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**Canadian National**

**Submission**  
**to the**  
**Canada Transportation Act Review Panel**

**November 2000**



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## Executive summary

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The North American Free Trade Agreement, the cornerstone of Canada's trade and economic policy has triggered a period of unprecedented economic growth for Canada's manufacturers and exporters. It has fundamentally changed trade flows between Canada, the United States and Mexico. Canada's trade with the United States and Mexico has increased by 80 per cent and 65 per cent respectively and now exceeds \$1.5 billion per day. Growth is expected to continue at an annual double digit pace for the foreseeable future.

Sustaining this level of activity requires an integrated transportation network with rail a key component. Canada needs a transportation policy that will help the nation realize the full benefits of NAFTA. The Canada Transportation Act Review Panel must consider Canada's competitiveness in the context of the NAFTA marketplace.

The impact of the integration of North America's economy is clear at Canadian National (CN). More than half the company's revenues are generated from traffic moving to, from or within the United States. Of CN's top 20 customers, representing about one third of company revenues, more than three quarters have plants in at least two of the three NAFTA countries.

As North American and world economies integrate further, Canadian rail regulatory policies – particularly the extent to which they are aligned with those that govern rail transportation in Canada's principal end market, the United States – will have a great influence on the ability of CN and its customers to compete in the NAFTA marketplace. Any new rail policies must reflect the economic realities of NAFTA and the need for the Canadian economy, railroads and their customers included, to continue to compete.

For the past several years, it is this NAFTA environment and its related growth – more than any other factor – that has influenced strategic decisions and corporate investment at Canadian National.

***Further deregulation – not re-regulation – is required to position railroads to better compete and to help their customers succeed in their end markets.***

In 1998, CN acquired the Illinois Central Railroad, extending customer reach from coast to coast in Canada and south to the Gulf of Mexico. Recent service improvements mean CN's intermodal customers can reach major Canadian markets faster than if they used competing long-haul trucking firms. CN's participation in e-commerce alliances and marketplaces builds on the advantages the Internet gives customers and suppliers.

Today, Canadian railroads still face conflicting and discriminatory regulations and tax policies that inhibit their competitiveness and that of their customers. Continued economic growth in Canada will depend, to a large extent, on the efficiency and effectiveness of its national transportation network. Canada's railroads have much to

contribute to such a network. But that will require a national transportation policy that treats all modes equitably and equally within a framework where outcomes are determined by market forces.

***The Canada Transportation Act of 1996 came at a crucial time for Canada's railroads – helping lift the domestic rail industry from deficits and economic decline. Shippers and receivers have also been major beneficiaries. They now enjoy the lowest freight rates in the western industrialized world – 60 per cent below the international average.***

As measured by ton-miles, the 68 railroads that make up Canada's rail transportation sector account for more than 60 per cent of all transportation services provided. On a revenue basis, however, railroads capture less than 25 cents of every dollar earned by transportation service providers in Canada. The reason is intense competition, among the railroads themselves, and with trucks, water carriers and pipelines, as well as between competing plants and global sources for raw and manufactured material.

The one segment that has remained regulated – grain – has not experienced the full range of market driven improvements, as have all other segments. Although the prices of all other farm inputs, in real terms, have risen sharply over the past decade grain freight rates have remained essentially flat. CN understands that grain transportation is a sensitive issue for both regulators and legislators. The challenge for the Panel is to ensure the special circumstances of grain do not overshadow consideration of the benefits further deregulation can deliver to Canada's economy.

Recent financial gains by Canada's railroads have been largely achieved through the elimination of surplus assets and rigorous cost containment. At CN these initiatives were coupled with a major redesign of the operating plan to greatly improve service levels.

CN is now arguably the best railroad in North America – operationally. But future success will depend on the ability to recapture market share lost to other modes, especially trucks, through premium service offerings. And premium service can only be offered if the industry can innovate and recover its costs through the rates it charges. The industry needs to achieve a high rate of return to attract market capital to reinvest in the network and new services.

CN is only now beginning to cover its cost of capital. CN requires more assets to generate a dollar of revenue than does any other of Canada's top 1000 corporations. Every year, these assets need to be replaced, maintained and improved. CN will invest \$1 billion on its network and infrastructure in 2000 alone.

Capital markets will not respond if regulatory policies are seen to distort or displace normal market-driven economic incentives. If capital investment does not occur, Canadian producers and manufacturers cannot hope to compete with their North American and global competitors.

The privatization of Canadian National levelled the playing field between CN and Canadian Pacific. And the Canada Transportation Act allowed the railroads to make the

network adjustments necessary for financial success in a competitive marketplace. Both decisions also respected the need to reduce the gap between the Canadian and U.S. regulatory frameworks and the need to respect Canada's trade obligations under NAFTA.

But despite these deregulation initiatives, the Canadian railroad industry, and by extension its customers, have been unable to realize their full potential. One major contributing factor is the absence of a national transportation policy that would treat each mode equitably within a system driven by the discipline of the marketplace.

The Panel has an opportunity to recommend the federal and provincial governments establish a more balanced tax and regulatory regime between rail and truck – one that addresses market distortions that have resulted from public investment in highways.

The Panel must also examine ways in which the regulatory structure of the CTA can be fine-tuned to remove existing barriers to increasing rail productivity and efficiency.

For example, CTA '96 allowed CN and CP to more easily address the costs associated with an overbuilt railroad system. This process of rationalizing the networks of the country's two major railroads has led directly to the development of a strong, vibrant shortline rail industry in Canada. Currently, there are more than 40 shortlines and regional railroads operating more than 16,000 kilometres of track in Canada. They are vital components of regional economies across Canada through their partnership with the mainline carriers.

However, rail line abandonment and transfer provisions are still not as streamlined and efficient as they could be. There are several situations where communities have delayed line acquisitions well beyond the reasonable time limits initially contemplated in the CTA. This process should be clarified. In addition, urban centres that wish to acquire abandoned rights-of-way for commuter services should do so under clear rules at fair market value.

It is CN's view that shipper protection regulations can also be streamlined. Final offer arbitration, for example, is too cumbersome, costly, and therefore, ineffective. Adopting commercial arbitration practices would address these concerns.

The competitive access issue the Panel is examining, and that CN responded to in its October 6, 2000 submission, requires close and careful scrutiny. Competition for traffic handled by railroads is fierce. It encompasses direct rail-to-rail competition, intermodal competition, as well as product substitution and source competition.

Because competition is fierce and deregulation has delivered tangible benefits, open or regulated access would be a fundamental change to a system that is performing to world class standards. The Panel should perform rigorous, quantitative research to determine the actual levels of existing competition. Any decisions on fundamental change to the future structure of the industry should be based on sound analysis. In addition, any changes must be fully consistent with all provisions of NAFTA, including avoiding

indirect subsidies to shippers, and preserve the rail industry's ability to recover its fixed costs.

The Panel can improve the position of shippers and railroads by proposing changes that:

- ◆ Respect NAFTA and WTO obligations:
  - avoid indirect subsidies;
  - respect shareholder rights; and
  - avoid confiscatory measures by insisting on full cost recovery.
  
- ◆ Result in further deregulation:
  - remove regulation where market forces are efficient; and
  - ensure remaining regulation is fair and reasonable to all parties.
  
- ◆ Fairly balance competing interests:
  - between modes;
  - between railroads; and
  - between railroads and their customers.

The financial health of Canada's rail industry is recovering from near collapse prior to the CTA of 1996, but remains fragile. The CTA Review Panel is uniquely positioned to balance the needs of shippers and railroads to ensure both can prosper under NAFTA.

## 1.0 History of rail deregulation

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By the mid-1970s, the anachronistic regulation of the North American rail industry had moved it to the edge of bankruptcy.

Governments in both Canada and the United States slowly came to realize that if the industry were to survive it would either have to be deregulated and allowed to compete on a commercial footing, or be heavily subsidized with public funds.

The United States was the first to move, with passage of the Staggers Rail Act in 1980. The Act introduced a number of sweeping reforms, all adhering to the overriding principle that railroads be allowed the freedom to manage their assets and price their services like all other businesses.

While the Act did not completely deregulate the industry, it did return U.S. railroads to the path of financial health. U.S. railroads emerged from this period with a competitive advantage over Canadian railroads.

The Canadian government followed in 1987 with passage of the National Transportation Act (NTA). NTA '87, however, fell short of Staggers. It introduced market competition to the revenue side of rail economics but left the cost side heavily regulated. And Canadian railroads remained unable to tailor their networks in line with commercial principles.

As confirmed by the National Transportation Act Review Commission in 1993, the future of the Canadian rail industry remained precarious. The Commission noted: '...if Canada does not wish to pay the price of a serious deterioration of the rail industry in this decade, it is essential that the carriers be allowed and encouraged to make the changes needed to compete.'

During the same period, Harvard Professor Michael Porter's highly publicized study of the Canadian economy warned that Canada's standard of living was destined to fall. The study cited an insulated economic environment resulting from paternalistic government policies and highly protected domestic markets.

Poor financial performance persisted to the extent Canadian National and Canadian Pacific considered merging their eastern Canadian operations in 1994.

Canada signed the North American Free Trade Agreement (NAFTA) in 1994. The agreement dramatically altered trade and traffic patterns between Canada and the United States. That same year, the federal government announced a Federal Regulatory Review 'to ensure that the use of the government's regulatory powers results in the greatest prosperity for Canadians.'

The 1995 privatization of Canadian National quickly followed by passage of the Canada Transportation Act (CTA) were two of the many decisions taken in response to the findings of this Review.

Combined with the CTA '96, the privatization of Canadian National allowed CN and Canadian Pacific to make the network adjustments necessary for financial success in a competitive marketplace.

Both decisions also respected:

- ◆ the need to reduce the gap between Canada's regulatory framework and that of its largest trading partner, the United States; and
- ◆ the trade obligations Canada assumed as a signatory to NAFTA.

## 2.0 Enhancing competitiveness

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### 2.1 NAFTA growth

The North American Free Trade Agreement (NAFTA) is the cornerstone of Canada's overall trade and economic policy.

The agreement recognizes that globalization means prosperity at home and depends on a nation's ability to integrate with economies throughout the world. NAFTA created the world's largest trading block, serving 400 million people and producing more than \$8 trillion in goods and services.

Canada's merchandise trade with the United States increased by 80 per cent in the first five years of the agreement. Trade with Mexico doubled over the period. Canadian trade with the U.S. and Mexico now exceeds \$1.5 billion per day. Growth is expected to continue at an annual double-digit pace for the foreseeable future.

For the past several years, it is this NAFTA-related growth – more than any other factor – that has influenced strategic decisions and corporate spending in Canada and at Canadian National.

CN is moving in tandem with its customers and the new economy. In the process, CN has been transformed into a truly North American railroad. With its 1998 acquisition of the Illinois Central Railroad, CN is now the only North American railroad to cross the continent east - west and north - south.

CN trains serve 14 U.S. states and, as a result of a 1998 marketing alliance with the Kansas City Southern Railway, provide Canadian customers access to Mexico.

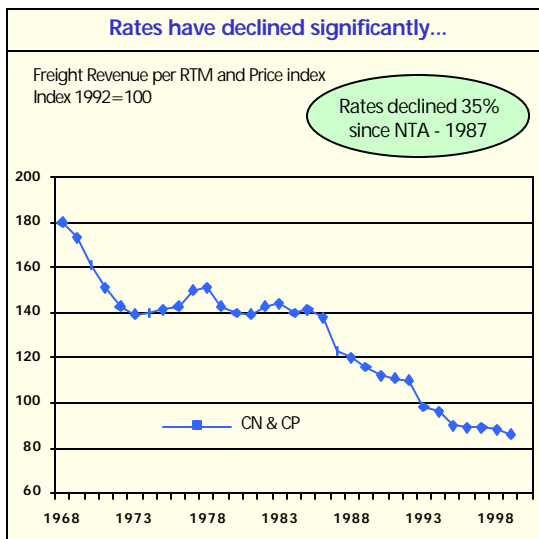
More than half of Canadian National's annual revenues are now generated by traffic moving to, from, or within, the United States. Of CN's top 20 customers - accounting for 34 per cent of revenues - almost three-quarters have plants in at least two of the three NAFTA countries.

