mcmillan

A CALL TO ADDRESS CANADA'S TRANSPORTATION SUPPLY CHAIN CRISIS: FINAL REPORT - PART III

Posted on November 16, 2022

Categories: Insights, Publications

Part III – Analysis of Task Force's Recommendation #2 of its Immediate Response Actions

This bulletin follows on our previous bulletins on the Final Report of the National Supply Chain Task Force and our initial review of the Task Force recognition of a need to modernize the transportation system in the national public interest which can be found here.

As we noted in Part II, the Task Force has divided its report into thirteen Immediate Response Actions to address the current transportation crisis, and eight Long-Term Strategic Actions:

> "to both initiate the systemic change required to drive the long-term competitiveness, prosperity and sustainability of Canada's transportation supply chain, and to maintain appropriate governance of the transportation supply chain going forward. A functional and reliable supply chain is essential to ensuring Canada's ability to fully and competitively participate in the global market."

In this bulletin, we address one of the Task Force's thirteen Immediate Response Actions, namely, Recommendation #2.

Immediate Response Actions

In addressing the current transportation crisis, the Task Force recommends that the federal government take legislative action to "*increase competition and balance negotiating power between stakeholders within the supply chain*." As explained in our Bulletin Part II, the existing policy established a long time ago that the *Canada Transportation Act* identifies the need for "a competitive, economic and efficient national transportation system."

The Task Force goes further, however, by recommending an increase in competition and addressing the current imbalance in bargaining power between CN Rail and CP Rail on the one hand, and rail shippers and receivers on the other. The rationale is that:

> "Railways are the only source of transport for many shippers, giving rail companies pricing and service

> discretion that is not balanced by normal market forces."

The *Canada Transportation Act* contains a few shipper remedies, which are partially or wholly ineffective, but which remain unaddressed. As soon as possible, the federal government should revise the statute to make existing remedies more effective.

Recommendation 2: Expand Interswitching Distance

However, until the federal government introduces robust rail shipper remedies, the Task Force seeks to address the inequality of bargaining power between railways and shippers at least to some degree, at Recommendation #2, which advises the federal government to:

> "Expand the 30 km interswitch distance across Canada to give shippers more rail options and to address shipper—railway power balance issues. The switch zone rates should be mileage based and set annually by the Canadian Transportation Agency ("**CTA**"). The CTA should also monitor and review the effectiveness of this change."

The current law allows a shipper located on one railway that is within a 30 kilometre radius from another federal railway (in most cases, that means CN or CP) to require the first railway to move its cargo, at a cost-based rate set by the Agency, to an interchange point for transfer to the second railway for delivery to destination.

McMillan Transportation Group Analysis of Recommendation 2:
Expanded Interswitching Distance

Status of Regulated Interswitching

Regulated interswitching is not new. With the passage of the *National Transportation Act*, 1987, Parliament extended the limit from 4.0 linear miles to 30 radial kilometres, currently within four radial distance zones. The Agency may designate a point beyond 30 kilometres that is reasonably close to an interchange, but none of the Agency's decisions have dealt with radial distances greater than 40 kilometres or track distances greater than 50 kilometres. The Agency also had the authority to establish a distance greater than 30 kilometres, which was repealed in May 2018 with the passage of the *Transportation Modernization Act* (Bill C-49). Earlier, with the passage of the *Fair Rail for Grain Farmers Act* (Bill C-30), the Agency temporarily expanded the radius for interswitching for all commodities from 30 kilometres to 160 kilometres in Saskatchewan, Alberta and Manitoba. Parliament eliminated this expanded limit in 2017, shortly before the passage of Bill C-49 in May 2018.

Rationale for Expansion

The Task Force recommendation declares that, "an expanded interswitch distance option provides increased competition by offering shippers more choices." The logic is largely sound. Absent all other considerations, expanding the regulated interswitching distance should achieve the intention of the Task Force's recommendation. That is, the remedy works where a shipper can switch its traffic from an originating rail carrier to a connecting carrier AND the connecting rail carrier can reach the destination served by the originating rail carrier. Our analysis of the recommendation addresses three main topics: who controls the remedy; the need for rate regulation; and, the metric for determining the regulated distance.

Control of the Remedy

Giving the Agency the power to expand distance is administratively preferable to the use of a cumbersome legislative process, especially if the Agency were to have the mandate recommended by the Task Force to "increase competition". McMillan's Transportation Group has participated in numerous Agency consultations in connection with the remedy, which has affirmed the desirability of Agency independence, authority and funding. The power is not useful without data and information disclosed in a transparent environment, however.

