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<b>Date</b>	December 30, 2014

**Via email to: [secretariat@reviewcta-examenlrc.gc.ca](mailto:secretariat@reviewcta-examenlrc.gc.ca)**

The Honourable David Emerson, P.C.  
Chair, Canada Transportation Act Review  
350 Albert Street, Suite 330  
Ottawa, ON K1A 0N5  
(613) 998-8405

Attention:      Secretariat

**Re:      Submissions**

Please find attached my submissions to the 2015 *Canada Transportation Act Review*.

I have participated on my own and on clients' behalf in several reviews of rail transportation law and policy, including before the Canada Transportation Act Review Panel (2000), processes before the Canadian Transportation Agency, Transport Canada, the Standing Committee and Transport, Infrastructure and Communities (and predecessors), the Ministries of Agriculture, Natural Resources, Foreign Affairs and International Trade, as well as before provincial bodies, and in private practice, representing shippers, intermediaries, railways, private investors and associations. It has been my good fortune to have been deeply involved in the practice and reform of rail practice and policy. My qualifications are attached.

The attached submissions express my own views and not those of my firm, clients or other persons. Thank you for the opportunity to make them. I look forward to further deliberations and would be pleased to participate in stakeholder representations and consultations. Best wishes to you all.

Yours truly,

François Tougas\*

FET/sgill  
Encls.

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## **Submissions to the Review of the *Canada Transportation Act***

The Discussion Paper issued in connection with the Review well describes Canada's transportation system and the challenges and decisions we face as Canadians in connection with that system, as well as the opportunities before us.

### **Scope and Thesis of Submissions**

These submissions are limited to the rail freight sector, although I have addressed the other commercial systems that rail freight transportation touches, including production, distribution and intermediaries, as well as other modes of transportation.

The thesis of these submissions is that adequate rail service in Canada is not priced correctly on some parts of the rail systems of Canadian National Railway and Canadian Pacific Railway because of a lack of direct competition. As a consequence, Canada suffers from reduced national income due to unutilized or underutilized productive capacity, lack of access to exportable or otherwise exploitable resources and government policy objectives that work against each other in overcoming that income shortfall.

This is not a call for economic intervention. That may be necessary in some cases, but is not an attribute of the thesis advanced. It is not a call for subsidization, although others might present a worthy case justifying it on the basis of economic or regional development, or even nation-building. Instead, this is a call for a simple policy change to let other actors, notably participants in the supply chain, make their own decisions as to what is and what is not commercially viable, using the same economic forces we count on for other commercial transactions, namely, direct competition.

### **1) Introduction**

As the Discussion Paper articulates, the sheer geographic expanse of Canada magnifies the challenges both in relation to our relatively small population (and tax) base and our ability as a country to compete in a dynamic global economy that is hungry for efficiency in all systems, including transportation. However, these challenges are borne out of the good fortune we have to live in a geography filled with abundant resources and the means to benefit from them. More daunting is the possibility that we will fail to act, in a meaningful way, to secure those benefits for future generations.

The authors of the Discussion Paper are correct to point out that our national wealth is very much a function of our ability to deliver goods from the point of production to our domestic and export customers via the transportation system. Indeed, Transport

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Canada's own data demonstrates the importance of transportation to national income. Notably, the value of exports to the United States dominates.

## Canada's Exports by Origin<sup>2</sup>, Destination and Mode of Transport, 2013<sup>P</sup> (\$Mils)

<i>Total exports<sup>1</sup> country of destination</i>	<i>Eastern provinces</i>	<i>Western provinces</i>	<i>Total 2013<sup>P</sup></i>	<i>Main modes used (Per cent of total value)</i>
<b>United States</b>	<b>220,936</b>	<b>136,537</b>	<b>357,473</b>	<b>Road (44), Pipeline (24)</b>
<b>Other Countries:</b>	<b>65,871</b>	<b>48,083</b>	<b>113,955</b>	<b>Marine (63), Air (31)</b>
Asia	19,665	30,883	50,548	Marine (78), Air (20)
Western Europe	29,750	5,960	35,710	Air (53), Marine (45)
Latin America	7,929	5,755	13,684	Marine (53), Road (20)
Middle East	3,523	1,913	5,436	Marine (63), Air (27)
Eastern Europe	2,279	964	3,244	Marine (60), Air (32)
Africa	1,441	1,710	3,151	Marine (67), Air (26)
Oceania	1,251	895	2,146	Marine (51), Air (31)
Other	33	3	36	Marine (77), Air (22)
<b>Total</b>	<b>286,807</b>	<b>184,621</b>	<b>471,428</b>	<b>8</b>

TABLE EC13 (SA2013)

P = Preliminary data

<sup>1</sup> Total exports are the sum of including domestic exports and re-exports. For exports, mode of transport information represents the mode of transport by which the international boundary is crossed. This may be different from the mode of transport within Canada.

<sup>2</sup> Province of origin for exports. Province of clearance for imports, as the final destination is unknown.

Eastern provinces include the Atlantic provinces, Quebec and Ontario. Western provinces include the Prairie provinces, British Columbia and the Territories (Yukon, Northwest Territories and Nunavut).

Another notable feature of Table EC13 is that rail transportation is absent. In fact, however, rail transport to the USA ranked third (projected 2013) when measured in value of goods, at \$75 billion, compared to "Other" (pipeline) at \$87 billion and road at \$157 billion, as seen below in the composite of Tables EC6, EC7.

## Exports to USA/ROW by Mode (2013 \$mil)

<i>Modes</i>	<i>USA Only 2013<sup>P</sup></i>	<i>USA Only 2003</i>	<i>ROW 2013<sup>P</sup></i>	<i>ROW 2003</i>
Road	157,249	173,465	4,790	2,977
Rail	75,094	71,671	2,132	900
Marine	23,573	12,061	71,338	35,772
Air	14,387	17,290	35,052	14,721
Other	87,171	52,212	643	2
<b>Total</b>	<b>\$357,473</b>	<b>\$326,700</b>	<b>\$113,955</b>	<b>\$54,372</b>

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### EC6, EC7 (SA 2013)

<sup>1</sup>For exports, the mode of transport represents the mode of transport by which the international boundary is crossed. This may be different from the mode of transport within Canada. Total exports are the sum of domestic exports and re-exports.