Clearly, Canada's railroads have played, and must continue to play, a central role in the realization of the benefits of domestic and international trade liberalization policies.

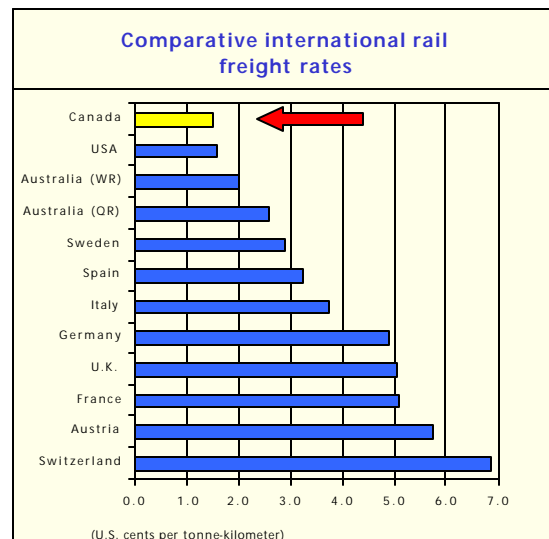
## 2.1.1 Deregulation has been a success

The industry could not have fulfilled this role without the benefits derived from the deregulatory provisions of the National Transportation Act, 1987 and the Canada Transportation Act, 1996. CTA afforded Canada's railroads the freedom to control costs and the flexibility to adapt their rail networks to the changes in the flow of economic activity.

***The real winners have been Canadian producers, manufacturers and taxpayers. Canadian rail freight rates, in real terms, have fallen over 35 per cent since 1987 and are now the lowest in the western industrialized world – 60 per cent below the international average.***

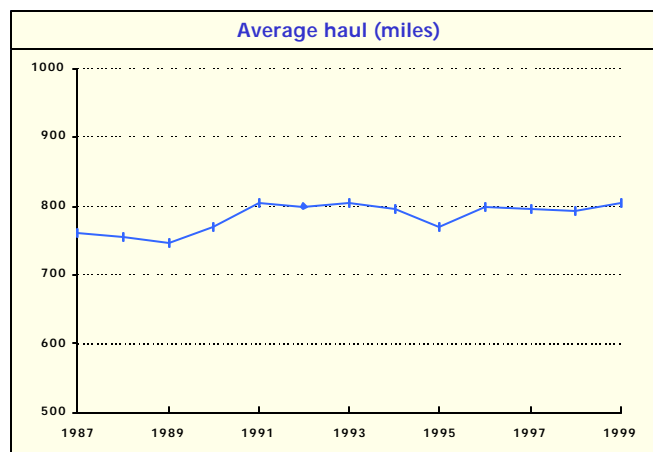


Canadian rail freight rates have declined significantly over time



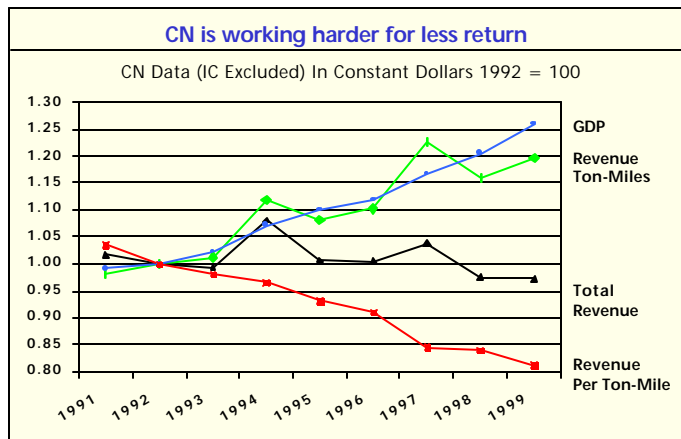
Canada's freight rates are the lowest in the world

Applied in the context of an expanded North American rail network, lower rates have allowed Canadian rail shippers to serve dozens of markets that were previously not within economic reach. An example of this is the significant increase of sales of Quebec lumber in Georgia and the Carolinas, a market not exploited prior to 1990.



Average length of haul has not increased significantly in the last ten years

Some shippers claim the reduction in average rates expressed in cents per ton per mile is not appropriate as, during that period, average length of haul could have increased. But the length of haul has not changed significantly in the past ten years.



CN revenues have been flat in spite of increased tonnage

The true contribution of CN to Canada's economic growth is well illustrated in the relationship between CN's revenues and Gross Domestic Product over the past decade. Revenue ton-miles have tracked GDP growth but revenue per ton-mile is about 20 per cent lower than it was at the start of the decade. This reflects both CN's increased productivity and a steady decline in rates.

## 2.1.2 Regulatory harmonization

As North American and world economies become further integrated, and as tariffs between the three NAFTA countries progressively fall away, north-south trade will continue to grow. To a large extent this growth will depend on the ability of Canadian railroads to compete with U.S. railroads within an equitable regulatory framework.

Canadian railroads are subject to shipper protection regulation that far outweighs what is available to shippers in the United States:

- ◆ in Canada all carload traffic is regulated. In the U.S. regulation applies only to commodities that are deemed captive to rail;
- ◆ interswitching in Canada is mandated and the rates regulated. Interswitching services and related rates in the U.S. are left to commercial negotiation between individual railroads;
- ◆ all Canadian rail shippers (with the exception of intermodal) have access to final offer arbitration. Only those U.S. rail customers that are captive to rail and can document that a pre-established revenue/cost ratio has been exceeded and that this rate causes commercial harm qualify for an STB rate review and decision;
- ◆ a Canadian shipper can 'force' a serving railroad to deliver traffic to a competing railroad. There is no such provision in the U.S.

## Canada – U.S. Regulatory Regimes Comparison

	Canada	U.S.
Applicable Traffic	◆ All carload	◆ Deregulated traffic is exempt
Interswitching	◆ Mandated ◆ Rate regulated	◆ Voluntary ◆ Rate negotiated
Rate Arbitration	◆ Mandated Final Offer Arbitration – available to all shippers	◆ Only if: ◆ Revenue/cost threshold exceeded ◆ No truck or rail competition ◆ Stand-alone costs exceeded
Competitive Line Rates	◆ Mandated	◆ None
Common Carrier Obligation	◆ Mandated	◆ Mandated

Recent financial gains by Canada’s railroads have been largely achieved through the elimination of surplus assets and rigorous cost containment. At CN, these initiatives were coupled with a major redesign of its network operating plan to greatly improve service levels.

However, future gains for the industry will depend on an ability to grow business volumes while maintaining a strong focus on cost containment. To do that, it won’t be enough to be the best railroad in North America, CN will have to offer its customers the best transportation solution. Market forces and policies balancing truck/rail competition, as opposed to rail re-regulation, must drive this growth. The less regulated U.S. railroads are already better positioned to compete for market share from the industries they serve.

### 2.1.3 Trade Obligations

Expanding trade through bilateral and multilateral agreements has always been a cornerstone of Canadian trade policy and an economic pillar for GDP growth. The most dramatic recent example is the North American Free Trade Agreement signed in 1994 by Canada, the U.S. and Mexico.

NAFTA is the guiding economic framework for trade and investment for the three North American partners. In Article 102 of the agreement, “Objectives,” the parties pledged to ‘eliminate barriers to trade in, and facilitate the cross-border movement of, goods and services’ between Canada, the U.S. and Mexico, and to, “increase substantially investment opportunities” for NAFTA investors in North America. The overriding aim of NAFTA is to achieve closer integration of the three North American economies, not only in the provision of goods and services but in transportation and investment.

The applicability of NAFTA to freight railroads was a conscious decision of the NAFTA signatories. The predecessor agreement, the Canadian American Free Trade Agreement

(CAFTA), specifically excluded rail transportation from trade liberalization. Each of the NAFTA signatories had the opportunity to exempt its rail sector from NAFTA liberalization obligations. Each government did take such reservations in other transportation sectors, such as air and trucking. But none did so with respect to rail, indicating the commitment on the part of all three signatories to fully liberalize the North American rail industry.

As the synopsis prepared by the three signatory countries states, NAFTA provides the phase out of restrictions on cross-border land transportation services among the three countries in order to create equal opportunities in the North American international land transportation market. NAFTA is designed 'to ensure that the land transportation services industries of the three countries will have full opportunity to enhance their competitiveness without being placed at a disadvantage during the transition to liberalized trade.'

Canada also relies on and accepts its obligation as a signatory of the GATT 1994 agreement, the WTO Agreement on Subsidies and Countervailing Measures, and the WTO Agreement on Agriculture.

***It is Canadian National's view, with the support of independent legal counsel, that any regulatory proposals that would artificially force access to rail infrastructure or force average freight rate regulation would be in breach of these obligations and constitute indirect subsidies to Canadian goods moving by rail to U.S. and world markets.***

#### 2.1.4 Mergers and Acquisitions

The Review Panel has asked all participants to comment on the appropriateness of the existing regulatory framework to deal with public policy issues that might arise from mergers or acquisitions in the rail transportation sector.

CN sees no compelling reason why such mergers or acquisitions should be treated any differently than those in other industry sectors.

Railroad transactions have been subject to general competition laws for many decades. In 1996, Parliament gave the Canadian Competition Bureau sole jurisdiction over transactions in the transportation sector.

CN fully recognizes the important responsibility parliamentarians and Ministers have in addressing public policy issues.

Parliament has, in the past, assigned a role in merger review to relevant Ministers of the Crown only in instances where bona fide public interest concerns have been established.

Canadian National would not object to an amendment to the Competition Act to give the Minister of Transportation standing to make representation to the Commissioner of

the Competition Bureau where public opposition to a proposed rail sector transaction exists.

Canadian National would not object to a further amendment to the Competition Act that would require the Commissioner to take into consideration the views of the Minister.

The Minister would have authority to make representations to the Bureau within 42 days of a transaction having been filed. The Bureau would consider the representations as part of its decision-making process. But it would remain the sole body charged with approving or rejecting a proposed transaction and it would continue to be guided by its mandate to protect and enhance competition, consistent with the merger review provisions of the Competition Act.

### 2.1.5 Recommendations

As North American and world economies become further integrated, and as tariffs between the three NAFTA countries progressively fall away, north-south trade will continue to grow. This growth will, however, depend on the ability of Canadian railroads to compete with U.S. railroads within an equitable regulatory framework.

CN recommends:

- ◆ That Canadian rail regulation be compatible with U.S. rail regulation to ensure Canadian carriers, shippers and receivers are not disadvantaged vis-à-vis U.S. competitors.
- ◆ That Canadian rail regulation be consistent with all aspects of NAFTA and WTO including meeting the rules against hidden subsidies and countervailing measures.
- ◆ That rail mergers in Canada continue to be subject to review and approval by the Competition Bureau but that the Competition Act be modified to give the Minister of Transport standing to intervene before the Bureau on a notifiable transaction in the rail sector where public interest concerns have been expressed. And that the Act be further modified to require the Commission to take the Minister's view into consideration.

