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RE: CONSULTATION ON GENERAL PURPOSE DEBT – CN SUBMISSION

Please find enclosed CN's submission provided in response to the Agency's discussion paper on whether general purpose debt should be included in the calculation of cost of capital rates. You will note that our submission also includes additional comments respecting questions which we consider important to be addressed by the Agency.

Yours truly,

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CN's response to the Agency's Discussion Paper on Whether General Purpose Debt Should Be Included in the Calculation of Cost of Capital Rates

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CN wants to thank the Agency for the opportunity to respond to the questions and issues raised in the "Consultation on General Purpose Debt" dated June 21, 2021, and the ensuing "Discussion Paper: Whether General Purpose Debt Should Be Included in the Calculation of Cost of Capital Rates".

There are three sections to our submission:

- Section 1: We submit our responses and comments to the questions raised in the above-mentioned Discussion Paper,
- Section 2: We submit our comments on some questions raised by the Federal Court of Appeal judgment (2021 FCA 69) since it was a motivating factor for this consultation, and
- Section 3: We summarize the still outstanding issues from the 2020 Consultation on Cost of Capital Rates, which is still on-going as it is a precursor to this current consultation.

1. Questions Raised in the Discussion Paper

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.*"

Q1: Should general purpose debt be defined differently and if so, how?

In general, all debt issuances have wording to the effect that the proceeds will be used for general corporate purposes, including:

a) The redemption and refinancing of outstanding indebtedness,
b) Share repurchases and dividends, and
c) Acquisitions and other business opportunities.

General corporate purposes other than the (a), (b), and (c) specifically listed above are working capital for day-to-day operating expenses, and capital expenditures.

General purpose debt as defined in the Discussion Paper would be adequate to highlight a distinction between debts used to finance capital assets vs. other corporate uses of debt proceeds. However, the issue lies in whether or not the debt used to finance "specific identifiable assets" can be unequivocally and objectively identified as such.

For example, in a year with a large acquisition or capital investments program that would exceed the cash generated from operations, it is clear that debt was necessarily issued to finance these expenditures and could therefore be identified accordingly. However, in most years, cash from operations dwarfs the net debt issuance for both Canadian Class I's, and it is therefore difficult to establish that one debt was issued for a particular purpose.

For instance, suppose a financial year during which cash from rail operations generated $1B and the company issued $0.5B of long-term debt, for a total of $1.5B of available funds; that were then used for (1) investment in properties (track and rolling stock), (2) acquisitions, and (3) share buybacks, for $0.5B each. In such a situation, which is in most years, one cannot unambiguously and objectively identify to which of the three uses of funds were the $0.5B of debt proceeds directed, especially when the debt prospectus would include a statement that the funds can be used for general corporate purposes. The problem is further compounded by the fact that both the sources and uses of funds can be distributed over both Canada and the U.S., requiring further allocation between the jurisdictions, and opening the door to subjectivity.

Therefore, unless debt is issued to finance "specific identifiable assets" and it can be unequivocally and objectively identified as such, CN believes that all debts should be considered "general-purpose debts" as defined in the discussion paper.

Q2: Should general purpose debt issued by a railway company be included in the calculation of that company's cost of capital rate?

CN is of the opinion that all debts issued, irrespective of whether the funds were used to finance assets (including acquisitions), working capital, refinancing existing debts, or paying shareholders through dividends or share buybacks, should be considered as debt that should be included in the company's cost of capital (CoC) calculation.

Most of the on-going problems in the CoC calculations today stem from the evolution of the Canadian railway companies into North American operations that span both Canada and the U.S. The Agency has jurisdiction only on the Canadian rail operations but it is the consolidated corporate entities which raise capital, both equity and debt, on the capital markets. The investors and lenders do not establish their expected returns (the costs of capital for railways) by considering only the Canadian rail operations, as represented by the prescribed Uniform Classification of Accounts (UCA) accounting. For this reason, UCA are a notional segment which is not referenced by investors or lenders when Canadian railways raise capital on the markets. Nevertheless, the Agency's declared intent is that CoC calculations, for the purpose of the Canadian regulatory framework, are to provide investors with adequate returns. If this is the intent, it would be much more consistent to consider the same consolidated corporation in which investors and lenders invest, and not the UCA sub-part. The challenges of the current approach are numerous, and CN is proposing in this submission an approach which would greatly facilitate the work of both the Agency and railway companies while remaining consistent with the legislative intent.

