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Reply to the Attention of *François E.J. Tougas*
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Date *February 2,2021*

BY EMAIL TO: ferroviaire-rail@otc-cta.gc.ca

Canadian Transportation Agency
15 Eddy St
Gatineau, Québec
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Re: Agency Consultation on Cost of Capital Rates – Response to Initial Submissions

This letter is in response to the response of Canadian Pacific Railway (CP) to our response to the initial submissions of CP and Canadian National Railway (CP). To the extent required here, the capitalized terms used here refer to those used in our initial submissions of November 25, 2020.

We appreciate the Agency's willingness to provide us with an opportunity to respond. We understand that CN is under the same time constraints as we are, with the significant difference that CN operates with information not at our disposal.

In these submissions, we raise both procedural and substantive points.

Procedure

We thank the Agency for consulting us on the issues raised by CP. We are raising fairness issues and seeking a resolution. There are three main fairness issues: case splitting, time allotted and information asymmetry. The first issue pertains only to CP, the second to the Agency and the third to the junction between the legislation and the Agency's determinations regarding confidentiality of information.

A. Case Splitting

While we acknowledge that the Agency's consultation process is administrative rather than quasi-judicial, it is CP that has violated a fundamental principle of fairness in this Consultation.

The Agency initiated the Consultation on September 25, 2020 with the following introduction:

> "We are providing 60 days for initial submissions, and then an additional 30 days to respond to initial submissions once they have been posted on our website. We will be

accepting initial submissions at ferroviaire-rail@otc-cta.gc.ca until November 25, 2020 and responses to initial submissions until January 4, 2021.

At the same time, Agency staff provided a discussion paper (https://otc-cta.gc.ca/eng/discussion-paper-methodology-determine-net-rail-investment-capital-structure-calculation-cost-capital-rates) that set out the issues to address. Agency staff made themselves available to meet with stakeholders to answer questions and provide greater clarity.

We note, too, that CP (and CN) will have had considerable time in advance of any consultation, including this one, to consider the issues relating to the Agency's considerations of cost of capital and capital structure. They have the information at their fingertips that make it possible. We have not had that kind of time; the earliest we can start is the moment the Agency presents an issue for consideration.

We made our initial submissions on November 25, 2020, as directed. Here, we make two observations:

(i) Our internal process involved many stakeholders, each of whom have their own internal review processes. We did not ask for extra time because we were at either a substantive or procedural disadvantage. Our internal processes are our problem, not the Agency's.

(ii) CP's initial submission was barely seven pages long and Issue 4 in particular took up four of those seven pages. It is not as if CP did not turn their minds to the issues addressed by the Agency.

Again as directed by the Agency's timeline, we set aside other work to prepare a response to CP's (and CN's submissions). Here, we make two further observations:

(i) Practically, we knew, as everyone does, that the holiday season would intervene before the January 4, 2021 due date. Thus, we organized our schedule and our internal processes so as to attempt to complete the bulk of the work to respond to CP and CN by December 23, 2020, knowing we would have difficulty getting internal review and feedback over the holiday period just to meet the January 4, 2021 deadline.

(ii) Much of our substantive attention was directed toward CN's submissions, which were more fulsome (24 pages long, of which six pages were devoted to Issue 4) than CP's.

We learned on December 22, 2020 that the time for responses to initial submissions would be extended to January 18, 2021, pursuant to the following Agency note:

> I am writing to inform you that we are extending the deadline for responses to initial submissions to the Consultation on Cost of Capital Rates.

> We have received stakeholder feedback expressing concern that this consultation period overlaps with the two weeks of the traditional holiday season. Given this timing, and the desire by the CTA to receive the most helpful feedback possible, it has been decided not to insist on submissions being provided by January 4, 2021.
>
> The new deadline for stakeholders to provide responses to initial submissions will be January 18, 2021.

The stakeholder feedback seeking more time referred to above did not come from us. Here, we have two further observations:

(i) CP was not prevented from advancing the issues in its initial submissions that it ended up raising in its January 18, 2021 response to our initial submissions. That would have been the proper time to address them.

(ii) CP's latest response submissions are 19 pages long, of which the majority is devoted to Issue 4.