<sup>P</sup> = Preliminary data

ROW = Rest of World

Composite table EC6/EC7 highlights the decline of road exports over the 10 year period ending in 2013 and the rather dramatic rise in marine and pipeline in the same period. Rail exports, somewhat bumpy over the period, in part due to weak lumber demand and the 2009 recession, finished somewhat higher. Once figures are in, we could see trucking fall to third place, as crude-by-rail shipments are added to the oil and gas pipeline exports to US destinations. See Crude-by-Rail discussion below.

Both table EC13 and the composite table EC6/EC7 above demonstrate the importance of the marine trade to the export of Canadian goods, while composite table RA18/RA24 below demonstrates the role that rail plays in getting volumes to export position for furtherance by vessel in that marine trade.

## Volume of Rail Marine Exports by Origin *(Thousands of tonnes)*

<i>Province/Country</i>	<i>2011</i>	<i>2013</i>
British Columbia	34,517.6	n/a
Alberta	25,360.3	-
Saskatchewan	23,982.0	-
<i>United States</i>	4,459.4	-
Manitoba	4,008.3	-
Ontario	3,002.7	-
Québec	1,035.1	-
Nova Scotia	1,269.2	-
New Brunswick	949.0	-
<i>Mexico</i>	2.4	-
<b>Total</b>	<b>98,585.9*</b>	<b>104,606<sup>P**</sup></b>

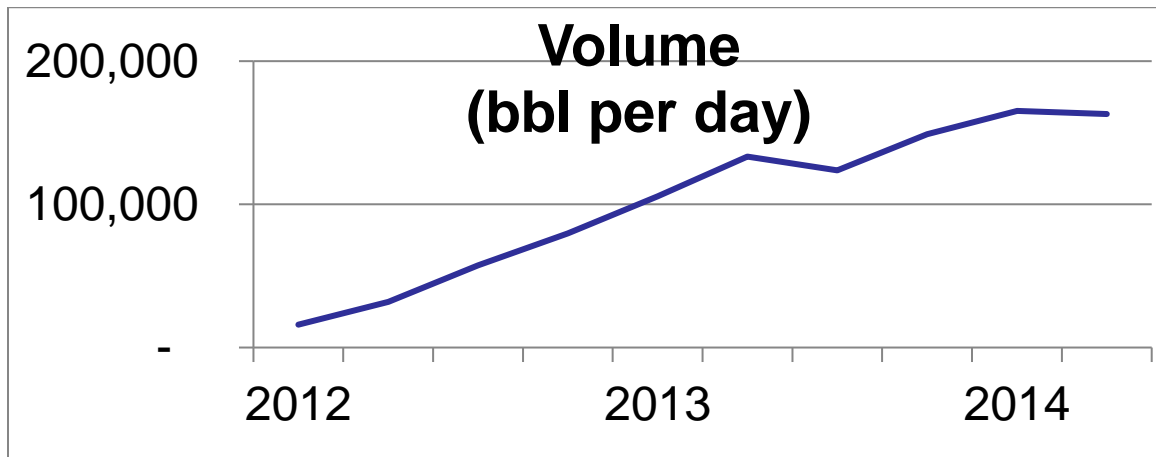
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\*RA24 (2011SA)

\*\*RA 18 (2013SA) 2013 = 104,606P

### 2) Crude-by-Rail

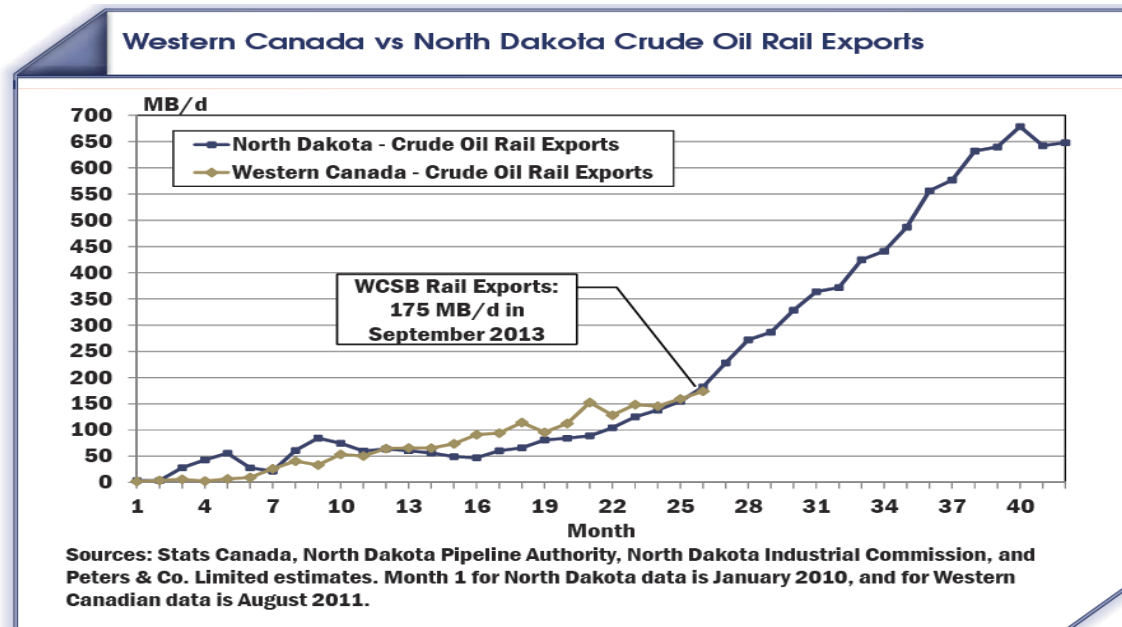
Total Canadian production crude oil reached 3.478 million barrels per day in 2013 and by the first half of 2014, had climbed to 3.763 mbd. Of that amount, total exports to US destinations reached 2.692 mbd or 71% of H1/14 production. And, while pipeline capacity was used up, Canadian rail exports to US destinations in Q1/14 was 0.165 mbd or 6.13% of exports. Whether that is a stable or rising number is yet to be determined, but the greatest likelihood is that crude-by-rail shipments will rise until pipeline capacity catches up or demand goes down. It is hard to ignore shape of the crude-by-rail exports to USA graph immediately below, based on the National Energy Board's quarterly tracking of all crude shipments.