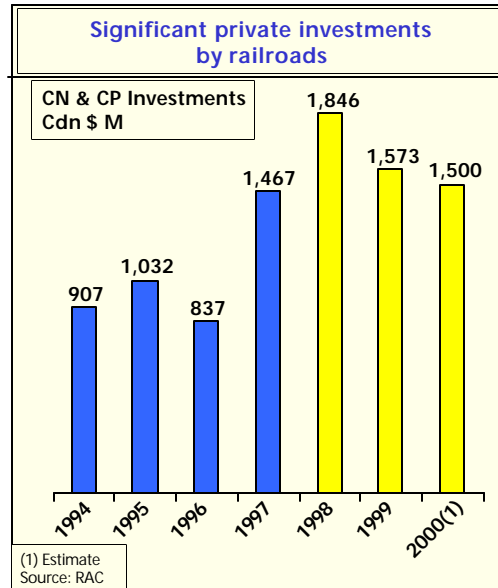
## 2.2 Further Deregulation Required

### 2.2.1 Railroad financial performance is fragile

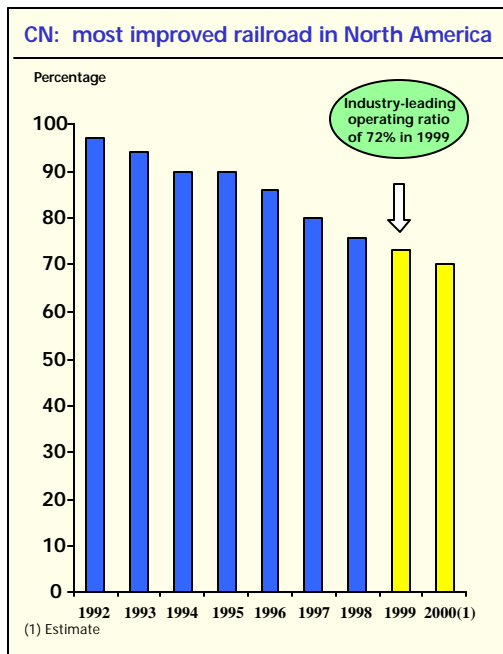
Railroads compete in the most competitive of all markets – the global capital markets. There they compete not only with other railroads, but with every other opportunity available to investors that poses comparable risks. If equity investors ever were to perceive that a railroad were not a profit-making enterprise, they would simply invest elsewhere.

Canadian National is in the most capital intensive sector of the economy. It requires more assets to generate a dollar of revenue than does any other of Canada's top 1000 corporations.

Every year these assets need to be replaced, maintained, and improved. CN will invest more than \$1 billion on its network infrastructure in 2000 alone.



Private investments by the railroads in Canada will be \$1.5 billion in 2000



CN - lowest operating ratio among Class I railroads

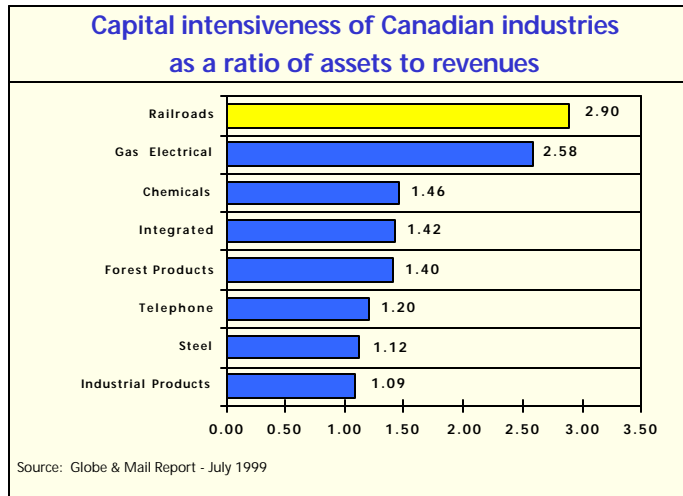
As competition is intense and because of rail sensitivity to economic cycles, Canada's railroads lag virtually every major industry group in terms of return on capital employed.

Canadian National has registered remarkable successes over the past five years. The company is particularly proud of the fact that its operating ratio – the key measure of efficacy – is the best of all the major North American railroads.

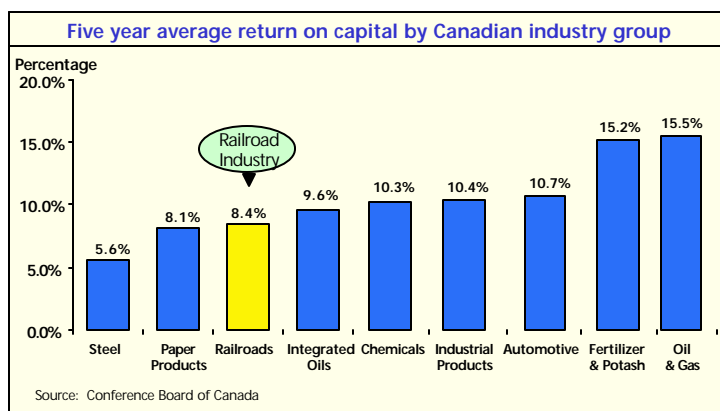
***In 1999, CN's returns equalled its cost of capital. There is, however, an expectation in capital markets that the company must continue to do so over a complete economic cycle, not just a single year.***

Global capital markets have responded well to CN's successes. CN shares have outperformed all other North American railroads in the five years they have been publicly traded.

But with little the industry can do to increase world demand for its traditional long-haul bulk business, and with competitive pressures continuing to compress Canadian rail freight rates, future growth will depend on an ability to recapture market share lost to trucks. Here, growth will come through the addition of premium service offerings.



Railroads are in the most capital-intensive sector of the economy



Railroads: one of the lowest ranked industries in terms of return on capital

The challenge will be met only if service can be improved. Service will improve only if the industry can continue to attract the capital necessary to acquire new locomotives and rolling stock, to improve the quality of its plant and infrastructure, and to develop the information technology needed to monitor and track shipments and to better manage asset utilization.

Furthermore, it is important to underline that capital markets will only respond if regulatory policies are fair and do not distort or displace normal market-driven economic incentives. Otherwise, investors will abandon the sector with the result that the cost of capital will become prohibitive, forcing railroads to cut back on investments.

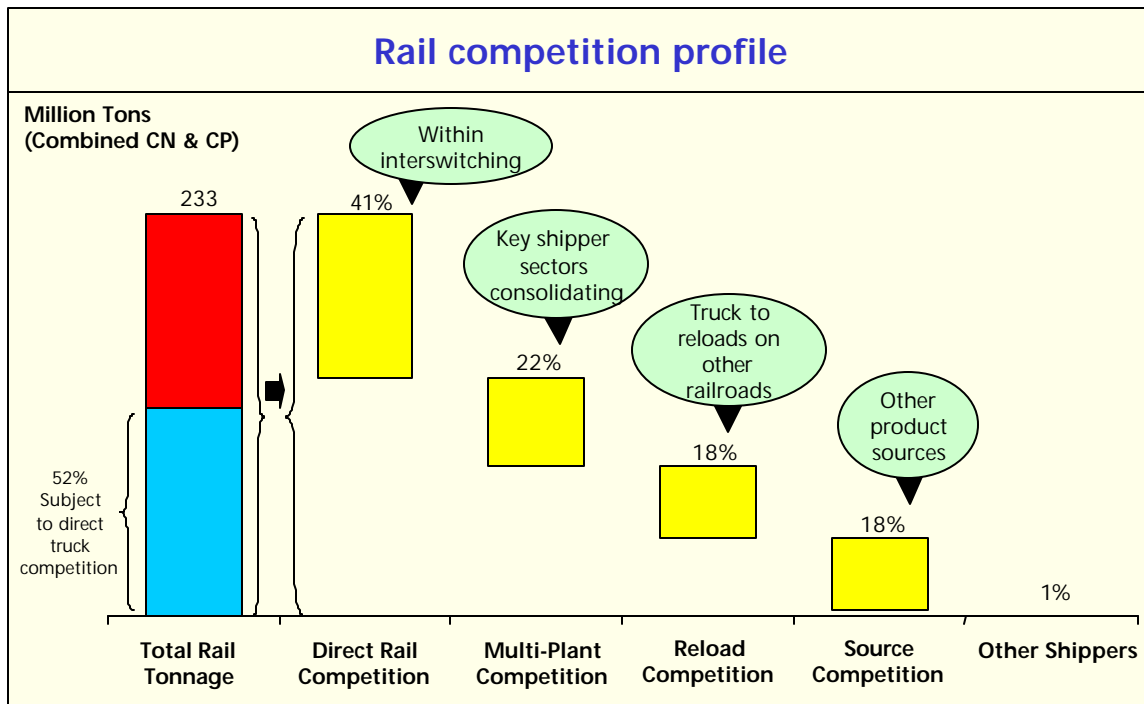
### 2.2.2 Key Drivers Of Railroad Competition

As measured by ton-miles, the 68 railroads that make up Canada's rail transportation sector account for more than 60 per cent of all transportation services provided.

On a revenue basis, however, railroads capture less than 25 cents of every dollar earned by transportation companies operating in Canada.

## Rail competition profile

The reason is competition, among the railroads themselves, and with trucks, water carriers and pipelines. Pervasive 'product substitution' and 'source' competition as well as the ability to aggregate purchasing power also provide rail shippers and receivers with significant leverage when negotiating for transportation services.



By Canadian National's analysis, almost all rail business in Canada is subject to intense competitive pressure. More than half – 52 per cent – of the combined business of CN and Canadian Pacific Railway is subject to direct competition from trucks.

In addition to direct truck competition, Canadian rail traffic is subject to a combination of various forms of competition. Specifically:

- ◆ 41 per cent is subject to direct rail-to-rail competition. This extends to the nine U.S. railroads currently operating into and out of five Canadian provinces. And because U.S. roads have access to the Canadian Transportation Agency's interswitching provisions, their reach is broadened considerably. Canadian railroads have no similar reciprocal rights forced by regulation in the United States.
- ◆ 22 per cent is subject to multi-plant and/or multi-shipper competition. Many rail shippers are large multi-plant corporations whose revenues exceed those of the entire railroad industry. For instance, the intense consolidation that took place

recently in the forest products and chemicals sectors increased shipper leverage considerably. These companies negotiate price and service concessions by bundling some or all of their plants before purchasing rail services. Other shippers contract with third parties and thus gain leverage by having their rail services purchased on behalf of multiple shippers at once.

- ◆ 18 per cent is subject to competition from trucks to re-load centres on other railroads. A great number of Canadian rail shippers are located within easy trucking distance of another Canadian railroad or U.S. rail lines. Canadian and U.S. railroads actively solicit Canadian traffic by absorbing the cost of having product shipped by truck to re-load centres located on their lines. Examples include potash from Saskatchewan, automobile parts from south western Ontario, lumber from British Columbia, and pulp and paper from Quebec.

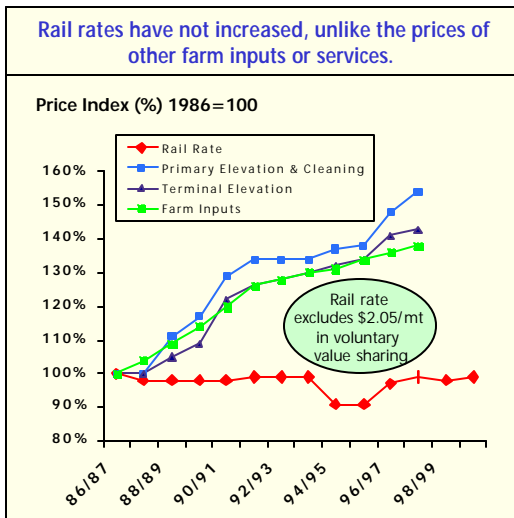
In addition to these competitive options available to shippers, another 18 per cent is subject to product source competition. Newsprint produced in Quebec for markets in New York, Pennsylvania and New Jersey vies for market share with newsprint produced in Georgia and Alabama. Ontario and Alberta plastics and petrochemical producers compete for markets with producers in Louisiana and Mississippi.

