

SOURCE: 2019 CP Annual Report, Page 98

NB: The capital structure shown in the table above results from certain calculations and classifications using CP’s 2019 financial statements, as explained more fully under the heading “Proposals”, below.

This demonstrates that CP’s regulated capital structure is not representative of CP’s corporate capital structure. The Agency has effectively ruled that investors require a much lower return on their investment in the Canadian rail entity than the return they require on their investment in CP’s other divisions.

The Agency determined CN’s cost of capital rate at 5.19%. CN’s consolidated capital structure is reflected below:

CN's Capital Structure, US GAAP			
	Book Value (\$)	Capital Structure (%)	CTA Cost Rates
Deferred Liabilities	9.6B	22%	0.00%
Debt	11.9B	34%	3.56%
Total Liabilities	21.5B	56%	
Total Shareholder Equity	18.0B	44%	9.72%
Cost of Capital			5.51%

SOURCE: 2019 CN Annual Report, Page 59

If the Agency had used CN’s consolidated capital structure in the cost of capital determination, and applied the cost rates used in the letter decision, the resulting cost of capital for CN would be 5.51%.

The similarity in CN's regulatory cost of capital and its consolidated cost of capital (as estimated above) implies that its regulated debt-to-equity ratio is similar to its consolidated.

CP's regulatory capital structure, on the other hand, is not at all similar to its regulatory capital structure once the allocation of general purpose debt has been taken into account. Again, this demonstrates that the allocation adjustment is not producing consistent results for the two companies. The allocation methodology is incomplete and untested – it has created a significant distortion in the capital structure of CP's regulated rail entity.

When the Agency reduced CP's equity in order to maintain balance on the balance sheet, it eliminated equity that was generated through rail operations. It should rather have reduced share capital, in order to reflect the share buy-back activity. But it could not do so because the share capital related to the public shares is carried on the parent company's balance sheet, not on the balance sheet of the Canadian regulated rail entity. In effect, the Agency calculation would have CP incur the cost of the share buy-back program twice. The cost is incurred once on the parent company balance sheet when the repurchased shares are retired as per normal accounting practice. And the cost is incurred again on the balance sheet of the Canadian regulated rail entity, when the Agency reduces the equity of the regulated railway.

The fact that the Agency's allocation method produces a reasonable result for CN, but not for CP, has to do with the differing organizational structures of the two railway companies. Recall that CP and CN have different corporate histories, and different capital structures:

- CP's Canadian rail operation was once a subsidiary of a conglomerate which had a number of rail and non-rail operations. Since that time CP's rail operations have been reorganized under a single parent company. The CP parent company manages all treasury functions on behalf of the other divisions, including issuing and buying back public equity.
- In CN's case the railway company is also the parent company, and as such it is responsible for all equity transactions. While CN's equity activities and related balance sheet accounts are likely to be fully reflected in its UCA accounts for the rail entity, CP's equity activities are not.

This means that a specific accounting adjustment may make sense for one company, but not for the other. When the CTA decided to allocate more debt to CP's Canadian rail entity, it decided to offset this adjustment by reducing equity by an equivalent amount. Since the share capital related to CP's public equity resides on the parent company's ledger, this means that the CTA has arbitrarily reduced the retained earnings and paid-in-capital of the regulated rail entity. In reality neither its paid-in-capital nor its retained earnings from railway operations had changed.

In 2020 the Agency found that CP had a higher cost of equity and a higher cost of debt than did CN. This corresponds to the findings of Bloomberg, an independent and widely referenced source for business and financial metrics. Bloomberg rates CP as having a higher cost of equity, a higher cost of debt, and a higher weighted average cost of capital. It also notes that CP has a lower credit rating than CN.

