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CP's Submission to the Agency's Discussion Paper: Whether General Purpose Debt Should be Included in the Calculation of Cost of Capital Rates

Thank-you for providing CP and other stakeholders with the opportunity to provide commentary on this consultation. CP recognizes the importance of the questions the Agency poses regarding the possible allocation of general purpose debt on railway companies' regulated entity balance sheets. Other general purpose activities are also important and relevant; therefore, CP includes consideration of these points as well within this submission.

The Canadian regulatory cost of capital method needs to provide reasonable and meaningful results. As the Agency noted in 2011:

The Agency's regulatory goal is to establish fair and reasonable rates of return on capital for federally-regulated railway companies for the sole purpose of Agency statutory and regulatory applications.¹

The cost of capital is a key component of the Maximum Revenue Entitlement (MRE), which determines how much a railway company may earn in grain revenue. Grain is a significant portion of CP's business. CP's grain volumes have grown by more than 70% since the 2010-11 crop year, and its MRE is now in the range of \$1 billion Canadian². The MRE is a major sector of Canada's export economy that is critical to many stakeholders in Canada and abroad.

¹ Decision 425-R-2011, para. 14

² See: [Statistics on the maximum revenue entitlement for western grain | Canadian Transportation Agency \(otc-cta.gc.ca\)](https://www.cta.gc.ca/en/maximum-revenue-entitlement-for-western-grain). In the 2010-2011 crop year, CP moved 16.4 MMT of regulated grain. CP's 2020-2021 crop year tonnage was approximately 26 MMT.

The regulatory cost of capital drives more than 10% of CP's Maximum Revenue Entitlement. It directly represents CP's financial ability to invest in its grain handling network. CP has invested nearly \$0.5 billion³ to procure modern, high capacity hopper cars in recent years. These new cars allow shippers to load 44%⁴ more grain on each carload, greatly enhancing the capacity of the western grain transportation system. In 2020, CP invested \$1.67 billion⁵ to improve the capacity and throughput of its network, 49.5% of which was directly applicable to CP's Canadian handling system. These investments are directly supported by the Agency's regulatory cost of capital determinations.

Given the importance of this issue to CP and all Canadian stakeholders, it is more important than ever that the Agency establishes "fair and reasonable rates of return on capital" for Canadian railways.

Further, CP notes that the issues in this consultation may result in the Agency reallocating general purpose activities from CP's parent company to the balance sheet of CP's regulated entity. While CP disagrees with any such allocation, as discussed below, in order to establish that the result of any such movements are indeed "fair and reasonable", it is important that the correct accounting methodology is used. Accordingly, as CP has submitted in previous responses to this consultation, it is also critical that the Agency understands the impact not only to the regulated railway entity, but also to the other railway company's divisions.

A detailed discussion of implementation of any changes will result in the examination of CP's commercially confidential financial information. Therefore, prior to the implementation of any decisions that may come out of this consultation, CP submits that further bilateral discussions between the Agency and CP would need to occur regarding what accounting adjustments would be necessary to allocate general purpose activities to CP's regulated entity's balance sheet. CP understands that confidential bilateral discussions would occur prior to any changes being made.

Thank-you again for your careful consideration of these submissions, and indeed the submissions of all stakeholders, on this important issue.

Question 1: Should general purpose debt be defined differently and if so, how?

The Discussion Paper states, "For the purposes of this discussion, the CTA defines general purpose debt as debt that is raised for broad corporate purposes – including share buybacks – as opposed to debt issued to finance specific identifiable assets." CP disagrees with this definition. CP submits that debt should only be defined as "general purpose" when it cannot be identified as debt raised or issued for Canadian rail activities, U.S. rail activities or non-rail activities as prescribed by the Uniform Classification of Accounts and Related Railway Records (UCA).

³ CP announces plans for half billion dollar investment in future of grain supply chain with railcar order, June 7, 2018: www.cpr.ca.

⁴ CP announces plans for half billion dollar investment in future of grain supply chain with railcar order, June 7, 2018: www.cpr.ca. CP infographic document.

⁵ CP rail 2020 Annual report, page 80. Capital programs. Total capital investment \$1.67 Billion. These capital investments represent 68% of CP's net income for 2020, on a consolidated basis.

Further, the definition, and issue in general, under consultation should be expanded to include all general purpose activities, including but not limited to debt, equity, deferred liabilities and assets.

A. General Purpose Debt

CP submits that general purpose debt should be defined as debt that is not raised or issued for Canadian rail activities, US rail activities or non-rail activities because the UCA states that U.S. rail activities and non-rail activities are not to be included in a railway's regulated UCA accounts.

As well, CP submits that share buy-back debt should not be included in the definition of general purpose debt because share buy-backs are non-rail transactions. UCA 1203.06 states:

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.

Share buy-backs are the responsibility of CP's treasury function and not the rail division. Therefore, share buy-back debt is not general purpose debt.

B. General Purpose Activities

As CP noted in its January 18, 2021 response to the submission of other stakeholders in this consultation ("January 18, 2021 Response"), there are many types of activities that provide a general corporate benefit, including significant amounts of equity-related activities. CP excludes billions of dollars of equity balances from its regulatory balance sheet on the basis that these are not rail-related activities pursuant to UCA 1203.01 and 1203.02. Specifically CP excludes \$2 Billion of share capital from its regulatory balance sheet, which represents the common shares of the CP consolidated company that are traded on the market.