The above forms of competition are not mutually exclusive as more than one form usually applies.

Canadian railroads, therefore, must price their transportation services so as to ensure that the products they carry can be sold competitively throughout North America. The same is true for virtually all export traffic that the railroads move to world markets.

**CN’s competition profile by sector**

Intense competition characterizes each of CN’s commodity groups as the following profiles clearly indicate.



Rail freight rates continue to be lower than other inputs.

**Grain:**

The one segment of CN’s business that remains highly regulated is grain. As a result, rates in this sector have not declined to the same extent as in other markets.

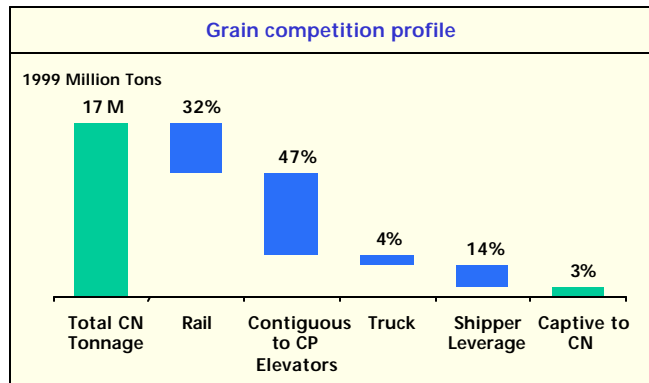
Grain freight rates, in real terms, have been essentially flat over the past 14 years, a sharp contrast to other input costs. CN believes grain transportation rates would decline if the efficiencies of a fully deregulated grain transportation marketplace were available to it.

Many farmers, farm organizations and industry participants argue that freight rates would be lower if CN and CP were forced to compete more vigorously against one another or together against new entrants.

But vigorous competition for market share already exists.

CN estimates that almost 80 per cent of CN's originating tonnage is subject to either interswitching or is within 50 kilometres of a competing point served by CP. Since all grain begins its journey to an elevator in a truck, proximity to a CP served elevator is an important competitive factor.

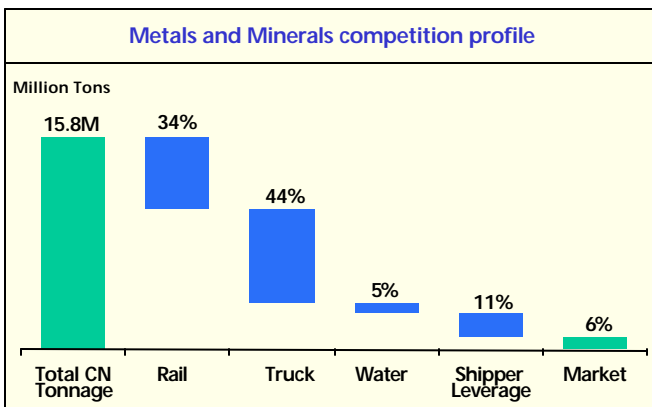
Shipper leverage is another factor that increases competition. With only five big grain companies, CN and CP compete vigorously for a share of their traffic which CN estimates to be about 14 per cent of its total tonnage.



Approximately four per cent of CN tonnage is traffic now moved by rail but could be trucked to border states.

The remaining three per cent is traffic originating with small grain companies outside interswitching limits and beyond 50 kilometres to the nearest CP-served location.

This competition profile applies in CN other business units as well.

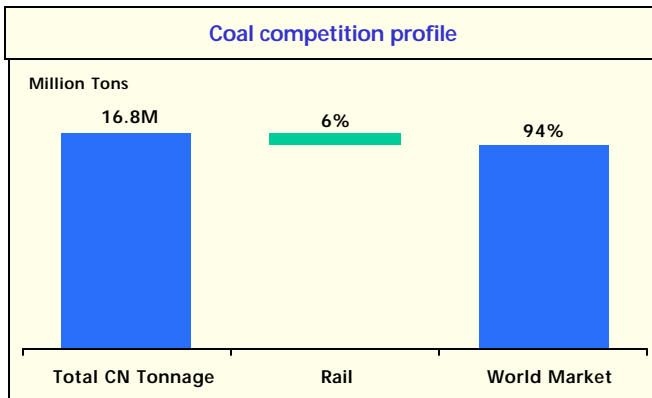
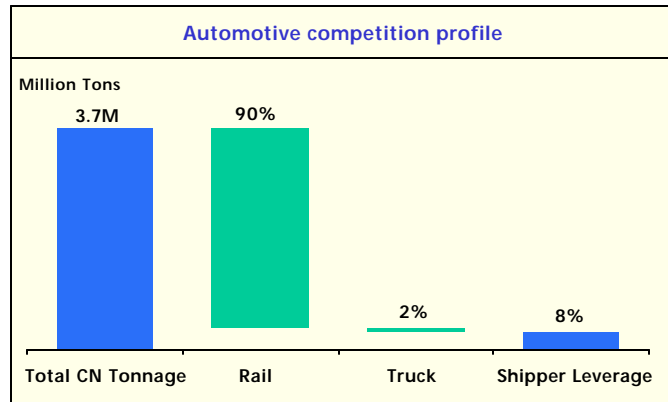


**Metals and Minerals:**

CN estimates that trucks compete for close to 45 per cent of CN's tonnage in this segment. Furthermore, rail-to-rail competition is a factor for about one-third of rail traffic. Finally, reload centres are playing a larger role in increasing shipper choice. Therefore, there are virtually no shippers truly captive to rail in this sector.

**Automotive:**

Every major automotive production plant in Canada is located at a competitive rail point. Furthermore, all CN's automobile and automotive parts business is subject to direct truck competition. For smaller parts plants, just-in-time business requirements favour trucks. No shipper can be considered truly captive in this sector.

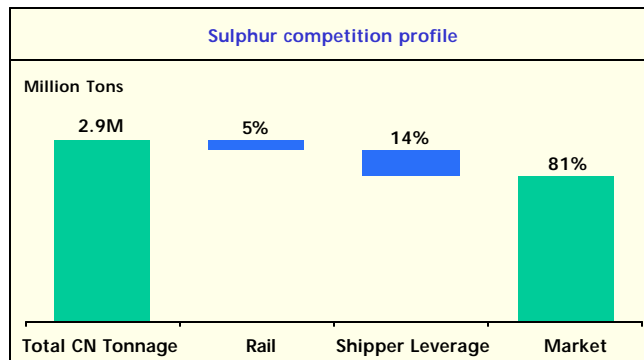


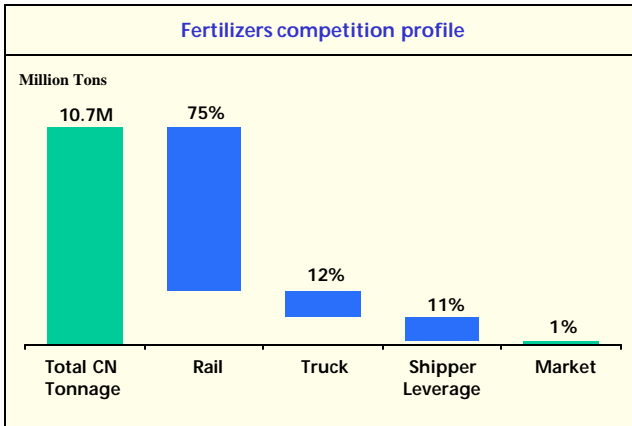
**Coal:**

While rail competition exists for only six per cent of CN's coal traffic, source competition to market has a significant effect on rail rates. For example, Australian coal competes for Japanese markets displacing Canadian coal. To help the Alberta and British Columbia coal producers maintain volumes, CN's average rate for export coal has declined by one-third since 1990.

**Sulphur:**

Similar to coal, rail competition for sulphur is only present for approximately five per cent of CN's sulphur tonnage. However, sulphur is a by-product of the oil and gas industry, and only moves when market prices cover marketing and transportation costs. Therefore, volume fluctuations are significant. Market and source competition serve as levers for shippers when negotiating rates.



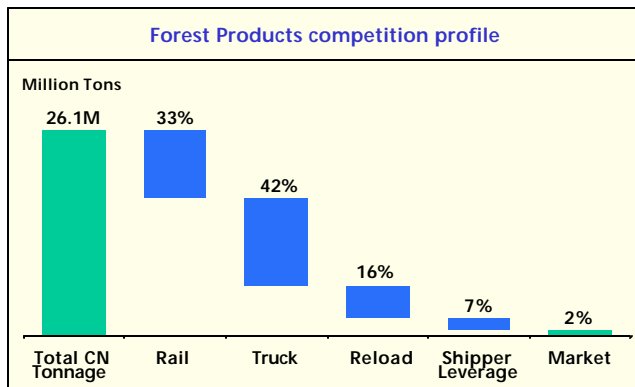


**Fertilizers:**

Rail-to-rail competition is present for 75 per cent of CN fertilizer traffic. The remainder is subject to strong shipper leverage in a very concentrated industry. Truck competition in short haul markets is intense.

**Petroleum and Chemicals:**

Rail-to-rail competition is present for almost 70 per cent of CN’s tonnage in the petroleum and chemicals sector. The balance is subject to significant shipper leverage in a sector where significant industry consolidation has taken place. In recent years, truck reloads have been used extensively.



**Forest Products:**

In addition to rail competition for one-third of forest products and extensive shipper leverage through recent industry consolidations, virtually all forest products can be trucked to market or to reload centres located on another railroad.

Those who seek to increase regulation of the Canadian rail industry often challenge the analysis in support of the existence of competition. The evidence in support of these challenges is invariably anecdotal.

***One of Canadian National’s important recommendations to the Canada Transportation Act Review Panel is that the Panel undertakes or commissions quantitative research to determine actual levels of existing competition. Decisions bearing on the future regulation of the industry should be based on definitive, rigorous research.***

### 2.2.2.1 Differential Pricing

Railroads price their services based on demand rather than according to cost formulas. It is a practice employed by virtually every Canadian business with high fixed costs, including those that advocate that its application should be denied the railroads.

For example, in the airline industry, fares paid by passengers travelling in economy class on any particular flight will vary widely. Last minute business travellers will pay full fare for the convenience of booking late, while another traveller, with months of advance planning, will pay a fraction of the full fare. Scheduled airlines count on a mixture of travellers on every flight to recover variable and fixed costs.

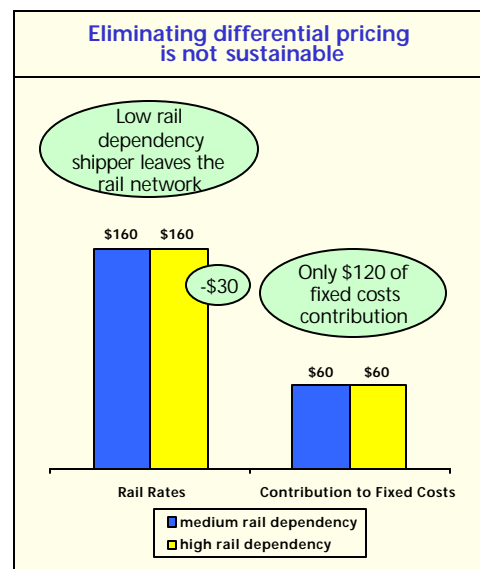
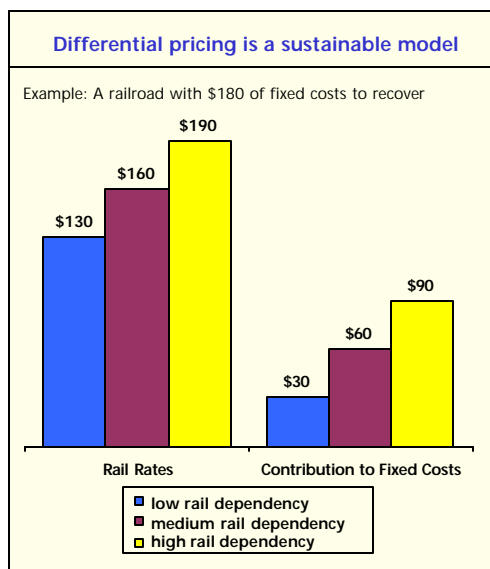
Shippers that place a high value on rail service – producers of bulk commodities, for example – generally pay a higher contribution to fixed costs than do those shippers where rail service is but one option and alternatives are readily available.