Comparison of CP and CN Bloomberg Metrics, 2020		
Bloomberg	CP	CN
Credit Rating	BBB+ / Baa1	A / A2
Cost of Equity	8.4%	7.8%
Cost of Debt (after tax)	2.2%	1.6%
% Equity (Mkt value)	80.7%	83.2%
% Debt	19.3%	16.8%
Weighted Average Cost of Capital	7.2%	6.8%

SOURCE: Retrieved from Bloomberg Terminal, May 1, 2020

Comparison of CP and CN Bloomberg Metrics, 2021		
Bloomberg	CP	CN
Credit Rating	BBB+ / Baa1	A / A2
Cost of Equity	9.4%	7.6%
Cost of Debt (after tax)	1.6%	1.4%
% Equity (Mkt value)	84.8%	87.6%
% Debt	15.2%	12.4%
Weighted Average Cost of Capital	8.2%	7.7%

SOURCE: Retrieved from Bloomberg Terminal, January 11, 2021

In contrast to the Bloomberg estimate that CP's cost of capital is 6% higher than CN's, the Agency's decision assigns CP a cost of capital 9% lower than CN. This is a 15% gap. Furthermore, the Agency's cost of capital estimates for both companies are more than 25% lower than Bloomberg's May 1 estimate.

In its response CN noted that Morgan Stanley estimated cost of capital rates for CP and CN, which were 6.9% and 6.7% respectively [CN response, page 8, Exhibit 50]. Again, CP's cost of capital is higher than CN's according to this public reference.

The regulated cost of capital methodology calculates the cost rates of debt and equity using CP's actual debt and stock price information, which reflect the financial position of the consolidated company. These cost rates are then applied to the deemed capital structure of the regulated rail entity.

However, the Agency assigned CP a balance sheet in the 2020 cost of capital decision that is predominantly composed of liabilities, with very little equity. A balance sheet that is primarily financed by debt is the balance sheet of a struggling company. Rather than having a low cost of capital, such a company would have a poor credit rating and a low price to earnings ratio on its stock price. As a result, it would face a high cost of capital, reflecting the fact that it is a speculative venture for creditors and investors.

Consequently, the Agency established a capital structure in the 2020 Decision that makes CP look like a financially troubled company, and then applied the credit rating and cost of equity of a financially sound company – namely the CP consolidated company – in order to calculate the regulatory cost of capital. The result is a cost of capital that would not be found anywhere in a real financial market. A real company having such a weak balance sheet would face a higher cost of capital because investors and creditors would require a higher return on equity and debt. On the other hand, a company with a stronger balance sheet would have a higher cost of capital because it would show a higher proportion of equity on the balance sheet.

Therefore, there are several reasons why the Agency should use CP's consolidated company's capital structure for the purposes of estimating the cost of capital:

1. The Agency is unable to assess whether the adjusted capital structure of the regulated rail entity is objectively reasonable, as compared to the capital structure of the consolidated company and its other divisions.
2. The Agency is unable to objectively determine allocations for all balance sheet accounts (debt, equity, assets and working capital) on an equitable basis.
3. The Agency determines cost rates for debt and equity using the capital structure and other information of the consolidated entity, and those rates are not valid when applied to a different capital structure.
4. The CP and CN Canadian Rail entities have different corporate structures, so that an adjustment made to one company may not be applicable to the other. This problem does not exist at the consolidated level.

ALLOCATION METHOD

In the 2020 Decision and CN's April 2020 cost of capital decision the Agency applied an interim method whereby it allocated debt according to the ratio of Canadian RTMs to total RTMs for each railway, for the year in which each debt was issued. The Agency stated that "The RTM-based approach ... reflects the reasonable expectation that there will be a relationship between investments in assets and revenues earned, and allocates a portion (rather than none) of CN's debt to its US operations." [LET-R-41-2019, para. 10]

On this matter we agree with CN's objections on pages 9 and 10 of its response. Namely, there is a considerable degree of separation between the acquisition of properties and the generation of RTMs. RTMs will increase or decrease in response to market conditions having nothing to do with the railway's capital investments made in a given year. As CN points out, property investments may be systematically more expensive in the US, so that an RTM-based methodology will over allocate debt to the Canadian rail entity. And furthermore, we reiterate that RTMs are a driver of operating expenses, rather than of capital expenditure.

