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Reply to the Attention of *François E.J. Tougas*
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Email Address *francois.tougas@mcmillan.ca*
Date *August 19, 2021*

BY EMAIL TO: ferroviaire-rail@otc-cta.gc.ca

Canadian Transportation Agency
15 Eddy St
Gatineau, Québec
J8X 4B3

Re: Agency Consultation on General Purpose Debt

We are solicitors for Teck Resources Limited and its affiliates Teck Coal Limited and Teck Metals Limited (collectively, "**Teck**") in connection with the Agency's Consultation on General Purpose Debt (the "**Consultation**") announced on June 21, 2021.[1]

In support of our submissions, we have appended letters from the Western Grain Elevator Association and, the Canadian Canola Growers Association ("**Stakeholders**"), all of whose members have extensive dealings with Canadian National Railway ("**CN**") and Canadian Pacific Railway ("**CP**").

Throughout these submissions, we refer to the *Canada Transportation Act* (the "**Act**") and the following documents and defined terms:

<u>Documents</u>

"**Discussion Paper**": the Discussion Paper entitled "Discussion Paper: Whether General Purpose Debt Should Be Included in the Calculation of Cost of Capital Rates"[2]

"**Gould Report (Feb 2021)**": the expert report prepared by Dr. Larry Gould, Ph.D., entitled "Comments on Issue 4 of CP's Round 2 Submission on the Methodology to Determine the Calculation of Net Railway Investment and Capital Structure," February 2, 2021

"**Gould Report (Jan 2021)**": the expert report prepared by Dr. Larry Gould, Ph.D., entitled "Response to Submissions on the Methodology to Determine the Calculation of Net Railway Investment and Capital Structure," January 18, 2021" in response to the submissions of CP and CN to the 2020 Cost of Capital Consultation

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[1] Available at: Consultation on General Purpose Debt | Canadian Transportation Agency (otc-cta.gc.ca)
[2] Available at: Discussion Paper: Whether General Purpose Debt Should Be Included in the Calculation of Cost of Capital Rates | Canadian Transportation Agency (otc-cta.gc.ca)

"**Gould Report (Nov 2020)**": the expert report prepared by Dr. Larry Gould, Ph.D., entitled "Issues in the Calculation of the Net Railway Investment and Capital Structure" dated November 25, 2020, in response to the 2020 Cost of Capital Consultation

For ease of reference, the Gould Report (Nov 2020), the Gould Report (Jan 2021) and the Gould Report (Feb 2021) are referred to herein as the **Gould CoC Reports.**

Defined Terms

- **"ARCM"**: Agency Regulatory Costing Model
- **"ARCM Consultation":** the Agency's "Consultation on the Agency's Regulatory Costing Model"[3]
- **"Cost of Capital Consultation"**: combined for the purposes of this Consultation to include the three phases, our submissions and the Gould CoC Reports
- **"LRVC"**: long run variable cost

As the Agency is aware, we have made submissions in connection with several prior consultations, including the ARCM Consultation and the Cost of Capital Consultation. We underscore, as we have in previous submissions, the importance of the ARCM, appropriately defined railway cost of capital and the output of LRVC for regulated interswitching, final offer arbitration and other purposes, and their respective impacts on rail freight rates generally. To the extent that CP and CN seek to minimize their importance, shippers, particularly those who do not enjoy access to alternative, effective, adequate and competitive means to transport their goods, suffer the harms associated with rates set at levels in excess of those that would prevail under conditions of effective competition. For these reasons, Teck and the Stakeholders rely on the Agency's efforts to adequately capture relevant elements of CP's and CN's cost of capital.

We understand that this Consultation is held for the purpose of seeking input as to whether General Purpose Debt ("**GPD**") should be included in the calculation of cost of capital rates of CN and CP.

We understand that at the conclusion of this Consultation, if it is determined by the Agency that GPD should be included on the regulatory balance sheets of CN and CP, the Agency will also make a determination on how GPD should be apportioned based on the submissions filed in the 2020 Consultation on Cost of Capital Rates.

The Agency asks the following three questions:

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

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[3] Initiated by the Agency and conducted between January 9, 2017 and February 28, 2017, as described at: https://www.otc-cta.gc.ca/eng/consultation/consultation-agencys-regulatory-costing-model-arcm.

