www.cn.ca

Law

Eric Harvey
Senior Counsel - Regulatory
935 de La Gauchetiere Street West
Montreal, Quebec, Canada
H3B 2M9
Telephone: (514) 399-5774
Facsimile: (514) 399-4296
E-mail: eric.harvey@cn.ca

Affaires juridiques

Avocat principal - Affaires réglementaires
935 rue de La Gauchetière Ouest
Montréal (Québec) Canada
H3B 2M9
Téléphone : (514) 399-5774
Télécopieur : (514) 399-4296
Courriel : eric.harvey@cn.ca

November 25, 2020

Ms. Marcia Jones
Chief Strategy Officer
Canadian Transportation Agency
15 Eddy Street
Gatineau Quebec K1A 0N9

ferroviaire-rail@otc-cta.gc.ca

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 our submission respecting Agency consultations about the methodology to determine net rail investment and capital structure for the calculation of cost of capital rates.

We remain available should the Agency require more information.

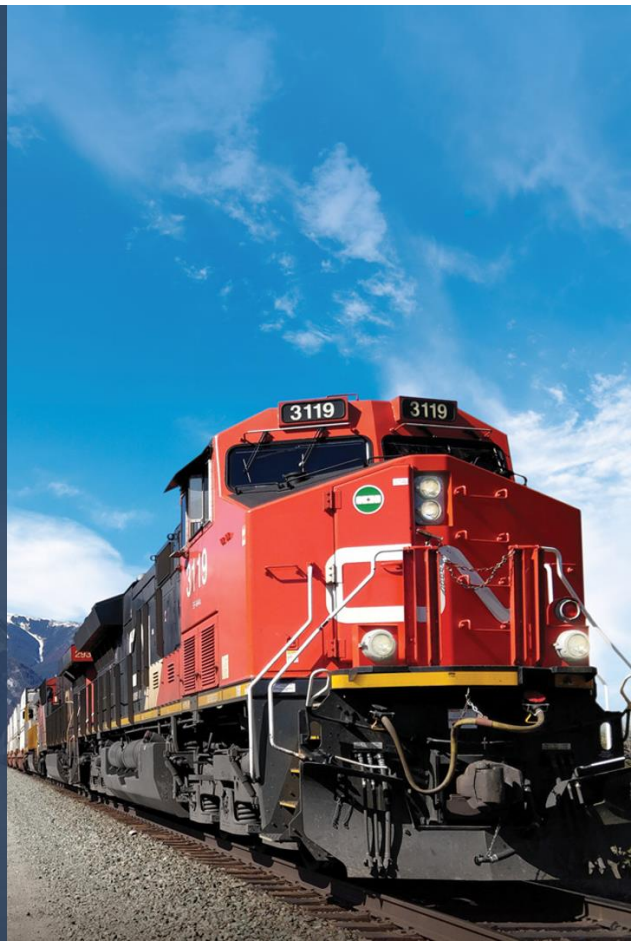
Yours truly,

Eric Harvey
Senior Counsel - Regulatory

Consultation on Cost of Capital Rates

CN Submission

Canadian Transportation Agency
25 November 2020



CN's response to the Agency's Discussion Paper on the Methodology to Determine Net Rail Investment and Capital Structure for the Calculation of Cost of Capital Rates

CN
935 De La Gauchetière W
Montréal, Québec
H3B 2M9

Thank you for the opportunity to respond to 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 the introductory remarks, we submit our comments following the same structure established in the Discussion Paper.

Introduction

As the Agency states,

> "*Cost of capital is an estimate of the total return on net investment that is required by debt holders and shareholders, so that debt costs can be paid and equity investors can be provided with a return on investment*" [Emphasis added].

The investment returns required by debt holders and shareholders cannot be determined from accounting measures alone. Investing in equities and bonds requires assessing and accepting risks, few of which are clearly expressed in accounting terms. It is generally acknowledged that economic or financial returns are different from accounting returns, and therefore estimating net investment returns from accounting statements requires certain judgement calls in order to accurately reflect the return expected from the market.

The overarching principle to guide the answers to the Discussion Paper questions is therefore whether the proposed method allows a fair, reasonable and adequate return to debt holders and shareholders, and not whether the answers adhere to accounting rules, the latter seeming to be the focus of most questions. Accounting rules were designed for financial statement purposes and not for determination of cost of capital (COC) purposes.

The main purpose of the Generally Accepted Accounting Principles (GAAP or U.S. GAAP) is to establish accounting standards to allow comparability of results and to help investors and lenders extract useful information for investment decision analysis. However, GAAP measures are not the only measures that investors use in their analysis of a company. For example, free-cash-flow and return on invested capital are considered non-GAAP measures but are frequently used by investors as indicators of the financial health of a company. Similarly, for railways, the operating ratio – a crucial measure that investors consider in their decision of whether to invest in a railway – is also a non-GAAP measure. Finally, the Agency itself prescribes a departure from GAAP when it comes to accounting for pension, and other labor costs, in its Uniform Classification of Accounts (UCA), showing that the assessment of the COC of a railway company cannot be limited to a strict adherence to GAAP measures.

In fact, the American Institute of Certified Public Accountants (AICPA), that established accounting standards and GAAP in the 1930s requires in its Code of Professional Ethics under Rule 203 – Accounting Principles, the departure from GAAP if its application would lead to a material misstatement, or otherwise be misleading in the circumstances[1].

Therefore, more discretion is required in order to assess a company and the returns required by its investors, beyond just studying its GAAP or UCA financial statement. The overriding concern should be whether the proposed method or measure is a faithful and useful presentation in estimating the returns actually required by shareholders and debt holders of the company.