The Agency then graciously provided us with this opportunity to respond to CP's submissions further to the following advice from Allan Burnside, Senior Director, Analysis & Regulatory Affairs, Analysis and Outreach Branch:

> CTA staff appreciates your organizations' involvement in the current consultation on the Agency's Cost of Capital (CoC). We feel the information provided has been helpful and as such are circling back on a final issue which arises from round 2 of the stakeholder submissions posted on our website.
>
> Unfortunately, it would appear that CP's round 2 submission – with respect to issue 4 – did not simply provide their commentary on the round 1 submissions of other stakeholders, but instead provided primarily new information and proposals. , Under the directions for the process as laid out in our discussion paper (and our website) this type of information should have been supplied in round 1 of the consultation to allow other stakeholders to comment thereon.
>
> In order to ensure that this new information is included in our internal analysis, and that it has been subject to the same process as all other information that has been submitted, the CTA has decided that the two other stakeholders that have provided submissions (CN & McMillan LLP will be given an opportunity to comment on this new material. As a result, additional time will be afforded for them to review CP's Issue 4 discussion.

> We feel that the timeline does not need to be overly long in light of the fact we are only asking for comments on only one section of one stakeholder's submission, but we also accept that CP's perspective, although provided at a later date, still form an important part of what needs to be considered on this issue. We also are conscious that all stakeholders share an interest with us to bring a conclusion to these proceedings, and allow CTA staff the time to complete our analysis and provide a full briefing to Members on the CoC issues.
>
> As such, CN and McMillan LLP are asked to provide any final comments (limited to assessing the new proposals in CP's Issue 4 Discussion) by no later than **Friday, January 29, 2021.**
>
> Information provided will be posted online, as in the previous two rounds, and will be considered in assessing the issues as set out.

Mr. Burnside underscores the direction to limit our final comments to assessing the new proposals in CP's Issue 4 Discussion. In other words, CP's submissions are in fact new. CP has split its case.

In the end, CP had the time to raise the issues it wanted on November 25, but decided not to do so. After obtaining a two week extension, CP then introduced the meat of its submissions, knowing that there is no further opportunity to respond. This is a deliberate action on their part, possibly even tactical, squeezing the available time, since, as Mr. Burnside appropriately instructs, we are to provide our final comments. We submit there can be no debate that CP could have addressed them in its initial submissions. Allowing CP's new submissions now is unfair and inappropriate, and they should be struck or postponed for consideration at a later date.

B. Time

We do not have enough time to respond to the many issues CP has raised at this late stage of the Consultation process.

Recognizing the unfairness of CP's tactics, it is Agency Staff that has offered us (and CN) the opportunity to respond to CP's inappropriate further submissions. We can see that Staff have been placed in a difficult position by CP's conduct in this Consultation. We would prefer the opportunity to respond with the benefit of the kind of time that CP has had, which amounts to four months since the Consultation started, to consider and reflect on the issues with which they are obviously familiar.

We have sought Dr. Gould's expertise in assessing CP's most recent submissions to provide at least some consideration on some of the many issues CP has raised. We have not had the time CP has had, and then there is the asymmetry of information described immediately below.

C. Information Asymmetry

We do not have the information available to CP, CN and the Agency.

In this particular instance, where CP has engaged in case splitting, after an extension of time, while Teck is left with less time, the information asymmetry is that much more pronounced. We submit that the combination of the foregoing is a serious impingement on principles of fairness.

As stated elsewhere, we do not have nor can we obtain the relevant information needed to make the decisions, submissions and judgements necessary to properly respond to the issues raised by this Consultation, not to mention the many prior submissions involving the partial regulation of CP's and CN's costs and finances.

That asymmetry is unlike other regulated network industries. We see no rational difference between rail and those other industries that so favours CP and CN in the exercise of discretion whether to regulate them in one particular way or another. They enjoy tremendous market power, they impose rate increases unilaterally and they determine the levels of service they are willing to provide, whether to optimize their own systems or to achieve other objectives. Those who rely on their services are very constrained in their ability to exercise the very weak statutory remedies available to them, if any. In Teck's case, their captivity to the rail mode is well understood and acute. Many, many shippers are in the same position.

While it is not within the Agency's jurisdiction to amend the legislation, we submit that the Agency has broader discretion than it is exercising to disclose certain information, even if aggregated, indexed or otherwise camouflaged so as to stay within the confines of the relevant legislation. In light of the asymmetry of information and market power, participants that do not have that information require more time to respond and better access to information to assist in their deliberations to make consultations fairer.

Recommendations

We submit that, to address the fairness points above, the Agency should either:

- Ignore CP's new submissions that are not strictly confined to the narrower issues raised in the Consultation to which we strictly responded, within the time allotted, or

- delay the process until Agency Staff produce a discussion paper on the new issues CP has raised, with a new round of consultation that allows us to respond within a reasonable time frame.

