Tyme Wittebrood
Director, Regulatory Finance

Building 1, 7550 Ogden Dale Rd SE
Calgary, Alberta
T2C 4X9
Phone: 403-319-6540
Email: tyme_wittebrood@cpr.ca

September 9, 2021

Via email: ferroviaire-rail@otc-cta.gc.ca
Allan Burnside
Senior Director, Analysis and Regulatory Affairs
Canadian Transportation Agency
15 Eddy Street - 17th Floor, Mailroom
Gatineau, Quebec
J8X 4B3

CP's Response to Other Stakeholders: Agency Consultation on Whether General Purpose Debt Should be Included in the Calculation of Cost of Capital Rates

CP thanks the other stakeholders for their considered responses to this important consultation.

As has been the case before in this consultation, CP agrees with much of what has been submitted by others contributors. The main point of agreement throughout this consultation appears to be that if the Agency decides to allocate general purpose debt (and other general purpose activities) to a regulated railway entity's balance sheet, it must be done in a way that results in a fair and reasonable cost of capital. A fair and reasonable result is one in which a regulated rail entity's capital structure echoes that of its consolidated company.

As well, CP would like to take the opportunity to provide respond to some of the points raised by other stakeholders.

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

While cash is fungible, it is possible to assign long-term debentures to specific assets or activities based on a reasonable interpretation of the railway's cash flows and activities. This is in keeping with the Agency's current practice.

In the last paragraph of the CN August 20, 2021 Response to question one, CN stated:

> … 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.[1]

CP notes that CN has stated in the past that it is possible to correlate specific debentures with specific assets or activities. For example, in its November 5, 2020 response to this consultation, CN stated:

> After removing debts issued to fund U.S. acquisitions and other special capital projects like the U.S.- mandated Positive Train Control (PTC) requirements, the remaining debt instruments should then be allocated between CN and U.S. operations using measures that are relevant to the use of the funds.[2]
>
> …
>
> 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.[3]

As well, based upon previous Agency decisions, it appears that CN has classified some of its debt as specifically applicable to its U.S. operation, which the Agency applied as such:

> With respect to any approved roll-over of CN's of U.S. debt, the Agency will continue to apply the RTM-based approach as outlined in Decision No. LET-R-41-2019.[4]

Therefore, CN's statement in this consultation does not agree with its prior statements on this topic and with the Agency's current practices.

Cash is a fungible asset, so it is impossible to draw an "unequivocal" link between a given source of cash and a specific cash disbursement. However, it is possible to draw conclusions based on a reasonable interpretation of the overall cash flows of the company.

For example, CP began its share buyback program in 2014. Over the next two years, CP repurchased $4.8 billion CAD of its own common shares ($2 billion in 2014, $2.8 billion in 2015).[5] In 2015 alone, CP issued a total of $3.4 billion CAD of new long-term debt ($2.9 billion net)[6]. This is the largest total long-term debt issuance in any fiscal year in CP's history. 2014 and 2015 also represent the largest share buy-

---

[1] CN August 20, 2021 Response at Page 2.
[2] CN November 5, 2020 response at Page 9.
[3] CN November 5, 2020 response at Page 9.
[4] CTA Determination LET-R-30-2020 at Issue 2.
[5] CP Annual Reports, 2014 and 2015, Consolidated Statement of Cash Flows.
[6] CP Annual Report, 2015, Consolidated Statement of Cash Flows.

back programs in CP's history. It is reasonable to conclude that the 2015 debt issuance is linked to the share buy-back program.

Similarly, a debt issuance may be correlated to a major project, such as the acquisition of a subsidiary company or a major capital program.

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

a) Impact of Regulated Rail Entity Cost of Capital Decisions on Investors

The differences in the history and corporate structures of Canada's two Class-1 railways has led to important differences in the structures of their UCA accounts, as each railway works to carve out its notional regulated railway entity from its corporate accounts. The Agency is now reviewing these differences while determining a fair and reasonable outcome.

CN echoed this in its response to question 2, wherein it stated:

> 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.[7]

CP agrees with this statement.