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[1] https://www.aicpa.org/content/dam/aicpa/research/standards/codeofconduct/downloadabledocuments/2013june1codeofprofessionalconduct.pdf

To accurately reflect current expectations of investors and lenders when making decisions regarding CN, we believe that the questions raised by the Discussion Paper should be answered as follows:

1. Railway working capital should not be allowed to be negative;
2. Commercial paper that is routinely rolled over should be considered as long-term debt;
3. The current portion of long-term debt should remain as long-term debt in the railway capital structure;
4. (*a*) The cost of capital should be that of the consolidated corporation, and not one of its operating divisions, just like the cost of equity and the cost of debt (both of which are components of COC) are those of the consolidated corporation;

   (*b*) Failing the consolidated approach, general purpose debt should be allocated between different operating divisions of the company based on the investment properties cost, or gross book value (GBV), which represents directly the cost of properties and hence directly the funds needed in their investment;

   (*c*) If the Agency continues with the interim RTM method that misrepresents the relationship between investments in assets and revenues earned, then the initial value of debt used in U.S. investments should be perpetually subtracted from total debt before the allocation, to account for the fact that U.S. market value acquisition RTM require more capital investment funds than book value Canadian RTM;
5. The BC Notes are an exceptional circumstance and their treatment should revert to the Agency historical treatment they had for 15 years at their discounted value.

In the following sections we discuss the questions raised in the Discussion Paper and offer CN's analysis and rationale for our submissions.

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.

As 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*".

In operating a railway day-to-day, a company needs to pay its labour, fuel, materials and supplies, before it is able to collect payment from customers for railway services. A negative working capital would require the railway to do the opposite and collect from customers <u>before</u> it pays its labour, fuel, materials and supplies.

The purpose of a lead-lag study, which as the Agency points out "*is generally considered to be the most accurate for determining the amount of working capital for a company*", is precisely to determine the amount of money that the company must have on hand to finance its operations between the time it

pays its current liabilities before it is able to collect payments from customer. Given railway operations, it is highly unlikely that such a lead-lag study would find a negative working capital. For example, labour is the railway's biggest operating expense, and such expense cannot be delayed until customer payments are received. Similarly, track materials have multi-year lives and suppliers would not wait for years to get paid while the railway is amortizing such costs over customer traffic, etc.

Some companies succeed in operating with negative working capital, but they are mostly merchandising companies, with large inventory financed by suppliers, with very tight inventory control and high turnover, where they are able to collect from customers before paying suppliers. Walmart is one such example famous for its legendary inventory management. Railway operation is very different from the merchandising model.

The financial working capital described above, needed for day-to-day operations, influences the company's capital structure and hence its cost of capital. It is different from the accounting definition of working capital presented in the financial statements. CN's negative accounting working capital occurs on the most part because of an accounting election to present continuously rolling commercial paper as current liabilities. Accounting rules allow the presentation of such commercial paper as a long-term debt (more on this later), and if CN had elected to use this long-term presentation alternative, CN would have a more positive accounting working capital. Without any change in the day-to-day operations needs, changes in CN's participation and accounting methodology for its commercial paper operations would yield very different results. Furthermore, the amounts determined by a lead-lag study, which is accepted as the most accurate way of estimating the working capital requirement, would not be influenced by the amount of commercial paper issued by the company.

The amount of money needed to operate the railway on a day-to-day basis should not be influenced by a company's accounting presentation selection. Some discernment is required to make a reasonable determination of working capital, based on relevant adjustments to the balance sheet, much like all the other adjustments that the Agency prescribes to derive the COC Balance Sheet from the annual Regulatory Balance Sheet.

As per 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 defined differently from the classical accounting definition 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]

The consensus was that the emphasis should be on the needs for day-to-day operations, and not purely on the accounting definition. Should CN decide to change its participation and accounting classification of its commercial paper operations without any change in the needs of day-to day operations, its accounting working capital calculation would yield different results. As previously noted, it is not reasonable to assume that CN can support its day-to-day operations with a negative working capital.

As such, CN submits that a negative accounting working capital does not reflect a railway company's economic reality and is not an accurate estimate for COC regulatory purposes.

The economic reality for a railway company is that it cannot have a negative working capital as an input to the determination of its capital structure. If its balance sheet presents a negative working capital, then the cause of this presentation should be investigated and adjustments for rail regulatory cost of capital purposes should be permitted to present the economic reality and the returns expected by investors or lenders.

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.

CN has a large amount of outstanding commercial paper. Although this commercial paper is short-term in duration, it is routinely rolled over from month to month such that in substance, though not in form, it looks and behaves as long-term financing. One of the main reasons that CN maintains a relatively large position in commercial paper is the low interest rates of such instruments in the recent past. CN could convert these instruments into long-term debt but at higher rates that would increase CN's interest costs. Considering the economic benefits that the roll over provides, CN's commercial paper strategy is deliberate and long-term, and therefore commercial paper should be considered as long-term debt.

The consequence of such a large position in commercial paper (again, that is short-term in form but essentially long-term in substance), when presented in the current portion of liabilities, is that it leads to a negative accounting working capital which, in turn, does not represent economic reality for COC purposes, as explained above.

As we have stressed earlier, the assessment of a railway COC cannot be limited to a strict adherence to GAAP measures. We must note however that the exclusion of commercial paper from short-term liabilities is supported by reporting alternatives in the accounting principles when using such an instrument for a long-term purpose. U.S. GAAP allow the classification of certain short-term instruments as long-term debt (LTD) under certain conditions, depending on a company's demonstration of <u>intent and ability to refinance such instruments</u> on a long-term basis, in order to avoid the working capital problem explained above. The guidance within U.S. GAAP that addresses this subject of classification is contained in the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 470-10-45-12 to 20, **"Short-Term Obligations Expected to Be Refinanced"** and **"Intent and Ability to Refinance on a Long-Term Basis"**. An extract of FASB ASC is enclosed as Appendix A for ease of reference. In Summary:

> ***45-12A***
> *Some short-term obligations are expected to be refinanced on a long-term basis and, therefore, are not expected to require the use of working capital during the ensuing fiscal year. <u>Examples include commercial paper, construction loans, and the currently maturing portion of long-term debt.</u>* [Emphasis added]

45-12B

Refinancing a short-term obligation on a long-term basis means either replacing it with a long-term obligation or with equity securities or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the operating cycle, if applicable) from the date of an entity's balance sheet. [Emphasis added]

45-14

A short-term obligation shall be excluded from current liabilities if the entity intends to refinance the obligation on a long-term basis … and the intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing … [Emphasis added]

Therefore, as long as CN has the intent to refinance the short-term obligation on a long-term basis – which is clearly demonstrated by its history of refinancing – and its ability to refinance is supported by a backstop credit facility, short-term obligations such as commercial paper and the current portion of long-term debt can be classified as LTD[2] which would therefore be excluded from the working capital calculation.

