Tyme E Wittebrood
Director, Regulatory Finance

7550 Ogden Dale Rd SE
Calgary Alberta
Canada T2C 4X9

Tel: 403-319-6540

Tyme_wittebrood@cpr.ca

August 20, 2019

CP's Response to the Consultation on the Canadian Transportation Agency's Approach to Setting Regulated Interswitching Rates

Pre-amble

Thank-you very much for this opportunity to provide our feedback to your consultation on the regulated interswitching rate setting methodology.

Our response to this consultation is founded on the principle that regulators should favor consistency and transparency in the application of the regulations, straying from that principle only when the benefits of doing so clearly outweigh the regulatory burden imposed. CP's position is that there would be no net benefit to amending the interswitching regulations at this time.

Recent research demonstrates that economic activity declines when uncertainty and complexity in the regulatory environment increases.[1] It is also apparent that increasing regulatory burdens discourage participation in the market by impacting small players disproportionately.[2]

Canadian Pacific (CP)[3] highlights the principles set out in the National Transportation Policy which provide that "competition and market forces" should be the prime agents in ensuring a "viable and effective transportation system."[4] However, the Act stipulates that interswitching is meant to be limited to cost and that the method undertaken by the Agency to calculate those costs should be compensatory to the railroads:

> *"In determining an interswitching rate, the Agency shall consider the average variable costs of all movements of traffic that are subject to the rate and the rates shall not be less than the variable costs of moving the traffic, as determined by the Agency."*[5]

Therefore, while CP will be discussing cost-based rate setting methods for the purposes of this consultation, we would like to make it clear that we do not support cost-based rate setting in general. CP emphasizes that its

---

[1] Davis, Steven J. "Regulatory Complexity and Policy Uncertainty: Headwinds of Our Own Making," *Hoover Institution Conference on "Restoring Prosperity" at Stanford University* (February 2017). Accessed August 14th, 2019: http://www.policyuncertainty.com/media/Davis_RegulatoryComplexity.pdf
[2] Lux, Marshall, and Robert Greene. "The state and fate of community banking." M-RCBG associate working paper 37, no. 31 (2015): https://www.hks.harvard.edu/sites/default/files/centers/mrcbg/files/Final_State_and_Fate_Lux_Greene.pdf
[3] Canadian Pacific (CP) is a trade name under which Canadian Pacific Railway Company and its United States subsidiaries operate.
[4] *Canada Transportation Act (S.C. 1996, c. 10). Section 5.* https://laws-lois.justice.gc.ca/eng/acts/c-10.4/
[5] *Canada Transportation Act (S.C. 1996, c. 10).* Section 127.1 (3). https://laws-lois.justice.gc.ca/eng/acts/c-10.4/

comments pertaining to the validity of the costing exercise only apply to the Agency prescribed interswitching calculation.

Issue 1

Q1: (a). Should separate regulated interswitching rates be determined for short-line railway companies? If yes, should there be rates for individual short-line railways companies or one single average for all short-line railway companies?

CP is not taking a position on whether or not rates should be determined for short-line railroads.

However, if the Agency decides to regulate short-line interswitching rates, then CP submits that the short-line rates must be separate from class one railroad rates.

The class one railroads in Canada focus on high-volume freight operations, and operate in an environment of economies of scale. By contrast, short-line railroads perform a gathering function or delivery function, linking the class one roads to origins or destinations that may produce lower volumes. Because of their differing business models and functions, Class-I carriers and short-lines have very different cost structures. Therefore, the interswitching cost determinations for Class-I carriers and short-lines should not be comingled.

Q1: (b). Should the CTA expand the current regulated interswitching rates development methodology to include the interswitching service units performed by and the unit costs of participating short-line railway companies?

Please see our answer to Question 1 (a).

Q1: (c) Should the CTA continue to rely solely on the costs of CN and CP to develop the regulated interswitching rates?

Please see our answer to Question 1 (a).