As CN noted, investors and lenders do not evaluate this notional regulated railway entity when making investment decisions. At the same time, the Agency's determinations directly impact the returns that investors receive. Whatever the Agency decides, it must ensure that it fulfills its mandate to ensure that the regulations permit a fair and reasonable return for investors of the consolidated railway companies.

b) Cost of Equity

It is a fundamental principle that the cost of debt and equity will reflect the capital structure under which they are determined. This means that it is incorrect to calculate a cost of debt and equity using a balance sheet having one capital structure, and then apply those estimates to another balance sheet having a different capital structure. This principle applies whether or not the companies are affiliated.

CN stated in its Response that:

> The Agency has settled the cost of equity 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

[7] CN August 20, 2021 Response at Page 2.

– where the CoC is applied – is different from the U.S. one, especially for grain transportation and interswitching which are the focus of CoC.[8]

CP agrees with this statement. The report provided by the Brattle Group, appended to CP's August 20, 2021 submission, explains why this is so. Briefly, it has been demonstrated within the economic literature that the after-tax cost of equity will increase when financial leverage increases, and the after-tax cost of debt will too as debt ratios become excessive (i.e., levels nearing financial distress, which is where the CTA's 2020 implementation is putting CP's regulatory capital structure).

At the fundamental level, a company's cost of capital will reflect the risks inherent in its business, known as its "asset risk". The returns required by lenders and investors merely reflect how that risk has been apportioned between these two groups.

c) Application of General Purpose Debt

As CP stated in its Response, general purpose activities should not be allocated to the regulated rail entity's balance sheets. CN disagreed with CP and stated that it believes general purpose debt should be allocated to the regulated rail entity's balance sheet. [9]

If the Agency determines that it will include such debt and other general purpose activities in its calculation of a regulated railway entity's cost of capital, CP submits that it should only apply in the following way:

- all general purpose activities, assets, and equity should be included in that calculation;
- the final capital structure used to calculate the regulated rail entity's cost of capital is similar to that of the consolidated company; and
- the cost of equity and debt are adjusted if the Agency makes changes to the capital structure.

Failing to do so will generate imbalanced results. As CP has submitted extensively in this proceeding, whatever method the Agency chooses, it must be holistic in nature, and it must lead to a fair and reasonable result.

CN appears to agree with this position because it stated that:

> 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.[10] [Emphasis added]

CP reiterates that its regulated railway entity accounts reflect the UCA requirements, which entails appropriate allocation of the asset, debt and equity accounts. For example, $2 billion of share capital has been excluded from the regulated railway entity's balance sheet because it was issued by the parent company. Billions more of intercompany investments and receivables have been excluded because they

[8] CN August 20, 2021 Response at Page 2
[9] CN August 20, 2021 Response at Page 2.
[10] CN August 20, 2021 Response at Page 3.

do not impact Canadian railway operations. CP has continued to report debt for Canadian rail operations, even when that debt has been refinanced using proceeds of a general-purpose debt. CP has adhered to the requirements of the UCA. Therefore, in the context of general purpose activities, the Agency must consider all aspects of the regulatory capital structure, rather than solely considering debt.

CN points to the standard statements that are noted regarding the debt issuances of corporations in North America to argue that these imply that the company has no particular purpose in mind when it issues debt, so a debenture cannot be linked to a specific asset or activity. CP disagrees with this statement. Railway companies do not normally identify specific uses for a debenture in its public disclosures. In some circumstances it is inappropriate for a company to limit the use of its debt issuance in such a way. One important reason for this is that it is often difficult, if not impossible, to prove that the funds raised were specifically directed toward the stated project, as CN itself has pointed out. CN's argument here stands in contrast to its own position regarding its US debt, and it stands in contrast to the Agency's methods, as we have noted above.

