

## RAIL FUEL SURCHARGES – HISTORY AND RECENT DEVELOPMENTS<sup>1</sup>

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### Introduction

In recent years, fuel surcharges have become an integral feature of the Class I rail carrier landscape. This paper examines some of the history of fuel surcharges in rail and other modes, recent rail carrier fuel efficiency improvements, and changes to certain fuel surcharge tariffs, all of which tends to suggest rail carriers may be over-recovering their actual fuel costs.

### Background

Fuel surcharges are incremental charges that are added to the base rate of a shipment to account for fluctuating fuel prices. Fuel surcharges were originally introduced in the 1970s by trucking companies as a result of fuel price volatility caused by oil supply disruptions.<sup>3</sup> These disruptions were caused by political events, such as the Organization of Petroleum Exporting Countries (OPEC) oil crisis and the Arab Oil Embargo. Both Canada and the United States, amongst other countries, were targeted by the Arab Oil Embargo, and fuel prices in North America spiked significantly in response. Once the political tensions of the 1970s subsided, fuel surcharges were generally removed, but trucking companies started to re-introduce them during the 1990s when the price of diesel escalated due to tensions in the Middle East and the Gulf War. Since then, fuel surcharges have become more common in rail, trucking, marine and air transportation.<sup>4</sup>

Many fuel surcharges across all modes of transport in North America are calculated using a pre-determined index. Diesel prices tend to be used for surcharges in the surface modes due to the prevalence of diesel engines in commercial trucks and freight locomotives, whereas jet fuel prices tend to be used for surcharges in air transportation.

The Energy Information Administration (“EIA”), an independent arm of the United States Department of Energy, calculates a National Retail Diesel Average, which is the national U.S. average price that retail consumers pay per gallon of diesel fuel, calculated on a weekly basis using information collected from fuel stations across the U.S. The EIA also publishes regional and sub-regional diesel price data, as well as information on other fuels, including jet fuels.<sup>5</sup> Natural Resources Canada publishes similar diesel fuel price information based on data taken from 45 Canadian cities.<sup>6</sup> Nonetheless, the EIA’s data tends to be more commonly used.

Although many carriers use EIA data to calculate fuel surcharges, the EIA does not actually assess or regulate fuel surcharges, nor does any other regulator in many contexts. Thus, in the absence of regulation, there is a risk that carriers’ fuel surcharges may over-recover their actual fuel costs where competitive pressure may not be sufficient (or exist at all) to limit that risk, as discussed below.

### Initial Rail Carrier Fuel Surcharges

Rail carrier fuel surcharges have been contentious since their inception in the early 2000s. Many of

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the initial fuel surcharge programs the Class I rail carriers implemented were tied to the freight rate paid by the traffic (*ad valorem*, or a percentage of the freight rate). As a consequence, the amount of fuel surcharge had little nexus with the actual amount of fuel being consumed by the carrier for the particular shipper's movement. This led to a significant United States Surface Transportation Board ("STB") proceeding and landmark 2007 decision (the "**2007 STB Fuel Surcharge Decision**") that determined that rate-based fuel surcharges are misleading and an unreasonable practice.<sup>7</sup> The 2007 STB Fuel Surcharge Decision also encouraged the rail carriers to base their fuel surcharges on the "U.S. No. 2 Diesel Retail Sales by All Sellers (Cents per Gallon)" ("**OHD**" or "**HDF**") published by the EIA.<sup>8</sup> Shortly thereafter, the Class I rail carriers responded by publishing fuel surcharge tariffs that imposed a per railcar charge that varied with the rail mileage associated with the traffic when the price of OHD exceeded a specified threshold.

In particular, Canadian National Railway ("CN") introduced CN Fuel Surcharge Tariff 7402 ("**CN 7402**"), which was a mileage-based fuel surcharge tariff that applied when the monthly average price of OHD exceeded US\$1.25.<sup>9</sup> A short time later, CN introduced CN Fuel Surcharge Tariff 7403 ("**CN 7403**") that became effective April 1, 2008, which was identical to CN 7402, except that CN 7403 applies when the price of OHD exceeds US\$2.30.<sup>10,11</sup> CN indicated in 2014 that "changes in the HDF Index and in CN's average fuel costs have generally tracked closely".<sup>12</sup> CN 7403 had remained substantially intact since its implementation, until recently.