The Agency has settled the <u>cost of equity</u> problem by considering only the cost of equity of the consolidated corporation as its shares trade on both the TSX and NYSE (expected return on shares). The Agency then applies this cost of equity *verbatim* to the Canadian rail operation, even though one can argue that the risk/reward of the Canadian market – where the CoC is applied – is different from the U.S. one, especially for grain transportation and interswitching which are the focus of CoC. The Agency does not try to calculate the cost of equity of Canadian rail operations in isolation.

However, the Agency insist on isolating the <u>cost of debt</u> for Canadian rail operations by artificially allocating debt as being deemed or not deemed to be for Canadian rail operations. This is contradictory to the treatment of equity. It also leads to subjective and artificial debt allocation which could be avoided if the Agency accepts CN's proposal to simply consider the cost of debt and the CoC of the entire consolidated corporation, and then apply that same CoC to the Canadian rail operations, in the same manner that the Agency already applies the consolidated corporation's cost of equity to Canadian rail operations. This would replicate how investors and lenders truly assess CN's financial performance to establish their expected return.

Consistent with this proposal, debt securities issued by CN indicate that proceeds from debt are for general corporate purposes, including the redemption and refinancing of outstanding debt, share repurchases, and other business opportunities. Similarly, CP's recent announcements of debt offerings have indicated that the net proceeds from debt are for the reduction and refinancing of outstanding indebtedness and for general corporate purposes. Just like CN, CP does not state that the funds are intended for share buybacks or any other specific identifiable asset. As reference:

- https://www.cpr.ca/en/media/canadian-pacific-announces-c300-million-debt-offering of March 5, 2020
- https://www.cpr.ca/en/media/canadian-pacific-announces-us500-million-debt-offering of March 3, 2020
- https://www.cpr.ca/en/media/canadian-pacific-announces-400-million-debt-offering of March 11, 2019
- https://www.cpr.ca/en/media/cp-announces-us-500-million-debt-offering of May 14, 2018

All the above state that:

> The net proceeds from this offering will be used primarily for the reduction and refinancing of outstanding indebtedness and for general corporate purposes.

This declared intent to use the funds for general corporate purposes is critical to the decision the Agency will make because the only corporate business of both CN and CP is rail transportation (more on this later). It is therefore hard to argue and objectively conclude that the net proceeds from either CN or CP's debt issuances were used exclusively for share buybacks or other particular purpose.

Debt, along with equity, are the quintessential ways for companies to raise capital and therefore should be on their balance sheet and included in the calculation of their cost of capital. Therefore, general purpose debt should be included in the calculation of a railway company's cost of capital rate.

Q3: Should general purpose debt be treated differently between railway companies?

CoC is used by the Agency for two regulatory purposes. First, to determine the Volume-Related Composite Price Index (VRCPI) used to calculate the Maximum Revenue Entitlement (MRE) of CN and CP under section 151 of the CTA. The provisions establishing the MRE create a regulated market for the transportation of grain. Only two railway companies are subject to these provisions, namely CN and CP. Second, the Agency uses the CoC determination to calculate interswitching rates under section 127.1 of the CTA. While railways other than CN and CP are subject to interswitching rules, the largest share of interswitching volumes in Canada is interchanged between CN and CP.

Respecting the MRE, it is difficult to conceive that Parliament's intent was that one of the two railways would derive an advantage or benefit over another through a determination of the CoC. It is noteworthy that the CTA sets out the rules applicable to the MRE without making a distinction between the two railways and no provision dealing with the VRCPI suggests otherwise. Clearly, the purpose of this market regulation is to constrain pricing by capping annual revenue of both railways without favouring one over another.

Similarly, the interswitching provisions apply equally to all railways subject to them.

In that context, it is difficult to conceive that these two measures should be applied differently and favour one railway over another. This would also contradict section 5 of the CTA which provides that competition and market forces are the prime agents in providing viable and effective transportation services. Importantly, the shift from a rate scale to a maximum revenue entitlement was intended to provide more pricing freedom to the railways so that they could compete for traffic but without exceeding a cap the MRE places on revenue.

