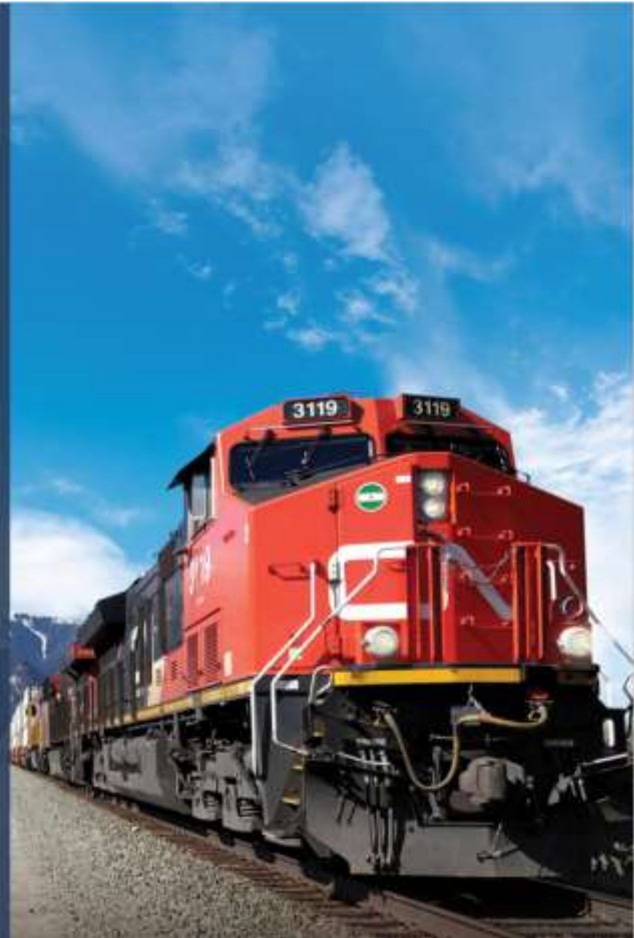
Consultation on General Purpose Debt

CN's Response to Initial Stakeholders' Submissions

Canadian Transportation Agency

09 September 2021



Canadian National Railway Company's Response to the Initial Submissions of Stakeholders Pursuant 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 initial submissions of stakeholders concerning the questions and issues raised in the **Consultation on General Purpose Debt**[1] dated June 21, 2021, and the ensuing **Discussion Paper: Whether General Purpose Debt Should Be Included in the Calculation of Cost of Capital Rates**[2]. After the general introductory remarks, we will offer our comments on each of the stakeholder's submission, highlighting the points with which CN agrees or disagrees, and offering our rationale as to why.

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1 Introductory Remarks

1.1 The Common Thread and Emerging Consensus

There is only one common thread through all the different submissions, and it is aligned with CN's proposal to use the cost of capital (CoC) of the consolidated railway company, which is the only entity that raises capital on both the equity and debt markets, rather than try to devise a CoC for only the Canadian rail division. There is a general agreement that the current attempt from the part of the Agency leads to more disagreements without reflecting the actual CoC.

In its 25 November 2020 submission[3] to the first round of Agency's "**Consultation on Cost of Capital Rates**", we stated:

> *The cost of capital should be that of the consolidated corporation, and not one of its operating divisions, just like the cost of equity and the cost of debt (both of which are components of COC) are those of the consolidated corporation.*
>
> *...*
>
> *There is only one entity that issues equity on the market, and that is the consolidated corporation, not the Canadian nor the U.S. operations. Similarly, there is only one entity that issues debt instruments on the market, and that is again the consolidated corporation. Therefore, there is only one cost of capital and that is for the consolidated corporation, and that unique cost of capital should then be the same for both Canadian and U.S. operations.*

In its 20 August 2021 submission[4] to this current "General Purpose Debt" consultation, CN repeated:

> *it would be much more consistent to consider the same consolidated corporation in which investors and lenders invest, and not the UCA[5] sub-part.*

[1] https://otc-cta.gc.ca/eng/consultation/consultation-general-purpose-debt

[2] https://otc-cta.gc.ca/eng/discussion-paper-general-purpose-debt

[3] https://otc-cta.gc.ca/sites/default/files/consultations/2020-coc-cn.pdf

[4] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_cn.pdf

[5] UCA is the Uniform Classification of Accounts issued by the Agency and its predecessors. It is used by railways for regulatory accounting and reporting, but not by financial markets who depend on audited financial statements prepared according to the Generally Accepted Accounting Principles (GAAP or US GAAP).

CN is pleased to note that **all** stakeholder submissions agree that the CN proposal that the cost of capital should be that of the **consolidated** corporation is a workable solution.

