DON'T COUNT YOUR EFFICIENCIES BEFORE THEY HATCH: EXPLORING THE FACTORS THAT IMPACT A RAILWAY'S OPERATING RATIO

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Canadian Pacific Railway ("**CP**") has significantly reduced its operating ratio in the past few years. From an investor's perspective, this is a good thing: a lower operating ratio means CP is incurring less operating cost per $ of revenue (i.e., "*Operating Ratio*" = *Operating Costs/Revenue*).

While commentary has attributed CP's operating ratio decrease to an increase in the company's efficiency (more specifically, operational improvements), our analysis identifies other significant drivers of the operating ratio decrease from 2012 to 2016. We discuss our findings and support for our conclusions in a recent paper presented by Ryan Gallagher to the Canadian Transportation Research Forum entitled "Operating Ratio As A Measure of Railway Operating Efficiency".

Highlights from the paper include:

- An analysis of the effect of CP's **fuel expenses** on its operating ratio, including the impact of lower fuel prices, over which CP has no control, and improved locomotive efficiencies, which arise from capital rather than operational decisions. The data shows that these fuel-related factors have independently reduced CP's operating expenses, (and therefore, operating ratio), over the years.
- An examination of the **impact** of CP's freight revenue (i.e., rate) increases on operating ratio, which have increased by approximately 12% between 2012 and 2016. The increase is even more striking when we remove the confounding impact of the decrease in CP's fuel expenses (which leads to lower freight revenue due to CP's fuel surcharge tariffs) over those years; subtract that, and the freight revenue increase is closer to 20% over the same period.
- A discussion of CP's failure to pass along any efficiency gains to its customers. For example, some of CP's $432 million reduction in annual fuel expenses between 2012 and 2016 is attributable to improved locomotive fuel consumption. In a competitive market, we would expect those efficiency gains to be shared with customers through reductions in rates or fuel surcharges or both. Since 2012, CP has continued to increase rates and has made no corresponding adjustments to how it calculates fuel

surcharges, securing a lower operating ratio at the expense of its customers, or at least the captive ones.

The full text of the paper can be found here.

by Ryan Gallagher, François E.J. Tougas, Lucia Stuhldreier, and Grace Shaw

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.