It would not be appropriate for the Agency to give preferential or differential treatment to one railway compared to another. When considering the CoC, both Canadian Class I's raise funds in the same North American market and compete for traffic in that same market. To maintain a level playing field, general-purpose debt should be treated identically for both railways.

In Decision LET-R-29-2020, the 2020-2021 CoC for CP was determined to be 4.79%. Consequently, Determination R-2020-81 determined the 2020-2021 VRCPI for CP to be 1.4205.

Following the Federal Court of Appeal [2021 FCA 69] ruling, Decision LET-R-33-2021 revised the 2020-2021 CP CoC to 7.42%, and Determination R-2021-63 revised the 2020-2021 CP VRCPI to 1.5055.

If the Agency rules that these revisions – which reflect differences in the treatment of CP compared to CN – are allowed to persist in future years by considering share buybacks and/or some debt issuances performed by the holding company Canadian Pacific Railway Limited (CPRL) as being independent of rail operations of Canadian Pacific Railway Company (CPRC), then CN is disadvantaged because its corporate structure does not have on the one hand, a holding company trading on the stock exchange and raising money on the debt market and, on the other, wholly-owned subsidiaries running rail operations.

CN estimates that if it had received similar CoC and VRCPI revisions as CP for 2020-2021, it would have been entitled to additional grain revenues of approximately $50 million per year. Though this large increase in revenues would more than justify the additional administrative costs for CN to adopt a new corporate structure with a holding company similar to CP, it does not make sense to do so solely for the purpose of fitting into the Agency's approach to the treatment of share buybacks and debt issuances; and more importantly, it changes absolutely nothing in the rail service provided to shippers.

Determining the CoC of a company is not a notional assessment that should turn on corporate structure or how specific costs may be labelled by a railway. If such were the case, the legislation could be circumvented by a cosmetic effort that would lead (as is the case now for CP) to a differential of 50% between the CoC determinations for CP and CN.

In conclusion, CN sees no reason nor justification, neither in the legislation nor in economics, to treat general-purpose debt differently between railway companies.

2. Questions Raised by the Federal Court of Appeal Judgment [2021 FCA 69]

2.1 Debt issued for share buyback

A major point of contention between the CTA and the railways has related to debt issued to finance share buybacks and whether such debt can be unequivocally identified. In the 2009 share buyback decision [LET-R-49-2009], the Agency ruled against excluding share buyback debt:

> The Agency does not consider debt incurred for the purpose of buying back shares in a company whose primary, if not exclusive, business line is the railway business to be appropriately classified as identifiable non-rail debt within the meaning of Agency Decision No. 125-R-1997.

The Agency did not give any detailed reasoning or argument in support of this statement. The referenced 1997 decision offers neither discussion nor guidelines to identify "non-rail" debt. The Federal Court of Appeal [*2021 FCA 69, Canadian Pacific Railway Company v. Canadian Transportation Agency, April 9, 2021*] notes:

> [89] ... CP concluded its remarks with a literary flourish, pointing out that trains do not run faster or slower after a share buyback event.
>
> [91] ... Buying back shares using borrowed money is not a way of raising capital since the amounts used to purchase outstanding shares are no longer available to the company to invest in rail-related assets.

We believe that caution should be shown before adhering to the reasoning proposed by CP which distorts the analysis of whether share buybacks do impact the CoC of companies, including railways. While the above statements appear attractive on the surface, they fail to account for the impact on railways operations and finances resulting from the issuance of debt for share buyback purposes. A railway's financial situation changes after issuing debt for share buybacks. Because of the higher debt load resulting from this operation, investors would consider it higher risk and therefore will require higher returns for both equity and debt. The railway may not have any additional cars, locomotives, nor track capacity, but they will surely have to work harder and smarter to generate the additional hundreds of million of dollars needed to pay the interest and principal of the additional debt. These are demonstrably costs that railway operations will have to bear, and therefore should rightly be considered to form part of their costs and hence CoC. If cash generated from railway operations is used to pay the principal and interest amounts, it is only logical to conclude that these costs are part of the CoC applicable to railway operations.

Moreover, dividends are another way to return money to shareholders. If debt is issued in order to finance dividend payments and share buybacks, it does not stand to reason that debt for dividends relates to railway operations while debt for share buybacks does not. Both forms of debt are used to pay returns to investors, and both will have to be paid back, interest and principal, using cash generated from railway operations. It would be contradictory to include one in the railway's CoC and not the other.

