
Canadian National
Initial Submission
to the
Canada Transportation Act Review Panel

Perspectives on Competitive Rail Access Issues

October 6, 2000



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5.0 Summary

1.0 Executive Summary

Canadian rail freight deregulation has been a success for the Canadian economy, shippers and taxpayers. It has significantly contributed to the substantial economic recovery of Canada's railroads, but this recovery is incomplete and fragile.

A Conference Board of Canada study released earlier this year concluded there is a strong, positive correlation between deregulation, freight rates, rail productivity, and financial performance. Canadian shippers now enjoy the lowest rail freight rates in the developed world and improved productivity has resulted in better customer service.

Equally significant, subsidies that were costing Canadian taxpayers hundreds of millions of dollars every year have been eliminated.

Reforms to Canada's rail policy have helped lift the domestic rail industry from deficits and economic decline. Deregulation, along with rigorous cost containment, investments, network rationalization, improved asset utilization and acquisitions and strategic alliances, has created a platform for growth at CN.

But the recovery is not yet complete. Despite impressive service performance and productivity gains, rail's share of the growing freight transportation market is still shrinking and more than eight years of sustained economic growth has increased rail traffic volume, but not revenues.

The challenge before Canadian railroads today is to grow the business, to recapture market share from trucks, and compete head-to-head with U.S. railroads for business in the fast growing, but intensely competitive North American market.

Canada has always been a nation of traders with around 40 per cent of our Gross Domestic Product earmarked for export and 85 per cent of all exports destined for the U.S. But Canadian goods face a distance disadvantage to U.S. markets compared to U.S.-based goods. Canada's future economic prosperity is directly dependent on an internationally competitive rail transportation system.

Cost recovery and investment is key to a competitive rail system. Railroads are highly capital intensive, much more than most industries. Railroads depend on investment. Investment, in turn, depends on capital markets getting adequate returns.

In this period of sustained economic growth, CN is now beginning to earn its cost of capital, but CN is far from earning its cost of capital over a full economic cycle.

To achieve both full cost recovery and the lowest rates for shippers, railroads rely on differential pricing. This approach is based on pricing in accordance with demand – a standard practice in North American industries with high fixed costs. It optimizes contribution to fixed costs to the benefit of all stakeholders, especially shippers that are highly rail-dependent.

Another key to an internationally competitive rail system is the alignment of the Canadian and U.S. regulatory environments. Currently, Canadian railroads are subject to more regulation than are U.S railroads.

It is against this background that the CTA Review Panel, in preparing its interim report on competitive access issues, will have to evaluate a number of proposals based on open access concepts. The challenge facing Review Panel members is to balance the legitimate concerns of shippers with the fundamental requirement for an internationally competitive rail system. No one benefits more from preserving balance than shippers.

Open access, allowing multiple carriers access to a network owned by another carrier, would constitute a major structural change to Canada's rail transportation system.

The story of open access around the world is a cautionary tale. Open access regimes in the United Kingdom, the European Community and Australia, are all significantly subsidized and fall well short of the performance and policy objectives met by Canada's current system.

Any recommendations for regulatory change based on access – including access provisions for regional railroads – must maintain the integrity of differential pricing and be measured against a set of core principles that first addresses:

- full cost recovery
- access reciprocity

Then includes:

- full deregulation
- commercial arbitration
- respect for NAFTA and WTO rules

Any access proposal that fails to address each of these principles constitutes regulated or forced access and may constitute a subsidy and/or expropriation under WTO or NAFTA respectively.

Current proposals, such as a regional railroad focussed on grain transportation or the CAR (competitive access rates) proposal, fail to meet the core principles outlined above and both would undermine differential pricing. To respond such proposals would quite simply constitute an unwarranted and possibly unlawful transfer of wealth from one participant in the transportation system to another.

CN is firmly of the view that the principles that underlie Canada's current legislative and regulatory system should be the basis for the future. Deregulation has significantly contributed to a safe, efficient, flexible, affordable and competitive rail transportation system for Canadian shippers.

The Canadian transportation system must be a key contributor to Canada's competitiveness, particularly in NAFTA markets. The public policy imperatives to realize this vision and ensure railroad sustainability are continued deregulation, a National Transportation Policy that is effective for all modes, and taxation equity between modes of transport and between jurisdictions.