Given that the Agency may not be in position to select either of our foregoing recommendations, we have appended a report from Dr. Larry Gould, which comments briefly on some of CP's novel submissions respecting the Agency's Issue 4. We informed the Agency on Monday, January 25, 2021 that we would not be able to respond by the January 29 deadline. Although we have not had the time necessary to allow us to respond to all of CP's comments, nor have we responded fully to those we have addressed at all, we are pleased to provide these submisions.

We again appreciate the opportunity to respond, especially in light of CP's tactical approach. We look forward to the Agency's further communications and determinations in connection with this Consultation.

Please do not hesitate to contact us if we can be of further assistance in the Consultation.

Yours truly,

François Tougas

cc: client
// Attachments: Gould Report (February 2, 2021)

SCHEDULE "A"

Gould Report (February 2, 2021)

BEFORE THE CANADIAN TRANSPORTATION AGENCY

IN THE MATTER OF THE CONSULTATION REGARDING THE METHODOLOGY TO DETERMINE THE NET RAILWAY INVESTMENT AND CAPITAL STRUCTURE FOR THE CALCULATION OF COST OF CAPITAL RATES

COMMENTS ON ISSUE 4 OF CP'S ROUND 2 SUBMISSION ON THE METHODOLOGY TO DETERMINE THE CALCULATION OF NET RAILWAY INVESTMENT AND CAPITAL STRUCTURE

REPORT

Prepared by:

LAWRENCE I. GOULD

Lawrence Gould

February 2, 2021

I. INTRODUCTION

The Canadian Transportation Agency (Agency) has initiated a consultative review of its methodology for determining the net railway investment and capital structure for the calculation of cost of capital rates (the "Consultation"). I was asked by McMillan LLP to provide my independent judgment and opinion to the Agency on the additional issues arising from the round 2 submission provided by Canadian Pacific Railway Company (CP) pertaining to the Agency's net railway investment and capital structure methodology in the Consultation.

I am Senior Scholar at the Asper Business School, University of Manitoba. Previously I have been Head, Department of Accounting and Finance at the University of Manitoba and Chairman, Finance and Business Economics at McMaster University.

I received the Bachelor of Science Degree in Economics from the Wharton School of Finance and Commerce, University of Pennsylvania in 1966. I completed the Master of Business Administration Degree in Finance from New York University in 1968 and the Doctor of Philosophy Degree in Finance from the University of Toronto in 1975.

During the last 40 years I have been employed as a consultant in a number of cases that posed a wide range of problems in applying financial theory to the determination of the cost of capital and valuation. I have testified on financial matters before the Canadian Transportation Agency, the Canadian Radio-Television and Telecommunications Commission, the Canadian Human Rights Tribunal, the Public Utilities Board of Manitoba, the New Brunswick Board of Commissioners of Public Utilities, the Newfoundland Board of Commissioners of Public Utilities, the Nova Scotia Utility and Review Board, the New Mexico Public Service Commission and the Federal Communications Commission.

I have also been engaged in academic research to extend the theory of the cost of capital. Among the subjects of this research have been the effects of income taxation on the cost of capital, the impact of growth on the cost of capital, the impact of inflation on the cost of capital, estimating the cost of capital for a non-traded division of a company and the use of the capital asset pricing model in estimating the cost of capital. I have published articles on the cost of capital and related problems in finance in the Journal of Finance, Financial Management, the Journal of Portfolio Management, the Journal of Accounting, Auditing and Finance, the Canadian Tax Journal and elsewhere.

II. STATEMENT OF THE PROBLEM

The Agency's staff produced a discussion paper that outlined certain issues about the Agency's methodology to determine net rail investment and capital structure for the calculation of cost of capital rates that should be considered.[1] These issues were in the form of questions on the working capital allowance component of net railway investment and capital structure. In response I provided my opinion on the Agency's existing methodology and commented on the issues raised in the Discussion Paper.[2]

In addition to the submission by McMillan LLP, submissions were made by the Canadian National Railway and the Canadian Pacific Railway. The process established by the Agency provided the opportunity for any party who made a submission to file a response to the initial submissions made by the other parties.[3] In response I provided comments on the submissions of the Canadian National Railway (CN) and the Canadian Pacific Railway (CP).[4]

After receiving the submissions and responses from all parties, the Agency determined that CP's round 2 submission[5] with respect to issue 4 did not simply provide commentary on the round 1 submissions of the other parties, but instead provided primarily new information and

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[1] Canadian Transportation Agency, Discussion Paper on the Methodology to Determine Net Railway Investment and Capital Structure for the Calculation of Cost of Capital Rates, September 25, 2020 [Discussion Paper].