- **CP:**
  While presenting it as one of three alternatives (more on the other two with our critique later), CP states[6]:

  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.

  And

  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 two.

- **The Brattle Group:**
  The Brattle report[7] also argues that the CoC of the regulated operations ought to be similar to the CoC of the consolidated company:

  *i. **Comparable asset risks should be allowed to earn comparable returns**. To the extent that CP's regulated operations are comparable to its consolidated operations and/or to CN's regulated operations, it should be allowed to earn a comparable cost of capital allowance.*

  ...

  To the extent that CP's regulated operations are similar to CP's overall operations, the cost of capital allowance (rate) should be comparable to the WACC of consolidated CP;

  ...

  A direct consequence for the present consultation is that if the average risk of the parent company's operations (CN or CP) are comparable to the risks of their regulated assets, then the properly computed cost of capital allowance for the regulated assets should be roughly comparable to the WACC of the parent company.

[6] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_canadian_pacific.pdf
[7] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_the_brattle_group.pdf

- **Statement of Dr. Michael W. Tretheway:**
  Finally, from the Tretheway report[8]:

  > *Second, the Agency could have utilized the capital structure of CPRL[9] when determining the CoC of CPR-Canada[10]. Adjustments would need to be made but the capital structure of CPRL is more reflective of the debt to equity ratio of CPRC's Canadian railway operations than the arbitrarily deemed financial structure of CPR-Canada action of the Agency.*

If the CoC calculation for the regulated Canadian rail operations were to use the capital structure of the parent consolidated corporation, it follows that the CoC of the regulated entity will be the same, or very similar with minor adjustments, as the CoC of the consolidated company.

There is no disagreement, nor any problematic issue raised by any of the stakeholders to object to the use of the consolidated corporation CoC. Quite the contrary, all agree that this would be an acceptable, even desirable solution to the current Agency's CoC determinations.

1.2 The Market Has Spoken

As noted in CN's 25 November 2020 submission[11],

> *Numerous financial institutions estimate and publish the cost of capital of CN and CP, as well as the other North American Class I's. We note that adopting the consolidated approach would allow benchmarking of the Agency's COC against the COC as determined by investment professionals at financial institutions who are active in the markets where the railways actually raise funds.*

i. In that same submission, CN provided a table from Morgan Stanley showing the 7 January 2019 CoC estimates for all North American Class I railways. The CoC of CP and CN were estimated at 6.9% and 6.7%, respectively, and in line with all other Class I railways operating in the same North American capital market. The ratio of CP to CN CoC, based on the Morgan Stanley estimates, was 103%[12].

ii. In the same year, in April 2019, Agency Letter Decision No. LET-R-40-2019 and LET-R-41-2019 estimated that CP and CN CoC were 7.55% and 5.04%, respectively, resulting in a CP to CN CoC ratio of 150%[13], in a striking contradiction of commercial market estimates, and notwithstanding the Agency's own assessment a month earlier in March 2019 in Letter Decision No. LET-R-33-2019[14]:

> *The Agency finds that CN's contention regarding the overstatement of debt is likely true.*

[8] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_tretheway_statement.pdf
[9] Canadian Pacific Railways Ltd (CPRL) is the parent publicly traded consolidated company
[10] CPR-Canada is the regulated Canadian railway operations of Canadian Pacific Railway Company (CPRC), a wholly owned subsidiary of CPRL
[11] https://otc-cta.gc.ca/sites/default/files/consultations/2020-coc-cn.pdf
[12] (6.9 / 6.7) X 100 = 103%
[13] (7.55 / 5.04) X 100 = 150%
[14] https://otc-cta.gc.ca/eng/ruling/let-r-33-2019

iii. Applying the interim methodology equally to both CP and CN, Agency Letter Decision No. LET-R-29-2020 and LET-R-30-2020 estimated that CP and CN's CoC were 4.79% and 5.19%, respectively, resulting in a CP to CN CoC ratio of 92%[15], the closest to market estimates of previous Agency determinations.

iv. CN checked the FactSet[16] financial data provider on 27 November 2020 which pegged this ratio at 109%.

v. Following the Federal Court of Appeal judgment (2021 FCA 69), the Agency revised the CP CoC to 7.42% (LET-R-33-2021) and brought this ratio back higher to 143%[17].

vi. Agency Letter Decision No. LET-R-34-2021 and LET-R-35-2021 estimated that CP and CN CoC were 5.57% and 4.33%, respectively, with a CP to CN ratio of 129%[18], again in contradiction with market estimates.

vii. Finally, the Tretheway report[19] in this consultation quotes that same ratio from the Bloomberg Terminal on 20 August 2021 at 107%.