McMillan Recommendation: Provide the Agency with authority to not only demand and receive relevant data and information from CN and CP, but also the authority to disclose that information to rail users and stakeholders on regulated terms.

Need for Interswitching Rate Regulation

Regulating the rates for the portion of a shipment from a shipper's or receiver's facility to the interchange is desirable and has helped increase competition for some rail traffic in some circumstances. The Agency's costing group uses the Agency Regulatory Costing Model ("**ARCM**") to determine regulated interswitching rates annually. CN and CP regularly challenge the Agency's ability and competence to determine rail long run variable costs, as well as the robustness of the ARCM itself. However, it is clear that the Agency has adapted to changes in CN's and CP's infrastructure and operations to adjust the mechanics of determining interswitching rates, providing both railways with the profit necessary to cover all of their costs, including elements of profit such as cost of capital.[1] If anything, there is a need for greater scrutiny, transparency, and disclosure to rail users on an annual basis, at the very least consistent with what CN and CP already are required to disclose in the United States. For the narrow purpose of extending interswitching limits, even modest disclosure of contribution bands would be helpful.

McMillan Recommendations: The Agency should establish annually the contribution margin above variable cost required by CN and CP, separately, to cover all of their respective costs (variable and constant). The Agency should determine the percentages of traffic in at least two bands below and two bands above that level, and determine the average contribution margin above variable cost earned by each of CN and CP from traffic in each band.

Setting the Right Distance

The relationship between rates and cost for any product in any market is a textbook means to determine the extent to which a party with market power increases its economic profit beyond a normal return that covers total cost. Identifying that rates are uncoupled from the cost function, contrary to what we observe in competitive transportation markets, is not the hard part. The hard part is finding a way to get monopolists to compete for a shipper's traffic. Regulated interswitching has done that for a small amount of traffic in some limited circumstances within the current statutory radius. The Task Force challenge is to find the optimal distance to achieve competitive outcomes, or rates that would prevail if there were effective competition. It is unlikely that duopolistic competition will achieve that objective. However, establishing a greater distance over which to apply regulated interswitching requires immediate attention.

Distance may not be the best determinant of competitive access or of simulating effective competition. Not all shipments will benefit from regulated interswitching because of the origin-destination characteristics of rail networks: even if a shipper can gain access to a connecting carrier via regulated interswitching, that does not mean the connecting carrier can get that shipper's traffic to the customer's destination; a lot of traffic is left out of a scheme focused only on distance. Moreover, for the remainder, service from two carriers does not mean those carriers will compete. However, for the rail traffic that can benefit from regulated interswitching, there is good reason to ensure access to at least another rail carrier, even if it is no more than duopolistic competition between CN and CP. That is the shipper's objective: to go from monopoly rail rates and service to a duopoly (i.e., a step closer to effective competition), which the shipper can achieve in some circumstances for some shipments, if regulation permits it.

The right radial distance limit could provide duopolistic competition for more shipments than today. Today, a shipper within close proximity to an interchange between CN and CP can create some commercial tension where CN and CP otherwise monopolize origin-destination pairs and exercise market power over rates and conditions of service. With the Task Force's recommendation that government "*increase competition and balance negotiating power*", the Task Force has identified one obvious remedy that could provide some of that balance to at least some traffic that is otherwise exposed to monopoly market power.

McMillan Recommendation: Increase the regulated interswitching distance into two additional radial zones, upon application of a railway company or interested person (as defined in the Act), without geographic or product discrimination as occurred under Bill C-30. The two additional zones should be meaningful, such as the previous Zone 5 of up to 160 kilometres as was available under Bill C-30, and another of up to 1200 kilometres as found in Bill C-49.

[1] Per Agency Determination No. R-2021-176: [22] *The Agency explained in Determination No. R-2018-254 how it would comply with its statutory obligation to consider the long-term investment needs of railways when it established its methodological approach to setting interswitching rates. The Agency stated that it aims to capture the economic costs of providing interswitching service, which includes both the accounting and the implicit costs of a railway. The Agency stated that "[c]ompensating railway companies with the full economic costs of their operations supports their long-term economic viability in the market" (see paragraph 19). The Agency stated that it would take these investment needs into account by including a cost of capital allowance using CP and CN's cost of capital rates, as well as a depreciation allowance.*

by The McMillan Transportation Group

A Cautionary Note

The foregoing provides only an overview and does not constitute legal advice. Readers are cautioned against making any decisions based on this material alone. Rather, specific legal advice should be obtained.

© McMillan LLP 2022