Finally, debt holders have a claim on the railway's assets. In case of default, the debt holders could force the sale of railway's assets, further indicating that the debt is intricately linked to railway operations, irrespective of whether the funds were initially used to fund the buying of assets or shares.

As to the "primary, if not exclusive, business line", CN does not make any claim that it is not a railway business. All its non-rail subsidiaries (trucking, transload and distribution, warehousing, logistics parks, customs brokerage services, freight forwarding, automobile distribution, etc.) are related to its railways business.

The same can be said about CP. In its 2020 Annual Report, on page 26:

> **ITEM 1. BUSINESS**
>
> **Company Overview**
>
> Canadian Pacific Railway Limited ("CPRL"), together with its subsidiaries ("CP" or the "Company"), owns and operates a transcontinental freight railway in Canada and the United States ("U.S."). *[Emphasis added]*
>
> ...
>
> CPRL was incorporated on June 22, 2001, under the Canada Business Corporations Act and controls and owns all of the Common Shares of Canadian Pacific Railway Company ("CPRC"), which was incorporated in 1881 by Letters Patent pursuant to an Act of the Parliament of Canada.

Furthermore, on page 28:

> **Operations**
>
> The Company operates in only one operating segment: rail transportation.

It is clear from CP's annual report that it is only a rail transportation company. Any funds raised by CPRL or CPRC can only be used for rail, as the Company operates in no other segment. Any debt incurred will also have to be paid, principal and interest, by cash generated from rail operations, as there are no other types of operations. We note that these public statements from both companies suggesting that their operations are both in the same sector (railway transportation), further support the argument that both railways should be treated on the same basis for the purpose of determining their CoC.

To quote from the 2009 decision, one can "not consider debt incurred for the purpose of buying back shares in a company whose primary, if not exclusive, business line is the railway business to be appropriately classified as identifiable non-rail debt". CP, whether CPRL or CPRC, does not have "non-rail" business.

2.2 Allocation of non-rail debt

From 2021 FCA 69:

> [97] ... CP's issue is not the method of allocation; it is whether non-rail debt should be allocated at all.

If CP had continued as a conglomerate with hotels, ships, an airline, etc. then CN would agree that debts identifiably used to finance these non-rail operations should not be allocated between Canadian and U.S rail operations.

However, as explained above and clearly stated in CP's annual report, CP "operates in only one operating segment: rail transportation". Also, since the Agency has already ruled that share buybacks cannot be considered as non-rail, there are no non-rail debts. Therefore, if the Agency chooses not to calculate CoC on a consolidated corporate basis, as CN suggests, then all debts should be allocated between Canadian and U.S. rail operations.

3. Questions Still Outstanding from the 2020 Consultation

The Federal Court of Appeal [*2021 FCA 69, Canadian Pacific Railway Company v. Canadian Transportation Agency, April 9, 2021*] clearly indicated that the Agency has a duty to address the points raised by the railways <u>in a meaningful way with reasoned analysis, as opposed to a superficial treatment or not addressing them directly at all.</u>

> [88] ... As a result, the Agency's answer is not responsive to the point made by CP.
>
> [92] ... The Agency's response does not engage with the argument which CP was advancing as to non-regulated entities and non-rail expenditures.
>
> [94] ... The question is whether this reasoning shows a serious attempt to deal with the arguments advanced by CP against the inclusion of non-rail debt on the regulatory balance sheet. In my view, it does not.
>
> [95] If one compares the sophisticated financial analysis in other Agency decisions such as the 2011 Decision to this reasoning, one is struck by its superficiality. ... It is simply speculation which is not indicative of a serious attempt to deal with CP's submission.
>
> [96] ... The decision turned on whether share buybacks could be identified as non-rail debt. CP offered reasons why such buybacks could be identified as non-rail debt, arguments which were not addressed by the Agency.
>
> [97] In addition, the Agency argued that the RTM Decision as to the allocation of debt is an interim decision until the Agency can conclude its consultations about the allocation methodology. With respect, that argument is beside the mark. CP's issue is not the method of allocation; it is whether non-rail debt should be allocated at all.
>
> [98] All of these factors persuade me that the Agency did not give serious consideration to CP's submissions that non-rail debt should not be included in the determination of CP's CoC. The Decision does not grapple in a meaningful way with CP's submissions and gives every indication that it was written to justify a decision which had already been made. As a result, I conclude that the Agency breached its duty of procedural fairness when it failed to consult with CP or, putting it another way, when it failed to consider CP's submissions with an open mind.