NATIONAL ENERGY BOARD (2014)

And, if we as Canadians thought that the advent of crude-by-rail was a Canadian thing, we can think again. Crude-by-rail shipments from North Dakota (Bakken shale formation) and Western Canadian origins were tracking each other until about Sep 2013, but then Bakken crude shipments took off, as seen below.

## WCS v Bakken Rail Exports



### WCS v BAKKEN CRUDE-BY-RAIL EXPORTS

Per Canadian Association of Petroleum Producers, Sept 2013

### 3) A Few Questions

#### a) What does the advent of crude-by-rail shipments mean for rail policy?

Both the onset and sudden rise in crude shipments may mean temporary or short-term congestion, whether caused by winter, bumper crops, overlapping peak demand of multiple commodities, etc. Or, perhaps crude-by-rail shipment increases are the primary reason in certain corridors but not others. Perhaps longer term congestion is caused by a repetition of some or all of these short term issues or by poor rail asset management or investment decisions, or other reasons, such as decisions not to size equipment fleets to meet peak or even mean demand. Legislating specified volumes of shipments within prescribed time periods is unlikely to succeed as a long term strategy to yield the benefits in the statement of national transportation policy articulated in section 5 of the Act.

b) How do we know the reasons for a service failure?

The data to make a good assessment of the causes of failed rail service to grain farmers in 2014, or regularly-occurring poor rail service over sustained periods generally, is not available in Canada. This is a significant shortcoming in federal rail policy, both for private users and policymakers that is easily remedied.

c) How would data help government manage our rail transportation system of indirect or surrogate competition for adequate rail service?

Rail freight transportation users rely on government to manage this part of the national economy as a long held policy choice. Government manages rail use through legislative remedies in order to countervail the exercise of railway market power, including express decisions by rail carriers to curtail supply or decisions to serve this shipper over that shipper in particular circumstances. In order to assess whether it should do this or that in response, government needs data.

d) How else would rail data help?

Transparent rail data would allow shippers, policymakers, adjudicators, regulators and intermediaries assess the reasons for failures and successes, whether a statutory or adjudicative remedy was reasonable in the circumstances, or even the right remedy or how much of the remedy should be available in which circumstances. A shipper could know whether to bring a complaint, a policymaker would know whether a new remedy was needed, an old one changed or discarded, an adjudicator would know whether either a carrier or shipper was over-demanding or under-supplying, a regulator would know whether a carrier was off-market for price or level of service or even questions about impact on networks, and intermediaries could benchmark, among other things, to generate the kind of information we are used to seeing in competitive marketplaces.

e) Would data help in a crisis?

Bill C-30 (*Fair Rail for Grain Farmers Act*) is an example of legislation responding in a rush, to a crisis the causes of which were surmised, and the effects of which were mostly foreseeable. In the absence of real time data, a regulatory system that relies on anecdotal evidence, typically one-sided, which relies heavily on complaints and defences that often cannot be proven, adds to the aggravation of rail users and puts government in the position of managing the economy blindly. Data could avert crises and manage the unavoidable ones better.

f) If not data, then what?

The most obvious solution, if we are not going to have fulsome, transparent, real time data, is direct competition for rail service. We count on direct competition in most industries, and have gone a long way in the past 30 years to privatize industry that previously was managed by government, in the hope of letting markets do their work in getting the right products to the right people in the right quantities and qualities at the right time. Where markets have not been able to do that, government has pushed industry, by regulation or intervention or otherwise, toward competitive market models. For rail policy, we have chosen surrogates for competition (without adequate data) instead, created schemes for dispute resolution that avoid direct competition, and have expected these schemes to answer all friction occasioned by a lack of market discipline. In the absence of robust reasoning, we have preferred episodic and often superficial change that merely pushes off the problem to the next crisis, whether it's a bumper crop resulting in Bill C-30, or several years of prolonged failures leading to the Rail Freight Service Review, the Dinning Panel and eventually Bill C-52 (The Fair Rail Freight Service Act) resulting in yet more government management of the rail economy using systems that may distort what a competitive market would otherwise dictate or that fail entirely for the barriers to access they create.

4) **Railway Company Competition for Capital, Customers and Supply**

Insofar as the rail freight transportation system is manifestly private, and in constant need of capital, decisions regarding investment in operations and infrastructure renewal and expansion is very much a function of the ability of two railway companies (Canadian National and Canadian Pacific) to access capital. They do so through public capital markets and answer the demands of participants in those markets, which are often at odds with the needs of the rail users and even at odds with the national interest in increasing total economic welfare.

a) The More or Less Competitive Parts of the Rail System

For significant segments of their respective rail systems, CN and CP compete for capital, customers and the supply of inputs. These two railway companies, like others, in many instances must compete against other railways, other modes of transportation, and other organizations for these essential enterprise components. The rail system segments of CN and CP that face competition for these three things can thrive, assuming effective management and barring unusual incidents, as long as they have access to all three. And, as long as that is the case, taxpayer funded assistance is



largely unnecessary because CN and CP can make their own decisions about the value of necessary investments and returns.

Government management of these parts of the two railway systems is perhaps unnecessary; demand and supply functions help managers make the decisions to the degree of the robustness of the competition. These functions may arise in the form of intramodal competition (railway v. railway) or intermodal competition (railway v. marine, truck, pipeline). Even with only two competing carriers or modes, in the absence of collusion (in the broadest sense, including tacit collusion), the benefits of competition may be realized. There are many examples of duopolies that work in some markets. It is not surprising that in many instances, duopolistic competition breaks down, sometimes for entire systems, but usually for parts of systems. At that point, others manage, usually in the form of government executive order (like Bill C-30), government administration of a regulatory scheme (through the offices of the Canadian Transportation Agency) or user dispute resolution (such as in the form of final offer arbitration with privately-appointed arbitrators).

b) The More or Less Captive (Uncompetitive) Parts of the Rail Systems

For many important segments of CN and CP's rail systems, competition for rail services is limited, ranging between inadequacy and outright captivity, resulting in a dual monopoly where neither the two carriers, nor other modes, compete at all. Often, these are geographically isolated markets for rail services. (The discussion in relation to this topic is characterized by polarized definitions, *e.g.* captive/not captive, when in fact competition in any market should be viewed as a continuum.)