If rail rates for high-value users were compressed through rate regulation or improper access rules, the railroads would have but two choices:

- ◆ increase rates for all remaining shippers, or
- ◆ lower service levels because of a diminished ability to invest.

For many customers with alternative options an increase in rail freight rates would prompt them to simply stop using the rail mode.

At the end of the cycle, the most rail dependent shippers would have to pay an even higher rate than was in place originally or have a non-commercial regulated rate supported by government subsidy.



Only by pricing their services in accordance with varying demand can railroads efficiently recover all of their costs, serve the largest number of rail customers at the lowest possible rate, and maintain the viability of the Canadian rail network.

Forced access by third party railroads to the physical plant of CN and CP or the imposition of regulated average rates would present a serious challenge to the financial sustainability of both Canadian National and Canadian Pacific.

It would seriously inhibit their ability to recover costs and would, over the long term, force the industry to either increase rates or lower service levels. Perhaps both.

### 2.2.2.2 Extended Interswitching

Current CTA regulations entitle shippers located within a 30-kilometre radius of two federal railroad interchanges to a competitive choice between the railroads at a rate set by the Agency.

Under the guise of increasing competition among railroads, a minority of western - based shippers advocate the 'simple' extension of the 30-kilometre radius to some undefined limit.

A variation on this theme, as put forward by the Canadian Fertilizer Institute (CFI), would dismiss the distance limit entirely, by requiring railroads to compete for the business beyond the interchange. Further, the Institute suggests a rate that would combine the current cost-based formula for the first 30 kilometres with a second component based on the system average revenue-per-tonne-kilometre of the commodity being moved for the remaining distance.

Current interswitching rates already constitute a problem for Canada's major railroads. Rates are regulated at a level such that they contribute but a small portion to the fixed costs of the network. The result is an income transfer, from railroads to their customers. CFI's formula would add to this inequity by eliminating differential pricing at the commodity level.

The objective in tampering with the existing 30-kilometre interswitching limit is to provide shippers on the connecting carrier access to the originating railroad's trackage, for long-haul or ultimate hand-off to any Canadian or U.S. mainline railroad.

That's regulated access by another name. And the harmful effects on the Canadian rail industry would be the same as those identified by the elimination of differential pricing.

Rail revenues would be reduced. To compensate, Canadian National would either have to reduce costs – and thus service levels – or increase freight rates for other shipper groups with the risk that these shippers choose other transportation options.

### 2.2.2.3 Competitive Line Rates

Competitive Line Rates, that allow a shipper located outside interswitching on one federal railroad to force the routing of traffic to the nearest interchange for delivery to a competing railroad, are rarely used.

Shippers contend that CLR's are little used because they must demonstrate 'substantial commercial harm' before such rates apply. It must be noted that this test was introduced in 1996, but CLR's were introduced in 1987. They were rarely used between 1987 and 1996.

However, other competitive forces such as trucking, reloads and customer purchasing power are usually sufficient to discipline rail rates. Furthermore, these customers have access to rate arbitration – a sufficient remedy in itself.

Therefore, Canadian National recommends that:

- ◆ competitive line rate provisions are redundant and should be abolished.

### 2.2.2.4 Final Offer Arbitration

Many of the shipper associations that have made representations to CTA Panel members support existing Final Offer Arbitration (FOA) provisions. The provisions are described as equitable and fair. Other shippers, however, believe the process is expensive and inappropriate.

From Canadian National's perspective, FOA is problematic. It is not applied uniformly and constitutes an inappropriate intrusion in the marketplace. It is also inconsistent with rules governing U.S. railroads.

Only a shipper can apply for Final Offer Arbitration. And it applies to all shippers, with the exception of the intermodal sector, regardless of the competitive options available, or of the value of the contract being negotiated. This process does not properly recognize that where competition exists no regulatory intervention is required.

Shippers using Final Offer Arbitration assume virtually no risk.

Having completed negotiations on a range of issues including service, car supply, etc. and received a final rate quotation from the railroad, the shipper can then apply to the Agency for arbitration.

The arbitrator must choose one of the two proposals submitted. There is no exposure for the shipper since the assigned rate cannot be any higher than the one quoted by the railroad in negotiations.

The pernicious issue is that along with assuming no risk, the shipper has no obligation, regardless of the outcome, to use the rail mode to ship any of the goods in question. Shippers can thus use the process as a simple means of leveraging a lower rate from another mode. If the arbitrator chooses the railroad's offer, there is no guarantee the railroad will win the business.

If arbitration is to be practical, and serve a fair and reasonable end, CN recommends these amendments to the FOA process:

- ◆ all applications be made subject to a 'prima facie' test to determine whether the shipper has other competitive means of transporting the goods.
- ◆ If the shipper faces commercial harm caused by the current rate and arbitration proceeds:
  - ◆ applicants must be made to commit to use rail to ship all of the goods under arbitration; and
  - ◆ the existing winner-take-all process be replaced by the Canadian Commercial Arbitration Act process that applies to any other commercial relationship.

The railroads and shippers generally agree that a more streamlined and abbreviated process should exist for smaller disputes – for example those where the annual revenues in question are below \$500,000. This streamlined process should also be based on commercial arbitration principles rather than FOA.

#### 2.2.2.5 e-Commerce

As a business tool, e-commerce will significantly increase choice for Canadian buyers of transportation. Shippers will be empowered with more information than ever before and have access to an increased array of transportation solutions. In response, the rail industry will have to invest, to ensure that its customers will be able to negotiate and execute freight transactions online, and do so reliably.

Internet-based electronic commerce provides leverage to shippers and presents opportunities for Canada's railroads.

Leverage for shippers:

- ◆ *demand aggregation* Downward pressure on rail freight rates is an expected result of shippers collaborating online to leverage size.
- ◆ *greater competition from trucks*. With an ability to communicate more quickly and accurately, manufacturers will need less inventory and require smaller shipments

delivered just-in-time. Because the trucking industry is less regulated, and thus more flexible and nimble than rail, it is the mode most likely to benefit.

Opportunities for railroads include:

- ◆ *increased market reach.* The Internet offers CN the ability to advertise its services to smaller shippers who cannot be economically reached by traditional means. Many of these shippers see themselves as captive to truck and are unfamiliar with the capabilities of the rail mode.
- ◆ *fewer third parties.* With an ability to serve customers cheaply and directly, there will be less of a need for those who serve as intermediaries between shipper and carrier.
- ◆ *ability to sell excess capacity.* Empty rolling stock running on 'backhaul' will be able to be offered to shippers online. This presumes non-regulated pricing flexibility.
- ◆ *reduced costs.* Business processes will be made more efficient with the growing number of paperless transactions.
- ◆ *inter-railroad collaboration.* With an ability to increase the standard and speed of communication among themselves, railroads will become more responsive to the competitive pressures of inter-line movements.
- ◆ *intermodal collaboration.* Same as for inter-railroad collaboration, communication will favor integration of modal activities.

It is in this context that Canadian National recently acquired an equity stake in FreightWise Inc., an internet-based, neutral, multi-modal, North American transportation marketplace, and the first such freight exchange available in Canada.

FreightWise does away with the inefficiency and expense of the traditional paper/phone/fax process of filling last-minute capacity requirements. It provides load matching for buyers and sellers of transportation and fulfilment capability through committed carrier capacity, enabling complete multi-modal freight movements. FreightWise also allows exchange users to conduct entire transactions online – from load matching through financial settlement. Sellers on FreightWise can offer their capacity through standard rates and auctions.

While e-commerce presents very interesting opportunities, it will enhance customer leverage moving closer to a 'perfect competition model' where regulation is less and less required.

### 2.2.3 Recommendations

Almost all rail business in Canada is subject to intense competitive pressure – particularly from trucks. The review Panel has an obligation to consider levels and sources of competition. Deregulation has worked to the benefit of railroads, shippers and taxpayers and more is required.

CN recommends:

- ◆ That Canadian rail freight legislation and regulation recognize that Canadian railroads already face strong competition in a context where railroads are capital intensive businesses requiring an adequate return on investment. This is critical for railroads to remain competitive in capital markets and renew their extensive infrastructure and equipment.
- ◆ That the Canada Transportation Act Review Panel undertake or commission rigorous quantitative research to determine actual levels of existing competition for the various industries served by rail. Decisions bearing on the future regulation of the industry should be based on definitive, rigorous research.
- ◆ That current interswitching rates be adjusted to be fully cost recoverable.
- ◆ That competitive line rate provisions be abolished.
- ◆ That the FOA process be amended as follows:
  - ◆ all applications be made subject to a ‘prima facie’ test to determine whether the shipper has other competitive means of transporting the goods.
  - ◆ If the shipper faces commercial harm caused by the current rate and arbitration proceeds:
    - ◆ applicants be made to commit to use rail to ship all of the goods under arbitration; and
    - ◆ the existing winner-take-all approach process must be replaced by the Canadian *Commercial Arbitration Act* process that applies to any other commercial relationship.
- ◆ Establish a shorter process, along commercial arbitration principles, for smaller claims involving less than \$500,000 in annual transportation costs.

## 2.3 Modal Balance

### 2.3.1 National Transportation Policy

Regulation by all levels of government is estimated to cost the Canadian economy between \$30 and \$50 billion per year, according to a February 2000 report of the Public Policy Forum, a non-partisan, non-profit organization aimed at improving the quality of government in Canada.

Furthermore, Canada's current regulatory regime continues to put the country's enterprises at a significant competitive disadvantage and if not reformed, the report said, runs the risk of driving investment and employment south of the border.

The CTA Review is of vital importance and concern to Canada's railroads, as much for the issues that will *not* be taken into account, as because of those that *will* be.

Canada's trucking industry is not subject to federal regulation and is unaffected by the CTA Review process. U.S. railroads are, per force, similarly excluded.

Yet trucks dominate the surface transportation market in Canada with a 68 per cent revenue share. And U.S. railroads are strong competitors of Canadian National, for business to and from Canada and for freight moving within the United States.

This inconsistency is one of many that impede the Canadian railroad industry from realizing its full potential. They are rooted:

- ◆ in the absence of a national transportation policy that would treat each mode equitably within a system driven by the discipline of the marketplace; and
- ◆ in unbalanced regulations whose lack of harmony, between modes and with regulatory regimes in the United States, retard Canadian economic growth.

The transportation industry in Canada suffers from a lack of harmonization, not only vis-à-vis the U.S. but among federal, provincial and municipal governments, and also within the governments themselves with respect to each of the modes.

Canada's railroads pay the full cost for the operation, maintenance and renewal of their infrastructure from revenues generated by transporting the goods of their customers. For Canadian National, these costs for the current year alone will exceed \$1 billion.

The nation's trucking industry has seen its share of Canada's surface transportation revenues grow from about 30 per cent in the 1950s to approximately 70 per cent today and is under no such obligation. Indeed, every major study conducted on highway cost allocation, at both the federal and provincial levels, has concluded that heavy trucks pay but a fraction of their share of the costs associated with the highways they use.

It is these ‘hidden’ subsidies to the trucking industry that explain, in large part, the shift in traffic from rail to highways. In some cases this shift has been legitimate and desirable. Trucks have much greater flexibility than railroads and are able to serve some shippers more effectively and efficiently. Much of the traffic moving by truck, however, is the result of inequitable variances in government philosophy, funding, and regulation.