In its submission of November 17, 2000, CN will develop recommendations that advance this vision.

2.0 Canadian Rail Freight Deregulation is Working

2.1 The best rail freight system in the world

Deregulation of the rail industry in Canada has created stronger railroads and more competitive transportation options for shippers with improved access to more North American markets. The process of deregulation has taken place in two major phases over the past 14 years.

In 1987, the National Transportation Act allowed railroads and their customers to enter into mutually agreed confidential contracts. At the same time, the NTA introduced significant shipper protection measures.

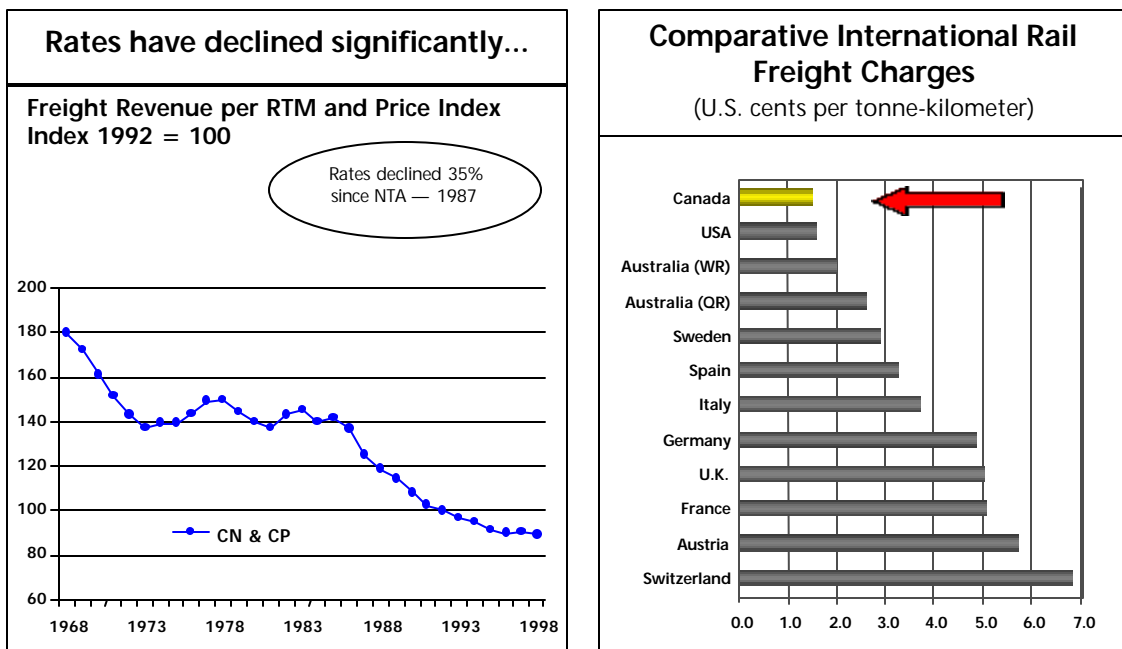
In 1996, the Canada Transportation Act recognized the need to reorganize feeder lines to address the costs associated with an overbuilt railroad system. This process of rationalizing the networks of the country's two major railroads has led directly to the development of a strong, vibrant shortline rail industry in Canada. Currently, there are 56 shortlines and regional railroads operating 10,000 miles of track in Canada. The shortlines took over local service to shippers on former CN and CP feeder lines while delivering, in partnership with CN and CP, the long-haul benefits of a mainline railroad.

These significant moves to deregulate the industry in Canada have made the rail industry much more productive and efficient and have produced substantial, quantifiable benefits for shippers. Public benefits include the elimination of costly taxpayer-funded subsidies and a more competitive rail system within North America.