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

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

We appreciate the Agency's willingness to provide us with an opportunity to respond.

The Agency is familiar with procedural issues we have raised in prior consultations. We trust that, in connection therewith, the Agency will provide us with adequate opportunity to respond to substantive and procedural issues either CN or CP or both may address both in their initial submissions and in any responses to submissions that we could not reasonably have anticipated, particularly given the information asymmetry that exists between Teck and the Stakeholders, on the one hand, and CN and CP, on the other.

To further underscore the point, we note that CP was granted a further extension of 15 days for their initial submission. We trust that this extension will eliminate CP's prior case-splitting conduct; if not, we trust that we will receive the same opportunity to respond, both to CP's and CN's submissions, given that we begin this consultation at a disadvantage relative to both CP and CN. To reiterate the point we have made in prior consultations, we do not have the information available to CP, CN and the Agency, to which we refer without repeating them anew.

We have appended a report from Dr. Larry Gould, which comments briefly on the three questions above.

Once we have received CP's, CN's, and other stakeholders' submissions, we intend to respond at the revised deadline of September 9, 2021.

We again appreciate the opportunity to participate in this Consultation and look forward to the Agency's further communications and ultimate determinations in connection with this Consultation.

Please do not hesitate to contact us if we can be of further assistance in the Consultation.

Yours truly,

François Tougas

cc: client
// Attachment: Gould Report (August 5, 2021) and Stakeholder Letters

SCHEDULE "A"

Gould Report (August 5, 2021)

<u>BEFORE THE CANADIAN TRANSPORTATION AGENCY</u>

IN THE MATTER OF THE CONSULTATION ON WHETHER GENERAL PURPOSE DEBT SHOULD BE INCLUDED IN THE CALCULATION OF COST OF CAPITAL RATES

GENERAL PURPOSE DEBT

REPORT

Prepared by:

LAWRENCE I. GOULD

Lawrence I. Gould

August 5, 2021

I. INTRODUCTION

The Canadian Transportation Agency (Agency) has initiated a consultative review of its methodology for determining the net railway investment and capital structure for the calculation of cost of capital rates (the "Consultation"). I was asked by McMillan LLP to provide my independent judgment and opinion to the Agency on the additional issues concerning general purpose debt pertaining to the Agency's net railway investment and capital structure methodology in the Consultation.

I am Senior Scholar at the Asper Business School, University of Manitoba. Previously I have been Head, Department of Accounting and Finance at the University of Manitoba and Chairman, Finance and Business Economics at McMaster University.

I received the Bachelor of Science Degree in Economics from the Wharton School of Finance and Commerce, University of Pennsylvania in 1966. I completed the Master of Business Administration Degree in Finance from New York University in 1968 and the Doctor of Philosophy Degree in Finance from the University of Toronto in 1975.

During the last 40 years I have been employed as a consultant in a number of cases that posed a wide range of problems in applying financial theory to the determination of the cost of capital and valuation. I have testified on financial matters before the Canadian Transportation Agency, the Canadian Radio-Television and Telecommunications Commission, the Canadian Human Rights Tribunal, the Public Utilities Board of Manitoba, the New Brunswick Board of Commissioners of Public Utilities, the Newfoundland Board of Commissioners of Public Utilities, the Nova Scotia Utility and Review Board, the New Mexico Public Service Commission and the Federal Communications Commission.

I have also been engaged in academic research to extend the theory of the cost of capital. Among the subjects of this research have been the effects of income taxation on the cost of capital, the impact of growth on the cost of capital, the impact of inflation on the cost of capital, estimating the cost of capital for a non-traded division of a company and the use of the capital asset pricing model in estimating the cost of capital. I have published articles on the cost of capital and related problems in finance in the Journal of Finance, Financial Management, the Journal of Portfolio Management, the Journal of Accounting, Auditing and Finance, the Canadian Tax Journal and elsewhere.