Following the publication of CN 7403, CN began to insist on a 'revenue-neutral re-basing' of the base rate in shippers' rail freight arrangements (contracts and tariffs) as they came up for renewal. While the vast majority of these negotiations occurred in confidential settings, there is at least some evidence of this rate re-basing initiative on the public record.<sup>13</sup> Importantly, the base rate increase would not allow shippers to receive a rebate or any other compensation when the price of OHD fell below US\$2.30 (which it has for significant stretches since 2008)<sup>14</sup>; in other words, the re-basing effectively trapped the cost of fuel below US\$2.30 within the base rate, whether or not CN actually incurred it. In addition, this trapped portion of CN's fuel costs would inevitably be subject to CN escalation of the base rate at each renewal period.

### **Improvements in CN and CP Fuel Efficiency**

CN and CP have typically defended their fuel surcharge tariffs on the basis that they simply recover the cost of fuel used; they steadfastly deny that their fuel surcharge programs generate profit. For example, a 2014 CN submission to the STB stated that CN "does not view and has not sought to use its fuel surcharge program as a profit center".<sup>15</sup> CP has also publicly represented to the STB that its fuel surcharge programs simply pass through to shippers CP's fuel costs without markup.<sup>16</sup>

However, CN and CP have both significantly improved the fuel efficiency of their operations since the 2007 STB Fuel Surcharge Decision, and also since 2014 (when CN confirmed its average fuel costs closely tracked the HDF index used in its tariffs). Figure 1 below summarizes the fuel efficiency of the locomotives used by CN and CP for each year since 2007 as publicly reported and expressed in gross-ton miles (GTMs) per gallon of fuel consumed:

**Figure 1 - CN and CP Fuel Consumption Improvements (2007 - 2021)<sup>17</sup>**

Year	GTMs per gallon of fuel consumed	
	CN	CP
2007	887	826
2008	893	820
2009	931	840
2010	959	855
2011	973	847
2012	987	870
2013	994	943
2014	1,019	966
2015	1,040	1,001
2016	1,061	1,020
2017	1,063	1,020
2018	1,060	1,049
2019	1,070	1,047
2020	1,124	1,062
2021	1,153	1,074
<b>% change since 2007</b>	<b>30.0%</b>	<b>30.0%</b>
<b>% change since 2014</b>	<b>13.2%</b>	<b>11.2%</b>

Figure 1 indicates that CN and CP have each improved the fuel efficiency of their operations by approximately 30% since 2007, and approximately 13% and 11%, respectively, since 2014.

Despite these fuel efficiency improvements, neither CN nor CP has significantly revised its fuel surcharge tariffs to pass along any benefit to shippers. It is trite to say that, in the long run, competition for the provision of freight rail services would result in the passing of cost savings to shippers. CN and CP have repeatedly proven they are immune to competitive outcomes; fuel is just another example. CN and CP realize these fuel efficiency gains (in the form of decreased costs of production) without a competitive need to revise downward the recovery from the application of their fuel surcharge tariffs. The available data strongly suggests that both CN and CP are significantly over-recovering their actual fuel costs, even before the change to CN 7403 described under the next heading.

Because the fuel surcharges of CN and CP are assessed on a per carload revenue mile basis, we examined whether each carload is carrying more GTMs, which may operate to offset the increased per GTM fuel efficiency. However, this appears not to be the case, as the average GTMs per carload revenue mile for CN and CP have been either stable or decreasing in recent years.<sup>18</sup>