The adequacy, effectiveness and competitiveness of alternatives faced by CN and CP for customers (primarily shippers) in these more or less captive markets for rail services is substantially diminished by three important factors:

- the disproportionately high cost of investment in infrastructure and operations,
- physical, logistical and regulatory barriers to entry, and
- policies at war with each other.

i) *Infrastructure Investment*

Rail infrastructure (and port, terminal and intermediary) investment is expensive. CN and CP repeatedly make this point. In a competitive market, say where both CN and CP can reach a prospective producer's built or planned facility, the proponents (and its financiers) may, in effect, auction off the right to serve the producer's facility to one or both of the two rail carriers (or other carriers

connecting to them). In fact, a decision to jointly serve a rail customer's facility is not in the interest of either carrier, although it happens. More likely, one of them prevails and gets more or less a monopoly right to serve. Once the infrastructure is in place, the monopoly is imbedded, since another rail carrier who comes along after the first has built into the producer's facility must spend capital to access a market that will be dual-served (subject to at least duopolistic competition) and therefore less likely to capture monopoly rents as part of its rate of return, thus making the investment less valuable to the second rail carrier. Consequently, a rail carrier has an incentive to invest in infrastructure where it will capture monopoly rents and has little fear of exposure to duopolistic competition if it is an auction winner.

The impact on infrastructure development of captivity is noteworthy. Since taxpayer-funded assistance for capital items is not part of Canadian development policy (and perhaps not even desirable), decisions whether to invest in infrastructure and operations, and in sources of railway inputs, is usually left to proponents (producers or shippers) and rail carriers. While private capital for developmental opportunities is restricted by the usual obstacles to investment, the market power enjoyed by CN and CP in these captive markets restricts infrastructure investment because returns are less than desirable for investors, proponents or both. That is because after the infrastructure is in place, the rail carrier is able to capture a greater share of the total surplus available from the very traffic that supports the infrastructure decision than it could capture in the face of competitive access to more than one carrier. Therefore, both internal and external investment incentives are tempered to the extent of the market power exercisable by CN and CP over the rates it can charge for the rail service once the infrastructure is in place. From a rail carrier's perspective, investment in infrastructure that yields monopoly rents is better than investment yielding returns subject to competitive pressures where contribution margins are smaller.

*ii) Barriers to Entry*

The provision of rail service is subject to physical, logistical and regulatory barriers to entry. A few examples follow, although no single example will serve to explain the gamut of such barriers or how each play on the other.

Physical: An example of a physical barrier to entry is the extent to which there is even room in a land corridor for more than one railway or other mode to provide a transportation service to a producer's facility. For a mill or mine in a remote location, physical access may be limited by economically accessible and suitable lands for rail. Facility location and rail accessibility are part of the

calculus in determining whether this part of a rail network will face competition. Similarly, they may determine whether the first carrier builds into a monopoly and its associated rents.

Logistical: An example of a logistical barrier to entry is whether the producer's product can be carried by more than one mode. Some fortunate producers have access to both more than one mode and more than one carrier per mode; the Mississippi River Valley is a good example. In these cases, barriers to entry are low. Possibly, a comparable in Canada is the St Lawrence River Valley, although its geographic orientation and location limits its usefulness. Some products are exposed to rail carriage only, including most bulk resources and many agricultural products. Low value, low density products that are shipped in high volumes over relatively long distances are particularly prone to carriage by rail (coal is a common example), but even more valuable, higher density products shipped in lower quantities can also be prone (a single carload of lumber shipped from Northwestern BC to a customer in Florida might be an example). There are many, many products on this continuum and the list includes much of Canada's resource and agricultural production. In these circumstances, neither trucking nor marine provide the slightest competition to rail; there are no rivers to carry coal where Canadian coal is located and the volumes involved are infeasible for trucking, and while volumes might be acceptable for trucks, to the extent available, the distances are too great for trucks, while no rivers can carry these products to customers from origin to destination. And, although trucks are physically able to carry lumber, say, the most they can do for the long haul nature of lumber shipments in North America is to carry it relatively short distances to a few railheads. Hence, many producers' facilities are logistically captive.

Regulatory barriers: Attempts have been made over the years to introduce remedial schemes to address the exercise of market power. Government regulation has created competition at origin or destination for some shippers and left many others out – regulated interswitching is an example – to that extent, the availability of a remedy to some but not others acts as a barrier to those left out. One might ask why one shipper would be favoured over another; the answers tend toward arbitrariness or expediency. Some remedies do not work for anyone (competitive line rates) and thus have the illusion of creating competition when rail carriers simply have avoided the remedy by refusing to participate altogether. Others are limited by domesticity and degree of captivity (final offer arbitration), which is available only for Canadian shipments to the most captive producers, where the efforts of rail carriers have been designed to make the remedy expensive and daunting, if not prone to retribution. Yet others, like the level of service complaint, have found few takers for some of the reasons mentioned

above, while the new service level arbitration scheme has built-in barriers to its use that limit its application. It is possible that, with a few tweaks here and there, all of those remedies could be improved and that something would be available for everyone. But, direct competition in the form of the running rights remedy, discussed further below, provides the most market-like attributes, little ongoing government oversight and very little legislative effort to make it work.

Similar situations regarding physical and logistical barriers to entry exist in the provision of terminal handling services. The BC coast, for example, has few outlets and considerable demand for available space; once a handling facility is built, it enjoys barriers to entry similar to those enjoyed by railways, in the form of monopoly rents or supracompetitive pricing and subcompetitive service levels, apart from the disincentives to innovate. (Note that in both the railway and terminal cases, however, there is an incentive to lower their own costs, since the monopolist also captures the surplus created by doing so, without having to forego productivity gains in those captive markets.) For terminal services, however, there is no regulatory scheme to prevent the exercise of market power, or perhaps even monopolization.