Table 1 summarizes these results and shows Agency determinations compared to commercial market estimates. While CP may protest that 92% is slightly below market expectations, it is yet the closest to market estimates. CN strongly objects to findings of CP to CN CoC ratios of 150%, 143% and 129%, as per CoC rates from Agency determinations, as they are way out of line with market estimates.

Date	January 2019	April 2019	April 2020	November 2020	April 2021	April 2021	August 2021
Crop-Year	-	2019-2020	2020-2021	-	2020-2021	2021-2022	-
CoC Ratio	103%	150%	92%	109%	143%	129%	107%

Table 1 - CP to CN CoC ratio from market sources compared to Agency determinations

If Agency decisions must be commercially fair and reasonable to the shippers as well as to the railway companies, then Agency determinations must be similar to what is observable in the real commercial market.

The market has spoken and determined that CP and CN have similar CoC, while CP CoC might be only slightly higher because maybe CP is a smaller and more leveraged (and therefore riskier) company than CN. However, the difference is nowhere near what the Agency finds when it applies its different treatment to CP than to CN.

[15] (4.79 / 5.19) X 100 = 92%
[16] https://www.factset.com/
[17] (7.42 / 5.19) X 100 = 143%
[18] (5.57 / 4.33) X 100 = 129%
[19] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_tretheway_statement.pdf

To reiterate from our 25 November 2020 submission:

> *Surely, different analysts use different methods and arrive at different results, but it is hardly expected that two similarly successful railways, competing in the same markets for both traffic and capital, would exhibit the significant difference in COC arrived at by the Agency methods. Such discrepancy in COC results is not only putting into question the credibility of the method used but can also be misleading if investors were to rely on them to make informed decisions. Most importantly, such discrepancies translate into millions of dollars when the Agency applies these COC in determining the Volume Related Composite Price Indices for MRE purposes. The large variations between CN and CP's COC provide different grain revenue opportunities to each railway company which are otherwise competing in the same market. This exercise should not lead to the large variations between CN and CP that were witnessed in previous years and that led to a distortion in the position of each railway in the market.*

The Western Grain Elevator Association (WGEA), in its letter of support to the McMillan report[20] in this consultation, estimates that this differential treatment allowed CP to extract an additional $30 million dollars from its member companies within the months of May, June and July 2021. From CN's perspective, this provides an unfair competitive advantage to CP as these additional $30 million dollars (per crop year) enhance CP's abilities to buy more railcars and locomotives, hire more crews, and improve its service, all because of a flaw in the Agency's methodology of determining the CoC of railways.

If competition and market forces are to be the prime agents in providing viable and effective transportation services as declared in the National Transportation Policy of the Canada Transportation Act (section 5), then the Agency must level the playing field by having an equitable treatment of both railways, and ensure that the results of its methodologies are in agreement with commercial realities readily observable in the market. The current advantage CP derives cannot be maintained.

[20] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_mcmillan.pdf

1.3 The CoC Distortions Introduced by the Agency's Methods

The Brattle report[21] has an excellent graph, Figure 9 in the report and reproduced below as *Figure 1* in this submission, that illustrates very well:

(a) the wrong treatment of allocating too much debt to CP's regulatory balance sheet (RBS) without doing other adjustments, which leads to a lower than warranted CP CoC.

(b) the <u>same</u> wrong treatment applied to CN's RBS, that led CN to question the Agency's treatment starting in 2017, and that led to this series of consultations on CoC, which also resulted in a lower than warranted CoC for CN.

(c) the wrong treatment of allocating too little debt to CP's RBS, and which leads to a <u>higher</u> than warranted CoC for CP, with the ratios CP to CN CoC of 150%, 143%, and 129% documented above.