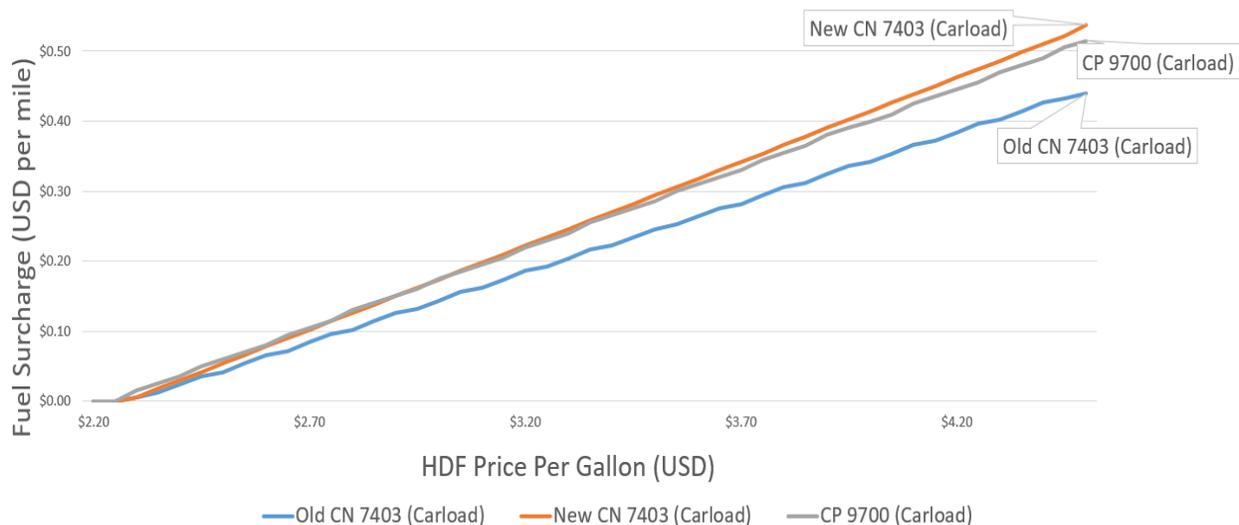
Fuel revenue recovery is not correlated to cost, as a competitive environment would demand. Instead, fuel surcharges above cost are nothing more than rate increases by another name. Any over-recovery of fuel costs calls for regulatory oversight. Indeed, the STB implicitly acknowledged the need for regulatory oversight, when it issued a companion decision to the 2007 STB Fuel Surcharge Decision that required the U.S. Class I rail carriers to submit a monthly report to the STB containing certain fuel consumption, cost, and revenue information.<sup>19</sup> However, the corresponding Canadian regulator, the Canadian Transportation Agency (the “**Agency**”), has not received any publicly available application in which it could review the issue.

### CN's Recent Changes to CN 7403

CN has not only failed to pass along its fuel efficiency improvements over the past several years, recently it has gone a step further and unilaterally modified CN 7403 to increase its unconstrained revenue recovery even more. Effective November 1, 2021, CN increased the slope of CN 7403 (“**New CN 7403**”) such that each carload shipper pays an incremental US\$0.06 for each incremental increase of US\$0.025 per gallon of OHD, instead of each US\$0.030 per gallon increase in OHD under the previous iteration of CN 7403 (“**Old CN 7403**”).<sup>20</sup> CN made a corresponding change to the version of CN 7403 that applies to “Bulk” traffic.<sup>21</sup> Figure 2 below depicts the slope of Old CN 7403 for carload traffic, New CN 7403 for carload traffic, and the carload version of CP’s mileage-based fuel surcharge tariff 9700 (“**CP 9700**”).

CN has subsequently split New CN 7403 into an “Intra-Canada Fuel Surcharge” section for shipments that originate in and are destined to a point in Canada, and a “U.S. Fuel Surcharge” section that applies to shipments that originate in or are destined to points in the United States or Mexico. Effective March 3, 2022, CN increased the slope of the U.S. Fuel Surcharge such that each bulk and carload shipper pays an incremental US\$0.065 for each incremental increase of US\$0.025 per gallon of OHD above US\$2.30. We ignore that change for the purposes of this paper, and focus on the Intra-Canada Fuel Surcharge in New CN 7403. However, the many Canadian shippers that ship rail traffic into the United States from Canada will be negatively impacted by the increased slope of the U.S. Fuel Surcharge in New CN 7403.

**Figure 2 - Old CN 7403 vs. New CN 7403 vs. CP 9700**



As demonstrated in Figure 2, the more that the OHD price increases, the more New CN 7403 diverges from Old CN 7403, to the detriment of shippers subject to New CN 7403. That difference is far from trivial. For example, even if only 50% of shipments on CN are subject to CN 7403, at an average fuel price of US\$3.50 per gallon, CN would generate in excess of US\$100 million per year simply due to the slope change from Old CN 7403 to New CN 7403 (and ignoring the further slope increase of the U.S. Fuel Surcharge in New CN 7403).<sup>22</sup> At US\$4.00 per gallon, the incremental revenue exceeds US\$150 million using the same assumptions.

To our knowledge CN has not publicly articulated any rationale for the increase to the slope of New CN 7403 despite the slope of Old CN 7403 being in place since the inception of CN 7403 in 2008, much less justified it on the basis of its actual fuel costs.

