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November 25, 2020

Via email: ferroviaire-rail@otc-cta.gc.ca
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CP'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

Thank-you for requesting stakeholder feedback on your review of the cost of capital methodology. As you have noted, the regulatory cost of capital is a significant input into the VRCPI and Maximum Revenue Entitlement regulatory program, as well as to the regulated interswitching rates and other costing exercises. As such the cost of capital rate has a material impact on freight rates, and on the continued well-being of the Canadian transportation system.

CP is pleased to provide its thoughts on the Agency's proposals.

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

CP requests clarification on this issue. The question, as written, does not provide enough information for CP provide a fulsome response to this question. It is not entirely clear why the Agency has raised this issue here. But more importantly, we respectfully request that the Agency describe how it intends to adjust the balance sheet and the capital structure if a negative value for working capital were to be disallowed. It is necessary to understand the impact to the capital structure and the cost of capital before a fruitful discussion can be had on this issue.

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

In general, commercial paper should not be shown on the regulated balance sheet at all, unless it is used to finance "Canadian rail operations" as defined in the Uniform Classification of Accounts (UCA) section 1201.

CP's use of commercial paper is primarily to provide a short-term financing instrument in order to meet immediate cash needs when funds from operations and other sources are not immediately available. It is very useful to have a flexible financing instrument that can absorb immediate demands for cash. Whereas cash from operations and long-term financing instruments may not be immediately available when they are required, commercial paper may be drawn down and repaid as needed.

For the same reasons, however, commercial paper is not well-suited to financing the acquisition of long-term rail assets such as track and equipment. For this reason CP does not commonly use commercial paper to finance rail operations. Rather it is a tool used by the parent company for Treasury purposes to provide short-term liquidity for corporate activities, many of which are not directly related to providing rail services as defined in the UCA. As discussed further below, the UCA specifies that Treasury functions are not to be accounted for in Canadian Rail operations. Therefore it is incorrect to include CP's commercial paper, generally, in the UCA accounts and the Canadian UCA financial statements.

However, the preceding notwithstanding, to the extent that commercial paper is to be included in the calculation of the regulatory cost of capital, it should be treated as a current liability. This is for the simple reason that commercial paper is, in fact, a current liability. Regardless of the time period that commercial paper is outstanding, any amount of commercial paper outstanding represents a reduction in the company's access to liquidity, and as such it is properly reflected as a reduction in working capital.

Commercial paper represents a short-term advance of funds to help to meet immediate financing needs. CP has only been using commercial paper for approximately the last five years, and the outstanding balance regularly fluctuates from month to month between zero and several hundred million dollars demonstrating that it is a short-term, flexible credit facility.

Theoretically speaking, a company could roll its commercial paper forward repeatedly. But for practical purposes there is a limit on a company's access to such flexible, short-term financing instruments. A company must be selective in how it applies its short-term financing capacity so that it may continue to benefit from the flexible nature of these credit facilities. Longer term financing requirements are normally met using long-term debt issues, reflecting the actual long-term financing needs of the company.

Even in the unusual circumstance when commercial paper is rolled-forward over a long time period, this does not somehow transform it into a long-term debt obligation. It remains a short-term financing instrument with short-term rights and obligations attached. Accordingly it is treated as a short-term liability under US-GAAP accounting regardless of whether or not it has been rolled-forward.

Furthermore, as cash is a fungible commodity, it would be impossible to distinguish an instance of commercial paper being rolled forward from an instance where old commercial paper is retired, and new commercial paper in a similar amount is issued for a new purpose. Therefore any ruling that commercial paper has been rolled forward would be arbitrary.

UCA section 1202.01 provides that railroads are to follow GAAP accounting except where it is modified by the UCA:

> **1202.01** The accounting principles followed shall, subject to specific instructions in this UCA, be accounting principles generally accepted for use by railway companies in Canada. This includes both Canadian Generally Accepted Accounting Principles or United States Generally Accepted Accounting Principles, depending on the entity.

The UCA itself does not provide any instruction to modify the accounting for commercial paper. Indeed the instruction for the relevant UCA account is provided as follows:

> **49 Notes and Other Loans Payable** Include all such obligations due on demand or within one year.

It should be noted that the proper reporting of commercial paper, as a current liability, does not eliminate it from the regulated rail balance sheet or from the regulated cost of capital calculation. It will be included, along with all other current liabilities, in the working capital element of the regulatory capital structure. This is further discussed in the Agency's proposal paper, as well as in the Agency Determination R-2017-198.

Commercial paper should not be included in the calculation of working capital unless it has been explicitly used to finance Canadian rail assets as defined by the UCA. Where commercial paper is to be included in the calculation of the regulatory cost of capital it should be included as a current liability and as such a component of the railroad's working capital.

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

The current portion of long-term debt should be treated as a current liability. Similar to the commercial paper discussion above, the current portion of long-term debt is a current liability under US GAAP. The UCA does not modify the US GAAP treatment for this account. The UCA specifies the required accounting treatment:

> **57 Long-Term Debt Maturing Within One Year** Include that portion of long-term debt which matures within one year or has matured but is unpaid.