Canada’s railroads have the capacity to handle significantly more freight traffic. They are more fuel efficient, safer, and more environmentally friendly than large trucks. They are also willing and able to finance the required investments in infrastructure and physical plant with no need for public funds.

The Railway Association of Canada in its submission to the CTA argues that rail is a more environmentally sustainable form of freight transportation than trucking. The RAC says that increased use of rail will reduce the amount of emission credits that Canada would have to purchase abroad to offset increased emissions from trucking. CN supports the RAC’s submission and recommends the panel recognize the environmental efficiency of rail as a means of helping Canada achieve its greenhouse gas emission targets.

At the federal level, it is highway issues – and virtually only highway issues – that precipitated the recent signing of a Canada-U.S. Memorandum of Co-operation ‘to enhance co-operation on surface transportation matters.’

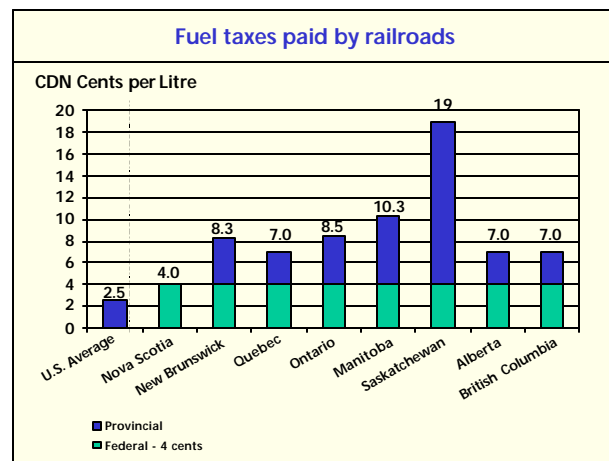
***Canada’s transportation policy environment is replete with inequities and distortions that harm the national interest. Inconsistencies in the provision of, and the charging for, transportation infrastructure are rooted in conflicting policies at the federal and provincial government levels.***

The National Transportation Agency, forerunner to today’s CTA, noted in its first annual review in 1988 that ‘...decisions affecting roads and railways are usually made in a separate arena and often do not produce the most effective use of scarce transportation resources, resulting in higher than necessary total costs.’

Little has changed.

Canadian railroads remain highly regulated at the federal level but without the guaranteed return on investment that normally accompanies such regulation. Regulation of their primary competitor, the trucking industry, is the responsibility of provincial governments.

A major effect is the provincial tax burden that the rail industry is required to bear.



Railroads paid \$95 million in fuel taxes in 1999

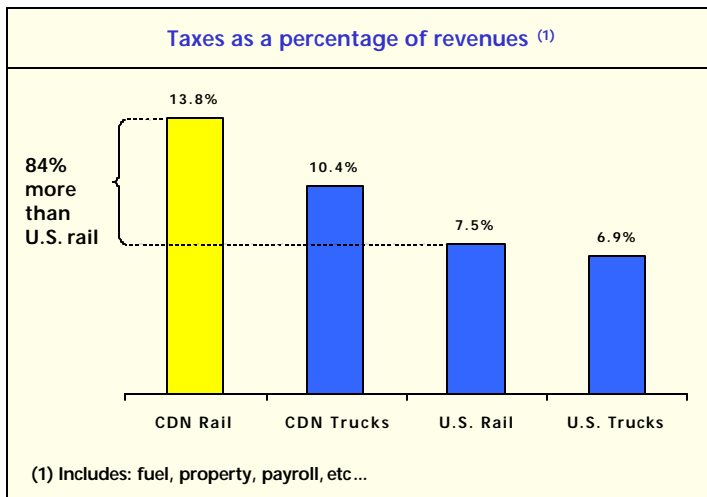
Canada's railroads paid \$95 million in locomotive diesel fuel taxes to provincial governments in 1999. The railroads pay this money without any corresponding benefit in terms of provincial investment in rail infrastructure.

Another \$70+ million in fuel taxes is paid by the railroads to the federal government. Introduced as a 'temporary, deficit-reduction tax' of two per cent in 1985, the rate was doubled two years later. While the federal deficit has been eliminated for several years, the federal government continues to collect its temporary deficit reduction tax.

It can be argued that a portion of these federal tax revenues are applied to improving the national highway system through the Federal Infrastructure Program to the benefit of our competitors.

***These taxes constitute a tax on productivity. Fuel taxes increase with workload not revenue. So the harder the railroads work for their customers the more tax they pay regardless of how much revenue they earn.***

An additional, if unintended, effect of these taxes is to limit the effectiveness of Canada's railroads vis-à-vis their U.S. counterparts.



In Canada, taxes on rail inputs are 50 per cent higher than in the U.S.

Taxes on rail inputs – fuel, material, equipment purchases and railroad rights-of-way – are almost 50 per cent higher in Canada than they are in the United States. As a percentage of revenues the U.S. railroad industry's tax burden is 7.5 per cent; in Canada it is 13.8 per cent.

A Seattle-to-Buffalo freight train, for example, pays approximately \$7000 less in federal and regional taxes than does a like-sized train operating from Vancouver to

Toronto. As a result, more than half of all container traffic originating from Pacific Rim countries and destined for Ontario markets is moved cross-country by U.S. railroads and trucked to destination from Buffalo – to the disadvantage of Canadian railroads, Canadian ports, and even the Canadian trucking industry.

More than 40 per cent of Canada's Gross Domestic Product is tied to exports. Some 40 per cent of these exports move by rail. With the emergence of Pacific Rim nations as major trading blocs, and with continuing double-digit growth in NAFTA-related trade, Canadian economic prosperity will depend, to a large degree, on the efficiency and effectiveness of its national transportation network.

Canada's railroads have much to contribute to such a network. Relative to other modes, they are safer, more efficient, consume less land and energy, reduce highway congestion and impact less on the environment.

Applying these inherent strengths, however, requires a national transportation policy that treats all modes equitably and equally within a framework where outcomes are determined by market forces.

Indeed, Parliament's overriding instruction to the Canadian Transportation Agency when putting it in place in 1996 was '...unless absolutely necessary to let the marketplace prevail without interference to ensure that Canada's transportation industry can compete with the best in the world.'

The Railway Association of Canada in its submission to the Panel recommends that the Panel assess the current situation of taxation as it affects railroads in Canada. The RAC identifies several opportunities for change - including accelerated capital cost allowance for railroad equipment - to match the trucking industry and U.S. railroads. CN supports the RAC's call for a review of railroad taxes and a move toward more equitable tax treatment.

### 2.3.2 Recommendations

The transportation industry in Canada suffers from a lack of harmonization, not only vis-à-vis the U.S. but among federal, provincial and municipal governments. The Review Panel must consider how this hodgepodge of conflicting regulations introduces inefficiencies.

CN recommends:

- ◆ That the Panel recognize the environmental efficiency of rail as a means of helping Canada achieve its greenhouse gas emission targets and adopt the sustainable development proposals advanced by the Railway Association of Canada.
- ◆ That Canada adopt a National Transportation policy, with the objective of optimizing each mode, by treating all modes equitably and equally within a framework where outcomes are determined by market forces.
- ◆ CN supports the Railway Association of Canada's call for a review of railroad taxes and a move toward more equitable tax treatment.

## 3.0 Maintaining rail system integrity

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### 3.1 Regulated Access

In establishing the terms of reference for the CTA Review, the Minister of Transport curiously instructed Panel members to consider proposals for 'enhancing competition in the railway industry...'

In interpreting the instruction, a component of western Canadian rail shippers saw an opportunity to achieve further regulation of the Canadian rail industry and obtain lower rates.

These shippers - most of them members of a loose alliance of western-based rail customers called the Western Canadian Shippers' Coalition - are producers of resource-based products for export, and thus heavy users of rail.

In what they label as 'open' access, these shippers advocate that third parties be permitted to operate trains and/or crews over the lines of Canada's two major mainline railroads.

The term 'open' access is used indiscriminately and inaccurately by advocates of the principle. In fact, 'forced' or 'regulated' access would be a more appropriate term.

As proposed, neither Canadian National nor Canadian Pacific would have reciprocal access to the third party railroads that would be operating over their track.

Nor would the terms of this 'open' access be determined according to commercial principles. The Canadian Transportation Agency, it is suggested, would determine the access fees to be paid by third party operators and, in doing so, would ensure that shippers benefit.

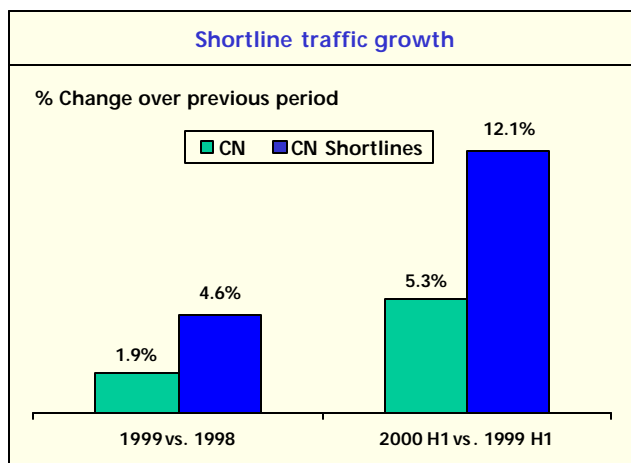
***The suggestion then, is not being advanced from an ideological or philosophical base. Rather it is put forward as a form of contrived competition for the purported purpose of reducing Canadian rail freight rates, already the lowest in the industrialized world. And it comes from a segment of the Canadian shipping community where many enjoy greater returns than do Canada's railroads, and whose enterprises require far less capital to maintain than do Canada's railroads.***

### 3.2 The Shortline Community

Canadian National has played a leading role in the creation of Canada's shortline industry. Since the Canada Transportation Act became law in 1996, CN has transferred in excess of 4600 miles of track to shortline operators. In the process, CN has conclusively demonstrated an ability to successfully work with a diverse range of parties interested in operating local rail services. Today more than 30 profitable and efficient shortline railroads operate lines that CN once owned.

On its network as a whole, CN connects with 80 shortline operators. And these connections account for a significant part of Canadian National's overall business. Almost one quarter of all the tonnage that CN moves is either received from, or delivered to, shortline carriers. Five years ago this volume represented less than five per cent of the total.

More importantly, shortlines have been key to growing rail business at CN. Shortlines are well positioned to offer premium service and grow the business significantly to the benefit of both the shortlines and CN in partnership spirit.



Shortline traffic has grown consistently

Virtually every member of the Canadian shortline community is on record as being opposed to enhanced access in any form. They believe that the future of the Canadian rail industry – and their own commercial interests – are best served when working in partnership with mainline carriers to seize and create business opportunities, as dictated by market forces.

### 3.3 Other Railroads

Canada's regional and shortline railroads are overwhelmingly opposed to any re-regulation of the industry that would afford them forced or regulated access to Canadian National or Canadian Pacific trackage.

Only two of the country's 68 railroads favour such a step.

### **3.3.1 OmniTRAX**

OmniTRAX, Inc. is a U.S.-owned and Denver-based real estate conglomerate, operating 15 railroad companies and shortlines, three of them in western Canada. None of their three Canadian holdings are members of the Railway Association of Canada, the national body that represents the interests of the Canadian rail industry.

The largest OmniTRAX Canadian property is the 1300-kilometre Hudson Bay Railway that carries resource-based products, primarily grain, for export through the Port of Churchill.

With \$16 million of Canadian taxpayer money, OmniTRAX purchased the line from CN in 1997. Management of the Port of Churchill was turned over to OmniTRAX. As part of the transaction, the company received more than \$30 million in federal and provincial subsidies for infrastructure improvements and dredging at the Port.