2.1.1 For shippers: competitive rates, improved service

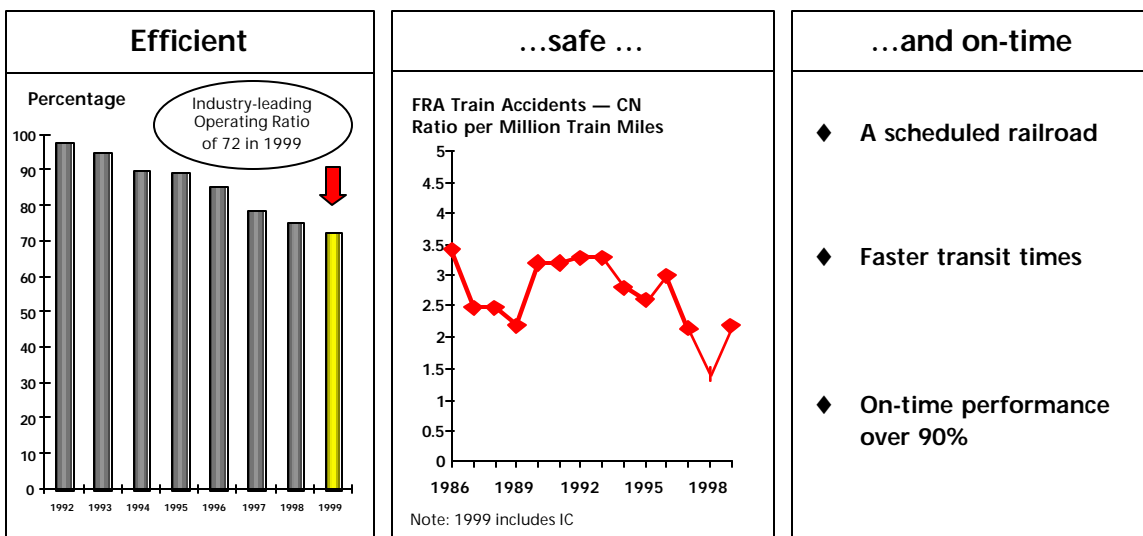
An element of a competitive rail system is competitive rates for shippers. Today, rail freight rates paid by Canadian shippers are the lowest in the world – 60 per cent below the international average. Since deregulation of the rail industry in 1987, shippers have benefited from a 35 per cent decline in real freight rates. The Canadian rail system is now one of the most efficient in the world.

Competitive Freight Rates



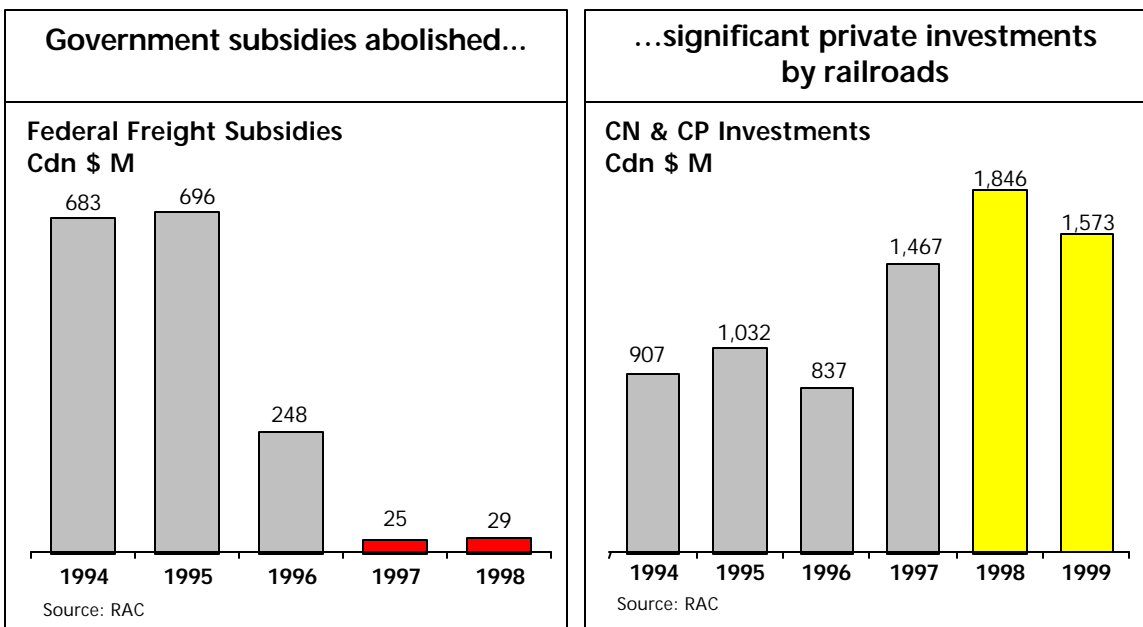
Shippers have also benefited from CN's faster transit times and on-time delivery performance levels better than 90 per cent for carload traffic.