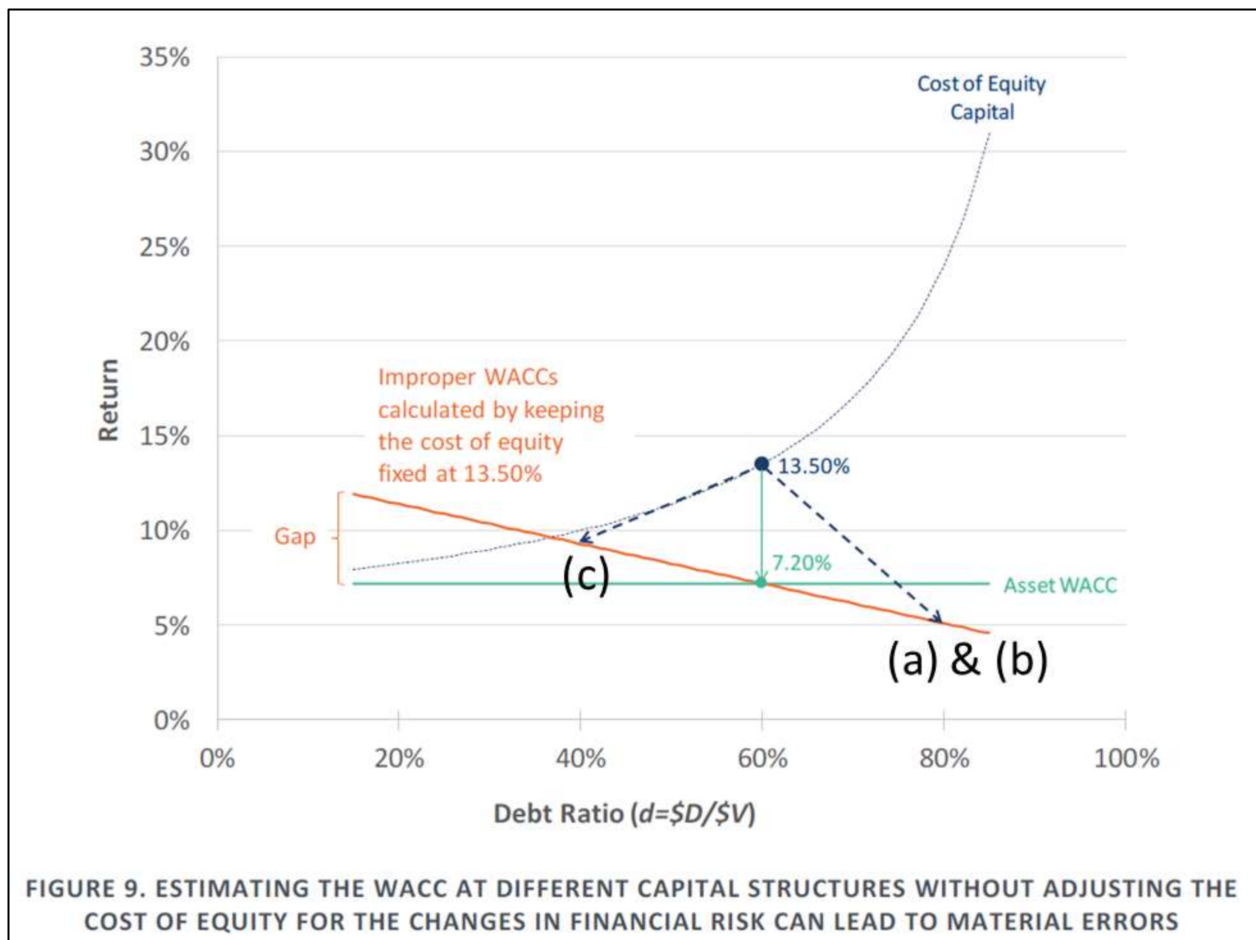

Figure 1 - Brattle report figure illustrating CoC distortions by the Agency's methods

[21] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_the_brattle_group.pdf

To illustrate our point about the Agency treatments above, we will use the same 2018 data already submitted to the Agency during the Consultation on Cost of Capital Rates on 29 January 2021[22], concerning the Agency's 2019 CoC determination, keeping in mind that similar conclusions can be drawn from more recent similar figures.

From the publicly available audited annual financial statements, the leverage of both publicly traded railways on a consolidated basis is shown in *Table 2*.

2018 Audited Annual Report	CP	CN
Total long-term debt (LTD)	$ 8,696 M	$ 12,569 M
Shareholders' equity (SHE)	$ 6,636 M	$ 17,641 M
Leverage (LTD/SHE)	131%	71%

Table 2 – 2018 Consolidated Leverage of CN and CP

Yet in its Decision No. LET-R-40-2019 and LET-R-41-2019, the Agency determined that the railways' 2018 leverage on their respective RBS was as shown in *Table 3*.

Agency Decision No. LET-R-40-2019 & LET-R-41-2019	CP	CN
RBS Leverage (LTD/SHE)	50%	219%

Table 3 – 2018 RBS Leverage of CN and CP

In addition to the fact that a leverage of 219% for CN is simply not credible for a corporation that maintains a top credit rating, it is this flaw in Agency methodology that increased CN leverage from 71% to 219%, illustrated as in the direction of (b) in Figure 1, and reduced CP leverage from 131% to 50%, illustrated as in the direction of (c) also in Figure 1, and that led the Agency to determine in 2019 that CP's CoC was 7.55% whereas that of CN was 5.04%, contrary to what would be expected from the railways public financial statements.

This discrepancy is largely due to the improper allocation of debt to Canadian rail operations, for both CP and CN, which leads to this vastly different leverage for both railways on their Canadian-only regulatory balance sheet (RBS), compared to their consolidated statements.