As the Agency determines whether general purpose debt is properly allocated to the railway entity's balance sheet, CP submits that the Agency must take a balanced approach and consider all types of general purpose activities. CP reiterates its November 25, 2020 submission, which reads in part:

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.⁶

C. Corporate Structure

During the Consultation, the Agency also must take a holistic view of the railway company and all of its entities when examining general purpose activities.

⁶ CP Submission, November 25, 2020, at page 4.

CP reiterates its statement from the January 18, 2021 Response:

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.⁷

That is, if the Agency intends to adjust the capital structure of the regulated entity using amounts on the balance sheets of the corporation's other divisions, then it must understand the impacts on the balance sheets of the other divisions. Given that CP's regulated railway entity is the largest division within the corporation, it would not be appropriate if the capital structure of the regulated railway entity bears little resemblance to that of the consolidated railway company. Once the differences between US-GAAP and the UCA accounting standards have been taken into consideration the capital structures should be similar between the two⁸.

To illustrate, if the Total Liabilities-to-Equity ratio for the regulated railway entity was two or three times greater than that of the whole corporation, there would be a real risk that the cost of capital so determined would be unreasonably low.

In Decision LET-R-29-2020 (the "2020 Cost of Capital Decision"), the Agency applied a methodological change that it called the "RTM methodology", and it stated that this would be used on an interim basis until a final methodology was arrived at via consultations.⁹ This methodology applied a deemed amount of general purpose debt to the regulated capital structure, which it allocated on the basis of RTMs. Several other changes to the cost of capital method were applied as well, including the elimination of a significant amount of regulated railway equity, among other things (methodology defined herein as "Interim Method").

The application of the Interim Method created the situation described above. In that determination, CP's ratio of Total Liabilities-to-Equity for the regulated railway entity was 6.7:1¹⁰, while in that same year this ratio was approximately 2.2:1¹¹ for the CP Rail consolidated corporation.

Further, in that same year, CP and CN had very similar capital structures at the consolidated level. CP showed approximately 2.2:1 Total Liabilities-to-Equity as noted above, while CN showed 1.4:1¹².

⁷ CP January 18, 2021 Response at page 7.

⁸ For example, under the UCA, railway companies may not value property the same as under US-GAAP.

⁹ Decision LET-R-29-2020 at para 3.

¹⁰ CP's regulatory capital structure was disclosed in confidence, by the Agency, to CP pursuant to determination Decision LET-R-29-2020. In keeping with the confidential nature of this information, CP has included an aggregated view of debt and other liabilities in this response.

¹¹ CP Rail 2019 Annual Report, Form 10-K: Consolidated Balance Sheets, at Page 98. CP total liabilities of \$15,298, total equity of \$7,069.

¹² CN Annual Report, 2019: Consolidated Balance Sheets, at Page 59. CN total liabilities of \$25,743, total equity of \$18,041.

However, while the Agency found that CP's regulatory cost of capital decreased by 37%¹³ versus the prior year, CN's cost of capital was relatively unchanged. This implies that its regulatory capital structure did not change significantly¹⁴. CP understands that this discrepancy is due to the Agency's allocation of debt to the regulated railway entity, to the exclusion of other general purpose activities. The Agency must consider all general purpose activities, including debt, equity, deferred liabilities and assets.

Question 2: Should general purpose debt issued by a railway company be included in the calculation of that company's cost of capital rate?

No, each railway company's cost of capital should be based on the financial statements for the regulated railway entity filed with the CTA using the Uniform Classification of Accounts and Related Railway Records ("UCA"). Any manipulation or adjustments to these financial statements could result in material distortions of the regulated railway entity's capital structure as well as the implied capital structure of the other entities within the company (U.S. railway, non-rail entities).

A. Uniform Classification of Accounts

CP continues to rely on its November 25, 2020 submission regarding capital structure, which states:

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.

¹³ Decision LET-R-40-2019: CP's 2019 regulated cost of capital rate was 7.55% vs LET-R-29-2020: CP's 2020 cost of capital rate was 4.79%, before being re-determined pursuant to a court order.

¹⁴ For CN, Decision LET-R-41-2019's cost of capital rate is 5.04% vs Decision LET-R-30-2020's cost of capital rate is 5.19%.

In *Canadian Pacific v. Canada (Canadian Transportation Agency)*, the Federal Court of Appeal (“FCA”) considered CP’s arguments regarding why share buy-backs do not constitute general purpose debt. In that Appeal, the Agency disagreed with CP and pointed to UCA 1203.05. This section states¹⁵:

1203.05 The rail division will become involved from time to time in non-rail activities, which will result in transactions which will affect current assets and current liabilities, and, in some cases, on a temporary basis, other assets and liabilities. The UCA balance sheet accounts are to be used to record such assets and liabilities.