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?

Commercial papers are seldom renewed one for one. If in one month a company had two papers for $150M and $250M (total $400M) and the next month had only one for $300M, how could one decide which paper was renewed and which was not? And if in the following month the company had two papers for $250M each (total $500M), can we consider the $300M to be renewed? Trying to follow which paper was renewed and which was not is a quagmire.

Once it is accepted that a railway can classify its commercial paper as LTD, all of its commercial paper should be classified as such. One cannot make a distinction that some commercial paper is LTD and some other is short-term. Commercial paper simply becomes another source of funds, like equity or bonds, with its own interest cost.

The amount of commercial paper will vary from month to month. Since the Agency's prescribed method for calculating working capital requires taking the average of twelve monthly calculations of working capital, by removing the monthly commercial paper amount from the monthly calculation of the working capital, we will automatically take into account the effect of diminishing commercial paper if the latter was not rolled over in sufficient amounts to cover the maturing ones.

As such, there is no need for any additional special treatment to specifically identify commercial paper that is rolled over and commercial paper that is not.

[2] Until 2009, CN used to include its commercial paper in LTD. For example, in its 2009 audited annual report, CN stated in its financial notes "Commercial paper debt is due within one year but is classified as long-term debt, reflecting the Company's intent and contractual ability to refinance the short-term borrowings through subsequent issuances of commercial paper or drawing down on the long-term revolving credit facility."

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.

Once classified as LTD, commercial paper should be allocated to regulated activities by the same method prescribed to allocate all other LTD.

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.

CN has access to several financing sources other than LTD:

- Revolving credit facility, for general corporate purposes, including backstopping the Company's commercial paper programs
- Commercial paper, discussed above
- Accounts receivable securitization program

Funding is sourced amongst these programs continuously, as opposed to only a short-term borrowing that simply matures within the year. They should therefore also be treated as LTD, similar to the above arguments for commercial paper, i.e. they become a source of funding in the Company's capital structure, each with their related interest costs.

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.

As explained in Issue 2 above, U.S. GAAP allows the classification of the current portion of long-term debt as a long-term debt instead of current liability, provided the Company has the intent and ability to refinance it as a long-term debt.

From the point of view of determining the Company's capital structure, (i.e. the percentage of funds provided by debt holders vs. shareholders), it is most logical to consider the current portion of LTD as long-term debt. To illustrate why, let's consider the example of a company with a capital structure made of 50% equity and 50% LTD, and the LTD instrument being a five-year bond that is renewed every time at maturity. No one could suggest that the capital structure would jump to 100% equity and 0% LTD once every five years because the LTD would be classified as current liability in the year the LTD comes to maturity, when in reality the company's capital structure would have not changed with the company continuing to pay interest. The nature of an LTD and its role in a company's capital structure remains the same irrespective of the accounting presentation of its current portion.

Typically, as a railway company grows, so does its LTD to finance working capital; capital expenditures relating to track infrastructure, rolling stock and other; acquisitions; dividends; and share repurchases. CN's LTD has been growing over the years – a clear indication that it has been continuously rolled over and refinanced, rather than retired and paid off.

For these reasons, and similarly to commercial paper, the current portion of CN's LTD should be treated as long-term and not short-term liability.

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

Most debt instruments are not issued for one single purpose or jurisdiction. CN operates a North American network for which shareholders and lenders expect a return. For this reason, CN strongly disagrees with the notion of allocating debt between CN's Canadian (regulated) and U.S. (non-regulated) operations. **Such an allocation will always suffer from discrepancies between different interpretations of the purpose of debt instruments because they are not issued for a single purpose.**

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. Numerous financial institutions estimate and publish the cost of capital of CN and CP, as well as the other North American Class I's. We note that adopting the consolidated approach would allow benchmarking of the Agency's COC against the COC as determined by investment professionals at financial institutions who are active in the markets where the railways actually raise funds.

We must add that CN's COC should not exhibit dramatic variations whether based on U.S. GAAP consolidated financial statements, or on UCA regulatory balance sheet. The exercise should reflect the relevant information that investors and lenders rely upon for making their decisions, and therefore should be the foundation for determining CN's COC, the purpose of which is estimating returns expected by investors.

Experience shows that the reliance on debt allocation does lead to skewed results. Agency Decision No. LET-R-40-2019, where the Agency determined that CP's COC was 1.5x that of CN, shows a disproportionate gap that all other financial analysts contradict. For example, the table below shows that Morgan Stanley estimates[3] that CN and CP COC (called weighted average cost of capital, or WACC, in the industry parlance) was about the same and in line with all other Class I railways operating in the same North American capital market:

[3] *Freight Transportation - North America*, Morgan Stanley, January 7, 2019

Exhibit 50: Morgan Stanley Transportation Coverage Universe: MS Valuation Case Summary

Morgan Stanley Transportation Coverage Universe: MS Valuation Case Summary

1/4/2019 Ticker	MS Rating	Current Price	Price Target	TMF Upside %	Rank	PT Multiples MSe TMF P/E	Valuation Methodology
Rails - Analyst: Ravi Shanker							
CNR	OW	$100.77	$115	14%	10	17.1	We use a 10-year DCF assuming 6.7% WACC and terminal cash flow perpetual growth rate of 1.5% (implying an exit EBITDA multiple of 10.0x). Our DCF valuation implies a fwd P/E of 17.1x, which is above CNR's 5-year average, reflecting our view that CNR is the best positioned rail against coming industry disruption.
CP	OW	$242.25	$276	14%	11	15.5	We use a 10-year DCF assuming 6.9% WACC and terminal cash flow perpetual growth rate of 1.5% (implying an exit EBITDA multiple of 9.0x). Our DCF valuation implies a fwd P/E of 15.5x, which is relatively inline with CP's 5-year average.
CSX	UW	$62.79	$56	-11%	20	13.2	We use a 10-year DCF assuming 7.4% WACC and terminal cash flow perpetual growth rate of 1.5% (implying an exit EBITDA multiple of 9.0x). Our DCF valuation implies a fwd P/E of 13.2x, which is below CSX's historical average.
GWR	UW	$73.99	$70	-5%	19	14.4	We apply a 14.4x multiple to our October 2019e TMF EPS est. to generate our PT of $70. Our October 2019e TMF P/E multiple is inline with GWR's historical trading range. Our valuation is supported by our DCF which assumes a 7.8% WACC and 1.5% perpetual growth rate.
KSU	EW	$96.90	$113	17%	9	15.6	We use a 10-year DCF assuming 7.1% WACC and terminal cash flow perpetual growth rate of 2.5% (implying an exit EBITDA multiple of 8.0x). Our DCF valuation implies a fwd P/E of 15.6x, which is below KSU's historical avg. given our cautious outlook on rails.
NSC	UW	$150.53	$116	-23%	25	11.4	We use a 10-year DCF assuming 7.5% WACC and terminal cash flow perpetual growth rate of 1.5% (implying an exit EBITDA multiple of 8.0x). Our DCF valuation implies a fwd P/E of 11.4x, which is below NSC's historical avg. given our cautious outlook on rails.
UNP	UW	$137.79	$133	-3%	17	14.5	We use a 10-year DCF assuming 7.1% WACC and terminal cash flow perpetual growth rate of 1.5% (implying an exit EBITDA multiple of 10.0x). Our DCF valuation implies a fwd P/E of 14.5x, which is relatively inline with UNP's historical 5-year avg.
Average				**0%**		**14.5**	