One might infer that the slope increase to CN 7403 was responsive to the variety of public criticisms levelled at CN by CIFF Capital UK LP and TCI Fund Management Limited (together, “TCI”), a UK-based hedge fund beginning, at least publicly, in late spring of 2021.<sup>23</sup> Other activist investors reportedly sought similar changes.<sup>24</sup> In particular, TCI sought, and ultimately achieved, changes to CN’s board of directors and management, including the replacement of J.J. Ruest as CEO of CN with Tracy Robinson in late January 2022.<sup>25</sup> TCI explicitly expressed a goal of generating “better operating margins” and “higher free cash flow, increased return on invested capital”.<sup>26</sup> CN announced the change to the slope of CN 7403 in late September 2021 following increasingly public and hostile criticism from TCI in late summer 2021. The strategic plan CN announced on September 17, 2021 did not explicitly address the change to the slope of CN 7403, although it made reference to increasing shareholder returns and lowering its operating ratio, both of which would be advanced by the increase to the slope of CN 7403.<sup>27</sup>

## Conclusion

CP and CN appear to be over-recovering their actual fuel costs via their fuel surcharges. CN has not been required to demonstrate that its recent changes to CN 7403 are necessary and reasonable. Excessive revenue recovery requires regulatory oversight, in the same way that rail freight rates that long ago surpassed the competitive level of rates requires a regulatory response to diminish or at least restrict the well-understood harms of excessive pricing.

## Endnotes

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<sup>3</sup> For an overview of considerations and history, see U.S. Energy Information Administration, Oil and Petroleum Products Explained: Oil prices and outlook, available at: <https://www.eia.gov/energyexplained/oil-and-petroleum-products/prices-and-outlook.php>

<sup>4</sup> Fuel surcharges are also applicable in some passenger contexts, but that topic is outside the scope of this paper.

<sup>5</sup> U.S. Energy Information Administration, Petroleum & Other Liquids, available at: <https://www.eia.gov/petroleum/gasdiesel/>

<sup>6</sup> Natural Resources Canada, Transportation Fuel Prices, available at: <https://www.nrcan.gc.ca/our-natural-resources/domestic-and-international-markets/transportation-fuel-prices/4593>

<sup>7</sup> STB decision 37341 dated January 25, 2007 in STB Ex Parte No. 661, page 7: “...the term “fuel surcharge” most naturally suggests a charge to recover increased fuel costs associated with the movement to which it is applied. If it is used instead as a broader revenue enhancement measure, it is mislabeled. This sort of mislabeling appears designed to avoid the type of response a carrier would likely receive if it were to honestly inform a shipper that a higher rate was being imposed to recover not only the increased fuel cost of serving that shipper, but also the increased cost of fuel for another shipper’s traffic— which is what would often occur under rate-based fuel surcharges. But the fact that a railroad may not be able to recover its increased fuel costs from some of its traffic (for example, traffic covered by a contract lacking a provision to pass through such costs) does not provide a reasonable basis for shifting those costs onto other traffic in this manner. We believe that imposing rate increases in this manner, when there is no real correlation between the rate increase and the increase in fuel costs for that particular movement to which the surcharge is applied, is a misleading and ultimately unreasonable practice.”

<sup>8</sup> 2007 STB Fuel Surcharge Decision, page 11.

<sup>9</sup> CN 7402 is no longer available on CN’s website.

<sup>10</sup> CN 7403 is available at: <https://www.cn.ca/en/customer-centre/prices-tariffs-transit-times/fuel-surcharge/>

<sup>11</sup> Also effective April 1, 2008, CN reduced the slope of CN 7402 for carload commodities from a US\$0.0064 surcharge for each US\$0.03 increase in the price of HDF per gallon, to an incremental US\$0.006 for each US\$0.03 increase in the price per gallon of HDF. At the same time, CN reduced the slope of CN 7402 for bulk commodities from a US\$0.0061 surcharge for each US\$0.03 increase in the price of HDF per gallon, to an incremental US\$0.00575 for each US\$0.03 increase in the price per gallon of HDF. This was the same slope as the then new CN 7403. The slope of CN 7403 remained the same until the implementation of New CN 7403.

<sup>12</sup> See CN submission dated August 4, 2014 to the STB in Ex Parte No. 661 (Sub No. 2), page 3: “Since that time [2008], changes in the HDF Index and in CN’s average fuel costs have generally tracked closely, so that the difference between average retail fuel prices reflected in the HDF Index and CN’s actual average fuel costs has remained relatively stable over that time. Therefore, the HDF Index has been and continues to remain a reliable and reasonable proxy for changes in CN’s fuel costs.”