Subsidies of another kind, in the form of a transfer of CN and Canadian Pacific revenues, are at the core of the OmniTRAX 'managed access' proposal. In fact, OmniTRAX is on record as opposed to 'open access' and this is why they named their proposal 'managed access'.

The proposal would see OmniTRAX gain access to CN and CP lines in Manitoba and Saskatchewan and 'bridge' traffic over one to reach the other. Further, OmniTRAX would have the right to service customers on lines owned by CN and CP.

None of these forms of access would be reciprocal, thus ensuring that current OmniTRAX customers would continue to be served exclusively by it.

Access fees, in the absence of an ability to negotiate terms, would be set by the Canadian Transportation Agency.

The OmniTRAX proposal is put forward out of self-interest. The objective is to establish a regional rail monopoly with the power to 'expropriate' those parts of the CN and CP franchises that would increase OmniTRAX revenues without regard to the effects of this 'poaching' on the overall financial health of the two mainline carriers.

### **3.3.2 B.C. Rail**

B.C. Rail, a provincially-regulated regional railroad owned by the Government of British Columbia, also seeks running rights and forced haulage over the trackage of CN and CP. B.C. Rail wants the access federal regulations will give it while at the same time hiding behind its provincial status to protect it from competition.

B.C. Rail rejects the idea that shortline and regional carriers be able to serve customers on lines owned by others. In its October submission to the Panel, B.C. Rail said this would adversely affect the fundamental economics of the industry 'thereby leading to a long-term deterioration of the rail network and the undermining of service provisions.'

There is a further irony in the B.C. Rail proposal.

The company is prohibited from operating over provincial boundaries without first relinquishing its status as a provincially-regulated railroad. Doing so would require it to accommodate higher federal standards for safety and would subject B.C. Rail to federal interswitching rates and rate arbitration. On those lines that cross provincial boundaries, therefore, B.C. Rail seeks a less intrusive form of access known as 'haulage' agreements.

This inconsistency has been noted by B.C. Rail customers. During a stakeholders session organized by the B.C. government, most participants supported a recommendation that B.C. Rail be subject to the same rules as federally regulated railroads so that its customers, now prevented from directly accessing competing railroads could access federal remedies.

Finally, both B.C. Rail and OmniTRAX describe their proposals as equating to further deregulation of the industry. Discounted are the cumbersome and costly bureaucratic processes that would have to be put in place to determine access fees, resolve operational disputes, establish train priorities, adjudicate disagreements over rates, and ensure that rail operations remain safe.

### **3.4 Lessons Learned In Other Contexts**

Some of those who see review of the Canada Transportation Act as an opportunity to increase regulation of Canada's railroads often point to regulatory regimes in other countries. Specific references usually relate to 'open' access models in the United Kingdom, Australia, and some member countries of the European Union.

Before rail restructuring efforts were introduced in these countries in the 1980s and 1990s all, or nearly all, of the railroads were government-owned and heavily subsidized. Most were operated under severe management constraints and were technologically backward.

By introducing change, in the form of broadened access to rail infrastructure, all of the countries had a common objective: reduce the financial burden on taxpayers by attracting private investment to drive innovation, not to drive more competition.

There have been few successes to date. Most countries have failed in reducing the flow of subsidies to the rail industry and very few private investors have come forward.

### 3.4.1 European Union

With a view to increasing cross-border rail traffic, the European Union, in 1993, issued a directive calling for 'open access' on all movements of international freight. Open access in the European Union has failed to achieve its objectives and new legislation is under development. The fluid cross-border system originally envisioned has not been realized. Rail's share of the freight market has failed to grow. There have been few new entrants and little new rail-to-rail competition. Finally, the governments continue to subsidize rail operations.

As a result, Europe's railroad network remains balkanized – made up of a number of non-integrated national rail systems. Its primary use remains the provision of publicly funded passenger services.

### 3.4.2 United Kingdom

In an effort to reduce subsidies of more than a billion dollars per year, the United Kingdom adopted the EU's open access policy in 1996.

Six freight companies were sold, 25 passenger companies were created, and a single company established to own and operate track infrastructure.

With the U.S.-based Wisconsin Central Railway winning five of the six freight concessions, the transaction clearly attracted little interest from investors. Recently, Wisconsin Central advised its intention to withdraw from the market citing, among other concerns, the fact that the infrastructure owner 'exhibits the characteristics of a high-cost, inefficient and indifferent monopoly protected from market forces.'

The U.K. model has proved difficult to implement. Network safety has become a major issue. Government financial support, rather than decreasing has, and, for the foreseeable future at least, will continue to increase dramatically.

Recent media reports state the British government is going back to the drawing board in an attempt to sort out what is referred to as a rail crisis.

### 3.4.3 Australia

Like many European countries, the Australian rail network is composed of several state-owned operators, few of which are integrated.

In the mid 1990s, the Australian government created a separate corporation with formal authority to sell access to this interstate rail network. The purpose was three-fold: to

reduce the then level of subsidies, counter market domination by the trucking industry and implement an integrated national network with compatible rail gauge.

While the threat of competition has encouraged cost reductions, and reduced subsidies, the six new entrants handle only three per cent of the freight market. Rail-to-rail competition has not materially increased and trucks remain the dominant mode.

In response, the state of Western Australia recently gave notice of its intention to privatize its railroad and apply North American standards in doing so. It will be established as a vertically integrated freight operation and the new entity will both own and operate all of the transportation components required to deliver service.

### 3.4.4 Utilities Comparison

The argument that the characteristics of the Canadian rail sector parallel those of the telecommunications industry, and other 'network' industries – as posited by those who seek imposed access to rail infrastructure – is specious.

Regulated access in the telecommunications industry was introduced as a means of forcing competition, by imposing a 'common carrier obligation' into a monopoly market that had existed for 50 years. And regulated access in utilities still includes full cost recovery for system owners.

Canada's two major railroads are not monopolies. They have competed with each other, and with trucks, virtually since their inception. Together they capture less than one quarter of all freight revenues; continue to lose market share to trucks; and for several years have seen their average yields fall sharply.

Network industries such as telecommunications and electric utilities sell homogenous – or virtually interchangeable – products. Induced competition in these industries is related to the commodity being sold, not to the infrastructure over which it moves.

The business of railroads is to move commodities they do not sell, with equipment it owns, or leases, over infrastructure it owns and maintains. Train operations account for the majority of a railroad's total operating expenses.

There is no direct equivalent expense in the electricity and telecommunications industries. Their 'traffic' costs represent but a fraction of the operating expenses incurred by railroads. And they can increase the volume moved with little impact on costs and capacity.

The overriding purpose of imposing access regulations in the telecommunications, natural gas, and electric utility industries was to create a competitive structure where member companies would be required to carry each others' product over their lines.

Railroads have had this 'common carrier' requirement for years. They are required to receive, carry, and deliver all traffic offered for movement and to do so according to standards set by the Agency. In the event of a breach, the Agency has pervasive powers to ensure that these standards are met, including the power to order the purchase of equipment and the construction of facilities.

Another hidden consequence of utility deregulation is the additional oversight required by regulators to ensure industry players treat consumers fairly. A recent example is electricity deregulation in Alberta that has resulted in new rate setting and monitoring bureaucracies at the municipal level.

### 3.5 Recommendations

In CN's October 6 submission to the CTA Review Panel, the company asked the Panel to make clear that any access models proposed for consideration respect a set of principles that would ensure the economic integrity of the rail system without taxpayers subsidies. Specifically CN called for:

- ◆ *Full cost recovery* – Access fees must be market-based and negotiated rather than regulated. Failing a negotiated agreement of the access fee, commercial arbitration must consider the following principles of cost recovery:
  - ◆ increased operating costs due to a new entrant
  - ◆ return on embedded capital
  - ◆ payment for new capital
  - ◆ lost contribution to fixed costs, including opportunity cost
- ◆ *Enhance efficient competition* – Given full cost recovery to preserve infrastructure quality, railroads would compete on service and variable costs.
- ◆ *Full deregulation* – With open access, market forces and not regulation, drive industry efficiency, service and price. Perfect competition and customer protections cannot co-exist.
- ◆ *Maintain vertical integration* – The North American model allows for efficient allocation of capital to maintain and improve the network and protect safety standards.
- ◆ *Access reciprocity* – CN and CP will insist on full reciprocity rights to each other and to shortlines and regional railroads that are granted access on their lines. Particularly critical is the need to balance access between Canadian and U.S. carriers operating in both countries; otherwise U.S. railroads could 'cherry pick' Canadian traffic.
- ◆ *Commercial arbitration* – Commercial arbitration would be used to resolve access fee and rate disputes.

- ◆ *Maintain a Canadian rail system that is competitive in North America* – To succeed, Canadian shippers need an efficient rail system that allows them to be competitive in their end markets.
- ◆ *Respect NAFTA rules* – Under NAFTA and WTO, access rules that are, in effect, disguised subsidies would be counter to Canada's international trade obligations.

CN further recommends:

- ◆ That open access regimes implemented elsewhere in the world be rejected as models for Canada because of their failure to eliminate government subsidies and improve rail efficiency.
- ◆ That provincial regional rail networks be subject to the same regulatory regime as federal railroads for safety standards as well as for shipper relief provisions.

## 4.0 Corridor and Commuter Services

### 4.1 Rail Line Abandonment Process

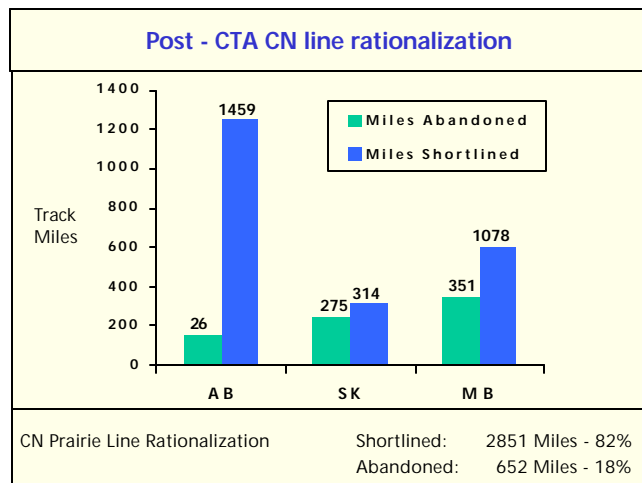
The Review Panel has asked whether the existing rail line abandonment process accommodates the need to preserve corridors for future use.

Canadian National believes that current CTA provisions do, indeed, provide the means of protecting these corridors. These measures fall short in two important areas, however.

- ◆ the provisions are susceptible to political and public pressure, pressure to which the railroads often have to succumb; and
- ◆ the inappropriate use of net salvage value in establishing the worth of transportation corridors in high-density urban areas.

The line discontinuance process contained in the Canada Transportation Act was introduced, in part, to encourage the development of a Canadian shortline industry and has been exceptionally successful in this regard.

The provisions were also meant to protect the public interest. When looking to dispose of an uneconomic section of line, the railroads have an initial obligation to offer the line for commercial sale. In the event of a lack of interest, the lines must then be offered for sale, at no more than net salvage value and in priority order, to each of the three levels of government – federal, provincial, and municipal.



The railroads are prohibited, therefore, from abandoning trackage without every level of government having the right to acquire ownership of the line, even if for a future use that is but at the moment conceptual, at a net salvage value as set by the Agency.

These provisions were intended, correctly, to place responsibility for the public interest with those duly elected to expend public funds in support of that interest.

## 4.2 Eliminating discontinuance delays

In practice, especially in respect of grain dependent branch lines, some governments have blatantly ignored the provisions, or applied a number of disingenuous means, to either try to acquire the lines for nothing, or burden the railroads with the continuing costs of ownership. Heritage designation and onerous reclamations by-laws are two current examples.