Today CN is



2.1.2 For governments: subsidies eliminated, private investment at record levels

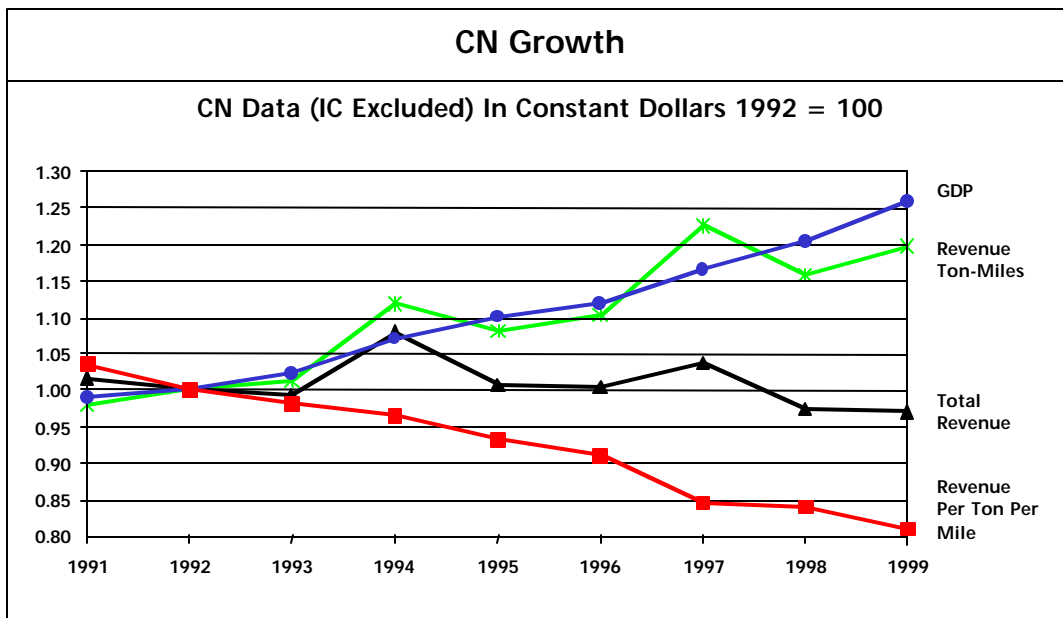
Deregulation has led to improved service, improved safety and lower rates. In addition, under deregulation, subsidies that were costing Canadian taxpayers hundreds of millions of dollars every year have been eliminated. The virtual elimination of federal government freight subsidies, except for grade crossing upgrades, has been a further benefit of deregulation in Canada. In 1994, these annual subsidies were nearly \$700 million. Since 1994, Canada's two major railroads have doubled their investment in plant and infrastructure. In 1999, CN and CP together invested more than \$1.5 billion to ensure continued service improvements for their customers.



2.2 But rail recovery is fragile

2.2.1 Economic growth has increased traffic volume but not revenues

The railroad industry has been successful in substantially reducing costs. However, it still faces significant revenue challenges. Canada is in a sustained period of economic expansion and growth. Rail freight volumes are at record levels, keeping pace with the expanding economy. But rail freight revenues have been virtually flat during this period, because average rates per tonne-kilometer have fallen dramatically. Impressive productivity gains have helped CN deliver the efficient service that shippers demand. However, increased workloads combined with flat revenues jeopardize CN's, and indeed the industry's, long term ability to sustain the level of investment necessary to maintain and continuously improve the network.