<sup>13</sup> Paragraphs 31 - 36 of CN's factum dated August 1, 2013 in support of CN's appeal to the Supreme Court of Canada of a Governor-in-Council decision overturning an Agency decision relating in part to CN's fuel surcharge programs makes reference to CN's practice of re-basing its tariff rates generally, and for a particular shipper: [https://www.scc-csc.ca/WebDocuments-DocumentsWeb/35145/FM010\\_Appellant\\_Canadian-National-Railway.pdf](https://www.scc-csc.ca/WebDocuments-DocumentsWeb/35145/FM010_Appellant_Canadian-National-Railway.pdf)

<sup>14</sup> For example, CP's fuel surcharge tariff 9700 demonstrates that OHD prices fell below US\$2.30 in early 2016: <https://www.cpr.ca/en/customer-resources/pricing-and-tariffs/fuel-cost-adjustment/tariff-9700>. Earlier iterations of CP fuel surcharge tariff 9700 indicate that OHD prices fell below US\$2.30 in early 2009.

<sup>15</sup> See CN submission dated August 4, 2014 to the STB in Ex Parte No. 661 (Sub No. 2), page 4.

<sup>16</sup> See Verified Statement before the United States Surface Transportation Board of Marcella Szel, Senior Vice President, Marketing and Sales for CP, dated April 26, 2006, page 5 in STB Ex Parte No. 661: "The Board's March 14 Decision indicates that some shippers are concerned that railroad fuel surcharges "are designed to recover amounts over and above increased fuel costs." (March 14 Decision at 1.) This is certainly not true of CPR's fuel surcharge program....CPR's fuel surcharge program is not designed to recover amounts in excess of the increase in its fuel expense during a given year and it has not done so."

<sup>17</sup> All data sourced from the public disclosure of CN and CP. CN's public disclosure for 2019 and earlier reports "GTMs per US gallon of fuel consumed" directly, while CN's disclosure for 2020 and later uses the measure "US gallons of locomotive fuel consumed per 1,000 GTMs", which is the inverse of the data in Figure 1. CP's public disclosure reports fuel efficiency using "U.S. gallons of locomotive fuel consumed / 1,000 GTMs".

<sup>18</sup> For example, CN's public disclosure reports that in 2010 it transported 4,696,000 carloads of revenue freight an average haul of 600 miles, which produces approximately 2,817,600,000 total carload revenue miles. CN transported 341,219,000,000 total GTMs in 2010, which produces a ratio of 121.1 GTMs/carload revenue mile. By 2019, the last year for which CN had publicly reported its average length of haul across all commodities at the time of writing, the same calculation produced a ratio of GTMs/carload revenue miles of 105.1. The corresponding calculation for CP produces a ratio of 118.0 GTMs/carload revenue mile for 2013 and 115.2 GTMs/carload revenue mile for 2020.

<sup>19</sup> STB decision 37582 dated January 25, 2007 in STB Ex Parte No. 661 (Sub-No. 1).

<sup>20</sup> See CN 7403 effective November 1, 2021.

<sup>21</sup> CN 7403 defines "Bulk commodities" as coal, fertilizer and grain and includes a list of eligible Standard Transportation Commodity Codes.

<sup>22</sup> This approximation is based on US\$3.50/gallon OHD price, total carloads of 5,595,000 (CN 2020 actual), travelling an average of 777 rail miles (CN 2019 average for all commodities). For the purposes of this approximation, we use the carload version of New CN 7403 and Old CN 7403 and ignore the relatively minor difference between the bulk and carload versions of CN 7403.

<sup>23</sup> For example, see TCI's letter to CN dated May 18, 2021. TCI's various public statements are no longer publicly available on TCI's website.

<sup>24</sup> For example, see the BNN Bloomberg report dated October 20, 2021 that indicates Elliott Investment Management LP sought changes at CN: <https://www.bnnbloomberg.ca/paul-singer-s-elliott-owns-cn-rail-stake-will-push-for-change-1.1669291>

<sup>25</sup> See CN news releases dated January 25, 2022 at: <https://www.cn.ca/en/news/2022/01/cn-announces-appointment-of-tracy-robinson-as-president-and-chie/> and <https://www.cn.ca/en/news/2022/01/cn-reaches-resolution-agreement-with-tci/>.

<sup>26</sup> TCI document entitled "The Case for Board and CEO Change at Canadian National" dated October 2021, slide 34.

<sup>27</sup> See CN news release dated September 17, 2021: <https://www.cn.ca/en/news/2021/09/cn-outlines-details-of-strategic-plan/>. Also, see CN news release dated October 1, 2021 entitled "CN Responds to TCI's Misleading Claims": <https://www.cn.ca/en/news/2021/10/cn-responds-to-tcis-misleading-claims/>