Issue 2

Q2: (a). Should the CTA continue to determine a single rate in each zone, to maintain the simplicity and ease of administration of the interswitching remedy, or should the CTA determine multiples rates for each zone, to better match the rates to the costs of providing the service.

CP submits that any additional rates or zoning would only serve to confuse stakeholders and complicate the process.

The current rate structure has successfully provided competitive access to shippers for over 25 years. The single rate-per-zone approach is consistent and easily administered.

It is important to note that interswitching rates are reconciled separately from the shipper, and, instead are charged directly between railroads. To be clear, interswitching costs are not directly charged to the customer for two reasons:

- first, railroads and shippers negotiate freight rates on a commercial basis;
- [redacted]

In practice, freight rates are not sensitive to changes in interswitching rates. Increasing the complexity of the rate structure will, consequently, have no noticeable impact on the market for railway services while increasing the administrative burden.

Q2: (b). If multiple rates are preferable, should the rates be by interchange, by province, by region (e.g., Western Canada, Prairies, Eastern Canada) or another alternative?

CP does not recommend introducing stratification of rates by interchange, province, or region.

[redacted]

As noted in our response to Question 2(a), adding complexity to the rate structure will have minimal impact on the market for railway services. By consequence, regional rates would neither: open access to shippers that do not already have it, provide additional cost savings to shippers, or more accurately compensate the railroads.

Q2: (c). Should there be different rates for different commodities? If yes, how should the commodities be broken down?

CP does not recommend introducing different rates for different commodities.

[redacted]

<u>Issue 3</u>

Q3. Is the CTA's current distance based interswitching zones sufficient?

[redacted]

Q4. Should the CTA introduce more factors, such as customer characteristics, train size, or grades of track characteristics to create a broader range of rates?

Again, we do not recommend adding complexity to the rate structure.

[redacted]

To the contrary, it will increase the regulatory burden on all stakeholders.

Q5. Should the CTA collapse the four zones and have one interswitching zone for all customers within the regulated interswitching limits?

CP submits that the current zones should not be amended.

[redacted]

[redacted]

Q6. Should the CTA reinstitute the use of weighted linear regression to produce rates that increase proportionately by zone?

[redacted]

[redacted]

__Issue 4__

Q7. Does the CTA's inclusion of a cost of capital and depreciation allowance appropriately inform the consideration of long-term investment needed in the railway companies?

One of the (many) reasons that cost-plus rate setting should be avoided, in general, is with respect to the complexities involved in accurately determining the correct contribution to cover cost of capital and depreciation expenses for the traffic at hand.

We maintain that the cost of capital as annually determined by the CTA does not fully account for CP's true cost of capital. However, our main objections revolve around how the CTA develops the capital structure of the company. This topic was deemed explicitly out of scope for this consultation. Our objections and proposals have been detailed in our public response to the CTA's 2016 consultation on the capital structure methodology.

Q8: (a). Is the cost of equity model, an input to the cost of capital methodology, currently used by the CTA appropriate for determining an adequate rate of return on investment?

The shortcomings of the traditional Capital Asset Pricing Model (CAPM) have been discussed and documented in the literature.[6]

It is CP's position, though, that in the absence of any new model, the traditional CAPM provides the most pragmatic measure of the cost of equity at this time. [redacted]

[redacted]

Q8: (b). If it is not, which cost of equity model or combination of cost of equity models should be considered by the CTA?

Please see our response under Question 8(a).

<u>**Issue 5**</u>

DEADLINE FOR SUBMISSION WAS EXTENDED TO JANUARY FOR THIS SECTION

<u>**Issue 6**</u>

DEADLINE FOR SUBMISSION WAS EXTENDED TO JANUARY FOR THIS SECTION

<u>**Issue 7**</u>

Q14. Is the current block size minimum of 60 cars sufficient for recognizing the efficiencies gained from moving cars in a block?

