



November 18, 2016

Canadian Transportation Agency

Consultations
15 Eddy Street
Ottawa Ontario K1A 0N9

Re. Agency Staff Consultation: Cost of Capital Methodology

This document is a response to the submissions of other parties. CP will respond selectively to points made by other respondents, only where specific issues were not addressed in CP's initial response.

This document will not address the arguments of other respondents where the same issues were addressed in CP's initial response. CP continues to rely on its initial position, and the lack of a response on a particular issue here does not indicate CP's agreement with, or the concession of, any point made in the submissions of other respondents.

CP would like to express its appreciation to all respondents for their considered opinions.

Response to the Submission of CN

With respect to Item 2.3 – The Net Cash Balance

With due respect to our colleagues at CN, for historical reasons CN has not been subject to an intercompany financing adjustment (referred to alternately as the "cash-flow method" or the "balance sheet method") and is therefore likely unaware of the reasoning and the function of this adjustment.

In fact, as discussed at length in CP's initial submission, adjustments for intercompany financing have been central to the development of CP's regulatory capital structure over time. As a consequence, the discontinuance of the practice for CP will introduce a material inconsistency and discontinuity in the development of CP's capital structure going forward. It would also entail that CP's capital structure would increasingly be predicated on subjective determinations regarding levels of debt and financing (please refer to paragraph 135 of CP's initial submission).

It is necessary to apply an objective method to deal with intercompany financing issues because of the fact that CP, as a subsidiary of a company that has other significant operating branches, has access to non-arm's length financing. The same may be said about the Canadian portion of CN, which is subject to Canadian regulation, and is part of the same organization that operates its US network. But that is not to say that CN should necessarily be subject to the intercompany financing adjustment, because the concerns about continuity of the calculation of CN's capital structure may outweigh any concern

regarding consistency of treatment between CP and CN. These sorts of matters are solely the purview of the Agency. We raise the issue here only to demonstrate that there may be reasonable grounds to apply different methodologies to CP and CN on this particular matter.

Response to the Submission of McMillan

With respect to Item 1

Assuming that the Agency decides that a new lead-lag study is appropriate, CP would welcome comments on the design and results of any new study, to the extent that any disclosures of information are permitted under the Act.

With respect to Item 2

McMillan relies on Dr. Gould's conclusion regarding the adjustment to CP's balance sheet which accounts for intercompany financing. CP described the reasoning and functioning of the adjustment in detail in its initial submission. As explained, the operation of this adjustment has a sound basis, and it includes significant factors which Dr. Gould was understandably not aware of, given a plain reading of his discussion. Therefore, Dr. Gould's conclusion on this particular point should not be relied on.

The fact that the method was carefully considered in a number of regulatory decisions over several decades indicates that the justification for the methodology is sound, or at the very least, that it was sound at the time.

Furthermore, the idea that a regulatory agency should reconsider and retroactively re-compute previous regulatory decisions sets a dangerous precedent. This would open the door for all parties, including shippers and carriers, to launch complaints that seek to re-compute past decisions and seek settlements against decades of regulatory outcomes.

Note that, in CP's opinion, the aggregate impact of the intercompany financing adjustments have demonstrably reduced CP revenues since the method's implementation in 1973 (please refer to paragraph 78 of CP's initial submission).

Finally, it is not up to CP to justify the practice. CP is obligated to provide the data that the Agency requires to compute the regulatory capital structure according to the regulatory procedures. While CP may also provide a completed calculation of the final regulatory cost of capital rate as it believes to be correct, the Agency is under no obligation to consider CP's calculation. Indeed, it is the role of the Agency to review CP's submission of data, to correct or have CP correct that data where required, and to calculate the regulatory cost of capital using the regulatory procedure.

With respect to Item 3

The Agency's public decisions on the cost of capital rate regularly include descriptions of corrections to CP's submission. The recent decision LET-R-14-2016 indicates corrections to nearly every component of CP's submission on both the capital structure and the cost of equity. Clearly, the Agency does not unquestioningly accept CP's submissions.

With respect to Item 4

Again, it is not up to CP and CN to "comply with the correct principles of capital structure methodology". The railways are obligated to comply with the requirement to submit data to allow the Agency to calculate the capital structure using the regulatory methodology.

Indeed, the real situation is effectively the inverse of what was suggested here by McMillan. That is, CP calculates the capital structure and the resulting cost of capital rate in order to verify that the Agency is correctly applying the regulatory methodology.

CP respectfully suggests that it is not McMillan's role to verify whether CN, CP, or the Agency are complying with the regulatory methodology.

With respect to Item 5

Section 51(1) of the Canada Transportation Act clearly prohibits the disclosure by the Agency of any information concerning the content or structure of the railways submissions which are used by the Agency to determine the regulatory capital structure and cost of capital.

With respect to Section III, Item B (1), Deferred Income Taxes

Dr. Gould puts forward the position that deferred taxes should be treated on a "flow through" accounting basis. There has been a significant amount of research on the topic of accounting for tax deferrals in a regulated industry. Much of this research was done from the 1960's to the early 1980's. The general, but certainly not universal, consensus appears to favor the normalization approach over the flow through approach. The reason generally put forward is that flow-through accounting favors current customers over future customers of the utility, and also that flow-through accounting tends to exacerbate problems with regulatory lag.

However, most or possibly all of the previous research appears to consider industries that are entirely regulated. It is possible, in CP's opinion, that some of the objections to flow-through accounting may be mitigated or avoided under a partially regulated regime such as today's railway industry.

A change to flow-through accounting may have significant impacts on the evolution of rates and capital structure over the medium to long term. Also, the actual implementation may be technically difficult because of the number of separate asset classes, revenue streams, and depreciation rates involved. Any such change should be the result of a thorough analysis as to impact and practicality, and so it should form a separate consultation.