As stated by the FCA:

The Agency’s view was the fact that share buy-backs are managed through CPL’s treasury does not mean that these transactions have no impact on CP or that CP is therefore not relieved of the obligation to account for those impacts.¹⁶

CP continues to disagree with the Agency, and notes the FCA’s finding that:

The difficulty with this is that section 1203.05 deals with non-rail activities by the rail entity which will affect its assets and liabilities. CP’s argument was that share buybacks were activities by its parent company, CPL, which is not a rail entity (i.e. a rail division, as defined in section 1000 of the UCA). As a result, the Agency’s answer is not responsive to the point made by CP.”¹⁷

Further, this consideration applies broadly to general purpose debt (which CP reiterates does not include share buy-backs). UCA 1203.05 is specifically aimed at current accounts or “temporary” impacts to other accounts. It has been used in practice to avoid complicated adjustments to UCA accounts when dealing with transitory impacts of activities that cross over from the “rail-related” into the “non-rail” space, such as the sale of land that was previously designated as rail-related. The issuance of long-term debt is not transitory. In fact, debt is generally issued in terms measured by decades. Accordingly, UCA 1203.05 is not applicable to the issue of general purpose debt.

CP also reiterates that UCA 1203.06 specifically states that the treasury activities of CP’s non-rail divisions should not to be included in the UCA accounts. Much of CP’s general purpose debt was issued to finance share buy-backs of the publicly traded equity of the CP parent company division, CPRL. CPRL’s board of directors approved the share buy-back programs, and they concern equity that does not reside on the balance sheet of CP’s regulated railway operations. Therefore, these programs are non-rail activities under UCA 1203.06.

In *Canadian Pacific v. Canada (Canadian Transportation Agency)*, the Agency took the position that there is a general corporate benefit from buying back shares because “[t]he issuance of debt in lieu of

¹⁵ *Canadian Pacific v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 34.

¹⁶ *Canadian Pacific v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 35.

¹⁷ *Canadian Pacific Railway Company v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 88, [2021], Docket A-193-20

issuing more shares to fund rail-related investments lowers the company's cost of capital ..."¹⁸
However, CP disputes this position. In its 2011 decision arising out of a consultation on cost of capital methodologies, the Agency recognized that:

"... the cost of equity rises as the debt/equity ratio increases because of the risks associated with increasing debt levels in the capital structure."¹⁹

As explained in the 2011 Agency decision, the cost of capital will decrease as the debt/equity ratio increases, up to a point.²⁰ Beyond that point, the increased riskiness of the company will cause the cost of capital to increase. Therefore, the issuance of debt for the purpose of buying back shares may not generate a general corporate benefit, especially in a situation where the Agency deems that the railway has a 6.7:1 Total Liabilities-to-Equity ratio, or possibly even higher, as a consequence of this debt.

Further, the FCA opined in *Canadian Pacific v. Canada (Canadian Transportation Agency)* that that the question of whether or not the issuance of debt reduces a company's cost of capital is not germane to the question of whether to include such debt in the capital structure. The FCA stated, "The fact that debt is cheaper than equity is not a reason for including non-rail debt in the calculation of the CoC."²¹

Therefore, CP submits that the UCA does not support the inclusion of general purpose debt or share buy-backs on the regulated balance sheet.

B. Share Buy-Back Debt

As CP submits above in response to question one above, share buy-back debt is not general purpose debt. Accordingly, notwithstanding the reference to share buy-back debt in the Agency's definition of general purpose debt, CP submits that the current consultation does not include a question on whether share buy-back debt should be included in CP's regulated capital structure. The question of whether or not share buyback debt is rail-related debt is an issue that is separate and distinct from determining whether general purpose debt should be allocated to a regulated railway entity's balance sheet. This is especially true in CP's case wherein the share buy-back program and the related \$2 billion balance of public-share equity are both external to the regulated railway entity.

In *Canadian Pacific v. Canada (Canadian Transportation Agency)*, the Agency stated that a reduction in the number of outstanding shares, as a result of share buy-backs, increases the relative ownership stake of railway employees, which may lead to an increase in employee performance.²² The implication was that this represents a general corporate benefit, thus share buy-backs are a rail-related activity. The Court rightly pointed out that this is speculation, and this argument ignores offsetting factors such as

¹⁸ *Canadian Pacific Railway Company v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 90.

¹⁹ Decision No. 425-R-2011, at Appendix B at para 26.

²⁰ Decision No. 425- $\$$ -2011 at Appendix B at para 26.

²¹ *Canadian Pacific Railway Company v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 91.

²² *Canadian Pacific Railway Company v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 93.

the fact that there is reduction in a shareholder's claim on the company's assets after the claims of creditors have been accounted for.²³

As well, each shareholder's position has become riskier as a direct result of the increase in financial leverage. This may reduce the incentive to own shares, and could reduce any possible linkage between employee performance and share performance. Dr. Tretheway supports CP's position:

Further, there is no evidence that the CPRL treasury transaction to buy-back shares would actually increase the percent of current employee share ownership. Some of the bought back shares could be those of past employees and current employees may have previously sold their shares or sold their shares after the buyback.²⁴

In 2009, the Agency issued a nonpublic decision to CN in which it found that debt raised for the purposes of share buybacks to be rail-related debt²⁵. CP was not informed of this decision until the Agency issued the 2020 Cost of Capital Decision. CP was not consulted on the issue in 2009, in 2014 when CP's regulated railway entity's parent company initiated its share buy-back program, nor in the seven years since then as CP's regulated railway entity's parent company continued to buy back its publically traded shares.

CP reiterates its submissions made in its February 3, 2020 response to the Agency cost of capital call letter, that:

With the cost of capital call letter coming on January 14th, one month before CP's cost of capital submission is due to the CTA, there is no longer time for CP to assess and address these issues in anything like a fulsome manner prior to the cost of capital submission due date."