Surely, different analysts use different methods and arrive at different results, but it is hardly expected that two similarly successful railways, competing in the same markets for both traffic and capital, would exhibit the significant difference in COC arrived at by the Agency methods. Such discrepancy in COC results is not only putting into question the credibility of the method used but can also be misleading if investors were to rely on them to make informed decisions. Most importantly, such discrepancies translate into millions of dollars when the Agency applies these COC in determining the Volume Related Composite Price Indices for MRE purposes. The large variations between CN and CP's COC provide different grain revenue opportunities to each railway company which are otherwise competing in the same market. This exercise should not lead to the large variations between CN and CP that were witnessed in previous years and that led to a distortion in the position of each railway in the market.

Since the root of the problem is debt allocation, the best solution is to eliminate the allocation requirement rather than try to devise an allocation method that will suffer from subjective and arbitrary interpretations. Capital is raised in a market that relies on the consolidated financial statements as a basis for financial decisions and therefore it would be more consistent to use these same statements as the basis for estimating COC, which in turn would represent the returns expected by the market.

CN reluctantly participates in the debt allocation exercise, trying to find the most reasonable allocation method, not because CN believes in the appropriateness of this method of allocation, but rather because it is currently the mandated approach.

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.

The following are the uses of funds at CN by order of priority, as disclosed in its annual financial statements:

1. working capital requirements;
2. capital expenditures relating to track infrastructure, rolling stock and other;
3. acquisitions and other strategic initiatives;
4. dividends; and
5. share repurchases.

Only two of the above uses of funds can be unequivocally identified as belonging to Canadian or U.S. operations, namely acquisitions and capital expenditures on track infrastructure.

With rolling stock, equipment moves between the Canadian and U.S. jurisdictions. The administrative registration of equipment to a Canadian or U.S. entity may not be entirely representative of where the equipment will be used throughout the life of the asset.

Working capital, dividends and share repurchases clearly belong to the consolidated corporation.

After removing debts issued to fund U.S. acquisitions and other special capital projects like the U.S.-mandated Positive Train Control (PTC) requirements, the remaining debt instruments should then be allocated between CN and U.S. operations using measures that are relevant to the use of the funds.

The Agency's interim method of allocating debt is based on revenue ton miles (RTM). "*The RTM approach allocates debt to Canadian operations and U.S. operations based on the proportion of traffic moved in each jurisdiction using reported revenue ton miles.*" The Agency justifies this approach by stating that it "*reflects the reasonable expectation that there will be a relationship between investments in assets and revenues earned*".

While this may seem intuitively reasonable on the surface, there are several *caveats* about the relationship between investments, RTMs and revenues:

- First, capital funds properties, properties generate RTMs, and RTMs generate revenues. The relationship is far from being one-to-one-to-one across jurisdictions.

  To allocate funds based on RTMs makes the erroneous assumption that the same funds will generate the same RTMs in both Canadian and U.S. operations, which is definitely not the case. Most U.S. properties were obtained through acquisitions (e.g. Illinois Central (IC) in 1998, Wisconsin Central (WC) in 2001, and Elgin, Joliet and Eastern Railway (EJ&E) in 2009). Acquisitions are made, and most importantly funded, at market prices which are much higher than book values. By contrast, Canadian properties have been funded by CN over the last 100 years at levels much lower than the more recent U.S. acquisitions. Funds needed to generate RTMs in the U.S. are therefore much higher than funds needed to generate the same RTMs in Canada.

  The treatment is corrected by removing from the allocation process the LTDs that were used to fund the U.S. acquisitions. At their maturity, CN rolled them over into new debt instruments, and continued the practice of removing them from its LTD allocation, in order to keep accounting separately for this higher U.S. investment cost. The Agency refused this roll-over of debts, and put back into the allocation pool (i.e. distributed by RTM) the funds that were used to acquire U.S. properties, and hence reverted to assuming that the same capital investment generated the same RTM on both sides of the border.

  This is one example of the challenges associated with the allocation of debt by jurisdiction. Why should the Agency change the purpose of a debt contracted by CN to acquire U.S. operations if the intent of the Agency is specifically to assign debt by jurisdiction? The fact that the debt may have been later rolled over into a new debt instrument does not alter the value of the debt initially contracted to acquire operations in the U.S. and which can still be determined with certainty. To account for the different investment levels per RTM generated, debt used in U.S. acquisitions must be allowed to be rolled over. This is consistent with CN's position above in Issue 3, where we

explained how total LTD is expanding with CN's balance sheet, and that debt has been rolled over and increased over the years rather than paid off and decreased.

- Second, infrastructure investments are not always made to increase RTMs. Safety, network fluidity and/or service improvements are also major considerations and motivations. Service quality improvements may allow an increase in revenues but that is not always accompanied by a commensurate increase in RTMs.
- Third, flat and straight railway lines in the sparsely populated Prairies require much less investment (in both infrastructure and locomotive power) than curved and inclined lines in Wisconsin (or the Rockies), or along more densely populated areas along the Mississippi, to generate the same RTM. Maintenance and renewal costs are also relatively less in the Prairies where CN generates a big portion of its RTMs.
- Finally, not all RTMs generate the same revenue, and therefore may not attract the same level of investment.