CN has submitted that the correct method is to allocate general purpose activities according to the gross book value of assets for the Canadian rail entity compared to the total for the consolidated company. Since there exist UCA accounts for only the regulated rail entity, CN suggests using the US-GAAP values for this comparison. [CN response, page 11]

We have previously recommended in this proceeding that an asset-based allocation methodology is preferable to the RTM methodology, and we will not revisit the reasons here. We continue to submit that it is preferable to use the net-book-value of properties, rather than gross-book-value, but that either option is preferred over RTMs.

We also reiterate that CP is prepared to generate UCA accounts for its non-Canadian properties if required, and with reasonable notice. However we agree with CN's statement that "the Canada Transportation Act does not dictate the exclusive use of UCA" [CN Response, page 11, para. 5].

We note that the CTA uses other proxies for allocation purposes within the regulatory cost of capital process, for example when combining the US and Canadian cost of equity estimates according to the relative volume of activity on the US and Canadian exchanges. The US-GAAP value of properties would not enter the UCA accounts or the capital structure in any way – it would be used only to provide an apples-to-apples comparison of asset values across entities.

PROPOSALS

CP proposes three alternatives to achieve the Agency's objective to allocate general corporate activities to the Canadian regulated rail entity, depending on whether one wishes to show the share buy-back activity at the level of the parent company or the regulated rail entity.

1) Consolidated Capital Structure

We support CN's preferred approach to use the railway company's US-GAAP consolidated capital structure as prepared by the company for its public financial statements. This approach reflects the Agency's intent to capture any activity that creates a "general corporate benefit".

As discussed above, in the attempt to create a separate deemed regulatory railway capital structure, the Agency has created significant distortions. The delineation of what is, and what is not, a rail-related activity is not always clear. Further, creating a separate capital structure requires a thorough consideration of the correct accounting treatment. This creates considerable complexity and opportunity for error, and may be a further cause of distortions.

Using the consolidated capital structure will ensure that the resulting cost of capital is reasonable. Because the public financial reports are subject to a rigorous external audit, the possibility of distortions due to accounting errors is significantly reduced.

We therefore recommend that the Agency use the US-GAAP financial statements of the consolidated rail company, as presented in the railway's public financial statements, for purposes of estimating the regulatory cost of capital. The following table illustrates how the balance sheet accounts may be allocated to the capital structure, using CP's consolidated balance sheet from our 2019 annual report:

CP Consolidated Balance Sheet, 2019		
		<u>Capital Structure</u>
Current Assets	1,210	Working capital
Investments	341	
Properties	19,156	
Intangibles	206	
Pension Asset	1,003	
Other Assets	451	
Total Assets	22,367	
Current Liabilities	2,292	Working capital
Pension Liability	785	Deferred liability
Other Long-term Liabilities	562	Long term debt
Long-term Debt	8,158	Long term debt
Deferred Income Taxes	3,501	Deferred liability
Shareholder's Equity	7,069	Equity
Total Liabilities and Equity	22,367	

SOURCE: 2019 CP Annual Report, Page 98

For purposes of simplicity in this consultation we have shown all Other Long-Term Liabilities grouped under Deferred Liability in the capital structure, to provide a conservative view. In reality some of this amount would be assigned to Long-Term Debt.

We can develop the capital structure using the allocations indicated above. Again, for purposes of simplicity in this consultation, we have ignored the questions around the proper designation of commercial paper and the current portion of long-term debt. We will take the current assets and current liabilities as given on the balance sheet. Otherwise we have followed the working capital methodology that the Agency uses today.

CP Capital Structure, 2019	\$ Thousands	Weight	CTA Cost Rate
Working capital	(1,082)		
Deferred liability	4,848	24%	0.00%
Long term debt	8,158	41%	5.34%
Equity	7,069	35%	12.19%
Total Capital Structure	20,075		
Cost of Capital	6.46%		

We have used the cost rates as determined by the Agency in the 2020 cost of capital decision, although it bears mentioning that the cost rate of debt may need to be re-evaluated because the consolidated capital structure includes a different mix of debt issues than were considered in April.

The cost of capital so determined is 6.46%.

2) Parent Company Share Buy-backs

In the alternative, we recommend that the share buy-back activity is shown at the parent company level. In CP's case the parent company issues CP's public equity. This approach is logical because the CP public shares represent the entire corporation, including the Canadian rail entity.