Some communities also routinely express concern that the current process does not allow them enough time to react to discontinuance decisions made by CN and its customers. However, CN has worked hard with rural communities to ensure they have ample opportunity to participate in the discontinuance process and, if they wish, to acquire discontinued lines.

There are two current examples, both in western Canada.

For the Cowan Subdivision in Northern Manitoba, CN first notified the public that it intended to discontinue the line in July of 1996. In August 1997, the Village of Ethelbert accepted CN's offer to sell the line but disputed net salvage value. An agreement was finally signed in January 1998. Unable to quickly conclude an agreement, based on its original terms, CN consented to a revised agreement in March of 1999, with closure scheduled for May of 1999. Closing, with a signing ceremony, was delayed at the purchaser's request until September, but at the last moment the Village withdrew its acceptance of CN's offer. In June 2000, CN sold the Cowan Subdivision to Cando Contracting of Brandon.

Following the sale to Cando, every local government along the Cowan then applied to the Canada Transportation Agency to have CN's original discontinuance disallowed. The CTA, in October 2000, dismissed the complaints, saying CN took extraordinary measures to accommodate local concerns. In November 2000, the R.M. of Ethelbert asked CN to forward the branchline abandonment proceeds to the Village so it could invest the money in community improvements.

The Tisdale Subdivision in Saskatchewan followed a similar path. In July 1996, CN placed the line on its three-year plan as a discontinuance candidate. It advertised the line for sale in December 1997. In March 1998, CN offered to sell the line to local governments which they accepted in principle. Negotiations on acquisition price began in May 1998.

The local government purchasers then felt it necessary to apply to the CTA in September, 1998 for a net salvage value determination claiming that the line was negatively valued and that CN should in effect pay them to purchase it. While the determination process was to take 120 days, it did not. CN agreed to an extension and in April of 1999, the Agency determined that the net salvage value of the Tisdale branchline is \$297,000. In May 1999, the purchasers told CN that they did not intend to comply with the Agency's decisions. As a result, CN was forced to absorb the cost of this exception. Eighteen

months after the Agency's determination of net salvage value, the purchasers have yet to pay CN for its asset.

It is understandable that provincial and municipal governments may want lines kept in place for uses that are foreseen to arise in but five or ten years' time. CN is firmly of the view that in such circumstances, local governments, as intended by the law, should assume ownership of the line and thus the costs of maintaining it over that period of time.

Similarly, if the federal government wants a line maintained for passenger rail purposes, the costs of ownership and maintenance should be borne by either the federal government or the Crown Corporation charged with the provision of passenger services.

The process needs to be amended to ensure would-be government purchasers respect the reasonable timelines that currently govern line discontinuance processes.

### 4.3 Urban Corridor And Commuter Services

Canadian National believes it unreasonable to use net salvage value methods in establishing the worth of transportation corridors in high-density urban areas.

These properties are often unique.

- ◆ if the corridor did not exist the cost of recreating it would be prohibitive; and
- ◆ in converting these corridors to commuter use governments invariably avoid the expense of having to expand highway networks and/or the costs related to increased automobile traffic in downtown cores.

When the above circumstances apply CN submits that the value of adjacent property – the 'across the fence' (ATF) value – should apply as the means of establishing the minimum value of these corridors, to which a premium should be applied to recognize the corridor assembly value.

Recent sales of similar corridors in the United States were transacted at prices that averaged 108 per cent of ATF values. And, as reported by the management consulting firm of Arthur Andersen, the seven urban corridors sold between 1980 and 1993 attracted prices ranging from 114 to 150 per cent of ATF value.

Rail commuter services represent an important component of Canadian National's business base.

CN provides important services to commuters in both Montreal and Toronto. Together these services encompass the operation of almost 200 trains per day with daily ridership approaching 150,000.

Services in both cities continue to grow. Expanded service to Montreal's south shore has just begun and, in Toronto, CN recently reached agreement to sell its Uxbridge and Newmarket subdivisions to GO Transit by year-end.

The agreements that led to the establishment of these services were reached on commercial bases and took account of market values for both property and assets.

## 4.4 Recommendations

The current rail line abandonment process needs to be clear and parties wishing to acquire lines held accountable.

CN recommends:

- ◆ Where a level of government chooses to accept an offer from a railroad to transfer a rail line at net salvage value, the level of government shall, within 30 days of the date of acceptance, deposit, with the Agency, a sum of money equivalent to \$5,000 per mile of railroad.
- ◆ A railroad ceases to have any obligation to continue to operate that line 60 days after the Agency determines the net salvage value of that line; or where the Agency is not able to determine the net salvage value of a line in 120 days or less, the railroad ceases to have any obligation to continue to operate that rail line 240 days after the date on which the Agency became seized with an application to determine the net salvage value.
- ◆ Where the Agency determines the net salvage value of a rail line the purchaser shall tender the proceeds to the railroad within 60 days thereof; where the purchaser does not tender the proceeds, in full, within that time, then the net salvage value shall be increased by an amount equal to the Bank rate for the quarter plus 2%. This additional sum shall be payable from the purchaser to the railroad.
- ◆ The original timelines for the line discontinuance process under the CTA in 1996 need to be re-instated for non-grain lines; the longer timelines set out in the new Schedule I of the Act as amended by Bill C-34 should only apply to grain-dependent branch lines.
- ◆ For rail corridors intended for commuter rail use, across the fence valuations, with a premium for corridor assembly in urban areas, should be recognized as the most appropriate basis for negotiations between railroads and communities.
- ◆ Similarly, if the federal government wants a line maintained for passenger rail purposes, the costs of ownership and maintenance should be borne by either the federal government or the Crown Corporation charged with the provision of passenger services.

## 5.0 Conclusions and Recommendations

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Though modest in its deregulation of the rail industry, the 1996 Canada Transportation Act has improved the competitiveness of Canadian producers and manufacturers and thus moved the strength of the nation's economy forward.

Canadian rail freight rates are now the lowest in the developed world.

Government subsidies, that for the rail industry approached \$700 million prior to passage of the CTA, have been virtually eliminated.

The railroads themselves have made remarkable gains. Canadian National and Canadian Pacific, once woefully inefficient compared to U.S. railroads, are now one and two, respectively, among all North American carriers. The Canadian shortline industry, small and of no consequence before CTA 1996, now comprises more than 40 members operating more than 16,000 kilometres of track.

The challenge for the Canadian rail industry is to consolidate these gains – largely achieved through one-time reductions in surplus costs – and increase its North American market share.

Without change to the Canadian rail regulatory regime, the challenge will be daunting.

The Canadian rail regulatory regime is more constraining of its railroads than are regulations that govern the industry in the United States. It is also significantly more restrictive than are the rules that apply to the trucking industry in either country.

It is only by regaining market share lost to trucks, and by maintaining its relative strength compared to U.S. railroads – *in a North American marketplace* – that the Canadian rail industry can remain a sustainable, long-term competitive option for Canadian shippers.

The North American Free Trade Agreement changed the transportation needs of many shippers. In 1989, the value of Canada's trade with the United States was 83 per cent of Canadian inter-provincial trade. In the two years after NAFTA, the value of Canada-U.S. trade had grown to exceed inter-provincial trade by 42 per cent.

It is within the reality of this free market economy that the value and effectiveness of regulatory reform must be weighed.

***Regulation is effective when limited to correcting deficiencies in the market; when it imposes the least burden necessary to achieve its objective; and when its benefits justify its costs. In the final analysis, however, the regulated industry must be allowed to prosper.***

It is Canadian National's proposition that the recommendations put forward in this brief meet all of these criteria.

1. That Canadian rail regulation should be compatible with U.S. rail regulation to ensure Canadian carriers and shippers are not disadvantaged vis-à-vis U.S. competitors.
2. That Canadian rail regulation should be consistent with all aspects of NAFTA including hidden subsidies and compensation provisions.
3. That rail mergers in Canada continue to be subject to review and approval by the Competition Bureau but that the Competition Act be modified to give the Minister of Transport standing to intervene before the Bureau on a notifiable transaction in the rail sector where bona fide public opposition has been expressed. The amendments should, however, be pro-competitive and not be based on any return to subjective notions of public convenience and necessity.
4. That Canadian rail freight legislation and regulation recognize that Canadian railroads are shareholder-owned, capital intensive businesses requiring an adequate return on investment to remain competitive in capital markets and renew their extensive infrastructure and equipment.
5. That the Canada Transportation Act Review Panel undertake or commission rigorous quantitative research to determine actual levels of existing competition. Decisions bearing on the future regulation of the industry should be based on definitive, rigorous research.
6. That current interswitching rates be adjusted to properly contribute to fixed costs.
7. That competitive line rate provisions be abolished and the substantial commercial harm test be established as a prerequisite for those seeking rate arbitration.
8. That the FOA process be amended as follows:
  - ◆ all applications be made subject to a 'prima facie' test to determine whether the shipper has other competitive means of transporting the goods.
  - ◆ If the shipper faces commercial harm caused by the current rate and arbitration proceeds:
    - ◆ applicants must be made to commit to use rail to ship all of the goods under arbitration; and
    - ◆ the existing winner-take-all process be replaced by the Canadian *Commercial Arbitration Act* process that applies to any other commercial relationship.

- ◆ Establish a shorter process, based on commercial arbitration principles, for smaller claims involving less than \$500,000 in annual transportation costs.
9. That the Panel recognize the environmental efficiency of rail as a means of helping Canada achieve its greenhouse gas emission targets and adopt the sustainable development proposals advanced by the Railway Association of Canada.
  10. That Canada adopt a National Transportation policy that treats all modes equitably and equally within a framework where outcomes are determined by market forces.
  11. That any access models proposed for consideration must respect a set of principles that will ensure the economic integrity of the rail system without taxpayer subsidies.
  12. That open access regimes implemented elsewhere in the world be rejected as models for Canada because of their failure to eliminate government subsidies and improve rail efficiency.
  13. That provincial regional rail networks be subject to the same regulatory regime as federal railroads for safety standards as well as for shipper relief provisions.
  14. That the current rail line abandonment process be amended:
    - ◆ Where a level of government chooses to accept an offer from a railroad to transfer a rail line for net salvage value, the level of government shall, within 30 days of the date of acceptance, deposit, with the Agency, a sum of money equivalent to \$5,000 per mile of rail.
    - ◆ A railroad company ceases to have any obligation to continue to operate that line 60 days after the Agency determines the net salvage value of that rail line; or where the Agency is not able to determine the net salvage value of a rail line in 120 days or less, the railroad ceases to have any obligation to continue to operate that line 240 days after the date on which the Agency became seized with an application to determine the net salvage value.
    - ◆ Where the Agency determines the net salvage value of a rail line the purchaser shall tender the proceeds to the railroad within 60 days thereof; where the purchaser does not tender the proceeds, in full, within that time, then the net salvage value shall be increased by an amount equal to the Bank rate for the quarter plus 2%. This additional sum shall be payable by the purchaser to the railroad.
    - ◆ The original timelines for the line discontinuance process under the CTA in 1996 need to be re-instated; CN only agreed to the longer timelines for the grain-dependent branch lines set out in the new Schedule I of the Act as amended by Bill C-34.

- ◆ For rail corridors intended for commuter rail use, across the fence valuations, with a premium for corridor assembly in urban areas, be recognized as the most appropriate basis for negotiations between railroads and communities.
- ◆ Similarly, if the federal government wants a line maintained for passenger rail purposes, the costs of ownership and maintenance should be borne by either the federal government or the Crown Corporation charged with the provision of passenger services.

CN recommends that Canada's railroad industry continue along a path of deregulation. The review Panel needs to take a fact-based approach to competition and be careful with changes it proposes to a system that is now arguably the best in the world. CN will be an active participant in the review process and looks forward to working closely with the Panel and other stakeholders.