To illustrate these points:

Table 1 presents CN properties segmented by country as presented in CN's annual reports. The percentage of properties that are in Canada averaged 53.3% over the last three years. Therefore, capital from investors and lenders has been deployed 53.3% in Canada and 46.7% in the U.S. It would seem reasonable then to allocate 53.3% of LTD to Canadian operations.

In $CAD millions December 31,	*2017*	*2018*	*2019*
Properties			
Canada	18,305	19,737	21,482
U.S.	15,884	18,036	18,187
Total properties	34,189	37,773	39,669
Canada %	53.5%	52.3%	54.2%

Table 1 Segmented properties in $CAD

Table 2 lists the revenue ton miles for the same three years and shows that the Canadian percentage of RTMs averaged 73.6%. The Canadian share of RTMs is much higher than its share of properties, indicating that for the same value of properties, i.e. investments, more RTMs are generated in Canada. In the case of CN, RTMs are definitely not a faithful indicator of the use of investment funds.

In millions Year ended December 31,	*2017*	*2018*	*2019*
Revenue ton miles (RTM)			
Canada	174,389	181,684	179,347
U.S.	62,709	66,699	62,607
Total revenues	237,098	248,383	241,954
Canada %	73.6%	73.1%	74.1%

Table 2 Revenue ton miles

Properties per RTM are much higher in the U.S. than in Canada as illustrated in **Table 3**. It takes 2.4 times more properties investment in the U.S. than in Canada to generate the same RTM.

In $CAD per RTM December 31,	*2017*	*2018*	*2019*
Properties per RTM			
Canada	0.10	0.11	0.12
U.S.	0.25	0.27	0.29
U.S. / Canada Ratio	2.4	2.5	2.4

Table 3 Investment intensity

Table 4 shows the revenues and indicate that the Canada percentage of revenues averaged 67.6% over the same three years. The Canadian share of revenues is consistently lower than its share of RTMs, indicating that the revenue per RTM is much lower in Canada than in the U.S., as illustrated in **Table 5**.

In $CAD millions Year ended December 31,	*2017*	*2018*	*2019*
Revenues			
Canada	8,794	9,610	10,167
U.S.	4,247	4,711	4,750
Total revenues	13,041	14,321	14,917
Canada %	67.4%	67.1%	68.2%

Table 4 Revenues in $CAD

In ¢CAD per RTM December 31,	*2017*	*2018*	*2019*
Revenues per RTM			
Canada	5.04	5.29	5.67
U.S.	6.77	7.06	7.59
U.S. / Canada Ratio	1.343	1.335	1.338

Table 5 Revenue per RTM

The tables above demonstrate the inaccurate assumption that the same investment funds would generate the same RTM and the same revenues in both Canada and the U.S. While appealing because of its simplicity, this approach is not valid because it leads to a result that is not supported by the evidence available to the Agency regarding CN.

CN believes that a better method of debt allocation is by investment properties cost, or gross book value (GBV). GBV represents directly the cost of properties and hence directly the funds needed in their investment.

The only set of accounts that exist and that give us comparable figures for Canadian and U.S. operations are the consolidated accounts under U.S. GAAP. Unfortunately, the Agency has not agreed until now to use other options than UCA even if no investors or lenders refer to UCA to assess their expectations. We note that the Canada Transportation Act does not dictate the exclusive use of UCA and we are unclear as to why such limitations should be imposed, especially when, as shown above, they lead to results inconsistent with CN's information.

The choice made by the Agency to use only UCA has also another detrimental effect of CN. CN does not have nor can produce UCA-compliant accounts for CN's U.S. operations. This would entail revisiting every engineering project and mechanical repair in the last 25 years to determine their capitalization rate according to the UCA rules – an impossible feat. Since we cannot have UCA comparable accounts on both sides of the border, the practice adopted by the Agency until now prevents CN from presenting evidence for its U.S. operations to allow for an "apple to apple" comparison between the two jurisdictions. As the Agency does not accept the use of U.S. GAAP, to allocate LTD between Canadian and U.S. operations, CN is left with the RTM approach – not because it is a good measure, but because it is the only one that the Agency would allow notwithstanding the significant discrepancies disclosed by the tables above.

For all the above reasons, CN believes that allocation by RTM is not an appropriate approach. If RTM is kept as the method of allocation, then perpetual renewal should be allowed for LTDs used in the U.S. acquisitions or other specific U.S. investments, in order to account for the fact that they require more funding per U.S. RTM compared to Canadian RTM. Because a maturing debt can be refinanced in whole or in part by one or more debt issues, before or after the actual maturity date, it becomes very difficult over the long run to track which maturing debt was refinanced by which new issue. It would be much easier to administer, with the same final result, if the amounts used to finance non-Canadian rail operations were simply deducted from the total consolidated debt before applying the RTM allocation.

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

Debt instruments are seldom issued for a single purpose. Most debt covenants would have wording to the effect that the proceeds will be used for general corporate purposes, including the redemption and refinancing of outstanding indebtedness, share repurchases, acquisitions and other business opportunities. If it is not clear what the debt is for, then it must be assumed that it is for general corporate purposes.

CN prefers the allocation of debt by GBV. With the GBV methodology, it would be clear what proportion of debt is allocated to Canadian rail operations vs. all other operations of the company (U.S. rail, vessel transportation, trucks or planes, etc.). If the RTM approach is maintained, then debt reasonably identified for non-rail purposes, as well as non-Canadian rail acquisitions, should be excluded from the total debt and the remainder allocated by the proportion of rail RTMs in Canada vs. total rail RTMs.

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.

By definition, cash is fungible. A dollar from a debt issue is interchangeable with a dollar from operating revenue or from commercial paper borrowings. It is impossible to track the exact use of the proceeds of a debt instrument. Enforcing stronger data reporting would be a bureaucratic quagmire. Tracking fund

sources or uses can only be accomplished at a high level. For example, in a year with a large acquisition, we can show that not enough cash was generated from operations and therefore debt issue was necessarily used to finance the acquisition. But in a year where cash from operations can cover a smaller acquisition, who is to say whether the acquisition was financed with cash on hand and the LTD was for general corporate purposes, or the acquisition was financed by the LTD?