To avoid these kinds of distortions and estimate a CoC that is close to what commercial capital markets expect, the CoC should be evaluated at the consolidated company level. All stakeholders agree that the CoC of the regulated Canadian rail operations should be close to the CoC of the consolidated company.

1.4 Doing Technical Things Right vs. Doing the Right Thing

All the stakeholder submissions, including CN's, focused so far on technical points of accounting, economics and finance. CN would like to draw the Agency's attention on the higher principle of doing things right, rather than just doing the technically right thing.

[22] https://otc-cta.gc.ca/sites/default/files/consultations/2020-ccc-cnresponse-to-cp.pdf

Maximum Revenue Entitlement (MRE) provisions were introduced in 2000. The CP parent company, CPRL, was incorporated in 2001, i.e. after the MRE. If the Agency accepts that treasury functions of the CP parent company, organized after MRE was introduced, are independent of CP rail operations - which many stakeholders argue to be a technically correct point; then technically, this means that the Agency would also have to accept that if CN were now to adopt a similar corporate structure and disengage its treasury function from rail operations, then the Agency would have to increase CN's CoC. While this could be technically correct, the benefit for rail shippers would be none.

To the experts, this may appear as a technical argument of accounting, economics or finance, but it is common sense that there is no change in practice whether regulated Canadian rail operations are part of the company being traded on the stock exchange or whether they are part of a wholly owned subsidiary of the publicly traded company - **especially when the publicly traded company has no operations other than rail operations, as is the case for CP.**

Investors and the market are not oblivious and are not easily fooled by corporate structures. In fact, CoC exist specifically to look beyond corporate veil and focus on the financial performance. If the parent company were to dissolve and divest itself of its railways operations by handing them over to its own investors, the value of rail operations, together with their cost of equity and of debt, would most likely stay the same as those of the parent company prior to the dissolution; since the latter has no other business than rail transportation. For all intents and purposes, the market would treat the parent and subsidiary the same way when assessing their CoC. There is therefore no basis for the Agency to decide to treat them differently.

The world is rife with corporations that are legally and technically correct from an accounting point of view but nonetheless raise public indignation, like corporations setting up subsidiaries in tax havens to avoid taxes, or web giants raking in billions of revenues in countries where they pay little to no taxes. By disadvantaging railway companies that have a simple corporate structure, the Agency is essentially encouraging the adoption of more complex corporate structures for the purposes of changing their cost of capital.

2 CP's Submission

The following are CN comments on some of the major points raised by CP.

2.1 Confidential Bilateral Discussions

> *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.*

CN strongly disagrees that regulatory filings and determinations be decided following confidential (i.e. secret) discussions or negotiations. This is what led to the large discrepancies between the CoC of the railway companies because it was not clear how the debt flowed from the consolidated entity to the regulated entity.

The lack of transparency and communication is decried by CP when it was neither consulted nor informed of the 2009 Agency decision concerning the treatment of debts for shares buy-backs. The McMillan report[23] in this consultation also laments the lack of information to the other stakeholders. It would be inadvisable to add another layer or shroud of secrecy by introducing confidential discussions on adjustments for the purpose of perpetuating, in the meantime, the discrepancy between both railways' CoC.

The debt schedule of each consolidated company is publicly available in their audited annual financial statements, together with their balance sheet. If the Agency decides not to use CN's preferred solution of determining the CoC on a consolidated basis, which is also an accepted solution to all other stakeholders, then the rules about which debts to allocate or not to the RBS should be clear, fair and transparent to all, not the result of confidential bilateral discussions.

2.2 Share Buy-Back Debt

> *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.*

CP's treasury function serves no other business than the rail business. The separation between treasury and rail operations is an unnecessary artifice. CN sees no reason nor logic to justify the "Therefore" in the above sentence. The conclusion does not follow logically from the premise.

If it holds for CP, then one could argue that it should also hold for CN. Share buy-backs at CN are the responsibility of CN's treasury department, not CN's Canadian rail operations. If the fact that both departments are part of the same corporation poses a problem, a corporate re-organization and re-structuring can solve this technicality, but for what purpose? How would that be the right thing to do when considering the purpose of the CoC determination?

2.3 Cost of Equity of the Regulatory Balance Sheet

> *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.*

The RBS has no equity being traded on the market. Therefore, the cost of equity of shares traded on the market is that of the consolidated company and does not apply to the shares of the Canadian rail division.

Shares of the Canadian rail division (representing the UCA shareholder equity) do not trade on any market. Moreover, considering the economic theory that the cost of capital is an opportunity cost, the parent company is not considering whether to divest from rail operations and invest the money in another business. Essentially, the parent company has accepted an opportunity cost of zero, since it will continue to hold on to shares of its railway subsidiary no matter its returns. Taken to its extreme, the

[23] https://otc-cta.gc.ca/sites/default/files/consultations/2021_gpd_mcmillan.pdf

argument here would be that for the Canadian rail operations as a totally different entity from the parent company, the cost of equity would be zero. The Canadian rail operations does not have to pay a dividend nor show any appreciation of its shares for the parent company to continue holding these shares or to advance more capital.

