

Reply to the Attention of François E.J. Tougas
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Date September 9, 2021

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

Canadian Transportation Agency
15 Eddy St
Gatineau, Québec
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***Re: Agency Consultation on General Purpose Debt:
Responses to Submissions of August 20, 2021***

In connection with the Agency’s Consultation on General Purpose Debt (the “**Consultation**”) announced on June 21, 2021, these are the responses of Teck Resources Limited and its affiliates Teck Coal Limited and Teck Metals Limited (collectively, “**Teck**”),¹ to the August 20, 2021 submissions of Canadian Pacific Railway (“**CP**”) Canadian National Railway (“**CN**”).² We refer collectively herein to the CP response and the submissions of the Brattle Group and Dr. Trethewey, appended to CP’s response, as the “**CP Submissions**”.³ We refer to the CN response as the “**CN Submissions**”.⁴

Defined terms in this response have the same meaning as those defined terms used in Teck’s initial August 19, 2021 submissions.⁵ For ease of reference, we refer herein to the Discussion Paper entitled “Discussion Paper: Whether General Purpose Debt Should Be Included in the Calculation of Cost of Capital Rates” (“**Discussion Paper**”).⁶

We refer to the report of Dr. Lawrence Gould, attached at Schedule A (the “**Gould Report (September 9, 2021)**”). Due to the shortness of time permitted under the process established for this Consultation, Dr. Gould has limited his report to answering CP’s and CN’s points raised by the Agency in this Consultation, not points on which the Agency has previously consulted or points repeated by CP or CN elsewhere that are not strictly raised by the Agency in this Consultation.

¹ Supported by the Western Grain Elevator Association and the Canadian Canola Growers Association.

² Available at: <https://otc-cta.gc.ca/eng/consultation/consultation-general-purpose-debt>

³ *Ibid.*

⁴ *Ibid.*

⁵ *Ibid.*

⁶ Available at: <https://otc-cta.gc.ca/eng/discussion-paper-general-purpose-debt>

One repeated area of concern for stakeholders other than CP and CN is the disadvantage at which these stakeholders find themselves in Agency's consultations. We do not raise all of the points we have raised in prior consultations, and the arguments in support of those points, here. However, three points are worth a brief mention:

First, CP or CN or both sought and obtained an extension to the deadline for initial submissions in this Consultation. Non-carrier stakeholders can only respond to the information provided, either by the Agency or by the carriers, which was scant in this case. Practically, we could not begin our submissions until we received CP's and CN's initial submissions. Further, the inclusion of irrelevant considerations, not raised by the Agency, is a particular affront.

Second, related to the first, the deadline for responses was rather short, given the lengthy initial submissions, especially of CP, but also of CN. Fairness might have dictated a response period at least as long as the period between the Agency's announcement of the Consultation and the date initial submissions were due. Looking at CP's materials, it is obvious that their large team used the extra time to beef up, add to and refine the submissions they might have made had they not received a further extension.

Third, lack of transparency and information asymmetry denies shippers the opportunity to respond in a fulsome manner. While this is largely a legislative problem, we raise it here to highlight the need for a more balanced consultation process. CP and CN already use this lack of transparency and information asymmetry as a means of creating, maintaining and enhancing their market power in their unilateral ability to set freight rates and conditions of service. We submit that the Agency should make every effort to account for this disequilibrium between the parties in its consultative processes, including by maximizing information disclosure and by allowing sufficient time to address the voluminous materials filed by CP and CN.

At the risk of overshadowing our other submissions, we draw special attention to the distinction that CP makes between the business of Canadian Pacific Railway Company, incorporated in 1886, from the more recently formed Canadian Pacific Railway Limited, to which we refer herein, where necessary, as **CPRC** and **CPRL**, respectively. Our submissions address that distinction as well as other points raised by CP and CN in their submissions.

1. Purposes and uses of Agency Cost Determinations and Cost of Capital Determinations: *The Agency determines CP's and CN's costs and their respective costs of capital for three purposes: to determine the VRCPI for the subsequent calculation of the MRE; to calculate and set interswitching rates; and for other regulatory purposes.*

- 1.1. In their submissions, CP and CN both fail to acknowledge that cost of capital is used for many purposes other than the determination of the VRCPI and the setting of interswitching rates. Both CP and CN have been at pains to pretend there are no such purposes, much to the dismay of shippers and other stakeholders who rely on the Agency to collect reliable, transparent and unfiltered data and information as inputs to the Agency's Regulatory Costing Model for these purposes, including in final offer arbitration ("FOA") and other purposes.
- 1.2. To the extent that CP and CN oppose arbitrator requests to seek railway variable cost determinations from the Agency in FOA proceedings, as the only body with the regulatory mandate to do so, they up-end the scheme of the Act. Claims that cost determinations have no purposes other than the VRCPI and interswitching are invalid and also diminish the role of regulation to address the many uses of, and efforts to maintain, railway market power. Not that the Agency needs reminding, but for the sake of rail users that rely on the Agency's mandate in connection with cost determinations and cost of capital determinations, costing has a regulatory purpose. The Agency has stated in no uncertain terms in Decision No. 425-R-2011 that, among other things:

[13] A cost of capital rate is also calculated for regulatory purposes other than the transportation of western grain and interswitching. This cost of capital rate is one of the major inputs for the estimate of unit costs of railway activities and intermediate processes which, in turn, are used to determine the cost of a railway movement or service. The regulatory purposes that require such cost determinations include, among others, rate determinations for access and other rail services to be paid by a rail passenger service provider that uses the rail network, facilities and services of another railway company; the rate to be paid for running rights on another railway company's network; the establishment of competitive line rates and joint tariffs; cost apportionments for the maintenance and construction of road crossings; service and noise disputes where cost is a factor; and, provision of technical costing assistance to arbitrators in final offer arbitration (FOA) proceedings between a shipper and a carrier.⁷

- 1.3. Further to that Decision, the Agency pointed out that it makes three separate cost of capital determinations each year, as set out in Appendix A thereto, the relevant portions of which are set out below:

[2] For CN and CP, the Agency will make three separate cost of capital determinations annually:

⁷ <https://www.otc-cta.gc.ca/eng/ruling/425-r-2011>

1. Cost of capital rate for the transportation of western grain, to be used in the composite price index calculation under subsection 151(1) of the *Canada Transportation Act*;
2. Cost of capital rate for the development of interswitching costs and rates; and,
3. Cost of capital rate to be used for regulatory purposes other than for calculating the western grain composite price index and establishing regulated interswitching rates.⁸

1.4. The purposes for which the Agency engages in costing and cost of capital determinations, as articulated above, arise in this narrower Consultation. The regulatory scheme of the Act is designed to limit the extent to which CP and CN may exercise market power. To the extent they diminish this regulatory scheme, CP and CN necessarily harm freight rail users. The Agency may make judgement calls following on this Consultation; given the lack of competition for freight rail services, there should be no doubt that the Agency's purpose is to regulate CP and CN consistent with the objectives of the Act whereby

“... ”

(b) regulation and strategic public intervention are used to achieve economic, safety, security, environmental or social outcomes that cannot be achieved satisfactorily by competition and market forces.”⁹

2. Costing Determinations and Cost of Capital – *CP is bound by the costing determinations of the Agency, including with respect to cost of capital, and it does not matter whether CPRC or CPRL incurs a cost. Similarly, CN is bound and it does not matter when the cost was incurred. Lastly, CN and CP are bound irrespective of the manner in which they incur costs.*

2.1. The Agency has sole authority to calculate the cost of capital for the regulatory purposes described above (see Schedule B of these submissions for excerpt from section 157 of the Act). That authority is broad and flexible, and applies in particular to CP and CN.

2.2. By subsection 157(5) of the Act, CPRC and CN are required to provide the Agency data and information “required for the determination of costs by the Agency”, including with respect to cost of capital, which must be provided “in the form and manner specified by the Agency”. The Act does not obligate the Agency to issue regulations in order to require

⁸ <https://otc-cta.gc.ca/eng/appendix-a-decision-no-425-r-2011>

⁹ Section 5 of the Act.

CPRC and CN to provide such data and information; the Agency need only “specify” its requirements and has broad discretion in setting those requirements.

2.3. Section 157 of the Act grants the Agency a very broad discretion in determining costs, including with respect to cost of capital, *whether based on considerations the Agency prescribes by regulation pursuant to subsection 157(1) or based on other considerations pursuant to subsection 157(2)*. Further, the Agency’s cost determinations are final and binding pursuant to subsection 157(4).

2.4. The Railway Costing Regulations, which are contemplated by subsection 157(1), do not address the finer issues arising in this Consultation. Even on a narrow reading of its authority, subsection 157(2) requires the Agency to consider both the 1959 MacPherson Commission principles in paragraph (a) and the “later developments in railway costing methods and techniques and current conditions of railway operations” in paragraph (b).

2.5. Pursuant to subsection 157(3), the Agency may compute costs

- a. “of a portion of the railway of a railway company, or one of its operations”, “irrespective of *when, in what manner or by whom* the costs were incurred”, and
- b. “in respect of future operations ... on any basis that, in the opinion of the Agency, is reasonable in the circumstances”.