Under this approach the regulated rail entity has not engaged in an equity transaction when the parent company performs a share buy-back; therefore, an asset must be added to CP's balance sheet so that rail-related equity is not eliminated. In order to achieve the Agency's objective of allocating the general purpose debt to the regulated railway, it is necessary to add the debt to the regulatory balance sheet, and then show the regulated rail entity advancing the proceeds to the parent company so that it can perform the share buy-back. This will generate a receivable asset on the regulated balance sheet.

This approach will increase the amount of debt in the capital structure of the regulated rail entity, but does not incorrectly eliminate equity generated through rail operations. In CP's case the resulting capital structure is still relatively comparable to that of the consolidated company. Therefore, the distortion evident in the 2020 cost of capital decision is eliminated.

3) Fully Allocate all General Purpose Activities

In the further alternative, CP proposes a deemed regulatory capital structure for purposes of determining the cost of capital, wherein general purpose equity, assets and working capital are allocated to the balance sheet in the same way that the Agency has decided to allocate general purpose debt. Failing to do so creates a significant distortion in the capital structure because it applies an asymmetrical adjustment.

The Agency should treat the parent company level equity and assets the same way that it has treated debt. In 2020 the Agency allocated general purpose debt to the balance sheet of the Canadian rail entity. Accordingly, the Agency should allocate general purpose equity and assets to the regulated rail entity balance sheet.

To illustrate the process consider the following hypothetical balance sheets for a company with two rail divisions, including a Canadian regulated rail division and a US rail division. The consolidated balance sheet accounts have been allocated to the rail divisions where possible, and the remainder is shown as "General Activities" in the last column:

Hypothetical Corporate Balance Sheets: Consolidated and Rail Divisions				
	Consolidated Company	Canadian Rail Division	US Rail Division	General Activities
Current Assets	\$5,000	\$2,500	\$2,300	\$200
Other Assets	\$9,000	\$2,000	\$1,000	\$6,000
Properties	\$86,000	\$52,000	\$34,000	\$0
Total Assets	\$100,000	\$56,500	\$37,300	\$6,200
Current Liabilities	\$4,400	\$2,400	\$1,800	\$200
Deferred Liabilities	\$21,700	\$15,000	\$6,700	\$0
Long Term Debt	\$36,500	\$17,000	\$15,500	\$4,000
Share Capital	\$2,000	\$0	\$0	\$2,000
Retained Earnings	\$35,400	\$22,100	\$13,300	\$0
Total Equity and Liabilities	\$100,000	\$56,500	\$37,300	\$6,200
Debt:Equity Ratio	1.6:1	1.4:1	1.7:1	2:1

Note that the sum of the two rail divisions plus the General Activities add up to the total value of the Consolidated Company. The General Activities column represents those amounts that are not directly attributable to the rail divisions.

In order to allocate the general activities to the Canadian rail division (a suggestion with which CP disagrees in principle), it is necessary to select an allocation method. For this example we elect to use the net properties ratio, as we have recommended above. The Agency may use a different allocation ratio if it wishes – the methodology would be unaffected. The calculation of the allocation ratio is shown below:

	Canadian Rail Division	US Rail Division
Division Properties	\$52,000	\$34,000
Total Properties	÷ <u>\$86,000</u>	÷ <u>\$86,000</u>
Allocation %	60%	40%

The following table shows how the General Activities column will be allocated to the two rail divisions. Note that all of the general activities are allocated to the rail divisions.

Hypothetical Allocations of General Purpose Activities				
	General Activities	Allocate to Canadian Rail Division (60%)	Allocate to US Rail Division (40%)	Total Amount Allocated
Current Assets	\$200	\$121	\$79	\$200
Other Assets	\$6,000	\$3,628	\$2,372	\$6,000
Properties	\$0	\$0	\$0	\$0
Total Assets	\$6,200	\$3,749	\$2,451	\$6,200
Current Liabilities	\$200	\$121	\$79	\$200
Deferred Liabilities	\$0	\$0	\$0	\$0
Long Term Debt	\$4,000	\$2,419	\$1,581	\$4,000
Share Capital	\$2,000	\$1,209	\$791	\$2,000
Retained Earnings	\$0	\$0	\$0	\$0
Total Equity and Liabilities	\$6,200	\$3,749	\$2,451	\$6,200