The extreme separation of Canadian rail operations from the parent company is unrealistic because they cannot be totally separated.

2.4 The Purpose of Debt

Many of the CP arguments center around the notion of whether the debt was issued for Canadian rail operations, U.S. rail operations, share buy-backs, or non-rail operations (without any definitions or examples of what these might be other than they are none of the previous three).

The big problem is that debts are seldom issued for only one purpose. There is no debt contract that says that the proceeds will be used for only one purpose. All debt contracts specify that proceeds will be used, among other things, for corporate general purposes. As explained in CN's submission, other than in years with large acquisitions, cash generated from railway operations dwarfs the amounts of net debt issues. It is very difficult to "prove" that proceeds from one debt issue was used exclusively for only one purpose. Even more so that cash is, by definition, fungible.

Since CP arguments hinge on the fact that debt was issued for a particular purpose, especially share buy-backs, and it is very difficult to prove that fact and identify debts issued solely for that purpose, the arguments should not be accepted.

2.5 Equitable Treatment of Railways

> *CP submits that the definition of general purpose debt, and more generally the definition of all general purpose activities, <u>should be the same</u> for CP and CN. In addition, how much of the identified general purpose activities are added or allocated to the regulated balance sheet <u>should be treated the same</u> for all railway companies. [Emphasis added]*
>
> *However, the Agency <u>must apply different methodologies</u> if it chooses to adjust the capital structures of CP and CN, respectively, in consideration of these general purpose activities. [Emphasis added]*

CN agrees that CP and CN should be treated the same. However, it does not agree with the second part of the statement advocating for different methodologies (that CP did not specify). CN's view is that the different corporate structure is an unnecessary artifice that brings no change neither in railways operations, nor service to shippers, nor to capital markets access, nor credit rating nor financing costs. To level the playing field and remain a neutral regulator, the Agency should apply the same equitable treatment to both railways, regardless of corporate structure differences.

2.6 Reporting UCA Entities

> *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.*

CN does not issue its regulated UCA balance sheet at the parent company level. The parent company has substantial U.S. operations and other non-rail subsidiaries not subject to UCA reporting. Much like CP, CN reports at the level of the regulated railway entity. The only difference between the two railways is that the CN regulated railway entity is a sub-part of the publicly traded CN company, whereas the CP regulated railway entity is a sub-part of a wholly-owned subsidiary of the publicly traded CP company. It is CN's firm belief that this artifice in corporate structure does not warrant any difference in treatment.

2.7 Use the CoC of the Consolidated Firm

> *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.*

CN entirely agrees with this statement. This has been CN's position since the beginning and on previous consultations on CoC - there is no reason that the CoC of any of the rail operating divisions be any different than the CoC of the consolidated company, the vast majority of which business being rail business.

2.8 Other proposed alternatives

CP's alternative (ii) is to use the capital structure of the consolidated statements, which is clear, simple, and straightforward. Contrarily, alternatives (i) and (iii) entail complex and arbitrary manipulations of the balance sheet and introduce more discretionary and subjective adjustments.

2.8.1 (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.*

While CN understands the primary motivation of maintaining on the RBS a level of leverage similar to that of the consolidated company, it is difficult to decide which debt would go onto the RBS and which will not and why, the more so that debts are seldom issued as marked for one particular purpose.

Normally, in a simple corporation without the parent-subsidiary structure, when debts are issued, the assets of the company increase, first in cash then in properties as the cash is deployed. Assets (cash and properties) are balanced with liabilities (debt) and CN sees no reason to create another offsetting asset.

Furthermore, when debt proceeds are used to buy back shares, shareholder's equity is reduced, both paid up capital and retained earnings. This is the normal effect on the balance sheet of share buy backs. Again, CN sees no reason to introduce offsetting assets.

It is difficult to argue that, in CP's case, the share buy-backs of the parent company have no effect on the Canadian rail operations. After all, the effects of share buy-backs are reflected in the market returns measured by the Agency's CAPM method of estimating the cost of equity. If this cost of equity, including the boosting effect of share buy-backs, is used with the RBS then it follows logically that the equity on the RBS should also reflect the effect of share buy-backs. The problem now becomes not shielding totally the RBS equity from any reduction but deciding how much reduction in equity to allocate to the RBS and how much to the equity of other non-regulated (including U.S.) operations, a non-trivial problem.