2.6. Contrary to the assertions of CP, it does not matter that a cost, including the cost of debt or any other part of CP’s capital structure, was incurred by CPRL or CPRC, as plainly stated in paragraph 157(3)(a). The Agency makes the determination and the determination is final and binding. And, contrary to the assertions of CN, it does not matter *when* those costs were incurred – again, the Agency makes the determination and it is final and binding. Finally, contrary to both CP’s and CN’s assertions, it does not matter *in what manner* a cost is incurred. We read paragraph 157(3)(a) to expand the scope of the Agency’s already very broad discretion in making these cost determinations, including the cost of capital, right down to general purpose debt and share buy-backs. There is no provision in the Act that otherwise restricts the Agency’s broad and flexible mandate conferred by Parliament.

3. Uniform Classification of Accounts (UCA)¹⁰ – *The Agency, not the UCA, determines what is included in the cost of capital.*

¹⁰ <https://otc-cta.gc.ca/eng/publication/uniform-classification-accounts-and-related-railway-records-2014>

3.1. In their submissions, CP, and to a lesser degree, CN, resists the Agency's unique and exclusive authority to determine their respective cost of capital. On the narrow points in this Consultation, particularly with respect to whether general purpose debt should be defined differently, CP seeks to use the UCA to limit the Agency's authority, which we reject. As Dr. Gould explains:

“If the Agency determines that general purpose debt should be included in the calculation of the cost of capital, the UCA should provide the information that is necessary to regulate the railways.”¹¹

3.2. Even a cursory review of the legislative scheme establishes that the UCA is not a regulation contemplated under the Act; it is at best prescribed by Order. The Act does not prescribe items and factors the Agency must consider in determining costs. Further, the Act allows the Agency to establish the cost accounts and obligates CP and CN to maintain them, in the manner the Agency requires.

3.3. The Agency's authority to establish, change and interpret the UCA is broad and flexible. By section 156 of the Act, the Agency “may prescribe for the Canadian National Railway Company and the Canadian Pacific Limited” a system of accounts now represented in part by the UCA.

3.4. The UCA has a long history (see excerpt from the Agency's website at Schedule C of these submissions), beginning in 1955 and subsequently revised, amended and reissued on several occasions thereafter.

3.5. The Act specifies a CP entity – Canadian Pacific Limited – that no longer exists, but there is no question that before the former Canadian Pacific Railway Company was renamed Canadian Pacific Limited in 1971, the Agency's predecessor received information in conformity with the UCA. Similarly, upon a corporate reorganization in 1996, just as the current Act came into force, the Canadian Pacific Railway Company of the day became a subsidiary of a new corporate entity that took on the name of Canadian Pacific Limited. All the while, the UCA applied, regardless of the corporate structure of the business the Agency regulates. The same was true during further corporate reorganizations of CP on July 4, 1996, when the Canadian Pacific Railway Company became a subsidiary of a new company that assumed the Canadian Pacific Limited name, whereby the Canadian Pacific Railway Company of the day took on the railway operations. When, in 2001, Canadian Pacific Limited spun off its then remaining subsidiaries, CPRC and CPRL were the surviving rail-related entities.

¹¹ Gould Report (September 9, 2021), pp.8-9.

3.6. Simply reorganizing its affairs, cosmetically or otherwise, does not permit CP to escape the reach of the UCA; as long as there is a railway company, regardless of who or which entity owns it or how it fits within a particular corporate structure, CP remains subject to the UCA, just as it remains subject to the regulatory scheme of the Act that governs many of its activities, including costing determinations and determinations of the cost of capital.

4. Corporate Structure: *The treatment of general purpose debt between CN and CP does not depend on their respective corporate structures.*

4.1. Closely related to points 3.5 and 3.6 above, CN and CP take opposite views with respect to the impact of their respective corporate structures. CP seeks to shield its share buybacks from the Agency's purview by placing them in CPRL and, by doing so, pretends they are not included in net rail investment in Canada ("NRI"). However, as Dr. Gould explains, that effort is ineffective:

"As a result, CP argues that shares that were subject to the buy-back program cannot be removed from the Canadian regulated rail entity's balance sheet because those shares reside on the balance sheet of its parent company. However, this Consultation is concerned only with whether or not general purpose debt issued by a railway company should be included in the calculation of that company's cost of capital rate. Net rail investment must balance to the amount of debt, deferred taxes and equity. Once the amount of debt and deferred taxes has been determined, equity is the residual balance. If the amount of debt is increased by including an allocation of general purpose debt, equity must be reduced, regardless of whether it arose from retained earnings or the issuance of public equity. The treatment of general purpose debt between the railways should not differ as a result of their corporate structures."¹²

4.2. The corporate structure of CP makes no more difference to the inclusion of share buybacks in the determination of its cost of capital than it does to the corporate structure of CN. The point of the cost of capital determination is that the NRI balances to the three sources of capital.