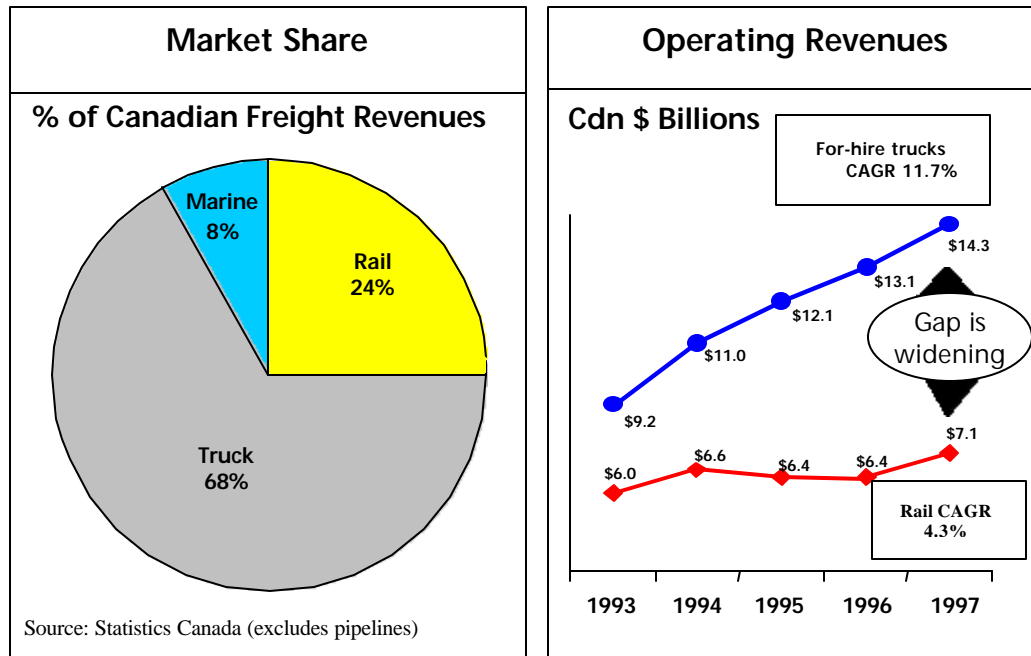


2.2.2 Need to increase market share against truck competition

While shippers' transportation requirements are growing, rail's comparative share of this growing market is shrinking. Truck competition is fierce. Technical innovations, coupled with expanded size and weight limits as well as extended hours of service, mean trucks can compete for freight that was once exclusive to rail. For railroads to grow their business they need to meet truck competition head-on with new service innovations and better reliability.

CN has introduced several new services in 2000 targeted specifically at winning back some of this traffic. The company has shaved 24 hours off its transit time between

Toronto and Vancouver, reduced Toronto-Moncton service to less than 24 hours, introduced overnight RoadRailer intermodal service between Montreal and Toronto and recently announced its expansion to Chicago. Continued investment in new services is required if rail is to win back market share.