[2] My opinion on these issues is contained in the McMillan LLP submission on behalf of Teck, the Western Grain Elevator Association, the Canadian Canola Growers Association, and the Mining Association of Canada, "Issues in the Calculation of Net Railway Investment and Capital Structure," November 25, 2020.

[3] Discussion Paper, page 8.

[4] My comments are contained in the McMillan LLP submission on behalf of Teck, the Western Grain Elevator Association, the Canadian Canola Growers Association, and the Mining Association of Canada, "Response to Submissions on the Methodology to Determine the Calculation of Net Railway Investment and Capital Structure," January 18, 2021.

[5] CP's Response to the Submissions of Other Stakeholders, CTA Discussion Paper on Capital Structure and Cost of Capital, 2020, January 18, 2021. [CP Response]

proposals. Under the directions for the process in the Discussion Paper this information should have been supplied in round 1 of the consultation to allow for comment by the other parties. As a result, the Agency decided that the other parties would be given an opportunity to comment on CP's Issue 4 discussion.[6]

The purpose of this report is to provide comments on issue 4 of CP's round 2 submission in order to assist the Agency in understanding the differences in the recommended methodology to determine net railway investment and capital structure for the calculation of cost of capital rates. Unfortunately, in deviating from the directions for the process in the Discussion Paper, sufficient time has not been given to allow a response to all of CP's comments or to respond fully to those comments that are addressed.

[6] Canadian Transportation Agency, "CTA Cost of Capital Consultation-Update & Request", January 21, 2021.

III. COMMENTS ON PROPOSALS IN CP'S ROUND 2 SUBMISSION

CP's round 2 submission with respect to issue 4 did not simply provide commentary on the round 1 submissions of the other parties, but instead provided primarily new information and proposals. The new proposals differ greatly from my analysis and recommendations, so I will respond specifically to those proposals.

Proposal 1: Consolidated Capital Structure

CP's Proposal 1 is to use the railway company's US-GAAP consolidated capital structure for the purpose of estimating the cost of capital, in respect of which CP states:

> "We support CN's preferred approach to use the railway company's US-GAAP consolidated capital structure as prepared by the company for its public financial statements. This approach reflects the Agency's intent to capture any activity that creates a 'general corporate benefit'."[7]
>
> and
>
> "CP understands, therefore, that the Agency's intent is that the regulated cost of capital should more closely reflect general corporate activities to the extent that such activities affect the Canadian regulated rail entity. Accordingly, the regulatory balance sheet should also more closely reflect the balance sheet of the consolidated company. However, CP's regulatory capital structure does not resemble the consolidated corporate capital structure."[8]

[7] CP Response, page 12.
[8] CP Response, page 8.

The nature of the problem can be described most effectively by means of the following simplified illustration. Assume that Northern and Southern are two independent companies that provide a regulated service and non-regulated service, respectively. Assume that they have the following capital structures:

Assets	Northern	Southern
Plant and Working Capital	$50	$50
Debt and Equity		
Debt	30	20
Equity	20	30

Note that Northern, the regulated company, has a 60/40 debt-to-equity ratio, while Southern, a more risky company, has a 40/60 debt-to-equity ratio.

Now, assume that the companies merge so that the consolidated statement for the two companies would then be:

Assets	Consolidated
Plant and Working Capital	$100
Debt and Equity	
Debt	50
Equity	50

It is clear that the consolidated balance sheet with a 50/50 capital structure is not relevant for the regulator in determining the cost of capital for Northern, the regulated entity that operates with a 60/40 capital structure. Furthermore, there is no reason why Northern's regulatory balance sheet should closely reflect the balance sheet of the consolidated company.

As I explained previously in my round 2 response, the cost of capital for the consolidated corporation is only an average cost of capital that is appropriate for the entire portfolio of its investments. It is not appropriate for a division of the corporation that is being regulated by the Agency. Each division of a consolidated corporate entity should be treated as if each were operating independently. The division of Canadian rail activities must be considered as a separate stand-alone entity, distinct from its parent company, because it is the cost of capital for that division that we are attempting to measure and not the cost of capital for the parent company's consolidated activities. The Agency should use a separated balance sheet reflecting the capital structure that the railway would have as an independent company.