5. General purpose equity: *There is no need for a separate calculation of general purpose equity*

5.1. CP makes an unwarranted and unnecessary argument that it says follows from its assertion that the definition of general purpose debt should be expanded to include general purpose equity. But this is not necessary because equity can be determined as a residual claim on the assets in NRI. As explained by Dr. Gould:

¹² *Ibid.*, p. 16

“This Consultation is concerned only with whether or not general purpose debt issued by a railway company should be included in the calculation of that company’s cost of capital rate. The Agency’s cost of capital process has distinct steps. These include the determination of net rail investment, which must balance to the amount of debt, deferred taxes and equity. Note that once the net rail investment, debt and deferred taxes have been determined, equity is the residual balance. There is no need for an allocation of what CP refers to as general purpose equity.”¹³

6. Canadian Rail Investment versus CP Treasury Function: *A treasury function is not a business and is irrelevant to the Agency’s determination of cost of capital*

- 6.1. CP confounds the purpose for calculating its cost of capital connected to its rail business unit (its rail division) with an internal corporate treasury function. For all intents and purposes, CP’s business is the ownership and operation of a railway. All other functions, including treasury, are ancillary to that core business. CP does not operate a treasury business. CP’s proposition that share buy-back debt is not GPD because “share buy-backs are the responsibility of CP’s treasury function and not the rail division” cannot be sustained. Its own financial statements and other public disclosure belie CP’s claim in this Consultation. CP’s income statements repeatedly demonstrate that 98% of its revenue comes from the freight rail business and 2% is “non-freight”.
- 6.2. The cost of capital that the Agency is charged with calculating pertains to the NRI. Share buy-backs form part of the GPD that forms part of CP’s capital structure that is related to the NRI, not to some other treasury business disconnected from the rail freight business.
- 6.3. It is this financial relationship that should be used to determine whether GPD should be included in the calculation of the cost of capital, not the UCA definition. As Dr. Gould explains:

“CP argues that share buy-backs should not be included in general purpose debt because they are non-rail transactions under the UCA definition. The basis for this argument is that share buy-backs are part of the treasury function and not the responsibility of CP’s rail division. However, that is a tautological argument. The purpose of this Consultation is to determine whether general purpose debt should be included in the calculation of the railways’ cost of capital. That question should not be determined by the UCA. The UCA should provide the information that the Agency has determined to be necessary to regulate the railways.”¹⁴

¹³ *Ibid.*, p. 9

¹⁴ *Ibid.*, p. 13

7. Private bilateral discussions: *Although at times necessary, with appropriate precautions, private communications by CP and CN with the Agency harm transparency and fairness.*
 - 7.1. We acknowledge that the Act provides that the Agency will maintain the confidentiality of certain information it receives, particularly from the Minister of Transport and in other narrow contexts, such as with respect to long haul interswitching. We also recognize that there may be times when, in its discretion, the Agency wishes to treat information as confidential that it receives from CP or CN that either of them may claim is commercially sensitive. We submit, however, that all occasions other than (i) those specifically enumerated in the Act and (ii) those when CP or CN can substantiate that information is in fact commercially sensitive, should be made publicly available, or at least available to rail freight users.
 - 7.2. Shippers already operate in circumstances of information asymmetry that exacerbates CP's and CN's market power in rail freight services markets. Consequently, as a means of addressing this one aspect of market imbalance, we urge the Agency to start from the premise that CN and CP information is not statutorily protected and not commercially sensitive unless proven otherwise.
 - 7.3. In the particular instance that CP now seeks private bilateral discussions with the Agency, we do not agree that rail freight users should be excluded from all such discussions. There is ample evidence that CP, and perhaps also CN in other contexts, has not disclosed information vital to the Agency determinations of cost of capital – including specifically its share buyback program – which has inflated its cost of capital in Canada to the detriment of those whose commercial relations rely on correct and fulsome disclosure.
 - 7.4. It is this kind of private, uncontested, approach by carriers, to the exclusion of those dependent on them, that entrenches the market power the carriers enjoy that harms users. In the end, we recognize that users are dependent on the judgement and discretion of the Agency to make those determinations. We urge the Agency to err on the side of disclosure.
 - 7.5. Where the Agency seeks to exercise its discretion in a way that diminishes transparency to users such as shippers, the appropriate remedy would be to limit that information to external counsel and experts.
8. Issues not raised in this Consultation: *The Agency should disregard CN and CP submissions in their initial submissions and any responses that are not in scope.*
 - 8.1. CN and CP have raised or repeated points they have made previously, or that are novel or outside the scope of this Consultation. Until the Agency seeks consultation, or seeks to repeat a consultation on those points, we have limited our submissions. Further, it would

be inappropriate for the Agency to consider them in the context of this Consultation and outside the scope of what respondents should have to address. However, in light of the confounding by CN and CP of the purposes of this Consultation and prior consultations, we draw attention to one point, best articulated by Dr. Gould:

“CN also repeats a proposal from the previous Consultation to use the cost of capital of the consolidated corporation for the regulated Canadian rail operations. As I previously explained, the cost of capital for the consolidated corporation is only an average cost of capital that is appropriate for the entire portfolio of its investments. It is not appropriate for a division of the corporation that is being regulated by the Agency. The division of Canadian rail activities must be considered as a separate stand-alone entity, distinct from its parent company, because it is the cost of capital for that division that we are attempting to measure and not the cost of capital for the parent company’s consolidated activities.”¹⁵

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/stakeholders
// Attachment: Gould Report (September 9, 2021)

¹⁵ *Ibid.*, p. 11

SCHEDULE "A"

Gould Report (September 9, 2021)

BEFORE THE CANADIAN TRANSPORTATION AGENCY

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

RESPONSE TO SUBMISSIONS
ON GENERAL PURPOSE DEBT

Prepared by:

LAWRENCE I. GOULD

Lawrence I. Gould

September 9, 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 (CN) and the Canadian Pacific Railway (CP). 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 CN and CP.⁴

After receiving the submissions and responses from all parties, the Agency determined that CP's round 2 submission⁵ 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

¹Canadian 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].

²My 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.

³Discussion Paper, page 8.

⁴My 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.

⁵CP'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 outlined certain issues about general purpose debt that should be considered.⁸ In response, I provided my opinion on the Agency's existing cost of capital methodology and commented on the issues raised in the Discussion Paper on General Purpose Debt.⁹

In addition to the August 19, 2021 submission by McMillan LLP, submissions were made by CN¹⁰ and CP¹¹. The process established by Agency provides the opportunity for any party who made a submission to file a response to the submissions made by the other parties.¹²

In reviewing these submissions, it became apparent that there were very important differences between my recommendations and the recommendations contained in the

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]

⁹ My opinion on these issues is contained in the McMillan LLP submission on behalf of Teck, the Western Grain Elevator Association and the Canadian Canola Growers Association, "General Purpose Debt," August 19, 2021. [Gould Report]

¹⁰ Consultation on General Purpose Debt – CN Submission, August 20, 2021. [CN Submission]

¹¹ CP's Submission to the Agency's Discussion Paper: Whether General purpose Debt Should be Included in the Calculation of Cost of Capital Rates, August 20, 2021. [CP Submission]

¹² Discussion Paper on General Purpose Debt, June 21, 2021, page 5.

submissions of CN and CP. CP's submissions contained reports by Michael Tretheway (Tretheway Report)¹³ and the Brattle Group (Brattle Report)¹⁴, which arrived at conclusions that were very different from my recommendations. The purpose of this report is to provide comment on the CN's and CP's initial submissions concerning the issues raised in the Discussion Paper on General Purpose Debt in order to assist the Agency in understanding the differences in the recommended cost of capital methodology.

¹³ Tretheway, Michael, Statement of Dr. Michael W. Tretheway, August 20, 2021. [Tretheway Report]

¹⁴ Aharonian, Matthew and Polek, Christine, The Brattle Group, Consultation Regarding the Methodology to Determine the Net Railway Investment and Capital Structure for the Calculation of Cost of Capital Rates, August 20, 2021. [Brattle Report]

III. ISSUES RAISED IN THE SUBMISSIONS

Instead of commenting separately on each submission, I have organized my response by the issues where there was a substantial difference in the conclusions or recommendations. As explained in the previous section, CN's and CP's recommendations differ greatly from my analysis and recommendations, so I will respond specifically to those submissions. In addition to the issues raised in the Discussion Paper on General Purpose Debt, I will also respond to other issues raised by CN's and CP's submissions.

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 issue in this Consultation is whether general purpose debt issued by a railway company should be included in the calculation of that company's cost of capital rate.

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. I argued in my

Report that 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.¹⁵

CN agrees with this definition, but expresses concern about the difficulty in identifying debt used to finance specific identifiable assets:

“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.”¹⁶

Therefore, CN maintains that unless debt can be identified as issued to finance specific identifiable assets, it should be considered general purpose debt as defined in the Discussion Paper on General Purpose Debt. This would include debt issued to finance share buy-backs.