...

"CP therefore requests to be placed on an equal footing with our commercial competitor, and be allowed a reasonable period of time to assess and address the issues described above, as well as any issues that we have likely overlooked at this early stage.

Neither the Agency's 2009 decision nor the Agency's 2020 decision appropriately considered CP's unique corporate structure and what the inclusion of share buy-back debt on CP's regulated railway entity's balance sheet implies for CP's regulatory accounts and its regulatory capital structure. These are complex issues that consider CP's commercially sensitive and confidential information, so they should be considered on a bilateral basis outside of the current consultation.

²³ *Canadian Pacific Railway Company v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 96

²⁴ Tretheway, Michael, "Statement of Dr. Michael W. Tretheway". At Para. 1.6.19

²⁵ *Letter Decision No. LET-R-49-2009* at page 1.

For all of these reasons, debt issued for the purposes of share buy-backs is not rail-related. Notwithstanding the foregoing, if the Agency determines it must include general purpose debt, such allocation cannot be determined until such time as the Agency has completed appropriate bilateral consultations with CP on these issues, and until it has fully dealt with the issue of how the allocation of general purpose debt and share buy-back debt would conform with the UCA.

Issue 3: Should general purpose debt be treated differently between railway companies?

Yes, if the Agency determines it must allocate general purpose debt to regulated railway entities, CP submits that the Agency should to apply different methodologies to allocate general purpose debt to the regulated railway entities' balance sheets due to the railway companies' inherent differences and unique capital structures.

A. Capital Structures of CP and CN

If the Agency determines it must allocate general purpose debt to the regulated railway entities, the capital structures of the different railway companies must be considered In order to achieve equitable outcomes.

CP submits that the definition of general purpose debt, and more generally the definition of all general purpose activities, should be the same for CP and CN. In addition, how much of the identified general purpose activities are added or allocated to the regulated balance sheet should be treated the same for all railway companies.

However, the Agency must apply different methodologies if it chooses to adjust the capital structures of CP and CN, respectively, in consideration of these general purpose activities. This is a result of the fact that CP and CN have different corporate structures, and that the Agency effectively regulates the two companies at different levels of the organization. While CN issues its regulated UCA balance sheet at the parent company level (as CP understands it), CP reports at the level of the regulated railway entity that is held by a corporate parent company.

Today, the Canadian railway operation, along with several other smaller railway operating entities, materially constitute the regulated railway entity. CP has structured its regulated accounts and financial statements in accordance with the requirements of the UCA accounting standards. These accounts include debt that was issued for railway operating purposes, and they include equity that was generated via railway operations. The corollary is that they exclude debt that was issued for non-rail operating purposes, and they also exclude equity that was not generated via railway operations. For example, the UCA accounts do not include the \$2 billion²⁶ of share-capital equity that was generated by way of the issuance of public equity by the CP consolidated railway company that trades on equity markets.

²⁶ CP 2020 Annual report, form 10K, page 105, Share capital. Share capital \$1,983M, additional paid-in capital, \$55M.

CP understands from prior submissions in this consultation that when the Agency is considering the allocation of general purpose activities with respect to CN, it is dealing directly with the parent company. However, when the Agency considers the general purpose activities with respect to CP, it will be looking to allocate general purpose activities from the parent company to the regulated entity. In his report (enclosed with CP's present submission), Dr. Tretheway states:

It is my opinion that the circumstances of the two operating railways are not equivalent. Notwithstanding whether the Agency's 2009 adjustment of the capital structure debt and equity shares of CNR-Canada was a justifiable action of the Agency, a matter on which I have not been asked to provide an opinion, it is my opinion that using the CNR-Canada decision as justification for adjusting the CPR-Canada capital structure shares would be inappropriate.²⁷

As CP explained in its January 18, 2021 Response:

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."

And,

"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.²⁸

In this exercise, the Agency would be moving account balances from one or more non-regulated entities to the regulated entity. The non-regulated entities are stated under a different accounting standard than the regulated entity, which greatly complicates such adjustments.

Further, the regulated entity is a component of the consolidated corporate entity. This means that certain account balances, including debt and equity, already reflect intercompany transactions between the regulated railway and the other CP entities. This greatly complicates the problem facing the Agency. As CP also pointed out in its January 18, 2020 Response:

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

²⁷ Tretheway, Michael, "Statement of Dr. Michael W. Tretheway". At Para. 1.6.6

²⁸ CP January 18, 2021 Response at pages 6 & 7.

the balance sheet of the parent company. Instead, the Agency has eliminated equity generated through rail operations.²⁹

There is approximately \$2 billion of equity on the balance sheet of CP's parent company that represents CP's publicly traded shares. This equity is not on the balance sheet of the regulated railway entity.

As noted above, in April of 2020, the Agency decided to offset the debt allocation by eliminating equity generated via Canadian railway operations. Equity that was generated via rail operations represents the retained earnings of the railway company. Retained earnings are the permanent manifestation of the yearly net income of the company. Likewise, future income taxes are the difference between the taxes payable on the net income as determined according to the prevailing accounting standards versus the tax expenses that were actually assessed.