In the on-going CoC discussion between CN and the Agency, including the consultation that was started in September 2020, there are many points and arguments that have been raised by CN and that remain to be addressed in a meaningful way by the Agency.

The following is a summary of the issues raised by CN and that have not yet been addressed by the Agency.

3.1 Interest rate on the BC Rail Debt

Following the Agency's April 28, 2020 determination LET-R-30-2020 of CN's cost of capital, CN argued in its letter to the Agency on May 28, 2020, that the financially appropriate treatment of the BC Rail debt is its valuation at Fair Market Value (FMV) and imputed interest rate of 5.75%:

> A more appropriate treatment would be the inclusion of only the current FMV of $12M at the imputed interest rate of 5.75%. This is the same rate that was used to estimate the FMV of 5 $M, as calculated by BC Rail before its acquisition, and continue to be used by both CN and BCRC as the interest paid on this debt, as evidenced in the financial statements of both companies.
>
> ...
>
> <u>Therefore, CN has to 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 the discounted value and the imputed interest rate of 5.75%, and not the face value of 842 $M at 0%.</u> *[Emphasis in original]*
>
> ...
>
> CN has to 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 $M.
>
> Given the interest amount that CN has to 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 capital structure and average interest rate on debt for COC purposes are the discounted value and 5.75%, and not the face value at 0%.

In its Letter Decision No. LET-R-35-2021, the Agency states:

> The Agency continues to assess the submissions made by stakeholders, including whether the BC Rail debt should have an implied interest rate of 5.75 percent instead of 0 percent.
>
> In light of the information provided by CN in its response letter dated May 28, 2020, which clarified its treatment of this debt, the Agency will allow the historical treatment of

> the BC Rail debt at its discounted value with an interest rate of 0 percent pending completion of the consultation.

It is undisputable that 0 percent does not allow CN to earn the returns required to pay the debtholders at maturity considering the valuation of the debt by BCRC at the acquisition and the valuation at maturity. Setting the interest rates at 0 fails to recognize the obvious and is also contrary to the fundamental purpose of the Agency's cost of capital methodology, as explained in Agency Determination R-2019-229:

> The cost of capital is an estimate of the total return on net investment required by debt holders (cost of debt) and shareholders (cost of common equity) such that debt costs can be paid and shareholders can be provided with a return on investment consistent with the risks assumed for the period under consideration. *[Emphasis added]*

The allowed interest cost in the CoC calculation is the amount that CN is allowed to earn in order to be able to pay the debt holders. For example, consider a debt of $100M that bears 5% interest and is due in one year. At maturity, CN has to pay back $105M, which includes the $5M interest that CN was allowed to earn according to its CoC calculation. If the debt holder agrees not to receive any payment and to extend the debt another year, at the end of which CN will now owe an additional $105M * 5% = $5.25M, for a total of $110.25M. The $10.25M is the interest that CN should be allowed to earn in its CoC calculation in order to be able to pay back the debt holder.

The situation for the BC debt is no different. The FMV was $12M and $13M, in 2019 and 2020, respectively. The increase in FMV represents the 5.75% interest that CN should be allowed to earn on the FMV of the debt in order to be able to pay back BCRC at maturity. The increase in FMV is proof that the debt obligation is not at zero cost to CN.

On this basis, CN urges to Agency to recognize that CN must earn an amount equal to 5.75% and this requirement therefore affects CN's CoC accordingly. If the Agency does not allow CN to earn the imputed 5.75% rate, how will CN earn the amounts necessary to pay the debt holder the full value of $842M at maturity?

3.2 Commercial paper as Long-Term Debt and Working Capital

In its Decision No. LET-R-30-2020 of April 28, 2020, the Agency wrote:

> The Canadian Transportation Agency (Agency) will hold a consultation with respect to how commercial paper should be included in the calculation of working capital and sets working capital to zero in the interim.