The establishment of a regulated railway entity requires the consolidated railway company to make notional allocations of all assets, liabilities and equity that are recorded in its general ledger in order to generate a ledger specifically for the regulated entity. These allocations must be made as stipulated by the rules laid out under the UCA. Without such allocations, there would be no regulated railway entity to discuss. When it comes to allocations, there often are no absolutes. For example, many assets are used by both U.S. and Canadian rail operations. Some activities support rail operations, but are not themselves involved in rail movements.

d) Gould Report

In his report, attached to the submission of McMillan and other stakeholders (the McMillan August 20, 2021 submission), Dr. Gould fails to address that what the CTA needs to determine is a fair return or cost of capital for every $1 of capital invested in the regulated railway.[11] If the underlying risk of the asset has not changed, then the cost of capital should not materially change with a change in the capital structure.

On page 8 of his report, Dr. Gould presents three alternative capital structures wherein the weighted average cost of capital decreases as a company increases its financial leverage. These examples neglect the fact that the cost of equity and debt will not remain the same as the capital structure changes. Dr. Gould himself recognizes this principle:

> 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

[11] The Brattle Group August 20, 2021 Consultation Regarding the Methodology to Determine the Net Railway Investment and Capital Structure for the Calculation of Cost of Capital Rates, at Page 9 at para 16

of equity capital in this range would be so small that a single rate can be used with a negligible error.[12]

However, Dr. Gould's examples do not present a "narrow" range of capital structure. Between example A and example C, the ratio of Total Liability-to-Equity changes from 1.2 to 1.9, a greater than 50% increase. The Debt-to-EBIT ratio changes from 4.3 to 6.2, a greater than 40% increase. As well, the interest coverage ratio (EBIT divided by interest expense) changes from 4.7 to 3.2, a decrease greater than 30%. All of these ratios point to capital structure that is increasing its leverage materially and therefore would require a higher cost of equity.

The Gould report example is simply not relevant and is misleading with respect to CP's situation. In CP's case, the 2020 interim method determined CP's Total Liabilities-to-Equity ratio for the regulated railway entity was 6.7:1[13], while in that same year this ratio was approximately 2.2:1[14] for the CP Rail consolidated corporation. In this scenario, the interim method results in a Total Liabilities-to-Equity ratio three times greater than the consolidated corporation. This reduction in CP's regulatory equity under the CTA's 2020 interim method is significant by any standard. A market-based cost of equity would increase dramatically under such a change in financial leverage.

CP would also like to highlight that there are several flaws with how Dr. Gould has presented the WACC for three alternative capital structures:

- Dr. Gould has presented the WACC for all three capital structures after tax, but under the current methodology the Agency would normally present the cost of equity and cost of capital before tax; and
- the WACC assigns a cost of 0% to current liabilities, but under the current methodology the Agency would adjust the capital structure for working capital.

This demonstrates that the example is overly simplistic, misleading and irrelevant.

As well, Dr. Gould points to the Agency's determination in LET-R-29-2020 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"[15]. CP notes that the Federal Court of Appeal set aside this decision and that this is the issue the Agency is currently considering in this consultation. Further, in obiter, the Court noted specific concerns with the Agency's decision to include share buyback related debt in the capital structure of CP. [16]

---

[12] McMillan August 20, 2021 submission at Page 8.
[13] 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.
[14] 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.
[15] McMillan August 20, 2021 submission at Page 7.
[16] *Canadian Pacific v. Canada (Canadian Transportation Agency)*, 2021 FCA 69 at para 88.

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

a) Fair and Reasonable Results for All Railways

The Agency has stated that its “goal is to establish fair and reasonable rates of return on capital for federally-regulated railway companies”[17]. However, as CP has previously submitted, the 2020 interim method did not achieve this result. Again, the very fact that the resulting ratio of Total Liabilities to Equity for the CP regulated entity was three times higher than CP’s consolidated ratio, combined with the fact that CN’s regulatory ratio did not appear to change very much at all, illustrates this point.

In its Response, CN stated that“… 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.”[18] CN has several more similar statements in its Response that Agency should not “favour”, or give “preferential” treatment, to one railway over another.