Proposal 2: Parent Company Share Buy-Backs

The question of whether general purpose debt for the purposes of share buy-backs is rail-related and must be included in the determination of the railway's capital structure was considered by the Agency in 2009, concluding:

> "The Agency does not consider debt incurred for the purpose of buying back shares in a company whose primary, if not exclusive, business line is the railway business to be appropriately classified as identifiable non-rail debt within the meaning of Agency Decision No. 125-R-1997."[9]

In 2020 CP requested further consideration of the issue of allocating its general purpose debt to the regulated rail operation's capital structure. The Agency determined:[10]

> "The Agency finds that debt issued for the purpose of share buybacks is rail-related. There is a general corporate benefit derived from buying back shares issued. The issuance of debt in lieu of issuing more shares to fund rail-related investments lowers the company's cost of capital, as the cost rate of debt issuance is lower than the cost of common equity rate that is expected from investors. Lower cost rates paid by the railway company for its investments might allow it to increase investments in other rail-related projects, or to lower freight rates paid by its customers."
>
> and
>
> "The Canadian Transportation Agency (Agency) determines that the use of general purpose debt for the purpose of share buy-backs is rail-related and must be included in the determination of CP's capital structure.
>
> The Agency will continue to consult on how to allocate general purpose debt to Canadian rail operations and, in the interim, general purpose debt will be allocated based on the Revenue Ton Miles (RTM) methodology pending the conclusion of such consultations."

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[9] Canadian Transportation Agency, Decision LET-R-49-2009, April 20, 2009.

[10] Canadian Transportation Agency, Decision LET-R-29-2020, April 28, 2020.

CP's Proposal 2 is to add the debt to the regulatory balance sheet, and then show the regulated entity advancing the proceeds to the parent company so that it can perform the share buy-back, generating a receivable asset on the regulated balance sheet. CP states that:

> "This approach will increase the amount of debt in the capital structure of the regulated rail entity, but does not incorrectly eliminate equity generated though rail operations. In CP's case the resulting capital structure is still relatively comparable to that of the consolidated company. Therefore, the distortion evident in the 2020 cost of capital decision is eliminated."[11]

This approach is not correct. CP's Proposal 2 includes the allocation of debt issued for share buy-backs, but eliminates the effects of the changes in equity capital in the regulated balance sheet. The Agency is concerned with determining the appropriate capital structure for the regulated rail operations, not with making it comparable to the capital structure of the consolidated company.

[11] CP's Response, page 14.

Proposal 3: Fully Allocate All General Purpose Activities

Issue 4 of the Discussion Paper asked for comments on how to apportion general purpose long-term debt of a railway company between its Canadian rail entities and non-regulated entities. CP argued in its submission that:

> "We recommend using net book-value rather than gross book-value because the net book-value more accurately represents the current size of Canadian rail operation, as a portion of the consolidated corporation. However, an allocation based on gross book-values would also be preferable to one based on RTMs."[12]

In my submission I argued that all general purpose debt should continue to be allocated to the regulatory balance sheet based on the proportions of RTMs in Canada in the year in which the debt was issued. My response to CP's submission was on the different recommendations for how to apportion general purpose long-term debt. However, CP's Proposal 3 is not a response to the other stakeholders. It contains a new recommendation for allocating general purpose assets:

> "In the further alternative, CP proposes a deemed regulatory capital structure for purposes of determining the cost of capital, wherein general purpose equity, assets and working capital are allocated to the balance sheet in the same way that the Agency has decided to allocate general purpose debt. Failing to do so creates a significant distortion in the capital structure because it applies an asymmetrical adjustment."[13]

There are several problems in responding to CP's Proposal 3. There was no information provided in the Discussion Paper on this issue. In addition, the regulatory balance sheets and income statements of the railways are not publicly available and they have not been provided by

[12] CP Submission, page 5.

[13] CP Submission, page 14.

the Agency or by CP for this consultation. Finally, the schedule of this Consultation was not designed to accommodate comments on new proposals that were made in the round 2 submissions. However, some observations can be made about CP's Proposal 3.

First, the Agency's cost of capital process has distinct steps. These include the determination of net rail investment, which must balance to the amount of debt, deferred taxes and equity. Issue 4 of this Consultation has been concerned with allocating the correct amount of general purpose debt to determine the amount of debt on the regulatory balance sheet. Note that once the net rail investment, debt and deferred taxes have been determined, equity is the residual balance. There is no need for an allocation of what CP refers to as general purpose equity.

Second, CP has provided no information on the specific general purpose assets to be allocated to the regulated balance sheet under Proposal 3 and the rationale for their inclusion. Other stakeholders should be allowed to comment on any specific general purpose assets that CP is proposing to allocate.