Railway market power on the captive parts of the two rail systems is not the only barrier to capital formation and the use and expansion of existing infrastructure corridors. And, these are not the only effects. The manifestations of railway market power in the form of supra-competitive rates and sub-competitive service levels, product choice and innovation directly impact total industrial output and national wealth.

### *iii) Policies at War with Each Other*

The adequacy, effectiveness and competitiveness of alternatives faced by CN and CP for customers in captive markets for rail services is diminished, too, by national policy choices. On the one hand, Canada has maintained a relatively strong pro-trade agenda for a long time, borne out of a recognition that it is in our national and individual interest to trade our abundant resources, goods and services. We need access to world markets to succeed. As has been said before, market access begins at home. If we cannot get to the resources or deliver the goods in a cost-effective, reliable and consistent manner, we undermine the efforts to gain access to export (and domestic) markets where we compete against others seeking to supply those markets.

If trade policy advances the interests of the export industries, rail policy does not. This is not to say rail carriers are incapable; quite the opposite. Canadian railways

have been and can be effective in carrying goods to domestic markets and to export position. Whether they do or not, however, and the impact on costs to the economy when they do not, has a lot to do with the structure of the markets in which they operate.<sup>1</sup>

Distinguishing between captive versus competitive markets is important in the analysis of adequacy, effectiveness, and competitiveness, however. Since incentives to meet demand diminish at origin as competition for cost-effective rail service diminishes, the need for direct and indirect competition increases to ensure that trade policy objectives are met for those shipping from captive markets.

Whatever one might think of the efforts to deregulate formerly regulated industries, particularly network industries such as telecommunications, gas and electrical utility generation and transmission, and transportation industries such as aviation and rail, a stark difference exists between the approach to rail and the rest. Ongoing efforts prevail to introduce direct competition on all of them, except freight rail. A possible explanation is that all of them directly react to most of the voting public, except freight rail. In any event, there has been no shyness from governments of all stripes to intervene in these other, formerly highly-regulated markets to introduce direct competition.

When it comes to freight rail, the contrast is all the more stark if only because of the statutory recognition that direct competition for freight rail is permissible in the form of running rights. The Act contemplates one rail carrier (a guest railway) running over the tracks of another rail carrier (a host railway). That provision has been in effect for 110 years, with nary an application between the large rail carriers. They should be at each other's throats and often claim that they compete against each other for business, yet CN and CP have not used the provision against the other. And, of the few outsiders who have tried, none have succeeded. Yet, we have not aligned trade and rail policy to achieve optimal results via competition.

## 5) Freight Railway Claims About Competitiveness

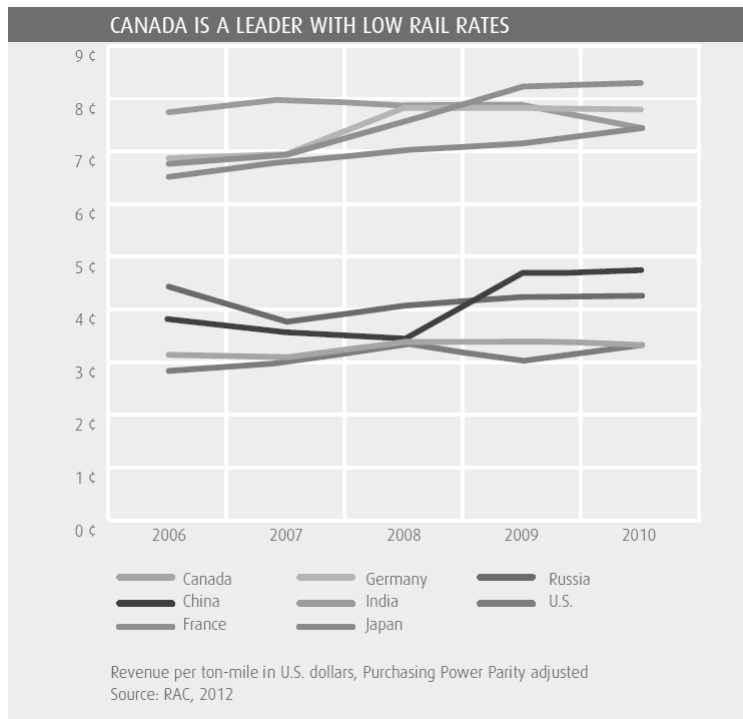
As represented elsewhere,<sup>2</sup> the Railway Association of Canada (RAC), as well as CN and CP, are fond of saying they offer “some of the lowest freight rates in the world”. They do

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<sup>1</sup> Gillen and Tougas, Transportation Policy, Competition and Economic Growth, 46<sup>th</sup> Annual Proceedings of the Canadian Transportation Research Forum (page 426 *et seq.*), May 2011

<sup>2</sup> Gallagher and Tougas, The Disclosure of Rail Carrier Costing Information, 48<sup>th</sup> Annual Proceedings of the Canadian Transportation Research Forum, June 2013, quoted at length here.

so by comparing rates on a cents per revenue tonne-mile (CRTM) basis. Rail carriers often quote units of cents per RTM in various materials as justification for rate levels. RAC, for instance, in support of its proposition, published the graph reproduced below:



Source: *Rail Trends 2012*, as published by RAC.<sup>3</sup>

RAC characterized the graph as representing “Canada’s freight rates throughout the last five years compared to most of the world’s largest economies”. The countries listed can be coarsely grouped into high cents per RTM countries and low cents per RTM countries, with Canada falling within the latter. When interpreting CRTM figures, it is important to note that the average distance travelled for each country is exactly as important to the expressed cents per RTM value as the average revenue figure. However, in respect of the above figure, the RAC provides no information as to the average length of haul in each country, thus rendering any comparisons essentially meaningless. Since Canadian rail carriers routinely transport bulk commodities such as grain, coal, potash, and others many hundreds of miles from origin to destination, they will necessarily have a disproportionately longer average length of haul relative to countries such as Germany and Japan, whose land mass simply would not allow for movements of such length. The RAC graph has simply identified large countries that contain relatively long rail movements, thereby obfuscating any meaningful revenue information. In other words, they have solved for distance, not rates.