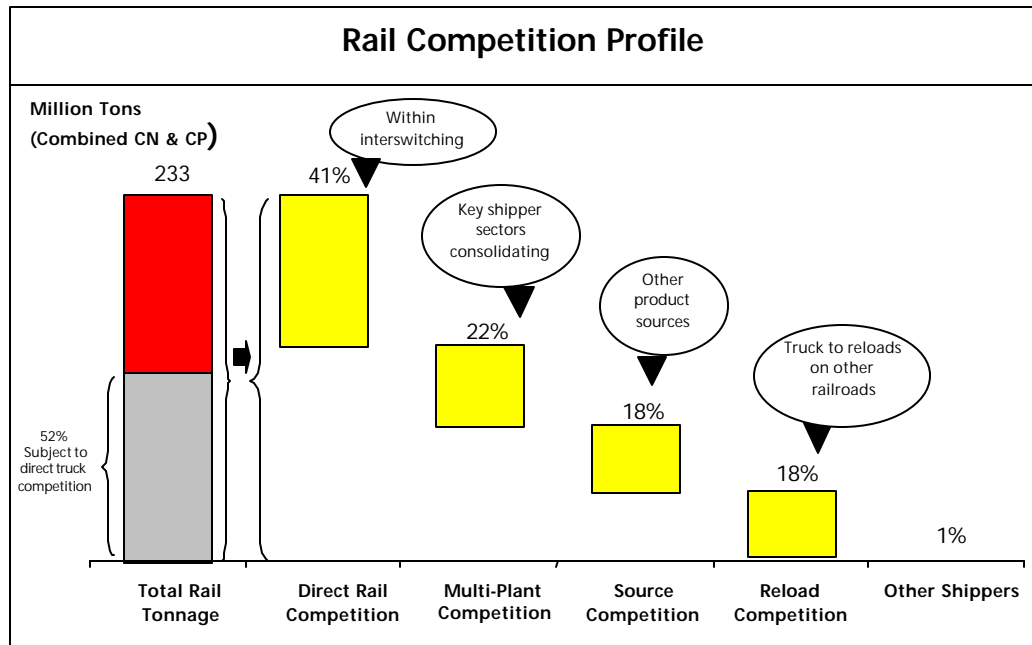


2.2.3 Shipper choices drive competition

To increase market share and ensure financial durability, railroads must shift their focus from cost containment to growing their business. This is an enormous challenge in today's highly competitive market where shippers have transportation choices and shippers' customers have greater sourcing options. Approximately 99 per cent of rail business is subject to intense competitive pressures. CN's freight service offerings must compete with many other options available to shippers and receivers. Most benefit from a combination of the following forms of competition, which are not mutually exclusive.

- Direct truck competition – over half of the combined tonnage of CN and CP can also be moved over-the-road.
- Direct rail competition – 41 per cent of the combined tonnage of CN and CP where shippers have fully competitive rail options.
- Multi-plant competition – For 22 per cent of the combined tonnage of CN and CP, shippers have the flexibility to bundle plant shipments resulting in further leverage with the railroads on rates and volumes.
- Source competition – 18 per cent of the combined tonnage of CN and CP is in commodities such as coal, for example, which are sensitive to alternate source competition.

- Truck to reloads on other railroads – for 18 per cent of the combined tonnage of CN and CP, a shipper can use over-the-road transport to reach a competitor railroad including U.S. rail terminals in Canada or the U.S.



Further competitive pressures are emerging as a result of structural and technological changes in the marketplace.

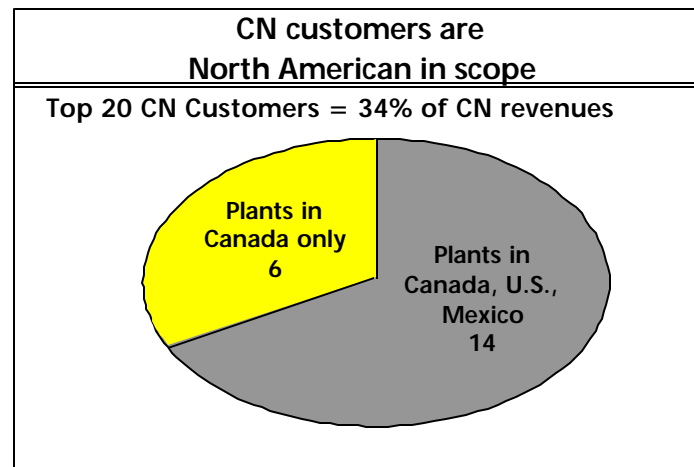
Shipper consolidations are creating more and more customers with the flexibility to move product from one plant to another. As a result, these customers are able to “bundle” their shipping requirements and leverage their market power in rate negotiations.

Similarly, e-commerce is putting added pressure on the railroads to increase their efficiency. E-commerce provides new means of aggregating demand, providing shippers with added pricing leverage. In addition, e-commerce accelerates the move toward just-in-time delivery and fragmentation into smaller shipment sizes. This trend poses a major service challenge for the railroad industry.

2.2.4 The challenge in north-south trade

Further to the competitive pressures of shipper choice and market trends, globalization generally, and the North American Free Trade Agreement in particular, are reconfiguring Canadian shippers' transportation requirements. Canada-U.S. trade is growing by approximately 10 per cent annually leading to an increasingly integrated North American marketplace and an intense need for efficient north-south transportation services for Canadian shippers.

Another contributing factor to the growth in north-south transportation requirements is the rise in transborder mergers of the railroads' customers. For example, of CN's top 20 customers, nearly 75 per cent have plants in at least two of the three NAFTA countries. These shippers require integrated and efficient North American transportation solutions.



Given that 85 per cent of Canadian exports are to the U.S. and that 40 per cent of this trade moves by rail, it is clear that efficient railroads are vital to Canada and its ability to compete. Currently, Canadian shippers benefit from the lowest rail freight rates in the world, which helps compensate for the longer distances goods must be transported to reach their destination in the competitive North American market.