In its November 11, 2020 submission to the Agency's September 2020 Consultation on Cost of Capital Rates, CN explained why it is not realistic for a railway company to operate with zero or negative working capital. The latter is a result of an accounting choice concerning the presentation of commercial paper. If CN had elected to present commercial paper differently, as GAAP rules allow and as CN did until 2009, and as explained in detail in CN's November 2020 submission, then CN would have a positive accounting working capital as prescribed by the Agency's calculation method.

In the same submission, CN also explained in detail that commercial paper that is routinely rolled over should be considered as long-term debt (LTD), as allowed under GAAP rules. This would eliminate the problem of negative working capital explained above.

The issue of classifying commercial paper as LTD is not an issue of subjective interpretation. It is an elective choice that is well framed by GAAP rules, as explained in detail in CN's previous submission.

A company that elects to make this GAAP choice must (1) demonstrate its intent to use commercial paper on a long term basis, and (2) must have in place a non-retractable contract that allows it to transform the commercial paper into LTD if it chooses to. Thus, not transferring to LTD is a deliberate choice, not a constraint forced upon the company because LTD is not available to it.

A company that uses commercial paper sporadically, and only a few months in a year, fails rule (1) above and cannot classify its commercial paper as LTD under GAAP. Similarly, a company that does not have the required backstop facility fails rule (2) above and also cannot classify its commercial paper as LTD under GAAP.

In accordance with these GAAP rules, CN can classify its commercial paper as LTD, but CP cannot. However, in the event that the Agency wishes to have a uniform treatment for both railways, CN suggests that always classifying commercial paper as LTD would serve CN's purpose without significantly affecting CP since the latter's 12-month average would be small compared to its total LTD. The Agency can choose to always follow GAAP rules and allow CN to make such a reclassification, while CP does not.

CN maintains its position on this point and awaits the Agency's decision.

3.3 Current Portion of Long-Term Debt as Long-Term Debt (LTD)

Submissions by both CN and McMillan presented arguments that, for determining a company's capital structure, the current portion of LTD should be considered as LTD.

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

Example: 2-yr bond

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

Such perennial changes only dependent on the short term of the bonds simply misrepresents the debt structure of the company. CN submits that it would be misleading to present either to a regulator or to investors that the company holding the 2-yr bond in the above illustration was 100% financed by equity investors in years 2 and 4 in order to calculate its CoC. In fact, in its Code of Professional Ethics under Rule 203 – Accounting Principles, the American Institute of Certified Public Accountants (AICPA) would require a departure from GAAP in such a case in order to avoid such a material misstatement. We believe that the Agency should adopt a similar approach.

3.4 Roll-over of debts used for U.S. acquisitions and investments

In the same Decision No. LET-R-30-2020 of April 28, 2020, the Agency wrote:

> CN did not provide sufficient information on the roll-over of its historical U.S. debt obligations to demonstrate to the Agency's satisfaction that the inclusion of these debts is justified and, as such, the Agency will not include them in the calculation of CN's cost of capital.

CN has filed with the Agency all the evidence required on this point in CN's debt schedules submitted annually and that show that the total debt of CN is increasing year over year. This constant increase proves that CN's debt is not retired at maturity but rather re-financed with newer debt issues. Moreover, every debt prospectus specifies that debt proceeds will be used "*for general corporate purposes, <u>including the refinancing of outstanding indebtedness</u> ...* "[emphasis added].

CN routinely issues new debt to re-finance its maturing debt, and this is one of the many use-of-funds that is explicitly indicated in the bonds' prospectuses. The Agency has rejected some of this refinancing and reclassified the new issues into the pool to be distributed by RTM even though it is clear to CN that these bonds would not exist if it were not for the U.S. acquisitions some years ago.

Moreover, CN has maintained a stable debt to EBITDA ratio, as evidenced in its public financial statements, earning a top credit rating, and lowering its borrowing costs. As CN's balance sheet has grown, so has its debt. Maintaining the debt/EBITDA ratio would not be possible in the circumstances if maturing debt was retired and paid-off rather than re-financed with new debt. The growing CN debt proves it.

As CN has grown, so has 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.

The debt schedules annually submitted by CN show a growing rather than shrinking debt load. It is unclear how the Agency can find retired debt to justify disallowing the rollover of historical debt, and what additional "sufficient information" is required by the Agency.