<sup>3</sup> Railway Association of Canada, *2012 Rail Trends*, (Ottawa: Railway Association of Canada, 2012), accessed online on February 28, 2013: [http://www.railcan.ca/assets/images/publications/2012\\_Rail\\_Trends/2012\\_RAC\\_TrendsE\\_Jan10a.pdf](http://www.railcan.ca/assets/images/publications/2012_Rail_Trends/2012_RAC_TrendsE_Jan10a.pdf), 7

This finding does not mean Canadian railways offer only high rates or poor service. It does, however, highlight how simple it is for CN and CP, who enjoy monopolies in some of their markets for services, to make these claims without consequence. In those markets, they are relatively immune from competition and do not have to worry about loss of customers because those customers, more or less, can do nothing about that state of affairs. It also underscores that those seeking to use rail freight services in those markets, as well as policy makers, are sorely lacking in data and relevant information to assess the degree to which they are not deriving the benefits of effective competition in the form of cost-effective service.

## 6) **Benefits of Competition**

While some barriers to the development of productive capacity and capacity underutilization are unavoidable or difficult to overcome, those erected or caused by the exercise of railway market power are avoidable. It is a function of a willingness to apply to the captive parts of railway networks the same benefits of competition we desire and promote in all other sectors of the economy, including other network industries.

The benefits of competition to individual Canadian consumers and to the economy of Canada are well known: lower prices, higher levels of service, choice of products, information to make good purchasing and selling decisions, innovation, among others. In addition, Canada has invoked competition as the means to strengthen the ability of business to adapt and compete in domestic and international markets, stimulate growth and strive for efficiency.<sup>4</sup> Both the *Canada Transportation Act*, which calls for a “competitive, economic and efficient national transportation system”, and the *Competition Act*, which has been declared the “most modern and economically literate law in the world”, place competitiveness and efficiency at the front of our national economic policies.

As discussed above, however, we have preferred surrogates for competition, rather than competition itself, when it comes to countervailing the market power enjoyed by CN and CP in the more or less captive segments of their respective rail systems. We might query the purpose of that preference.

## 7) **Rail Income v National Income**

The total output of the transportation system itself pales in comparison to the wealth that depends on it; the rail freight component is that much less significant. We have thus far

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<sup>4</sup> See Competition Bureau statement at <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/03336.html>.

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disallowed direct competition on rail systems, and the benefits we know flow from competition generally. Yet, we are so dependent on export earnings and the development of locked-in productive capacity that moves largely by rail and that contributes to much of our national income. This is where two policies are at odds: we have a trade agenda, but we restrict access to the exploitation of the resources that result in that trade, by permitting the exercise of railway market power over the captive segments of CN's and CP's systems.

Similar points could be made about the impact on domestic manufacturing industry resulting from freight rail service, among other things, that are not efficient, effective or competitive. Many examples involving the rail transportation of bulk resources and other commodity supply chains exist to demonstrate how we may fall short in developing our national productive capacity.

Direct competition, by reducing the barriers to entry over, or access to, CN and CP's existing railway systems, could address the shortcomings associated with the captive components of those systems, for projects not yet built and for those already built, with or without rail infrastructure, by driving toward an efficient, market clearing price for adequate rail service.

a) Cost of Adequate Rail Service as a Barrier to National Income

When we fail to exact market discipline on access to rail service, we forego potential increases in national income in favour of rail industry income. It's not that rail income has no value; it's that we ignore the incremental gain in national income by this conduct.

By way of example, take a proposed forest products mill or a proposed mine development each located in a remote region of Canada. Each represents untapped resources, each a source of national income. Each requires capital, construction and development, engineering and other professional services, supply inputs, labour and, of course, customers. Its value cannot be realized unless its output is distributed to those customers. Like many resource projects, transportation by rail is the only viable alternative because of the nature of its products, its location, distances travelled, volume or density, etc. As often happens, a railway company will say that the output of the mill or mine has no value in the absence of rail transportation. And, as resource and other producers know, the cost of adequate rail service is typically a significant percentage of delivered costs, in some cases more than any other cost component.



Project feasibility takes into account the cost of adequate rail service. If the proponent cannot get it, for whatever reason, the project may be abandoned. Or, the project may proceed at a cost that accounts for getting access to adequate rail service, either by first connecting to another mode, if possible or available, or by adding infrastructure, or both. The greater the distance to a rail head, the greater that cost, in either case. Even if the expected returns of the project can tolerate that cost, the proponent must determine the additional distribution costs of shipping by rail to ultimate customers, all of which are in excess of rail infrastructure costs or the costs of shipping to a railhead or both. That total cost of shipping is factored into the economic costs of the project. Every cent attributed to transportation diminishes the return on investment and imperils a project, just like any other cost.

At this point, anticipated distribution costs are factored into optimization equations; that is, what is the optimal size and output of the mill or mine, given these costs? The answer ultimately determines the contribution of the project to national income. The lower the transportation or distribution cost, the more cost effective it is for the mill or mine to exploit more expensive raw materials (less efficient fibre further from the mill or less productive seams that are harder or more expensive to access). It is at this point that a policy, law or practice that bars or restricts direct competition in rail transportation runs counter to trade, development and manufacturing policy and objectives. The optimization decision is made many years ahead of production, due to permitting timelines that are measured in years. There is limited ability to redesign a mill or mine without more permitting time, greater costs, etc. If transportation costs go up during that long timeline, the project may be halted, or the cost of capital may increase, or output may decrease, leaving behind further unutilized productive capacity. Even if, theoretically, rail rates were to go down at some point, expansion is not an obvious conclusion: the ability to expand is significantly impaired by permitting timelines, among other factors, and the difficulty of re-initiating a permitting process.