However, CP disagrees with this definition:

“CP submits that debt should only be defined as “general purpose” when it cannot be identified as debt raised or issued for Canadian rail activities, U.S. rail activities or non-rail activities as prescribed by the Uniform Classification of Accounts and Related Railway Records (UCA). Further, the definition, and issue in general, under consultation should be expanded to include all general purpose activities, including but not limited to debt, equity, deferred liabilities and assets.”¹⁷

CP argues that share buy-backs should not be included in general purpose debt because they are non-rail transactions under the UCA definition. The basis for this argument is that share buy-backs are part of the treasury function and not the responsibility of CP's rail division. But the purpose of this Consultation is to determine whether general purpose debt should be included in the calculation of the railways' cost of capital. That question should not be determined by the

¹⁵ Gould Report, August 5, 2021, page 6.

¹⁶ CN Submission, page 1.

¹⁷ CP Submission, pp. 2-3.

UCA. If the Agency determines that general purpose debt should be included in the calculation of the cost of capital, the UCA should provide the information that is necessary to regulate the railways.

CP also argues that the definition should be expanded to include general purpose equity:

“If, nevertheless, the CTA intends to allocate general purpose debt to the Canadian rail operation then it must also allocate general purpose equity to the Canadian rail operation. Debt and equity are opposite sides of the same coin: in combination they are the means by which the company finances its balance sheet.”¹⁸

This Consultation is concerned only with whether or not general purpose debt issued by a railway company should be included in the calculation of that company’s cost of capital rate. The Agency’s cost of capital process has distinct steps. These include the determination of net rail investment, which must balance to the amount of debt, deferred taxes and equity. Note that once the net rail investment, debt and deferred taxes have been determined, equity is the residual balance. There is no need for an allocation of what CP refers to as general purpose equity.

¹⁸ CP Submission, page 3.

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

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 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.

CN's General Purpose Debt Argument

CN is clearly in agreement that general purpose debt must be included in the calculation of the cost of capital rate:¹⁹

“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.”

and

“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.”

CN also repeats a proposal from the previous Consultation to use the cost of capital of the consolidated corporation for the regulated Canadian rail operations. As I previously explained, the cost of capital for the consolidated corporation is only an average cost of capital that is appropriate for the entire portfolio of its investments.²⁰ It is not appropriate for a division of the corporation that is being regulated by the Agency. The division of Canadian rail activities must be considered as a separate stand-alone entity, distinct from its parent company, because it is the cost of capital for that division that we are attempting to measure and not the cost of capital for the parent company’s consolidated activities.

¹⁹ CN Submission, pp. 2-3.

²⁰ Gould Report, February 2, 2021, pp. 6-8.

CP's General Purpose Debt Argument

CP argues that general purpose debt should not be included in the calculation of the cost of capital rate:

“No, each railway company’s cost of capital should be based on the financial statements for the regulated railway entity filed with the CTA using the Uniform Classification of Accounts and Related Railway Records (“UCA”). Any manipulation or adjustments to these financial statements could result in material distortions of the regulated railway entity’s capital structure as well as the implied capital structure of the other entities within the company (U.S. railway, non-rail entities).”²¹

CP claims that the question of whether or not share buyback debt is rail-related debt is an issue that is separate and distinct from determining whether general purpose debt should be allocated to a regulated railway entity’s balance sheet. In my opinion, share buy-back debt can be included in the question about general purpose debt and my comments on general purpose debt apply as well to share buy-back debt.

The basis of CP’s argument is an interpretation of the UCA:

“General purpose debt is, by definition, not used to finance rail activities and therefore it does not result from Canadian Rail operations as required by UCA 1203.01 if it is to be included in the regulatory accounts. Accordingly, the UCA specifically instructs that so called “general purpose debt” is not to be recorded in the regulatory accounts.”²²

And

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

²¹ CP Submission, page 5.

²² CP Submission, page 5.

CP's regulated railway operations. Therefore, these programs are non-rail activities under UCA 1203.06."²³

CP argues that share buy-backs should not be included in general purpose debt because they are non-rail transactions under the UCA definition. The basis for this argument is that share buy-backs are part of the treasury function and not the responsibility of CP's rail division. However, that is a tautological argument. The purpose of this Consultation is to determine whether general purpose debt should be included in the calculation of the railways' cost of capital. That question should not be determined by the UCA. The UCA should provide the information that the Agency has determined to be necessary to regulate the railways.

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."²⁴

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:²⁵

"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."

²³ CP Submission, page 6.

²⁴ Canadian Transportation Agency, Decision LET-R-49-2009, April 20, 2009.

²⁵ Canadian Transportation Agency, Decision LET-R-29-2020, April 28, 2020.

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.”

I explained in my Report why the determination of a regulated entity’s capital structure is critically important.²⁶ 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.

It is clear that changes in the capital structure have a significant impact on the regulated rail entity and its customers. Most importantly, 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. General purpose debt, including share buy-back debt, must be included in the calculation of the regulated entity’s cost of capital rate, allocated to the regulated balance sheet using the RTM based approach or whatever other allocation method the Agency determines to be appropriate.