Further, the current portion of long-term debt is the amount that must be settled within the year. As such it represents a claim on current assets (i.e. cash), and works to reduce the amount of working capital otherwise available to the company. Therefore it is properly treated within the context of working capital, which is only possible if it is accounted for as a current liability.

Again, there is no reason to contradict the UCA here – the current portion of long-term debt is a current liability, and it is best treated as such for purposes of determining the regulated cost of capital and for other railroad costing purposes.

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.

General purpose debt should not be allocated to the regulated rail operation. The UCA is specific that:

> **1203.01** All accounts provided in this UCA are intended to contain only transactions and balances resulting from Canadian Rail operations defined as follows:
>
> **1203.02** Rail operations consist of the transportation by rail of goods and passengers (both inter-city and commuter) and include intermodal transportation, which may involve the railway in transport modes other than rail, where such operations are required to complete a rail move.

General purpose debt is, by definition, not used to finance rail activities and therefore it does not result from Canadian Rail operations as required by UCA 1203.01 if it is to be included in the regulatory accounts. Accordingly, the UCA specifically instructs that so-called "general purpose debt" is not to be recorded in the regulatory accounts.

UCA 1203.06 squarely addresses general purpose debt issued by the Canadian Rail operation's parent company.

> **1203.06** When items such as cash, accounts receivable and accounts payable are the responsibility of a separate treasury function and not of the rail division, the prescribed UCA accounts for such items will not be used.

The primary purpose in issuing so-called general purpose debt at the level of the parent company has been to maintain a target capital structure at the corporate level. This has largely been accomplished by means of share buyback programs. The Treasury Department of CPRL manages the share buy-back program and issues debt to finance them. CPRL is not a "rail division". This cost is not a cost associated with CP's regulated railway operations and must be excluded from the Agency's determination of the regulatory cost of capital and the VRCPI.

If, nevertheless, the CTA intends to allocate general purpose debt to the Canadian rail operation then it must also allocate general purpose equity to the Canadian rail operation. Debt and equity are opposite sides of the same coin: in combination they are the means by which the company finances its balance sheet. In the consultation paper the Agency writes:

> When railway companies issue stock, the operating assumption is that the stock issued is a reflection of the future operating incomes that will be generated by the operating entities. In this case, the parent company's issuance is largely backed by the operating incomes of its rail entities.

> Likewise, when general purpose debt is issued, the proceeds of the issuances are used for general corporate purposes. These purposes logically include non-regulated entities, U.S. rail entities and Canadian rail entities.
> [CTA Discussion Paper, page 9]

By its own reasoning, if the Agency deems that it is appropriate to allocate general purpose debt to the rail entity (a conclusion with which CP disagrees), then the same principle applies equally to the equity of the parent company.

The above notwithstanding, to the extent that general purpose debt is to be allocated to the regulated rail balance sheet, it should be allocated using the most relevant basis of measurement available.

The Agency's method in the April 2020 cost of capital determination used the ratio of Canadian Revenue Ton Miles (RTMs) to total system RTMs. The problem with this approach is that RTMs are the primary driver of freight revenues, which are the company's primary means of generating net income and retained earnings. Hence RTMs are best understood as a driver of the equity component of the railroad's capital structure, rather than as a driver of debt.

There is no "good" allocation method for the stated purpose because, to the extent that one could say that a particular debt issuance was used to finance railway operations, that debt would already be shown on the Canadian regulated railway balance sheet. As noted above, general purpose debt is, by definition, not related to the Canadian Rail operation. Therefore there is no natural allocation mechanism available that is related to, or derived from, the Canadian rail operation.

Nevertheless, to the extent that such an allocation methodology will be required going forward, the best allocation methodology for this adjustment to the regulatory capital structure is to use the ratio of the total net book-value of Canadian railway properties to the net book-value of the consolidated company's properties. There is a logical link between long-term debt and long-lived assets of the company. While long-term debt may be issued for multiple purposes, one such purpose is to finance the acquisition or construction of rail properties. Long-term debt and rail properties both tend to have life-spans counted in decades, and creditors commonly have claims on a corporation's assets in case of default.

We recommend using net book-value rather than gross book-value because the net book-value more accurately represents the current size of Canadian rail operation, as a portion of the consolidated corporation. However, an allocation based on gross book-values would also be preferable to one based on RTMs.

The Agency has previously noted that, when using an asset based ratio, there is the issue of accounting standards to address. While the Canadian rail properties are stated under the UCA standards, this may not be true for non-rail properties and U.S. properties. Given a reasonable lead time (approximately six months) CP would be able to provide a statement of all corporate properties according to UCA accounting standards.

While we recognize that the above proposal is theoretically imperfect, having assessed all of the available options we believe that this is the best option from among the set of available options, all of which are rather less than perfect. We believe that this reflects the fact that the proposal to somehow allocate corporate level debt to the Canadian rail operation is itself fundamentally flawed.