---

[6] Elbannan, Mona A. "The capital asset pricing model: an overview of the theory." International Journal of Economics and Finance 7, no. 1 (2015): 216-228. URL: http://dx.doi.org/10.5539.ijef.v7n1p216

[redacted]

[redacted]

[redacted]

Consequently, the blocking occurs when it is practical for the railroads to segment the traffic in such a way. As observed by the Agency, 60 cars is the natural threshold:

> *"The Agency has determined from observation of actual movements that the 60-car block reflects established operational practices with respect to the assembly of trains."*[7]

It should be stated that it is not the Agency's threshold of 60 cars that dictates this operational structure. Rather it is an observed characteristic of the network operating in its most efficient manner.

Q15. Should the CTA determine rates for smaller or larger shipments?

Please see our response to Question 14.

<u>**Issue 8**</u>

Q16. Is there another way to collect interswitching service units to accurately calculate the average variable costs of all interswitching movements, as required by subsection 127.1 (3) of the Act? Please provide a rationale for your response.

Due to the nature of how railway traffic moves, and how the traffic data is recorded, train movement records for "local area operations" (i.e. gathering and switching of traffic) are not as good as that for mainline operations. Therefore, we do not recommend that the current service unit methodology be supplanted with a systems-data only based approach.

Further, it is beneficial for Agency staff, as well as for railroad regulatory and interline employees, to have a chance to study in person how interswitching activities occur in the field. The current methodology relies on interviewing the local supervisors of switching and yard activities. These people are best able to tell us what special considerations and alternative scenarios are applicable to each customer, and they are easily able to inform us what has changed since prior years.

---

[7] *Regulations Amending the Railway Interswitching Regulations,* SOR/DORS/2014-193, 2321. http://www.gazette.gc.ca/rp-pr/p2/2014/2014-08-13/pdf/g2-14817.pdf

In-person interviews are the best way to gain this information.

Issue 9

Q17. How can the CTA make the regulated interswitching rates and/or rate setting methodology more transparent and accessible to Canadians?

We believe that the main factor that contributes to greater transparency and accessibility is to ensure that the regulations and rates are consistent over time and transparent in their application. When the regulations are straight-forward, then all stakeholders can easily determine how to make use of them and what rate will apply.

CP also notes that the rates are accessible on the internet and that the Agency in Determination No. R-2018-254 provided detailed information in regards to the interswitching rates calculation.[8]

[redacted]

Q18. Are there measures that railway companies can take to ensure shippers are aware of the applicable rate? For example, would it be appropriate to require railway companies to show the regulated interswitching rate, as a separate charge on the waybill? Should this charge be paid by the shipper directly to the railway company providing the interswitching service?

With regards to explicitly showing the interswitching cost:

Interswitching rates are settled between railroads. Shippers are not billed for these costs directly; therefore, the cost should not be shown on the invoice.

If the simplicity of the rate structure is maintained as it is today, then each shipper can easily understand what rate applies to their traffic simply by examining the regulations. There is no need to display the interswitching rate on the invoice.

With regards to directly billing shippers:

Again, the interswitching rates are settled between railroads. This arrangement is relatively simple for railroads to apply, and effortless for shippers. The alternative of having shippers pay railroads directly for interswitching services would generate an extra burden on both parties: shippers would have to manage two invoices for each movement, and railroads would need to manage collections and disputes with numerous shippers.

We do not recommend asking shippers to pay the interswitching charges directly.

Conclusion

In summary, CP proposes no changes to the zonal interswitching rate structure. CP believes that all stakeholders will benefit from maintaining a consistent and transparent approach. Today's rail industry has evolved in response to these regulations, and as such it will benefit from ongoing consistency in their application.

---

[8] Canada. Canadian Transportation Agency. *Determination No. R-2018-254*. [Ottawa], November 2018. https://otc-cta.gc.ca/eng/ruling/r-2018-254

Finally, we submit that the rates are not compensatory because the regulatory cost of capital which is used in their calculation is not compensatory.

Yours truly,

Tyme Wittebrood
Director, Regulatory Finance | Regulatory Economics
CANADIAN PACIFIC