²⁶ Gould Report, August 5, 2021, pp. 8-10.

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.”²⁷

There has been no compelling argument from the railways to justify a differential treatment of general purpose debt. It should be treated consistently between the railway companies.

CN reaches the same conclusion:

“In conclusion, CN sees no reason nor justification, neither in the legislation nor in economics, to treat general-purpose debt differently between railway companies.”²⁸

However, CP argues that the Agency should apply different methodologies to allocate general purpose debt to the regulated railway entities’ balance sheets due to the railway companies’ inherent differences and unique capital structures.

CP’s Corporate Structure Argument

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

²⁷ 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.

²⁸ CN Submission, page 4.

level (as CP understands it), CP reports at the level of the regulated railway entity that is held by a corporate parent company.”²⁹

And

“CP has structured its regulated accounts and financial statements in accordance with the requirements of the UCA accounting standards. These accounts include debt that was issued for railway operating purposes, and they include equity that was generated via railway operations. The corollary is that they exclude debt that was issued for non-rail operating purposes, and they also exclude equity that was not generated via railway operations. For example, the UCA accounts do not include the \$2 billion of share-capital equity that was generated by way of the issuance of public equity by the CP consolidated railway company that trades on equity markets.”³⁰

As a result, CP argues that shares that were subject to the buy-back program cannot be removed from the Canadian regulated rail entity’s balance sheet because those shares reside on the balance sheet of its parent company. However, this Consultation is concerned only with whether or not general purpose debt issued by a railway company should be included in the calculation of that company’s cost of capital rate. Net rail investment must balance to the amount of debt, deferred taxes and equity. Once the amount of debt and deferred taxes has been determined, equity is the residual balance. If the amount of debt is increased by including an allocation of general purpose debt, equity must be reduced, regardless of whether it arose from retained earnings or the issuance of public equity. The treatment of general purpose debt between the railways should not differ as a result of their corporate structures.

²⁹ CP Submission, page 9.

³⁰ CP Submission, page 9.

CP's Argument for Adjusting Cost Rates of Debt and Equity

CP also argues that the cost rates for debt and equity must be adjusted:

“If the Agency finds that the regulatory capital structure is significantly different than the consolidated capital structure, then it would need to adjust the cost-rates for debt and equity for the regulated railway entity.”³¹

First, and most importantly, CP's Submission on the issue of adjusting the cost rates for debt and equity and the Brattle Report are not relevant to this Consultation. This Consultation is only concerned with the issue of whether general purpose debt should be included in the calculation of the company's cost of capital rates.

Second, the issue of adjusting the cost rates of debt and equity requires a determination that the capital structure of the regulated entity differs enough from the consolidated capital structure to require an adjustment in the cost rates. However, the Agency's determinations in the 2020 Consultation and this Consultation will affect CP's regulated capital structure, but have not yet been determined. Furthermore, CP has not provided the financial data for the regulated entity that would enable stakeholders to make this determination.

Third, if an adjustment is required to the costs of debt and equity based on a substantial determined difference between the consolidated capital structure and the regulated balance sheet, it would not be appropriate to use the Modigliani and Miller theorems or the Hamada equation to make that adjustment. The Modigliani and Miller theorems are theoretical models, derived under very restrictive assumptions, and the Hamada equation is derived assuming the Modigliani

³⁰CP Submission, page 9.

and Miller theorems are true. In my opinion, they are not valid for adjusting the costs of debt and equity in calculating the cost of capital rates.

Adjusting the cost of capital for differences in the capital structure is a complex problem, which is not within the scope of this Consultation. If it is determined that these rates should be adjusted, it should be the subject of a separate Consultation in order to give the stakeholders an opportunity to see the financial data and comment on the different methods for adjusting cost of capital rates.

CP's Argument for Using Alternative Methodologies

CP proposes three alternative methodologies if the Agency determines that general purpose debt or share buy-back debt is allocated to the regulated railway entity's balance sheet: create an offsetting asset or receivable, use the consolidated capital structure, or allocate general purpose equity to the regulated balance sheet.³² CP explains the goal of these alternatives as follows:

“Application of any of these alternatives would result in CP's regulated railway entity's capital structure (or total liabilities to equity ratio) moving closer to the Total-Liabilities to Equity ratio of the consolidated statements. As well, under these alternatives CP's regulated railway entity's equity would remain relatively intact and would not need to be reduced.”³³

In other words, if the Agency determines that general purpose debt should be included in the calculation of the cost of capital, these alternatives would reduce the resultant increase in the debt ratio and move the regulated capital structure closer to the consolidated capital structure.

³² CP Submission, pp. 15-17.