Thus, several problems would arise:

(a) How much debt and which ones to allocate to the RBS?
(b) How much debt is already offset by assets (e.g. cash, railcars, track, etc.)?
(c) The remainder of the debt would be used to reduce shareholder's equity to reflect the effect of share buy-backs.
(d) How to ensure that the resulting capital structure is compatible with that of the consolidated company?

Notwithstanding the difficulty in deciding objectively on the first two questions above, i.e. to determine with certainty the use of debt proceeds, there is no need to arbitrarily create offsetting assets simply to balance the balance sheet. In addition of solving the problem of allocating debts, the Agency will have to solve the problem of how to allocate equity from the parent company to the wholly owned railway subsidiary, and to its Canadian rail operations.

CN sees no need for these further complications and their potential for introducing more complexity, errors and disagreements on CoC issues when a simpler solution, of using the CoC of the consolidated company, is readily available.

2.8.2 (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.

This third alternative entails the same subjective and arbitrary allocations of debt and equity discussed above. CN opposes the introduction of more complexities in this contentious issue of cost of capital determination. Allocation of debt has not yet been resolved even after CN has raised this question back in 2017. Allocation of equity would be even more complex as it is not as simply measured as debt.

Similar to our conclusion in 2.8.1 above, using the CoC of the consolidated company is a far superior and simpler solution.

3 The Brattle Group's Submission

3.1 Comparable Returns for CP and CN

> ***Comparable asset risks should be allowed to earn comparable returns.*** *To the extent that CP's regulated operations are comparable to its consolidated operations and/or to CN's regulated operations, it should be allowed to earn a comparable cost of capital allowance.*

CN agrees with the assessment that the CoC of CP and CN should be comparable.

However, looking at the CoC of recent Agency determinations, it is evident that the ultimate assessed CoC of CP and CN are not comparable:

CoC	CP	CN	Difference
Initial 2020-2021	4.79%	5.19%	-40 bps
Revised 2020-2021	7.42%	5.19%	223 bps
2019-2020	7.55%	5.04%	251 bps

Table 4 - CoC of recent Agency determinations

CN deplores the fact that while the Brattle report focuses on the first difference of -40 bps from the initial 2020-2021 CoC, it entirely ignores the revised 2021-2021 and 2019-2020 CoC rates that are more than five times larger in difference. If comparability of CoC rates is the criteria, then these latter two Agency determinations are troublesome. In fact, the initial 2020-2021 determination is the one that offers the most comparable CoC rates, rather than being an indication of divergence.

3.2 Financial Leverage

> *The methodology should produce a financially healthy capital structure as a standalone railway company.*

CN agrees that the leverage (level of debt relative to equity) of the RBS should be similar to that of the consolidated company, and not to that of a company in financial distress. As explained in section 1.3 above, and illustrated in Table 2 and Table 3, it is the Agency treatment by artificially inflating CN leverage and deflating CP leverage that led to the very large differences in their CoC of over 200 bps in Table 4.

In fact, the initial 2020-2021 CoC determination is the first time that the Agency applied to CP the same leverage treatment it has been applying to CN, even as it was acknowledging that it is probably too high in Letter Decision No. LET-R-33-2019[24]:

> *The Agency finds that CN's contention regarding the overstatement of debt is likely true.*

We sincerely hope that this consultation will lead to estimating the CoC on a consolidated basis, which is the preferred solution, or alternatively be mindful of a sensible RBS leverage for both CP and CN.

[24] https://otc-cta.gc.ca/eng/ruling/let-r-33-2019

3.3 Assets Risk, Capital Structure, and the Modigliani-Miller Theorem

The Brattle report eloquently demonstrates the theoretical foundations of cost of capital financial issues. The basic business risk of a company, that generates the rewards to investors, is the risk of assets and their operations. It is the same risk, irrespective of how the company is financed. The capital structure simply splits that risk differently between bondholders and shareholders, as clearly demonstrated in the Brattle report. Different debt/equity ratios will produce different returns to bondholders and shareholders, even though the underlying risk remains the same, and the weighted average of debt and equity returns also remains the same.

Business risk is not directly observable nor measurable. However, bondholder and shareholder returns, as measures of their assumed risk, are observable and measurable. Yet the return on equity and the return on debt that the Agency estimates are not those of the regulated Canadian rail operations but rather those of the consolidated company, reflecting the way asset risk was split between shareholders and bondholders given the capital structure of the consolidated company. If the capital structure were different, the return on equity and the return on debt would also be different even as their weighted average remains the same.

Since the underlying assets and business risk for railway operations are both the same for the consolidated company and the regulated Canadian rail operation, it follows that the cost of capital should also be the same for both. The Agency cannot take the cost of equity and cost of debt appropriate to the consolidated capital structure and apply them to a different capital structure of the regulated Canadian rail operations.