Reducing the retained earnings of the regulated railway entity implies that the railway has earned less income than previously thought. Therefore, if the retained earnings of the regulated railway entity are reduced, the future income tax liability must also be reduced in order to accurately represent the revised accounting. This is relevant because future income tax liabilities are a significant component of the regulated railway entity's capital structure. Deferred tax liabilities are included at a cost rate of zero, which significantly reduces the final weighted average cost of capital.

The Agency will also need to consider how the equity balances of the regulated railway entity, the parent company, and the US railway subsidiaries relate to each other when adjusting the general purpose activities that affect these accounts. It will need to consider the intercompany investments, loans, receivables and share-capital, which all generate a general corporate benefit, to name just a few other potential problems.

CP does not know whether these complexities, or possibly different ones, exist in relation to CN given that CP understands that CN is reporting its parent company substantially as the regulated entity and that this is already stated under UCA accounting standards. However, CP submits that if the Agency undertakes a general-activity allocation exercise with respect to CP, the aforementioned issues will need to be dealt with on a bilateral basis due to the confidential nature of the information that would need to be considered.

B. Adjusting Cost-Rates of Debt and Equity to Reflect the New Capital Structure

If the Agency finds that the regulatory capital structure is significantly different than the consolidated capital structure, then it would need to adjust the cost-rates for debt and equity for the regulated railway entity. Widely accepted economic theory holds that the "choice of financing [i.e. capital structure] does not affect a firm's value"³⁰. At a high level, this is because the cost rates for debt and equity will increase as a firm makes increasing use of debt. The result is that the company's weighted-average-cost-of-capital does not change significantly when the company alters its capital structure. In

²⁹ CP January 18, 2021 Response at page 5.

³⁰ *Review of Regulatory Cost of Capital Methodologies, The Brattle Group* At Page 65 [September 2010], Prepared for the Canadian Transportation Agency

the end, the cost of capital will reflect the risks of the underlying assets and business, regardless of the company's capital structure.³¹

As CP states above, the Interim Method determined that the capital structure of CP's regulated railway entity had a Total Liabilities-to-Equity ratio of 6.7:1 (note that this calculation includes future-income taxes and similar accounts as liabilities). In that same year, the CP consolidated entity had a ratio of 2.2:1. The conversion of CP's consolidated capital structure to the structure deemed appropriate for regulatory purposes dramatically altered CP's apparent financial leverage. As CP stated in its response to other stakeholders:

... 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.³²

It is widely recognized that the amount of financial leverage employed affects the cost rates of debt and equity that will be faced by a company. In its report attached to CP's submission in this consultation, Brattle observes that "... increased leverage adds financial risk to a company's equity".³³

Indeed, there is a standard formula, known as the "Hamada equation"³⁴, which is generally recognized as dealing with the cost-of-equity side of this problem by adjusting the beta of a company's publicly traded equity through a process known as un-levering and re-levering. The Agency itself recognized this principle:

Despite CRS's criticism of the practice, the Hamada equation to unlever and relever betas is widely used among financial economists and experts, in part because it is the only known way to estimate beta for a non-publicly traded company.³⁵

CP notes that in 2011 the Agency ruled that the Hamada equation was the correct method to use when it was necessary to determine the cost of equity for a private company. At that time it also found that CP and CN were not private companies, and that therefore the beta estimates already account for the existing debt to equity ratio.³⁶ However, in CP's case, the Agency does not regulate CP at the level of the publicly traded firm. Rather, the Agency regulates CP's regulated railway entity, which is not publicly traded. Therefore, the Hamada adjustment is properly applied to the CP regulated cost of capital when the capital structure of the regulated railway entity is found to be significantly different from that of the

³¹ As noted below, this statement relies on a number of simplifying assumptions.

³² CP January 18, 2021 Response at page 11.

³³ Aharonian, Matthew; Polek, Nicole, "Consultation Regarding the Methodology to Determine the Net Railway Investment and the Capital Structure for the Calculation of the Cost of Capital" : The Brattle Group, 2021, at para 28

³⁴ Hamada, R.S., "The Effect of the Firm's Capital Structure on the Systematic Risk of Common Stock," *Journal of Finance*, 27, May 1972, pp. 435-452.

³⁵ Decision 425-R-2011, Para. 385

³⁶ Decision 425-R-2011 at para. 384.

consolidated public company. (Please find an example calculation of the adjusted beta and resulting cost of equity in Appendix A.)

In the past, CP's regulated railway entity resembled CP consolidated company, in terms of its capital structure. In that situation, it is reasonable to continue to apply the estimates for cost of debt and cost of equity that are determined using the financial statements and share information of the public firm.

However, as shown above, using the Agency's Interim Method, the Agency found in April 2020 that CP had a Total Liabilities-to-Equity ratio of 6.7:1³⁷ at the regulated level. This is more than triple the ratio of the CP public firm. In fact, CP estimates that if the Agency had applied the same methodology to determine CP's capital structure in its 2021 determination, then it would have likely found that CP's regulated Total Liabilities-to-Equity ratio would now be approximately 7.2:1³⁸, and CP expects this metric to continue to degrade if it were calculated using the Interim Method.