The following table shows the allocation of 60% of the General Activities column to the Canadian rail division, and the final adjusted balance sheet for the Canadian rail division:

Hypothetical Canadian Rail Division Balance Sheet, Adjusted			
	Canadian Rail Division, Unadjusted	Allocations	Canadian Rail Division, Adjusted
Current Assets	\$2,500	\$121	\$2,621
Other Assets	\$2,000	\$3,628	\$5,628
Properties	\$52,000	\$0	\$52,000
Total Assets	\$56,500	\$3,749	\$60,249
Current Liabilities	\$2,400	\$121	\$2,521
Deferred Liabilities	\$15,000	\$0	\$15,000
Long Term Debt	\$17,000	\$2,419	\$19,419
Share Capital	\$0	\$1,209	\$1,209
Retained Earnings	\$22,100	\$0	\$22,100
Total Equity and Liabilities	\$56,500	\$3,749	\$60,249
Debt:Equity Ratio	1.4:1	2:1	1.5:1

Note that the Allocations are balanced (i.e. Total Assets = Liabilities + Equity), thus maintaining the integrity of the capital structures of each of the affected corporate entities. The capital structure of the Canadian rail division has converged towards the capital structure of the consolidated company, as expected.

In this hypothetical example the Canadian rail division initially has a lower debt:equity ratio than does the consolidated company, and so the allocation has increased it. If the Canadian rail division were to have a higher debt:equity ratio at the outset, then the allocation would be expected to decrease it. This matches the principle that the allocation of general activities should cause the capital structure of the rail divisions to converge towards that of the consolidated company.

Since all of the general corporate activities have been allocated to the rail divisions, we can now say that the consolidated company has been entirely allocated to its divisions. This conforms to the principles of developing divisional capital structures as proposed by McMillan in its response.

Q.8: Alternatively, should the CTA disallow debt whose use cannot be identified? That is, should railway companies be required to identify what general purpose debt is incurred for, in order for such debt to be included or excluded in the calculation of cost of capital? Please provide a rationale for your response.

We are supportive of CN's position that debt is "seldom issued for a single purpose" [CN response, page 12], and that debt covenants are often general in nature. CP already identifies the purpose of each debenture according to the circumstances and appropriately records it as rail or non-rail debt on that basis. For example, in recent years CP has used a portion of the proceeds of a new general purpose debt issue to retire a rail-related debt, and has recorded it accordingly. When a specific use for the debt cannot be identified then it must be viewed as a management decision to achieve a specific capital structure for the consolidated company, meaning that it is a "general purpose debt" for the purposes of the Agency's cost of capital methodology.

McMillan argues that a regulated entity will pursue a capital structure that is heavily weighted towards equity, and therefore that "each debt issue should be considered initially to be on the railway's regulated balance sheet." [McMillan response, page 31, para. 3]. This contention is belied by the fact that both CP and CN have had share buy-back programs for at least the last five years.

While we agree with McMillan that the regulator must apply due diligence in assessing the capital structure of a regulated company, this does not imply a blanket policy to initially consider each debt to be on the railway's regulated balance sheet. After all, the Agency's responsibility is not exclusively to protect railway customers, as suggested by McMillan. In the Agency's own words, its core mandate is to:

“... ensure that the national transportation system runs efficiently and smoothly in the interests of all Canadians: those who work and invest in it; the producers, shippers, travellers and businesses who rely on it; and the communities where it operates.”

[CTA public website, “Organization and Mandate”; Accessed on January 12, 2021. Emphasis added.]

Q.9 Should the CTA enforce stronger data reporting (for example, tracking or projecting what proportion of general purpose debt is used in Canadian rail operations)? Please provide a rationale for your response.

We agree with CN’s statement that “It is impossible to track the exact use of the proceeds of a debt instrument. Enforcing stronger data reporting would be a bureaucratic quagmire.” [CN response, page 12, para. 5]

In response to McMillan’s assertion that stronger data reporting requirements are needed [McMillan response, page 32, para. 5], we note that CP consistently endeavors to provide all data that is required by the Agency in the execution of its regulatory responsibilities. CP takes its regulatory responsibility seriously, and has been compliant in providing accurate data in a timely manner upon request.