CN is in total agreement with the Brattle Group analysis and assessment, and stands by its recommendation to use the CoC of the consolidated company.

4 The Tretheway report

CN does not agree with Dr. Tretheway's opinion that CP and CN are different and should be treated differently. His position is expressed as follows:

> *1.6.4 The Agency emphasised that the activity (the share buy back transaction) was for the same company that operates the railway when it said*
>
> *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 [emphasis added in Tretheway report]*

CN disagrees with this interpretation as the Agency did not say that the company has to operate the railway, only that its primary business line is the railway business. In its 2020 Annual Report[25] to shareholders on page 28 CPRL states:

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

It is clear from CPRL'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. As such, CN finds that the Agency ruling applies to CPRL, whether it operates the rail directly itself or though a wholly owned subsidiary.

CN also disagrees with the opinion that the circumstances of the two operating railways, CPR-Canada and CNR-Canada, are not equivalent. The issues they face are very much the same issues related to their impact over the CoC.

CNR-Canada (the regulated Canadian railway operation of CNRC in Canada) does not issue shares nor debts. CNRC does. And CNRC buys back shares of CNRC, not of CNR-Canada. Yet the Agency puts the debt of CNRC on CNR-Canada's balance sheet.

CPR-Canada (the regulated Canadian railway operation of CPRC in Canada) does not issue shares nor debts, just like CNR-Canada. CPRL issues shares and CPRC issues debts, whereas CNRC issues both shares and debts. CPRL buys back shares of CPRL, the entity that issued the shares much like CNRC buying back its own shares. Neither CPRL nor CPRC buy back shares of CPR-Canada, much like CNRC does not buy shares of CNR-Canada. Yet the Agency puts the debt of CPRC on CPR-Canada's balance sheet, much like the Agency puts the debt of CNRC on CNR-Canada balance sheet.

The only difference between the two railways is that the CP regulated Canadian railway is twice removed from the publicly traded company, rather than being only once removed as for CN:

[CNRC] -- [CNR-Canada]

[CPRL] -- [CPRC] -- [CPR-Canada]

For both companies, the regulated railway is directly related to the entity emitting the debts.

The intermediate wholly owned subsidiary [CPRC] is a result of corporate structure paperwork that changes absolutely nothing in access to capital markets nor in determining cost of capital in the real commercial world. Therefore, the different corporate structure should be ignored for CoC considerations, and both railways should be treated equitably in the same manner.

[25] https://investor.cpr.ca/financials/default.aspx?section=annual

5 The McMillan Report

5.1 General Purpose Debt

Dr. Gould makes the same mistaken assumption as CP that one can unequivocally identify the purpose for which debt was raised, such as rail-related as opposed to general corporate purposes. CN repeats its assertion that it is only in exceptional circumstances that debt can be unequivocally identified to a particular purpose, such as a large acquisition. In the vast majority of times, debts are simply a source of cash which is by definition, fungible, and can be used for many different purposes.

5.2 Debt and the RBS

> *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.*

CN disagrees with this assessment. First, debt does not start on the RBS. Each debt starts on the consolidated balance sheet, that is the company that issues the debt. The consolidated balance sheet is the only place where we can see <u>all</u> debt. The regulated railway does not fund U.S. operations nor other non-rail operations. The consolidated company does. In the case of CP, technically it is CPRC (the rail company but <u>not</u> its regulated arm) that issues debts. It then loans the money to CPRL (the parent company) who then deploys the funds to U.S. and for other non-rail purposes. As stated earlier, this artifice in corporate structure has no bearing on capital market access, nor credit rating, nor cost of capital and the market considers CPRL and CPRC to be equivalent, one and the same.

Second, railways can seldom "prove" that the debt issued was for a particular purpose. The rare exceptions are large acquisitions or large government mandated investments in one jurisdiction but not another (e.g. Positive Train Control in the U.S.). Most of the time what railways have at best is circumstantial evidence. For example, buying $400M of locomotives in a U.S. subsidiary in a year where cash from rail operations exceeds $2,000M but the railway issued $500M of debt. Was the locomotive purchase made with the proceeds of debt or operations cashflow? It becomes a subjective interpretation question, surely the source of different opinions and yearly disputes between the railways and the Agency. A regulator should not base its decision on such subjective interpretations.

CN reaffirms its belief in the superiority of its recommended option to estimate the cost of capital on a consolidated basis where all debts are considered and none of the above subjective allocation to RBS is required.

5.3 Equitable Treatment of Railways

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

CN agrees and sees no reason nor any compelling argument to treat railways differently. Therefore, to be transparent and fair to railway companies, the Agency should treat them equitably in the same manner for cost of capital purposes.