As CP further stated in its response to other stakeholders, assuming that CP continues its share buy-back program, it is reasonable to expect that the CP regulated entity will soon achieve zero, or even negative equity³⁹ under that same regulatory methodology³⁹, even though CP's consolidated balance sheet remains healthy. Using the interim methodology, if CP's Total Liabilities-to-Equity ratio continues to degrade at the current rate CP anticipates it will have zero or negative equity within the foreseeable future. In his enclosed statement Dr. Tretheway states:

It is my opinion that this type of complication when introducing non-railway capital structure accounting activity into the accounting for the regulated railway entity, especially when the treasury action is that of a parent corporation, is one reason why the UCA guidance is to confine regulatory accounting to railway transactions and to exclude non-rail costs, revenues, *debt and equity*.⁴⁰

Until such time, however, and regardless of whatever methodology the Agency ultimately determines regarding general purpose activities, if the Total Liabilities-to-Equity ratio of the regulated railway entity no longer resembles that of the public firm then it will be necessary to grapple with the issues of cost-of-debt and equity for the regulated railway entity as separate from those of the public firm.

Brattle notes the "Modigliani-Miller" theorem, which is a financial theorem that states a firm's weighted average cost of capital is not sensitive to its capital structure⁴¹. That is to say, a firm can increase, or

³⁷ CP's disclosed its regulated railway entity's capital structure to the Agency in confidence pursuant to determination LET-R-29-2020. In keeping with the confidential nature of this information, CP shows an aggregated view of debt and other liabilities within this submission.

³⁸ This ratio is calculated using the balance sheet submitted by CP, to the CTA, in February 2021, and applying the same methodological choices that were used by the Agency in LET-R-29-2020, including the allocation of general purpose debt, and adjustments of negative working capital and equity.

³⁹ January 18, 2021 CP Response at page 5

⁴⁰ Tretheway, Michael, "Statement of Dr. Michael W. Tretheway". At Para. 1.6.12

⁴¹ See *Brattle* at para. 33

decrease its financial leverage as it pleases and its cost of capital will not change. This is because the cost of capital is ultimately a reflection of the intrinsic value of the firm, rather than of the firm's capital structure. In its basic form the theorem makes a number of simplifying assumptions, chief of which is that it ignores the impact of taxes, and financial distress.

The implication of this theorem is that, as a firm changes its own capital structure by increasing or decreasing its financial leverage, the risk profiles faced by the firm's creditors and shareholders respond in a parallel fashion. In general, a firm will face a lower cost of debt than its cost of equity. Therefore, at a prima-facie level, the firm is incentivized to increase the amount of debt that it employs to finance its balance sheet in order to reduce its average cost of capital. However, as the firm takes on more debt it also becomes a riskier proposition for both creditors and investors. As a result, both creditors and investors will demand higher rates of return in order to remain invested. This effect offsets the impact of increasing the debt-to-equity ratio, and the firm's cost of capital remains unchanged.

In reality, taxes and other factors entail that there is an optimal capital structure where a firm's cost of capital is minimized. If the firm strays from that capital structure by employing either more, or less debt than required, then it will face a higher cost of capital. Furthermore, extreme financial leverage will increase the risk faced by creditors and investors to an extent that the firm's overall cost of capital will increase.⁴²

Not only does a firm's cost of equity increase when its debt-to-equity ratio increases, but its cost of debt will also increase. The Agency has stated that the Hamada equation is the appropriate method for adjusting a firm's cost of equity in response to financial leverage.⁴³ The cost of debt must also be adjusted. It is possible to estimate a revised credit-rating for the regulated railway entity, given its regulated Total Liabilities-to-Equity ratio and its implied interest-coverage ratio. A revised cost of debt may then be calculated by examining the prevailing interest-rate spreads for different grades of corporate debt.

As a part of its 2011 consultation, the Agency obtained a report from the Brattle Group, which was consulted as an economic expert in the field of cost of capital. The Brattle Report applied the principles of the Modigliani-Miller theorem in a discussion of how a regulator may use a sample of public firms in order to determine the cost of capital of the regulated entity:

Even though the risk of the underlying assets may be comparable, a different capital structure splits that risk differently between debt and equity holders, making the equity in one firm potentially more risk than equity in another. Stated differently, increased leverage adds financial risk to a company's equity.⁴⁴

⁴² *Review of Regulatory Cost of Capital Methodologies, The Brattle Group* At Page 64 [September 2010], Prepared for the Canadian Transportation Agency

⁴³ Decision 425-R-2011, Appendix B at para. 309

⁴⁴ *Review of Regulatory Cost of Capital Methodologies, The Brattle Group* At Page 66 [September 2010], Prepared for the Canadian Transportation Agency

The Agency calculates the cost of debt and the cost of equity using the financial statements and share-data of the public firm, and applies these rates to the capital structure that it determines for the regulated railway entity. As the Brattle Group noted then, the firm's cost of capital should reflect the risk of the firm's underlying assets. The firm's capital structure merely splits that risk between the debt and equity holders, respectively.

The CP publicly traded firm is principally composed of its Canadian and US railway operations. If we adopt the assumption that CP's Canadian assets have a similar risk profile as its US assets, then it follows that the cost of capital for the regulated railway entity (which comprises the Canadian rail operation) should be similar to that of the US railway operations and also to that of public firm. In a situation where the Agency determines that the Total Liability-to-Equity ratio of the regulated entity is significantly different than that of the public firm, then it must address this issue by adjusting the cost-of-debt and cost-of-equity rates for the regulated entity.