CN does not believe that enforcing stronger data reporting to track the use of general-purpose debt will yield clearly defined results due to the high level of subjectivity required.

Alternatively, CN's recommendation of allocating LTD by GBV would eliminate the need of tracking which debt was used for which purpose.

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

Q.10 Are there examples of an abnormal situation (such as acquisitions of another railway company and its debt) where the market value of debt should be used, rather than the face value, in the determination of the railway company's capital structure? Please provide a rationale for your response.

There are instances of special circumstances where the Agency model, for calculating a railway capital structure and COC, breaks down and provides a result that is not economically nor financially sound. Every special circumstance warrants its own analysis to determine what is the most appropriate course of action to determine a COC in line with investors and lenders expectations.

One such special circumstance is the acquisition of a company that is in financial difficulty. In an acquisition, all accounting and financial rules require the assets and liabilities of the purchased company to be evaluated at market value. For profitable companies, the market value is often much higher than the face value of the investments in that company. If, on the other hand, the company has not been profitable for several years, it is possible that the face value of its debt would exceed the value of its assets. This is often the case in bankruptcy proceedings where bondholders and shareholders finally receive far less than the face value of their investment. For an unprofitable company in financial difficulty, 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 if the source of debt capital is valued at face value and is much higher than the net rail investment.

The acquisition of BC Rail by CN is one such special circumstance that warrants special considerations.

A. Introduction

In its April 28, 2020 determination of CN's cost of capital in LET-R-30-2020, the Agency describes the BC Notes assumed with the BC Rail acquisition as "*the debt used to purchase BC Rail*". In Appendix A of the letter, the Agency states:

> ***2.0 Capital structure***
> *CN recorded the debt used to purchase BC Rail in discounted value rather than face value. According to the 2017 Determination, long-term debt reported in the capital structure must reflect the face value of the debt instruments.*

The first sentence suggests that CN used the debt to purchase BC Rail. However, this is factually incorrect. The reference to the "debt used to purchase BC Rail" is not for the debt that was issued by CN, but rather the debt that BC Rail had on its books and owed to its parent, British Columbia Railway Company (BCRC), a BC Government Crown Corporation, before being purchased by CN. These BC Notes are a special creditor arrangement between BC Rail and its parent, before the CN acquisition, and not a debt issued by CN to finance its rail operations or acquisitions. They supplied very little debt capital to CN. Therefore, they warrant to be treated differently from standard long-term debts in evaluating CN Capital structure, since they were not issued to finance CN capital structure, nor BC Rail operations.

Since the 2004 acquisition of BC Rail, CN has always presented these BC Notes at their discounted value in the regulatory balance sheet (RBS) used in the regulatory determination of the cost of capital. In its latest decision, the Agency essentially reversed its 15-year treatment of these notes from their currently discounted value of $12M, to their face value of $842M.

The consequences of this decision to deviate from the historical treatment of these notes are obviously significant and led to: (a) a reduction in the weighted average interest rate by the inclusion of this large amount at 0% interest, and (b) an increase in the weight of long-term debt relative to the weight of equity in the company's capital structure. Since LTD has a lower cost than equity, this has led to a lower weighted average Cost of Capital for CN.

In what follows, CN presents the reasons why these BC Notes warrant the same historical treatment they have always been given, from the 2004 BC Rail acquisition up until the most recent 2020 determination. CN respectfully requests that these BC Notes be restored to their historical discounted value when being used in the determination of CN's capital structure and COC.

B. History

Before the 2004 acquisition of BC Rail by CN, BC Rail had $1.7B of debt owed to its parent company BCRC, a crown corporation of the BC government. The value of BC Rail debt far exceeded the value of its assets, and BC Rail had no hope of repaying it.

Before the acquisition by CN, all the various BC Rail debts were consolidated by BC Rail into two debts:

1. 90-year notes due in 2094 bearing 0% interest with principal amount of $842 million and fair value of $5 million;
2. Demand notes with the balance that were repaid/retired by the CN acquisition.

Upon closing, CN recorded the 90-year notes as a discounted debt of $5 million, their fair value, as required by all accounting and financial rules of acquisitions. The value of the debt has been accreting since then and will continue to accrete back to its principal amount over the life of the notes, at the implied interest rate of 5.75%. The value of the notes as at Q4 2019 was $12 million. The RBS mirrors this treatment, starting at $5 million in 2004 and accreting to $12 million in 2019.

The BC Rail acquisition was a share purchase, effectively transferring BC Rail assets and liabilities to CN. Based on the purchase price allocation disclosed in CN's 2005 annual report (see below), all LTD assumed (including the BC Rail 90-year notes) had a fair market value (FMV) of only $13 million, implying that the proceeds or assets received in return for assuming this obligation had a similar value.

Therefore, CN did not acquire a debt of $842 million counterbalanced by assets of $842 million, as would normally be the case in a solvent on-going rail operation.

In addition, in July 2004, CN issued USD$300 million of 4.25% Notes due 2009 and USD$500 million of 6.25% Debentures due 2034. CN used most of the net proceeds to finance the acquisition of the Great Lakes Transportation (GLT) in the U.S. as well as to refinance at maturity an LTD used in the IC acquisition. A portion of the proceeds was also used in funding the acquisition costs of BC Rail. Both debt instruments that were issued by CN are presented at face value in CN's capital structure as required by the Agency.

From the 2005 CN Annual report, the allocation of the purchase price is as follows:

BC Rail Purchase Price Allocation

In millions	
Current assets	200
Deferred income taxes	399
Properties	597
Other assets	3
Total assets acquired	1,199
Current liabilities	76
Other liabilities and deferred credits	119
Long-term debt	13
Total liabilities assumed	208
Net assets acquired	991

In the acquisition, there was not $842 million of long-term debt, and therefore there was not a countervailing $842 million of assets purchased by CN. These notes were an arrangement between BC Rail and its BCRC creditor before the CN acquisition. The total LTD that CN acquired was only $13 million, $5 million of which represented the fair market value of the 90-yr notes.