3.5 RTM is not an appropriate metric to allocate debt

Ever since the interim revenue ton miles (RTM) decision (LET-R-33-2019) was issued, CN has explained, on many occasions, why RTM is <u>not</u> an appropriate method to allocate debt. However, some of the major flaws of the RTM approach remain to be addressed by the Agency.

In its letter to the Agency of April 5, 2019 in response to the interim RTM decision, CN noted the following flaws in allocating debt by RTM:

1. The location where capital is deployed does not correlate with the location where the revenue or RTM are realized. For example, CN has invested heavily in the U.S. to improve the speed and fluidity of traffic between Prince Rupert and Chicago. This has resulted in record traffic levels originating from Prince Rupert. However, while the capital investment was in the U.S., most of the revenues and RTMs are recognized in Canada because most of the mileage is in Canada.
2. Over the last 20 years CN has acquired far more major assets in the U.S. than in Canada. The result is that the general debt of the corporation has increased in part to fund these acquisitions. This does not correlate to this debt being related to Canadian rail operations simply because there are more revenues, RTMs, or employees in Canada.
3. The amount of investment in locomotives and track to generate an RTM is not the same in all territories. For example, locomotive requirements between Chicago and the Canadian border is higher than between Winnipeg and Edmonton. To generate the same RTM, CN would need to invest in more locomotives in the U.S. than in the Prairies. Similarly, track costs are higher where there are grades and curvatures in the U.S., compared to the flat Prairies territory, requiring higher investments in track in the U.S. to generate the same RTM.
4. There is a significant lag between investment and RTMs. Major investments in track upgrades (capital spent now) may not generate major RTM increases for several years. For example, CN invested $3.5B in capital in 2018 in anticipation of further traffic increases in 2019, 2020 and beyond. The money is invested (debt issued) long before the increase in RTMs is realized. Allocating the debt by the RTMs in the year when debt was issued may not allocate the debt properly where the future RTMs will increase because of the investment.
5. Cars that do not require any capital from CN generate many RTMs. E.g. government grain cars, shipper-supplied cars, and leased cars. Allocating debt by RTMs would allocate debt to traffic that did not require financing of the railcars.

6. Acquisition of new cars in replacement of government grain cars requires capital investment, yet the RTMs remain the same. Issuing debt to finance the new car purchase would not attract additional allocation because the RTMs would not change.
7. Variations in RTMs are driven by economic or business cycles and market conditions that are only loosely related to capital requirements and hence debt issuance.
8. Some new debt is issued to refinance older debt that is maturing. The RTM distribution at the time of the new debt would be different from the RTM distribution when the original debt was issued, yet the debt level remains the same.
(*Note: This problem is further compounded across jurisdictions when the Agency refuses the roll-over of debts issued to finance U.S. acquisitions. After the maturing of the old debt, the new debt would be majority allocated to Canada, even though the original acquisition and original additional RTMs were in the U.S.)*

In its November 11, 2020 submission to the Agency's September 2020 Consultation on Cost of Capital Rates, CN further explained:

9. 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.
10. 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.
11. Not all RTMs generate the same revenue, and therefore may not attract the same level of investment.
12. In support of its arguments, from its publicly available financial statements, CN produced tables that showed, on average, over the last three years, that even though Canada accounted for 73.6% of RTMs, it had only 53.3% of properties and 67.6% of revenues. It takes 2.4 times more properties investment in the U.S. than in Canada to generate the same RTM, and the same RTM

generates 1.34 times more revenue in the U.S. than in Canada, justifying the higher investment in properties.

To the above points already raised with the Agency, CN also adds:

13. RTM is an operating expense measure, not a capital expense measure. As a general rule, companies do not fund their operating expenses with debt. Lenders are cautious about extending money to companies that need to fund their operating expenses with debt. Lenders extend the funds to companies that can back them up with assets. Therefore, assets (properties, or GBV) are a much better metric than RTM to allocate debts.

We believe that CN has amply demonstrated in its submissions that RTM is not an appropriate measure for the deployment of funds in properties, which in turn is the fundamental reason for raising funds in the first place. The Agency must address these important questions as, until now, the RTM approach remains the approach selected by the Agency although it has not explained how the flaws raised by CN are considered.