³⁰ CP Submission, page 9.

But as I have explained previously, that should not be the Agency's goal. The cost of capital for the consolidated corporation is only an average cost of capital that is appropriate for the entire portfolio of its investments. It is not appropriate for a division of the corporation that is being regulated by the Agency. Each division of a consolidated corporate entity should be treated as if each were operating independently. The division of Canadian rail activities must be considered as a separate stand-alone entity, distinct from its parent company, because it is the cost of capital for that division that we are attempting to measure and not the cost of capital for the parent company's consolidated activities. The Agency should use a separated balance sheet reflecting the capital structure that the Canadian railway would have as an independent company.

SCHEDULE "B"**Excerpts from Canada Transportation Act****DIVISION VII****OTHER MATTERS****Accounting****Uniform accounting system for CN and CP**

156 (1) The Agency may prescribe for the Canadian National Railway Company and the Canadian Pacific Limited a uniform classification and system of accounts of their assets, liabilities, revenues, working expenditures, capitalization, traffic and operating statistics relating to railway operations.

Uniform accounting system for other railway companies

(2) The Agency may prescribe for any other railway company a uniform classification and system as described in subsection (1) or in a condensed form.

Items to be classed

(3) The Agency may prescribe the items to be classed as items relating to railway operations in the accounts.

Depreciation

(4) The Agency may prescribe the classes of property for which depreciation charges may properly be included under operating expenses in the accounts, and the rates of depreciation to be charged with respect to each of the classes of property.

Requirements to keep accounts

(5) A railway company for which a classification and system of accounts is prescribed shall keep its accounts in accordance with the prescribed classification and system.

Determination of Costs**Regulations for determining costs**

157 (1) The Agency may make regulations prescribing items and factors that it shall consider in determining costs under this Part, including depreciation and the cost of capital.

Additional considerations

(2) The Agency may also consider

(a) the principles of costing adopted by the Royal Commission on Transportation appointed by the Order in Council dated May 13, 1959 in arriving at the conclusions contained in its report; and

(b) later developments in railway costing methods and techniques and current conditions of railway operations.

Computation of costs of a portion of an undertaking

(3) If the costs of a portion of the railway of a railway company, or one of its operations, are to be computed

(a) for a particular period, the Agency must include in the computation any of the costs of the whole railway, or any other portion of it, that, in the opinion of the Agency, are reasonably attributable to the portion or operation, irrespective of when, in what manner or by whom the costs were incurred; and

(b) in respect of future operations of the company, the costs must be determined in accordance with estimates made on any basis that, in the opinion of the Agency, is reasonable in the circumstances.

Determination final and binding

(4) A determination of costs by the Agency under this Part is final and binding on all interested or affected parties.

Costing information

(5) No later than August 31 of every year, the Canadian National Railway Company and the Canadian Pacific Railway Company shall provide to the Agency, in the form and manner specified by the Agency, all unit costs, output units and other financial, statistical and supporting information for the preceding calendar year that is required for the determination of costs by the Agency under this Part.

1996, c. 10, s. 157

2018, c. 10, s. 45

SCHEDULE “C”

Excerpt: History of the UCA¹

The UCA was first issued in September 1955 by the Board of Transport Commissioners for Canada, the predecessor of the Canadian Transport Commission. This first UCA was prescribed effective January 1, 1956 for the existing Class I railway companies (Canadian National Railway and the Canadian Pacific Railway Company at that time). Subsequently, a condensed classification of accounts was prescribed for all other railway companies within the legislative authority of the Parliament of Canada effective January 1, 1957.

There then followed a series of amendments which were incorporated into a revised version of the UCA which became effective January 1, 1959. This version, in turn, received a number of comparatively minor amendments which were documented in Accounting Circulars Nos. 8, 9, 10 and 11.

Apart from the above modifications, the 1959 version of the UCA was in effect for over twenty years. This document and its predecessors were based upon the Uniform System of Accounts for Railroad Companies, a classification of accounts dating back to the early 1900's and issued by the United States Interstate Commerce Commission.

In late 1977, the Canadian Transport Commission's Railway Transport Committee commissioned a comprehensive review with the objective of bringing the UCA into line with generally accepted accounting principles, facilitating rail cost analysis, as well as updating and streamlining the document. Significant changes were made to the structure, content and form of the UCA.

The UCA was reissued in January 1989 as a result of the coming into force of the *National Transportation Act, 1987* (NTA, 1987). Amendments to the UCA were issued during 1991. On July 1, 1996, the *Canada Transportation Act* (CTA) came into effect. Amendments to the UCA were issued in 2009.

¹ <https://otc-cta.gc.ca/eng/publication/uniform-classification-accounts-and-related-railway-records-2014>