Therefore, CN did not receive $842 million to finance the BC Rail acquisition as implied by the Agency's most recent determination. All the above information is confirmed by the BCRC annual reports available on the company's website. In 2004, the BCRC annual report shows the debt receivable from BC Rail at $5 million, and confirms that it was assumed by CN subsequent to the acquisition (https://www.bcrco.com/2004report.pdf). [4]

[4] The initial estimate of 823.6 $M of face value was finalized to 842 $M in 2007.

5. OTHER ASSETS

	2004	2003
Insurance deposits	$ 35,497	$ 33,349
Accrued pension benefit asset - Note 12 (a)	16,561	39,985
Mortgages receivable	9,278	109
Deferred property transfer tax	9,003	-
Long-term notes receivable from BC Rail	5,132	-
Foreign currency contract - Note 7 (c)	-	8,085
Long-term debt discounts	-	5,780
Other	1,741	5,925
	$ 77,212	$ 93,233

Intercompany debt which was previously owed by BC Rail Ltd. and BC Rail Partnership to related entities was restructured and assumed by CN. The face value of the debt is $823.6 million. At the time of the restructuring, the fair value of the debt was $5 million. The Company recorded a debt receivable from BC Rail at the fair value. The debt receivable is non-interest bearing and is due on July 12, 2094, and will be accreted each year to its ultimate face value.

In 2019, the BCRC financial statement (https://www.bcrco.com/fia2019.pdf) similarly shows that the debt has accreted to $11.8 million (at March 31st):

11. TRADE AND OTHER RECEIVABLES

As as March 31	Note	2019	2018
Trade receivables		$ 2,937	$ 2,221
Other receivables			
Mortgages receivable	(a)	194	213
Joint Capital Account receivables	(b)	129,807	97,172
Long-term notes receivable from CN	(c)	11,796	11,144
Long-term receivable for environmental remediation services	(d)	57,944	49,106
		199,741	157,635
		$ 202,678	$ 159,856
Current		$ 2,937	$ 2,434
Non-current		199,741	157,422
		$ 202,678	$ 159,856

(c) The long-term notes receivable from CN (Note 4) are non-interest bearing and due on July 12, 2094. The notes were initially recorded at fair value calculated based on the discounted cash flow using an implied interest rate of 5.75% and are accreted each year at 5.75% to their ultimate face value of $842 million.

Both CN and the BCRC creditor, two independent at-arm's-length companies, are in agreement that the current value of the debt is only $12 million in 2019.

C. Previous Agency Decision

Agency instructions in its Working Capital Decision R-2017-198, are to record the LTD at face value, and the average interest rate is calculated by the coupon rate over the face value. Premiums are to be recorded in other deferred credits, and discounts in other assets, both to be amortized over the debt term.

Decision R-2017-198 may well apply to typical debts issued with interest payments and relatively small discounts or premiums to account for small variations of market interest rates relative to coupon rates. However, the nature of the BC Notes is exceptional in many regards and continues to warrant the special consideration it has received for 15 years:

- The notes bear no interest
- They atypically have an extremely long term of 90 years
- They were not issued by CN for any financial purpose, nor by BC Rail to finance rail operations

For a normal or typical LTD, CN receives proceeds equal to the face value, minus issuance costs, and minus or plus any discounts or premiums due to variation between coupon rates and market rates or demand for such an LTD instrument. The 2019 average discount for exclusively all CN debts that have a discount[5] is only 0.6%. Therefore, the amount of funds supplied by creditors for CN's capital structure is close to the face value of the debts. Against the LTD liability, CN would have a counterbalance of also close to face value in assets on its balance sheet, first in cash and then in other assets as CN invests the cash.

In the case of the BC Notes, the discount is huge compared to normal LTDs. It started at (842 – 5)/842 = 99.4% in 2004, and has dropped to 830/842 = 98.6% in 2019, still huge by any standard. Additionally, CN did not receive $842 million in funds nor assets and, therefore, CN's capital structure did not receive an infusion of $842 million.

CN submits that the special nature and circumstances of these BC Notes warrant an exception from Agency prescriptions in R-2017-198 as many of the reasonings in this decision do not apply, and the reversal of their treatment from discounted value to face value, is not economically or financially sound in determining CN's capital structure for COC purposes.

D. Debt valuation

If CN were to cease operations, CN would normally have to pay bondholders the face value of the LTDs plus accrued interests. In the case of the BC Notes, since they are unsecured and subordinate to all other senior notes, in addition to being due only in 2094, it is highly unlikely that CN would have to pay the face value and there are no accrued interests. In fact, the credit rating Agencies do not consider the face value of such deeply discounted debts since under U.S. case law, such debt discounts are not permissible claims in bankruptcy proceedings.

[5] If we include all other debts with no discounts, the average would be even smaller.

In view of these facts, the only amount that is due on the BC Notes, and that can be construed as being lent to CN, is the fair market value that stands at $12M in 2019.

Q.11 If market value is determined appropriate, what rate or rate calculation should the CTA use for this debt? Please provide a rationale for your response.

E. Interest rate

CN does not pay interest on $842 million and did not receive $842 million in proceeds. It is therefore not economically or financially sound to include $842 million at 0% rate in the calculation of the average interest rate on the CN LTD. CN submits that the appropriate treatment is the inclusion of only the current FMV of $12 million at the imputed interest rate of 5.75%. This is the same rate that was used to estimate the FMV of $5 million, as calculated by BC Rail before its acquisition, and continues to be used by both CN and BCRC as the interest paid on this debt, as evidenced in the financial statements of both companies.

The initial FMV was estimated as follows (compounded quarterly, rounded for greater clarity, and simplified for illustrative purpose only):

$$FMV_{2004} = 842 \div \left(1 + \frac{5.75\%}{4}\right)^{90\times4} = 5\ \$M$$

Every quarter, CN adds the 5.75% interest to the debt, since there is not any repayment until 2094. For the 15 years since 2004, the FMV in 2019 becomes

$$FMV_{2019} = 5\ \times \left(1 + \frac{5.75\%}{4}\right)^{15\times4} = 12\ \$M$$

In 2019, CN's true indebtedness is only 12 $M at 5.75%. Adding 5.75% interest to 12 $M, the debt in 2020 would be

$$FMV_{2020} = 12\ \times \left(1 + \frac{5.75\%}{4}\right)^{4} = 13\ \$M$$

And so forth. Finally, in 2093, CN's debt and interest rate would not be 842 $M at 0%, since the principal is due only the next year. They will be rather be 795 $M at 5.75%, since for the final year

$$FMV_{2094} = 795\ \times \left(1 + \frac{5.75\%}{4}\right)^{4} = 842\ \$M$$

Which is the amount that is due on maturity.