The Agency should not allocate general purpose long-term debt to the regulated rail operation. To the extent that a debt allocation methodology is required, the ratio of Canadian rail properties to total corporate properties should be used, all stated according to UCA accounting standards, and all stated at net book-value.

Question 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?

It would be useful if the Agency could clarify this question. Is the Agency suggesting that any debt whose purpose cannot be clearly identified should be excluded from the cost of capital calculation? Or is the suggestion that a railway should not be allowed to issue a debenture unless it has first identified the purpose of that debt to the Agency's satisfaction?

CP respectfully suggests that the Agency's role is to accurately measure the capital structure of Class-I railroads. Its role is not to instruct a railroad as to how it is to achieve that capital structure, for example by prohibiting it from issuing debt unless certain pre-conditions are met.

Canadian railroads are free to issue and retire both debt and equity on the open market according to the same rules and conventions that apply to other market participants. If this principle is compromised then the railroads will face a reduced ability to access the capital markets, which will drive up the cost of capital for the railroads. This will in turn decrease the amount of available capital and will increase the cost of investing in the network, which will ultimately reduce the efficiency, capacity and competitiveness of the Canadian transportation system, to the detriment of railroads, shippers, and to the public interest alike.

The Agency should not limit the ability of railroads' to access the capital markets by obliging them to meet pre-conditions that are not imposed on other market participants.

Question 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.

The unwritten assumption underlying this question is that it would be possible to track a given dollar of financing from its origin through to its consumption. This is a fallacy. Money is a fungible commodity – one dollar is identical to the next. Once a dollar has been raised by the company, regardless of its source, it enters the common pool of available funding which will then be drawn upon in order to meet operating expenses and investment financing needs.

In practice, any “reporting” or “tracking” the use of funds raised via issues of debt and other credit instruments, or from any source for that matter, is not possible.

Projecting the use of funds raised may be attempted, but this will necessarily be an exercise in allocation. This may mean that the business would examine its projected cash needs for the foreseeable future, or possibly its cash consumption patterns over some recent time period, and it would then allocate its consumption of cash from any individual source accordingly.

For an enterprise as large and complex as a Canadian Class-I railroad, the above exercise may be excessively time consuming and subject to significant issues of interpretation. Thus, it may be desirable to simplify the approach using a readily available, objective measure – such as, for example, the ratio of Canadian to total RTMs (as the CTA did last year), or the ratio of Canadian rail properties to total corporate properties as CP proposes above.

The Agency should not enforce data reporting, tracking or projecting the uses of general purpose debt. Rather, to the extent that such allocation may be deemed necessary, the Agency should determine an objective allocation methodology.

This response is provided under the assumption that the allocation of general purpose debt by some means is a foregone conclusion. A more reasonable alternative would be for the Agency to recognize the company’s intent in raising capital, whether that be for purposes of financing rail operations or for Treasury purposes, and to include or exclude a debt issue from the cost of capital determination entirely on that basis alone, as has been the Agency’s practice up until April of this year.

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

As far as CP is aware, this is not a frequent issue in the context of determining the regulatory cost of capital for Canadian Class-1 railroads. To the extent that it may be an issue going forward we offer the following comments.

Ideally, the objective in determining the regulated cost of capital rate should be to accurately estimate the cost of capital that will be faced by each railroad in the foreseeable future, rather than determining the cost rate that the railroad faced at some point in the past.

The annual cost of capital determination will drive the pricing and revenues that the railroad may earn on a go forward basis, so it should serve to ensure that the railroad is able to cover the cost of interest on debt in the next period, cover the cost of income taxes over that period, and provide a return to investors sufficient to attract capital to the business in the future. In order to accomplish that objective, the cost of capital rate should reflect the cost of capital that the company will face in the foreseeable future, rather than that of some past time period.

While the cost of capital exercise is largely backward looking of necessity, since accounting information and market data are sources of historical information, this forward looking objective should be pursued wherever possible. To that extent it would seem appropriate to exclude debt that was issued by a company other than the Class-I railroad that is the subject of review. Debt issued by another company would be reflective of a different capital structure and risk profile, which would in turn affect the interest rate on that debt.

In the situation where the Class-I railroad has acquired a smaller carrier, it is likely that any debt items acquired under that transaction would exhibit higher interest rates. This is because smaller companies commonly face higher interest rates due to their relatively lower financial stability. It is also more likely, on balance, that the acquired company may have been experiencing a period of financial instability as that is a common precursor to a take-over bid. Both of these factors would lead to interest rates on debt that are not representative of the Class-I carrier's cost of debt.

Debt issued by a company other than the Class-I railroad should not be included in the determination of the regulatory cost of capital.

Thank-you again for this pro-active opportunity to engage on these proposed regulatory changes. Stakeholder engagement is key to ensuring that regulatory change is thoughtful and effective. As Canadians we are fortunate to benefit from a regulatory environment that encourages and values such engagement.

Yours truly,

[signed]

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