II. STATEMENT OF THE PROBLEM

The Agency's staff produced a discussion paper that outlined certain issues about the Agency's methodology to determine net rail investment and capital structure for the calculation of cost of capital rates that should be considered.[1] These issues were in the form of questions on the working capital allowance component of net railway investment and capital structure. In response, I provided my opinion on the Agency's existing methodology and commented on the issues raised in the Discussion Paper.[2]

In addition to the submission by McMillan LLP, submissions were made by the Canadian National Railway and the Canadian Pacific Railway. The process established by the Agency provided the opportunity for any party who made a submission to file a response to the initial submissions made by the other parties.[3] In response, I provided comments on the submissions of the Canadian National Railway (CN) and the Canadian Pacific Railway (CP).[4]

After receiving the submissions and responses from all parties, the Agency determined that CP's round 2 submission[5] with respect to issue 4 did not simply provide commentary on the round 1 submissions of the other parties, but instead provided primarily new information and

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[1] Canadian Transportation Agency, Discussion Paper on the Methodology to Determine Net Railway Investment and Capital Structure for the Calculation of Cost of Capital Rates, September 25, 2020 [Discussion Paper].

[2] My opinion on these issues is contained in the McMillan LLP submission on behalf of Teck, the Western Grain Elevator Association, the Canadian Canola Growers Association, and the Mining Association of Canada, "Issues in the Calculation of Net Railway Investment and Capital Structure," November 25, 2020.

[3] Discussion Paper, page 8.

[4] My comments are contained in the McMillan LLP submission on behalf of Teck, the Western Grain Elevator Association, the Canadian Canola Growers Association, and the Mining Association of Canada, "Response to Submissions on the Methodology to Determine the Calculation of Net Railway Investment and Capital Structure," January 18, 2021.

[5] CP's Response to the Submissions of Other Stakeholders, CTA Discussion Paper on Capital Structure and Cost of Capital, 2020, January 18, 2021. [CP Response]

proposals. Under the directions for the process in the Discussion Paper this information should have been supplied in round 1 of the consultation to allow for comment by the other parties. As a result, the Agency decided that the other parties would be given an opportunity to comment on CP's Issue 4 discussion.[6] In response, I provided additional comments on CP's round 2 submission.[7]

After receiving the submissions and responses from all parties, the Agency launched a new consultation to review an additional issue: whether general purpose debt should be included in the calculation of cost of capital rates. The Agency's staff produced a discussion paper that outlines certain issues about general purpose debt that should be considered.[8] The purpose of this report is to provide my opinion on the Agency's capital structure methodology and to comment on the issues raised in the Discussion Paper on General Purpose Debt in order to assist the Agency in prescribing a consistent unambiguous capital structure methodology for all regulated railway companies.

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[6] Canadian Transportation Agency, "CTA Cost of Capital Consultation-Update & Request", January 21, 2021.
[7] My comments are contained in the McMillan LLP submission on behalf of Teck, the Western Grain Elevator Association, the Canadian Canola Growers Association, and the Mining Association of Canada, "Comments on Issue 4 of CP"'s Round 2 Submission on the Methodology to Determine the Calculation of Net Railway Investment and Capital Structure," February 2, 2021.
[8] Canadian Transportation Agency, Discussion Paper: Whether General Purpose Debt Should Be Included in the Calculation of Cost of Capital Rates, June 21, 2021. [Discussion Paper on General Purpose Debt]

III. ISSUES RAISED IN THE DISCUSSION PAPER

The Discussion Paper on General Purpose Debt provides an overview of the Agency's current cost of capital methodology and sets out issues relating to the treatment of general purpose debt in three questions. This section of the report provides comments and recommendations for each of these questions.

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

The Agency's current cost of capital methodology only includes capital raised for rail-related investments for the railways' Canadian operations. Debt identified specifically to finance United States operations and debt identified specifically to finance non-railway operations are excluded from the railways' regulatory balance sheets.

The Agency has defined general purpose debt as debt that is raised for broad corporate purposes, such as share buybacks. This classification differentiates debt that is not used to finance specific identifiable assets, but may be used for rail-related operations. It provides a useful definition for considering whether that debt should be considered rail-related and therefore be included in the calculation of the railways' cost of capital rates.

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

The Agency's cost of capital calculation process requires the determination of the railway's capital structure, that is, the sources of capital used to finance net railway investment. Net railway investment is defined as the portion of the railway's net assets that are used to provide railway transportation services under the Agency's jurisdiction. It does not include assets that are used to provide rail transportation services in the United States or assets used for non-railway purposes.