Therefore, CN must earn every year 5.75% on the discounted value of the BC Notes in order to be able to repay them at maturity. The amount and interest rate that should be taken into consideration for calculating CN capital structure and average LTD interest rate are, respectively, the discounted value and the imputed interest rate of 5.75%.

F. Summary and Conclusion of Issue 5

There are special situations that warrant special treatments. The acquisition of BC Rail by CN is one such special case.

The BC Notes are not a debt issued by CN for the purpose of purchasing BC Rail. They were an arrangement already in existence between BC Rail and its parent BCRC prior to the CN acquisition.

When CN acquired the BC Rail, CN acquired $5 million of liabilities and countervailing assets, not $842 million. CN must earn 5.75% per year on this debt in order to be able to meet its obligation of repaying it at maturity in 2094 at the face value of $842 million.

Given the interest amount that CN must earn in order to meet this debt obligation and the value on which CN has to earn this interest amount, the more appropriate values for inclusion in the calculation of CN's capital structure and average interest rate on debt for COC purposes, are the debt discounted value and 5.75%, respectively.

Appendix A – Extract from FASB ASC 470

> **Short-Term Obligations Expected to Be Refinanced**

45-12A

Some short-term obligations are expected to be refinanced on a long-term basis and, therefore, are not expected to require the use of working capital during the ensuing fiscal year. Examples include commercial paper, construction loans, and the currently maturing portion of long-term debt.

45-12B

Refinancing a short-term obligation on a long-term basis means either replacing it with a long-term obligation or with equity securities or renewing, extending, or replacing it with short-term obligations for an uninterrupted period extending beyond one year (or the operating cycle, if applicable) from the date of an entity's balance sheet.

45-13

Short-term obligations arising from transactions in the normal course of business that are due in customary terms shall be classified as current liabilities. A short-term obligation shall be excluded from current liabilities only if the conditions in the following paragraph are met. Funds obtained on a long-term basis before the balance sheet date would be excluded from current assets if the obligation to be liquidated is excluded from current liabilities.

> **Intent and Ability to Refinance on a Long-Term Basis**

45-14

A short-term obligation shall be excluded from current liabilities if the entity intends to refinance the obligation on a long-term basis (see paragraph 470-10-45-12B) and the intent to refinance the short-term obligation on a long-term basis is supported by an ability to consummate the refinancing demonstrated in either of the following ways:

a. Post-balance-sheet-date issuance of a long-term obligation or equity securities. After the date of an entity's balance sheet but before that balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), a long-term obligation or equity securities have been issued for the purpose of refinancing the short-term obligation on a long-term basis. If equity securities have been issued, the short-term obligation, although excluded from current liabilities, shall not be included in owners' equity.

b. Financing agreement. Before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), the entity has entered into a financing agreement that clearly permits the entity to refinance the short-term obligation on a long-term basis on terms that are readily determinable, and all of the following conditions are met:

1. The agreement does not expire within one year (or operating cycle) from the date of the entity's balance sheet and during that period the agreement is not cancelable by the lender or the prospective lender or investor (and obligations incurred under the agreement are not callable during that period) except for violation of a provision with which compliance is objectively determinable or

measurable. For purposes of this Subtopic, violation of a provision means failure to meet a condition set forth in the agreement or breach or violation of a provision such as a restrictive covenant, representation, or warranty, whether or not a grace period is allowed or the lender is required to give notice. Financing agreements cancelable for violation of a provision that can be evaluated differently by the parties to the agreement (such as a material adverse change or failure to maintain satisfactory operations) do not comply with this condition.

2. No violation of any provision in the financing agreement exists at the balance sheet date and no available information indicates that a violation has occurred thereafter but before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), or, if one exists at the balance sheet date or has occurred thereafter, a waiver has been obtained.

3. The lender or the prospective lender or investor with which the entity has entered into the financing agreement is expected to be financially capable of honoring the agreement.

45-15
Repayment of a short-term obligation before funds are obtained through a long-term refinancing requires the use of current assets. Therefore, if a short-term obligation is repaid after the balance sheet date and subsequently a long-term obligation or equity securities are issued whose proceeds are used to replenish current assets before the balance sheet is issued or is available to be issued (as discussed in Section 855-10-25), the short-term obligation shall not be excluded from current liabilities at the balance sheet date. See Example 5 (paragraph 470-10-55-33) for an illustration of this guidance.

45-16
If an entity's ability to consummate an intended refinancing of a short-term obligation on a long-term basis is demonstrated by post-balance-sheet-date issuance of a long-term obligation or equity securities (see paragraph 470-10-45-14(a)), the amount of the short-term obligation to be excluded from current liabilities shall not exceed the proceeds of the new long-term obligation or the equity securities issued.

45-17
If ability to refinance is demonstrated by the existence of a financing agreement (see paragraph 470-10-45-14(b)), the amount of the short-term obligation to be excluded from current liabilities shall be reduced to the amount available for refinancing under the agreement if the amount available is less than the amount of the short-term obligation.

45-18
The amount to be excluded shall be reduced further if information (such as restrictions in other agreements or restrictions as to transferability of funds) indicates that funds obtainable under the agreement will not be available to liquidate the short-term obligation.

45-19
Further, if amounts that could be obtained under the financing agreement fluctuate (for example, in relation to the entity's needs, in proportion to the value of collateral, or in accordance with other terms of the agreement), the amount to be excluded from current liabilities shall be limited to a reasonable estimate of the minimum amount expected to be available at any date from the scheduled maturity of the short-term obligation to the end of the fiscal year (or operating cycle). If no reasonable estimate can be made, the entire outstanding short-term obligation shall be included in current liabilities.

45-20
The entity may intend to seek an alternative source of financing rather than to exercise its rights under the existing agreement when the short-term obligation becomes due. The entity must intend to exercise its rights under the existing agreement, however, if that other source does not become available. The intent to exercise may not be present if the terms of the agreement contain conditions or permit the prospective lender or investor to establish conditions, such as interest rates or collateral requirements, that are unreasonable to the entity.