Response to McMillan’s Submission

CP strongly disagrees with certain assertions made by McMillan.

First, we take exception to McMillan’s characterization of the relative balance of market power in the rail industry. In the numbered paragraph 9 of its submission McMillan raises a concern that “shippers who must ship by rail have few opportunities to negotiate rates”, and “negotiations are one-sided, not just because of the traditional kinds of market power enjoyed by a rail carrier, but also because of the information imbalance between them.”

These statements overlook the fact that competition in the Canadian transportation sector has increased significantly over time, and railways now compete head-on with multiple alternative modes of transportation like trucks and air-freight. Direct competition between Canadian and US railways has also increased significantly. This has been affirmed not least by the MacPherson Royal Commission on Transportation as early as 1961, who stated that “Since the end of World War II, the transportation environment in Canada has been transformed from a monopolistic one, very much dominated by the railways, into a highly competitive one in which a number of different modes of transport are vying actively for the available traffic.” [MacPherson “Royal Commission on Transportation”, 1961. Vol. 1, page 26].

Competition was also a key theme expressed by David Emerson P.C., O.B.C, in his 2015 report to the Minister of Transportation for the Canada Transportation Act review. In his report “Pathways: Connecting Canada’s Transportation System to the World”, Mr. Emerson presents data showing that, as a result of increased competition and consequent efforts by the railways to improve productivity, prices paid by Canadian freight rail customers have fallen by more than 30% between 1988 and 2012 (2012 is the last year in the data series).

McMillan also overlooks the fact that a Canadian rail customer has access to a number of regulatory remedies and arbitration forums regarding freight rates and service levels. For example, Canadian shippers have access to regulatory remedies including final offer arbitration, level of service arbitration, regulated interswitching, and long haul interswitching, to name a few. Indeed, the regulatory environment provides rail shippers with more information and leverage than is commonly available in other markets. To the extent that some railway customers still have limited options for transportation, despite ever increasing competition, the regulations ensure that railways are not able to unduly exercise any resulting market power.

Second, we take exception to McMillan calling into question CP’s approach to its regulatory responsibility. McMillan states “It is therefore terribly concerning that either CN or CP would characterize and allocate debt to the Canadian parts of its system on a basis that artificially inflates its cost of capital”. [McMillan response, page 5, para. 1]

As a major participant in an industry that is heavily regulated under Canadian law, CP is keenly sensitive to its obligations under that law. CP submits the data that is required by the Agency or indeed any of its regulators, and configures those submissions to be fulsome and accurate to the best of its ability.

Furthermore, details regarding all of CP’s debt issuances and commercial paper liabilities are available in CP’s public 10K filings and audited financial statements.

Finally, we would like to address McMillan’s calls for the Agency to release more of CP’s confidential information that is submitted to the Agency for regulatory purposes [see for example McMillan’s submission at numbered paragraph 10.c]. McMillan correctly notes that the Agency is constrained by statute from publicizing confidential information. This is not a matter of degree or interpretation. All information provided under the statute is to be treated as strictly confidential.

McMillan asserts that it is unlikely that all of the railway’s capital structure information could be considered commercially sensitive. To the contrary, the very fact that this information is a key determinant of a railway’s regulatory cost of capital means that this information is extremely sensitive. The cost of capital determination is not only a key driver of a significant portion of a railway’s revenues, it is also a major factor in the basis on which Canada’s railways compete with each other.

The Agency is not only protecting the ongoing viability of the rail industry when it protects confidential information under statute, it is also protecting the other stakeholders in the industries which are subject to Canadian transportation law, including railways, , airlines, and all of their stakeholders and customers. Acquiescing to McMillan's request would require more than a simple review and determination by the Agency. It would require a revision of the statute.

We would like to thank the Agency and all respondents for your time and attention to this important matter.

Yours truly,

[signed]

Tyme Wittebrood
Director, Regulatory Finance
CANADIAN PACIFIC