Failing to do so provides the railway customer with the benefit of the strong financial position and capital structure of the public firm, with its attendant low cost of debt and equity, and then also provides the benefit of a highly leveraged balance sheet, making maximum use of the relatively low cost of debt. However, it fails to recognize that such a cost of capital would never exist in a real market, because both the cost of debt and cost of equity would increase as leverage increases. In essence, it provides the shipper with a short-term benefit of a reduced cost of capital rate that is based on unrealistic assumptions. In the long run, this will harm the industry and all of its stakeholders as the railway is no longer able to invest sufficient capital into its network in order to maintain capacity and efficiency.

If this occurred, the railway company would bear the burden of the costs. As noted above, this will directly erode the railway's ability to invest in the Western Canadian grain-handling network, eventually reducing its ability to serve that market to the detriment of all stakeholders.

C. Alternative Methodologies

CP submits the following alternative methodologies for consideration, if the Agency determines that general purpose debt and/or share buy-back debt is properly allocated to the regulated railway entity's balance sheet. CP believes that these methodologies could be applied to both railway companies, based upon CP's understanding of CN's structure from its submissions within this consultation. However, any such application would need to be applied differently pursuant to each railway company's corporate structure, as discussed above.

Application of any of these alternatives would result in CP's regulated railway entity's capital structure (or total liabilities to equity ratio) moving closer to the Total-Liabilities to Equity ratio of the consolidated statements. As well, under these alternatives CP's regulated railway entity's equity would remain relatively intact and would not need to be reduced. Essentially, the income of the regulated railway entity would continue to be deemed rail-related.

If any of these methodologies are implemented, CP recommends the Agency adjust the beta to take into account any change made to the capital structure of the regulated railway entity's balance sheet.

i. Create an Offsetting Asset or Receivable

This alternative would entail creating an offsetting asset or receivable for any general purpose debt or equity allocated to the regulated railway entity's balance sheet. This alternative ensures that retained earnings or net income earned by the regulated railway entity is not eliminated or deemed to be non-rail related and transferred to another division of CP.

Assuming general purpose activities would still be allocated to the regulated balance sheet using the Interim Method, and that there is no change to the treatment of commercial paper or working capital, this would likely result in a Total Liabilities-to-Equity ratio of 1.7:1 for CP using 2019 data⁴⁵. This is very close to the US GAAP consolidated ratio of 2.2:1 and is more appropriate than the 6.7:1 ratio created by the LET-R-29-2020 determination.

In CP's case, this alternative would follow the proper accounting and transfer of cash within CP's divisions. If CP's regulated railway entity were to assume the debt, the cash would then be loaned and transferred to CP's parent company in order for the parent company to buy back the common shares that are on its balance sheet (in the case of share buy-back debt).

ii. Alternative #2: Use the Capital Structure of the Consolidated Statements

This alternative would involve applying the regulatory calculated cost of equity, cost of debt and cost of deferred liabilities to the capital structure of the railway company's US GAAP consolidated financial statements.

This methodology ensures all general purpose activities are included in the calculation of the railway's cost of capital. It also has the benefit of using the capital structure that the market cost of equity and cost of debt are based on given it is the consolidated company that raises equity and issues debt.

iii. Allocate General Purpose Equity or Share Capital to the Regulate Railway's Balance Sheet, as well as General Purpose Debt

This alternative would require the Agency identify all debt and equity that would need to be allocated to the regulated railway entity's balance sheet. Then the Agency would add the net amount (debt minus equity) to the long-term debt on the regulated railway entity's balance sheet. To ensure the balance sheet still balanced, the Agency would offset the remaining variance to total assets in equity, either positive or negative.

⁴⁵ The estimation is done base on CP 2019 year end cost of capital balance sheet information.

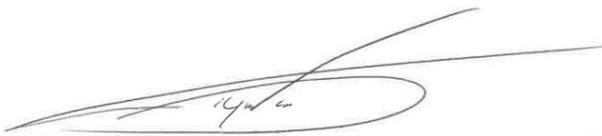
For CP, this methodology would likely result in a Total Liabilities-to-Equity ratio of approximately 2.4:1, which is higher than CP's consolidated ratio, but much closer than the 2020 Cost of Capital Decision.

This alternative would include general purpose activities, while the assets would remain unchanged. However, this methodology may still lead to a negative equity position for CP.

Thank-you for providing this opportunity to provide CP's comments on this important issue. To summarize CP's position:

- The Agency should consider all general purpose activities, which includes more than debt alone.
- General purpose debt is debt that cannot be identified as either rail-related, or non-rail related.
- General purpose activities should not be included in the cost of capital rate because such a treatment does not conform to the UCA.
- If, nevertheless, the Agency includes general purpose activities in the cost of capital rate, the Agency must take a holistic view of the corporate entities, and ensure that the resulting capital structure of each makes sense relative to the others.
- Share buy-back debt requires special consideration.
- If general purpose activities are included in the cost of capital rate, then the Agency should use a different implementation methodology for CP and CN respectfully, in recognition of their differing corporate structures.
- If the Agency determines that it is correct to include general purpose activities in the regulated cost of capital, then it must hold confidential, bilateral consultations with CP regarding the implementation methodology.
- If the Agency finds that the CP regulated railway entity has a significantly different capital structure than CP's parent company, then it must adjust the cost-rates of debt and equity that it applies.

Yours truly,

A handwritten signature in black ink, appearing to read 'Tyme Wittebrood', with a long horizontal flourish extending to the right.