CP agrees. There is no language in the Act that implies that the cost of capital exercise should show favoritism of one railway over another. Therefore, if the Agency determines that it will allocate general purpose activities to the regulated rail entity’s balance sheet, the accounting adjustments and methodology should be done in a way that also does not provide an advantage or benefit to one railway over another. Therefore, due to the historical differences between CP and CN, such accounting adjustments would necessarily need to be done in a different way for each railway.

CN concluded its response to question 2 by stating that “… CN sees no reason nor justification, neither in the legislation nor in economics, to treat general-purpose debt differently between railway companies.”[19]

CN appears to argue that the Agency must treat both railways exactly the same when it comes to general purpose debt. However, CN then argued that the Agency should apply different treatments between CN and CP in other theatres.

For example, at pages 8 and 9 of its Reply, CN reiterated its argument that its BC Rail debt should be treated on a fair market value basis, and using the imputed interest rate. The Agency’s standard method is to require the book value of debt combined with the nominal interest rate. CP does not take a position on CN’s BC Rail debt.

Similarly, CN points to the different strategies that CN and CP apply to their commercial paper portfolio. It uses this difference to argue that CN should be allowed to apply different accounting treatment for the purposes of the regulatory cost of capital. Presumably this will be of benefit to CN’s cost of capital

---

[17] Decision 425-R-2011, para. 14
[18] CN August 20, 2021 Response, at Page 4.
[19] CN August 20, 2021 Response, at Page 4.

since, as it stated that "[t]his would eliminate the problem of negative working capital explained above."[20]

Again, CN feels that its situation is unique, and should require a treatment different than that applied to CP. CP notes that CN is asking the Agency to consider certain characteristics regarding these issues that require an application that is different from that applied to CP. CN's arguments on these points affirm CP's position in this consultation, that it is sometimes necessary to consider different mechanical treatments for both railways in order to achieve a fair and reasonable outcome.

CP further notes that the Agency has a history of applying different mechanical treatments to both railways. For example, as CN points out on pages 11 and 12 of its Reply, the Agency has not permitted CN to classify certain debt issuances as non-rail debt, when it has used that debt to re-finance existing U.S. debt "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."[21] On the other hand, the Agency has required CP to continue to recognize a rail-related debt although it had been refinanced using a portion of the proceeds from a predominantly non-rail debt. Again, a different treatment was applied for each railway, depending on the circumstances.

As well, the Agency has used various methodologies as required to provide fair and reasonable outcomes, rather than adhering to rigid mechanics. An example of this is that the Agency has previously used the financial information of another railway (namely CP) to determine the cost of equity for CN. This was done at a time when CN did not have complete public market information due to its corporate structure.[22]

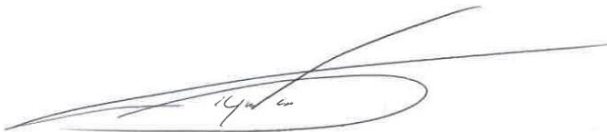
---

[20] CN August 20, 2021 Response, at Page 10.
[21] CN August 20, 2021 Response, at Page 11.
[22] CTA Determination 125-R-1997, at Issue 1.

Regardless of the mechanical procedure the Agency used for the interim method, the results were dramatically different for the two railways, and did not represent a simple alignment of capital structure to reflect wider corporate activities. In CP's view, its regulatory capital structure did not make sense after these adjustments were made. CP is not aware of what changes were made to CN's regulated railway entity; however, it appeared that CN's capital structure did not change significantly. CP's position is that a methodology that leads to a favorable, and objectively reasonable (we presume, since CN's figures are not published) capital structure for one railway, and an unrealistic and severely detrimental capital structure for another, does not represent fair and reasonable treatment. In order to assess whether a policy or method is fair and reasonable it is necessary to examine the outcome, and not just the mechanics of how it is applied.

CP is not requesting preferential treatment through this consultation process. If the Agency determines it will allocate general purpose activities to the regulated railway entities balance sheets, then it should be done in a way that results in fair and reasonable outcomes for both railways.

Yours truly,



Tyme Wittebrood
Director, Regulatory Finance
CANADIAN PACIFIC