Therefore, it follows that the capital structure should only include capital raised for rail-related investments for the railway's Canadian operations. Debt identified specifically to finance United States railway operations and debt identified specifically to finance non-railway operations should be excluded from the railway's regulatory balance sheet.

The issue in this Consultation is whether general purpose debt raised for broad corporate purposes should be included on the railway's regulatory balance sheet. The question of how to apportion general purpose debt for rail purposes has already been addressed by CN, CP and the stakeholders in the 2020 Consultation on Cost of Capital Rates, and is not an issue in this Consultation. The issue in this Consultation is only whether general purpose debt is rail-related debt, and therefore should be included in the Agency's cost of capital calculations.

The question of whether general purpose debt for the purposes of share buy-backs is rail-related and must be included in the determination of the railway's capital structure was considered by the Agency in 2009, concluding:

> "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."[9]

In 2020 CP requested further consideration of the issue of allocating its general purpose debt to the regulated rail operation's capital structure. The Agency determined:[10]

> "The Agency finds that debt issued for the purpose of share buybacks is rail-related. There is a general corporate benefit derived from buying back shares issued. The issuance of debt in lieu of issuing more shares to fund rail-related investments lowers the company's cost of capital, as the cost rate of debt issuance is lower than the cost of common equity rate that is expected from investors. Lower cost rates paid by the railway company for its investments might allow it to increase investments in other rail-related projects, or to lower freight rates paid by its customers."
>
> and
>
> "The Canadian Transportation Agency (Agency) determines that the use of general purpose debt for the purpose of share buy-backs is rail-related and must be included in the determination of CP's capital structure.
>
> The Agency will continue to consult on how to allocate general purpose debt to Canadian rail operations and, in the interim, general purpose debt will be allocated based on the Revenue Ton Miles (RTM) methodology pending the conclusion of such consultations."

The determination of a regulated entity's capital structure is critically important. To elaborate, the higher the debt ratio the lower the weighted average cost of capital (WACC) and, more important, the lower the revenue requirements imposed on customers. This takes place, in part, because the WACC is reduced and, in larger part, because the income tax component of the revenue requirement is reduced as the debt ratio is raised.

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[9] Canadian Transportation Agency, Decision LET-R-49-2009, April 20, 2009.

[10] Canadian Transportation Agency, Decision LET-R-29-2020, April 28, 2020.

To provide some indication of the relative magnitude involved in the capital structure decision, the revenue requirements imposed on customers were calculated under three alternative capital structures and the following assumptions: (1) a corporate income tax rate of 30%; (2) an interest rate on debt of 5%; and (3) a cost of equity capital of 10%. It is also true that in principle the interest rate on debt and the cost of equity capital both increase with the debt ratio, but the range over which the debt ratio is varied in the illustration below is very narrow, and the increase in the interest rate and the cost of equity capital in this range would be so small that a single rate can be used with a negligible error.

The three alternative capital structures are present below:

	Capital Structure		
	A	B	C
Current Liabilities	$ 7,000	$ 7,000	$ 7,000
Deferred Taxes	13,000	13,000	13,000
Debt	35,000	40,000	45,000
Equity	45,000	40,000	35,000
Total	$100,000	$100,000	$100,000

The revenue requirements under these capital structures and the above tax rate and capital cost rates are:

	A	B	C
EBIT	$8,179	$7,714	$7,250
Interest Expense	1,750	2,000	2,250
Earnings before Taxes	6,429	5,714	5,000
Income Taxes	1,929	1,714	1,500
Income to Common	4,500	4,000	3,500

To understand these figures, we work up from the bottom as follows: In Case A the $45,000 common equity gets a 10% return and income to common equity of $4,500. With a 30% tax rate the income taxes are $1,929. Add to these two items the $1,750 interest expense on $35,000 in debt with a 5% interest rate, and we have earnings before interest and taxes, which are the revenue requirements imposed on customers, of $8,179.