A similar point can be made about a project to expand a mill or mine that already has access to rail service. The decision on the size or output of the expansion is determined in no small part by the distribution costs, of which the cost of adequate rail service (for these types of facilities in particular) are typically the largest component. That cost is factored into project feasibility, which itself is an optimization exercise, as described above. If the cost of adequate rail service is too high, output diminishes. If the cost were to decrease, even if only theoretically, the opportunity to change optimal output is either long gone or impaired and expensive to reacquire.

Even where a mill or mine has access to rail service in the absence of expansion plans, the cost of access to adequate rail service determines whether products can be distributed viably throughout North America and to export terminals for overseas shipments. Whenever that cost is too high, we lose productive capacity and national income because of the decisions that have to be made about exploitable resources at a mill or mine, among other similarly-situated production facilities and exploitable resources.

b) Non-rail income v national income

To be sure, the cost of adequate rail service is not the only concern. The same points could be made about other distribution costs in a supply chain, such as terminal and intermediate facility handling costs. Each contributes to foregone projects, shipments, jobs, exports, corporate earnings, tax revenues and national income.

The difference between these kinds of costs and all other costs is the extent to which they are subject to a competitive process. Whenever supply of services is subject to direct competition, the benefits of competition described above are determined in the marketplace through the interaction of market participants; that is, buyers and sellers of those services. Whenever a buyer of services is captive to a sole source supplier, those benefits are doled out by the supplier, there is no way to determine the market clearing price, and there is no market friction to determine the price of adequate service and the optimal output that flows from it.

Where there is competitive supply of service, market interaction increases toward optimization. When that competition is ineffective or inadequate, national welfare is diminished, quite apart from the welfare of the proponent buyer of those services.

8) **Indirect v Direct Competition**

Current policy favours surrogates for competition to address the shortcomings created by uncompetitive rail service, in the form of regulated interswitching as the primary example, but also including dispute resolution mechanisms such as final offer arbitration and level of service complaints. The latter two have significant limitations. Other mechanisms exist, but have been proven not to work or have not been used, such as competitive line rates and service level arbitrations. No policy addresses uncompetitive terminal and intermediate handling services at all, where there is increasing need.

Direct competition means running rights. As mentioned above, it is a remedy that has been in legislation since 1904 but has never been used successfully and only tried a very few times, never by CN or CP against the other. CN and CP are entirely opposed to

them, the current barriers to their use are significant and the possible users are few. With very little legislative change, however, Canadian rail policy could improve the economic environment for wealth-producing bulk shippers generally and align itself better with trade policy, if not regional and resource development policy and the manufacturing economy. Government intervention, such as that experienced through the processes around Bill C-30, could be unnecessary.

Indirect competition in the form of the remedies and dispute resolution mechanisms set out in the Act, eventually fade from use because rail carriers work to avoid them or otherwise render them ineffective (indeed they have an incentive to do so), or are so limited in scope as to leave significant parts of the rail shipping economy without access to cost-effective rail service at all.

Direct competition, while it could not, and perhaps should not, help every shipper in every circumstance, has the obvious merit of introducing into the rail shipping economy the well-accepted benefits of competition without causing upheaval to the entire rail transportation system. Rail carriers like to claim that advocates for running rights want “open access”, and use the expression freely when facing the prospect of running rights in statutory reviews such as the present exercise. They do this because it sounds like expropriation and evokes visions of trains running freely all over their respective rail systems without oversight and compensation. In reality, however, very few could take advantage of running rights because of the significant cost of entry and the efforts required to stay in the market for rail services. Further, those shippers and intermediaries who have the benefit of competition for rail services would be disinclined to deploy capital in this way since the market would already be doing what is necessary – achieving adequate service at market-clearing prices. There is already a complete statutory code to deal with safety and insurance issues. The possible compensation schemes for the benefit of the host railway, which are not novel, need only the discipline of adequacy, effectiveness and competitiveness.

There is also very little legislative change required to make the proposal effective.

## **9) Proposals for Direct Competition**

The Canada Transportation Act Review Panel (2000), in its Final Report, made a number of recommendations regarding the implementation of running rights. Although the recommendations were ignored for a variety of reasons, there is every reason to now implement them in a way that introduces direct competition for rail freight services.

The proposals in these submissions are by no means exhaustive. Perhaps a separate process is needed to help design an effective, efficient and competitive system. A few

points are key to establishing a successful process to introduce direct competition into the rail services market for the benefit of the rail shipping economy to optimize the exploitation and distribution of bulk resources and other products, perhaps even agricultural and other products.

a) “Any person may apply...”

The opening words of subsection 138(1) currently read: “A railway company may apply to the Agency for the right to...” This outright barrier could be eliminated by changing the words “A railway company” to “Any person”. As it currently stands, only a railway company – that is, someone with a certificate of fitness – may apply for running rights, while only someone with a federal railway can apply for a certificate of fitness. This simple amendment to the Act would eliminate the circularity of the prerequisites to an application for running rights and make it possible for new entrants to break down barriers to adequate, competitive and effective rail service where they are needed.

b) Scope of Discretion

The success of an application would be confined to a set of conditions no different than any other person would have to demonstrate in order to obtain the right to operate a federal railway in Canada. Currently, after establishing federal jurisdiction over a proposed railway operator, two separate, uncoordinated regulatory schemes determine whether someone qualifies: one scheme administered by Transport Canada relates to safety; another scheme administered by the Canadian Transportation Agency involves a fitness determination measured by adequacy of insurance. There is no need to create a new running rights bureaucracy or regulatory scheme for these purposes.