Tyme Wittebrood
Director, Regulatory Finance
CANADIAN PACIFIC

Appendix A - Calculation of the adjusted beta and resulting cost of equity for CP

The Hamada equation is expressed as:

$$\beta L = \beta U \times [1 + (1 - T) \times D/E]$$

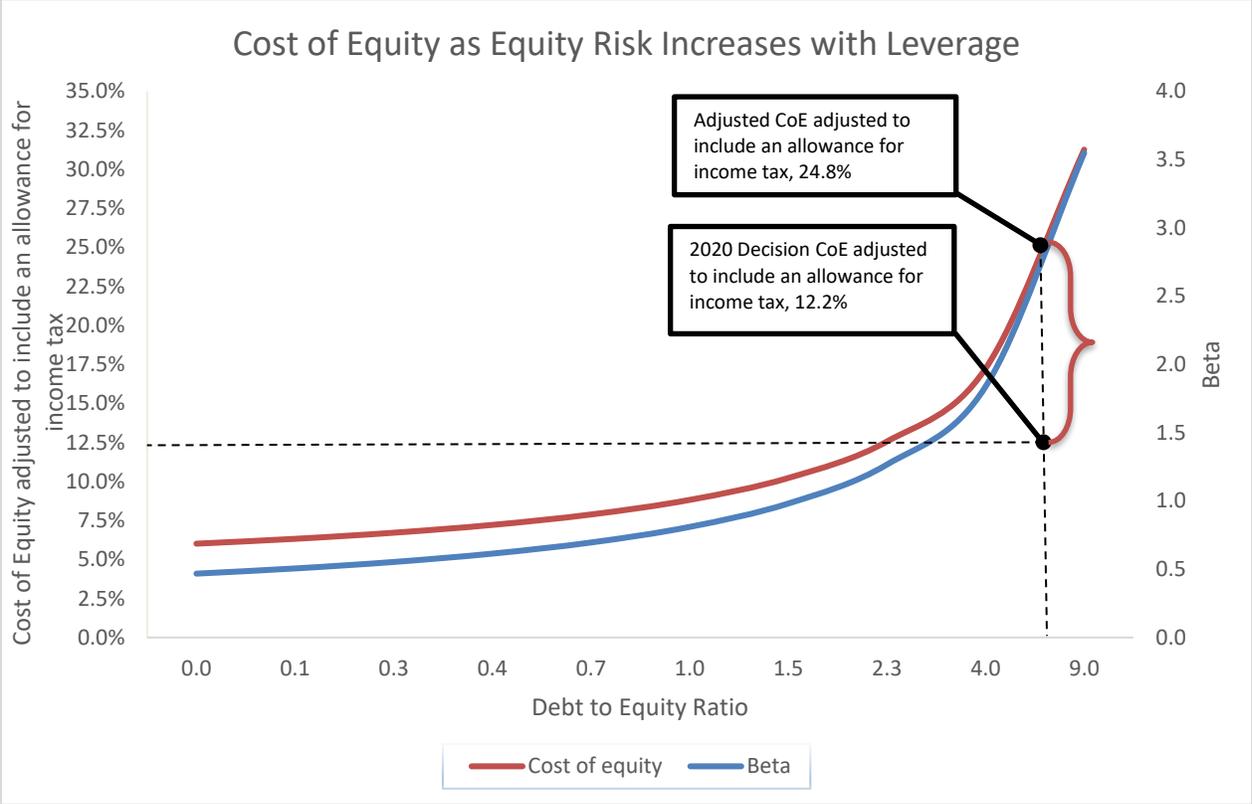
The equation to calculate un-levered beta is:

$$\beta U = \frac{\beta L}{[1 + (1 - T) \times D/E]}$$

The table below demonstrates a variety of capital structures from the Agency's decisions to calculate CP's un-levered beta, re-levered beta, and adjusted cost of equity. Assumptions are from 2020 Cost of Capital Decision, and the redetermination in Decision LET-R-33-2021.

Illustrate re-levered beta and adjusted cost of equity	2020 Interim Method	2020 Re- determination
<i>Assumptions from LET-R-29-2020 decision</i>		
Weight average Risk Free Rate	1.6%	1.6%
Weight average Beta	1.2	1.2
Weight average Market Risk Premium	6.0%	6.0%
Total liabilities to equity ratio from decision	6.7:1	1.0:1
After-tax cost of equity	8.9%	8.9%
Cost of equity adjusted to include an allowance for income tax	12.2%	12.2%
Cost of capital	4.8%	7.4%
<i>Apply Hamada equation</i>		
2019 US GAAP total liabilities to equity ratio	2.2:1	2.2:1
Un-levered beta, using US GAAP Total liabilities to equity ratio	0.5	0.5
Re-levered beta using CTA decision Total liabilities to equity ratio	2.8	0.8
Adjusted after tax cost of equity	18.2%	6.4%
Adjusted Cost of equity adjusted to include an allowance for income tax	24.8%	8.7%
Adjusted Cost of capital	6.4%	5.6%

The graph below illustrates the relationship between different levels of capital structures, the cost of equity, and the adjusted equity-beta.



This graph demonstrates that there is a positive relationship between capital structures and cost of equity. As the debt to equity ratio increases, the equity-beta and cost of equity will increase.