The three capital structures in the above illustrative case may be compared on the basis of the WACC and on the basis of the revenue requirements imposed on customers. The WACC in each case is the sum of the income to common equity and interest on debt divided by the capital employed, while the revenue requirement is the EBIT. The two figures in each case are:

Case	A	B	C
WACC	6.25%	6.0%	5.75%
Revenue Requirements	$8,179	$7,714	$7,250

It can be seen that the WACC falls from 6.25% to 5.75% between cases A and C, a percentage change of 8.0%. However, the revenue requirements fall from $8,179 to $7,250, a percentage change of 11.4%. This is not a trivial benefit to customers, particularly when it is noted that the capital change that provides the benefit is quite small.

It is clear that changes in the capital structure have a significant impact on the regulated rail entity and its customers. Furthermore, this is true whether the capital structure change results from a debt issue that is wholly related to the regulated rail entity as specific debt, or partially related to the regulated rail entity as general purpose debt.

Therefore, each debt issue should be considered initially to be on the railway's regulated balance sheet. If the railway can prove that the debt issue was raised for specific non-rail purposes or to finance United States railway operations, it should then be removed from the regulated balance sheet. If the railway can prove that the debt issue was raised for general purposes by identifying its use, it should then be allocated to the regulated balance sheet using the RTM based approach or whatever other allocation method the Agency determines to be appropriate.

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

The Agency has stated its goal for determining cost of capital methodology:

> "Our goal is to ensure that the methodology we use to calculate cost of capital is rigorous, transparent, and fair for rail system users, including shippers, and railway companies. The methodology we use should also treat railway companies consistently."[11]

In the absence of a compelling argument from the railways, general purpose debt should be treated consistently between railway companies.

[11] Canadian Transportation Agency, Discussion Paper on the Methodology to Determine Net Railway Investment and Capital Structure for the Calculation of Cost of Capital Rates, September 25, 2020, page 1.

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August 19, 2021

SCHEDULE "B"

Stakeholder Letters

WESTERN GRAIN ELEVATOR ASSOCIATION
Ste. 1320-220 Portage Ave.
WINNIPEG, Manitoba
R3C 0A5
Telephone: (204) 942-6835
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E-Mail: wgea@mts.net

July 30, 2021

Canadian Transportation Agency
15 Eddy Street
Gatineau, QC
J8X 4B3

ferroviaire-rail@otc-cta.gc.ca

Dear Sir/Madam,

Re: Consultation on General Purpose Debt

The Western Grain Elevator Association (WGEA) is an association of six major grain businesses operating in Canada, which collectively handle approximately 95% of western Canada's bulk grain exports. The WGEA members account for approximately 20% of railway revenues and pay annual total rail freight of 1.6 billion dollars. Our members are listed at the bottom of our letterhead.

The outcome of the Canadian Transportation Agency's Consultation on the whether or not general purpose debt should be included in the calculation of cost of capital rates, will have a material impact on the Volume Related Composite Price Index and therefore the Maximum Revenue Entitlement going forward. The April 9th decision by the Federal Court of Appeal to set aside the Agency's previous decision on this matter resulted in a significant cost impact to the entire grain sector. It allowed CP to extract an additional $30 million unrecoverable dollars from WGEA member companies within the months of May, June and July 2021.

In this regard, the WGEA has joined with McMillan LLP, Teck Resources Limited, the Mining Association of Canada and the Canadian Canola Growers Association in support of the enclosed submissions.

Thank you in advance for considering our views on this important matter.

Yours truly,

Wade Sobkowich
Executive Director

August 5, 2021

Canadian Transportation Agency
15 Eddy Street
Gatineau, QC
J8X 4B3

Re: Agency Consultation on General Purpose Debt

The Canadian Canola Growers Association (CCGA) supports the submission on the above noted consultation prepared by McMillan LLP.

CCGA represents 43,000 canola farmers from Ontario to British Columbia on national and international issues, policies and programs that affect farm profitability. The canola sector contributes $29.9 billion to the Canadian economy annually and supports 207,000 jobs across the country.

Rail transportation is critical to farmers and the industry as we export 90% of Canadian canola production annually to over 50 countries. These exports keep farms successful and help ensure strong rural communities, employment and value-added activities.

CCGA appreciates the opportunity to participate in this initiative.

Sincerely,

Rick White

Rick White
President & CEO