The applicant would not have to demonstrate that it already owned or leased a federal railway to get a certificate of fitness in the case of a running rights application. The federal government would not have to get involved in judging the economic merit or business case for the application or even the financial viability of the operation any more than it currently does for the two determinations currently made by Transport Canada and the Canadian Transportation Agency. It is possible, however, that the Agency and Transport Canada need some administrative guidance to help direct their respective efforts in accomplishing the objective of introducing an effective, efficient and competitive rail freight transportation system.

c) Compensation

The compensation that should be paid by a successful applicant (the guest railway) to run trains over the lines of a host railway is subject to some debate. Pro-rail carrier literature on the subject advocates the payment by the guest railway of amounts equal to (i) the cost of building and operating a new railway or (ii) the value of all business lost by the host railway to the guest railway as a result of its operations. The first is a complete barrier; indeed, that is part of the reason the shipping economy does not enjoy the benefits of competition today. Such schemes should be dismissed out of hand. The second rail carrier proposal essentially means that the host railway would be no worse off with or without a guest railway, since it would retain the monopoly rents it currently enjoys, while the guest railway only would benefit to the extent it was more efficient than the host railway at providing the service. This is a waste of resources better deployed elsewhere. The foregoing is also a very rough description of the efficient component pricing rule (ECPR), advocated by rail carrier proponents, the effect of which would be to act as a deterrent to applicants. In any event, ECPR should only be used in circumstances where prices are regulated downstream; it is not applicable to rail freight service in Canada.

The Canada Transportation Act Review Panel (2000), in its Final Report, made a number of recommendations in regard to pricing of running rights or access rights, beginning under the heading *Rail Access Pricing*, not replicated here. While there is much to be debated in terms of pricing, some principles that should prevail are as follows:

1. a host railway should be compensated for actual and direct costs it incurs as a result of the operation of a guest railway,
2. a guest railway should not pay for access to a host railway; it should only pay for costs identified in item 1,
3. the price paid by a guest railway should not exceed the price that would prevail under conditions of effective competition, even if some of the extra costs in item 1 are borne by the host railway,
4. the cost components included in item 1 should be limited to the variable costs of the host railway; if, in some peculiar and rare circumstances, a contribution to the host railway's constant costs is deemed desirable, those should be limited to actual and direct line costs (those allocable, by some approximation, to the railway lines over which the guest railway seeks to operate) the host railway would otherwise not incur.

d) Adjudication of Disputes

Where a host and guest railway are unable or unwilling to agree on compliance with the terms of running rights, the Canadian Transportation Agency is perhaps best positioned to assess both (i) whether a host railway complies or interferes with running rights granted to a guest railway and (ii) whether the guest railway is abiding by the terms of access. Again, there is no need to invent a new bureaucratic apparatus when it already exists. Indeed, the Act already contemplates that the Agency will administer running rights. Where the Agency is unable, there is already provision for direct intervention by the federal cabinet in section 139 of the Act.

e) Ancillary Matters

Questions such as (i) whether a guest railway should be able to solicit business on a host railway's lines that are not at the point of origin or destination of the guest railway's proposed operations, (ii) the duration of a proposed compensation scheme in any given instance, and (iii) changing compensable cost factors, among others, also require attention. All of these can be readily addressed by the Agency, which with some administrative guidance can create its own rules and determinative procedures to make these proposals effective.

## **Conclusion**

It has been almost 15 years since running rights were recommended in the Final Report of the Canada Transportation Act Review Panel. None were implemented. Since then, rail freight service has gone through significant periods of poor rail freight service and significantly appreciating returns to the Class I rail carriers in North America, including CN and CP. Not every service shortfall can be attributed to any particular cause. However, some are more obvious than others and some are fixable. To the extent supra-competitive pricing and sub-competitive service are a manifestation of market power, they are fixable. It is irrelevant to users of those parts of CN's and CP's systems that are not cost-effective whether the rest of their systems are competitive. The need for individual rail freight shippers, as well as the national economy, is for effective, efficient and competitive rail service, whether to optimally exploit otherwise locked-in resources, to justify infrastructure and other capital spending or to compete against suppliers of those resources in other countries. The way to address that need is to engage the benefits of direct competition in the form of running rights, failing which a number of initiatives are needed to make the surrogate system work to try to indirectly achieve those benefits.

## **Canada Transportation Act**

### *National Transportation Policy*

**5.** It is declared that a competitive, economic and efficient national transportation system that meets the highest practicable safety and security standards and contributes to a sustainable environment and makes the best use of all modes of transportation at the lowest total cost is essential to serve the needs of its users, advance the well-being of Canadians and enable competitiveness and economic growth in both urban and rural areas throughout Canada. Those objectives are most likely to be achieved when

- (a) competition and market forces, both within and among the various modes of transportation, are the prime agents in providing viable and effective transportation services;
- (b) regulation and strategic public intervention are used to achieve economic, safety, security, environmental or social outcomes that cannot be achieved satisfactorily by competition and market forces and do not unduly favour, or reduce the inherent advantages of, any particular mode of transportation;
- (c) rates and conditions do not constitute an undue obstacle to the movement of traffic within Canada or to the export of goods from Canada;
- (d) the transportation system is accessible without undue obstacle to the mobility of persons, including persons with disabilities; and
- (e) governments and the private sector work together for an integrated transportation system.

### *Running Rights and Joint Track Usage*

**138.** (1) A railway company may apply to the Agency for the right to

- (a) take possession of, use or occupy any land belonging to any other railway company;
- (b) use the whole or any portion of the right-of-way, tracks, terminals, stations or station grounds of any other railway company; and
- (c) run and operate its trains over and on any portion of the railway of any other railway company.

(2) The Agency may grant the right and may make any order and impose any conditions on either railway company respecting the exercise or restriction of the rights as appear just or desirable to the Agency, having regard to the public interest.

(3) The railway company shall pay compensation to the other railway company for the right granted and, if they do not agree on the compensation, the Agency may, by order, fix the amount to be paid.

**139.** (1) The Governor in Council may

(a) on the application of a railway company, a municipal government or any other interested person, or on the Governor in Council's own initiative, and

(b) after any investigation that the Governor in Council considers necessary,

request two or more railway companies to consider the joint or common use of a right-of-way if the Governor in Council is of the opinion that its joint or common use may improve the efficiency and effectiveness of rail transport and would not unduly impair the commercial interests of the companies.

(2) If the Governor in Council is satisfied that significant efficiencies and cost savings would result from joint or common use of the right-of-way by two or more railway companies and would not unduly impair the commercial interests of the companies, the Governor in Council may make any order for the joint or common use of the right-of-way that the Governor in Council considers necessary.

(3) The Governor in Council may also, by order, fix the amount of compensation to be paid in respect of the joint or common use of the right-of-way and any related work if the companies do not agree on the amount of that compensation.