But market developments – such as further consolidation among U.S. railroads – could quickly tip the balance of competitive advantage in favor of U.S. suppliers.

Should U.S. transcontinental mergers occur, the longer singleline service created would push U.S. railroads to favor U.S. originated goods over Canadian ones.

2.2.5 Canadian railroads more regulated than U.S. roads

In the context of growing north-south trade, the Canadian rail industry's ability to continue to deliver efficient, integrated and cost-effective service depends, in significant part, on the alignment of the Canadian regulatory regime with that governing rail transportation in Canada's principal end market, the United States. Regulation imposed in one country can produce competitive consequences that could directly impede a shipper's ability to compete in its end-market. Shipper protection regulation for example, can impede flexibility, efficiency and the revenue flows required for re-investment in the rail network.

Currently, Canada provides the highest level of shipper protection of any jurisdiction and significantly more shipper protection than does the regulatory system of the United States our primary competitor.

Canada – U.S. Regulatory Regimes Comparison

	Canada	U.S.
Applicable Traffic	<ul style="list-style-type: none"> All 	<ul style="list-style-type: none"> Deregulated traffic is exempt
Interswitching	<ul style="list-style-type: none"> Mandated Rate regulated 	<ul style="list-style-type: none"> Voluntary Rate negotiated
Rate Arbitration	<ul style="list-style-type: none"> Mandated Final Offer Arbitration — available to all shippers 	Only if: <ul style="list-style-type: none"> Revenue/cost threshold exceeded No truck or rail competition Stand-alone costs exceeded
Competitive Line Rates	<ul style="list-style-type: none"> Mandated 	<ul style="list-style-type: none"> None
Common Carrier Obligation	<ul style="list-style-type: none"> Mandated 	<ul style="list-style-type: none"> Mandated

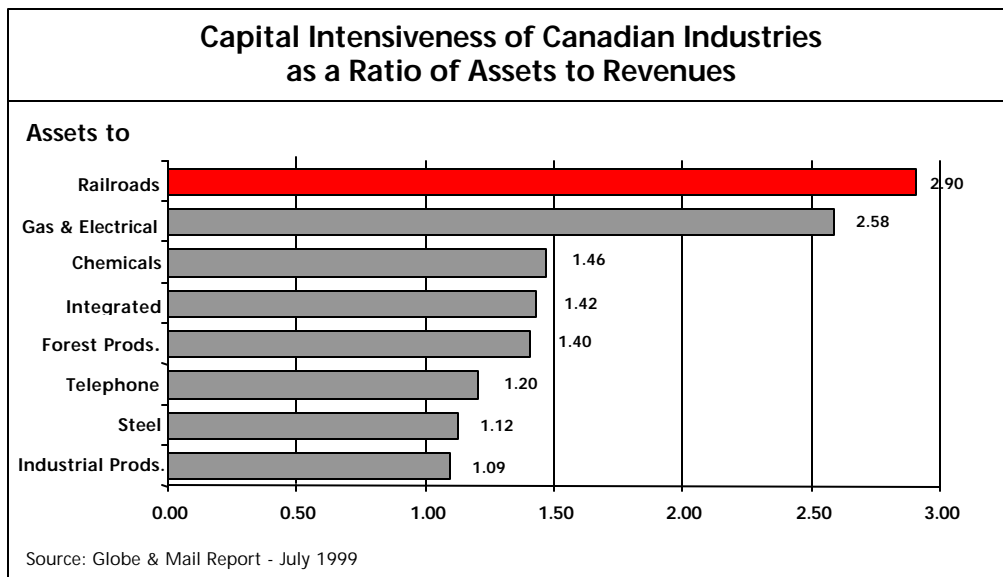
3.0 Full Cost Recovery is Necessary to Preserve Gains Made

The Canadian rail system has made tremendous gains under deregulation. For shippers, the rates are lowest in the world, and service has continued to improve. Government subsidies have been abolished and private investment is at record levels. But we have also seen that rail recovery is fragile as a result of revenue challenges, market share shrinkage and shipper choice.

In a highly competitive market, the railroad industry's capacity to compete is dependent on its ability to continue to invest in its network and, in so doing, provide shippers with better service. This investment necessitates that railroads cover their cost of capital.

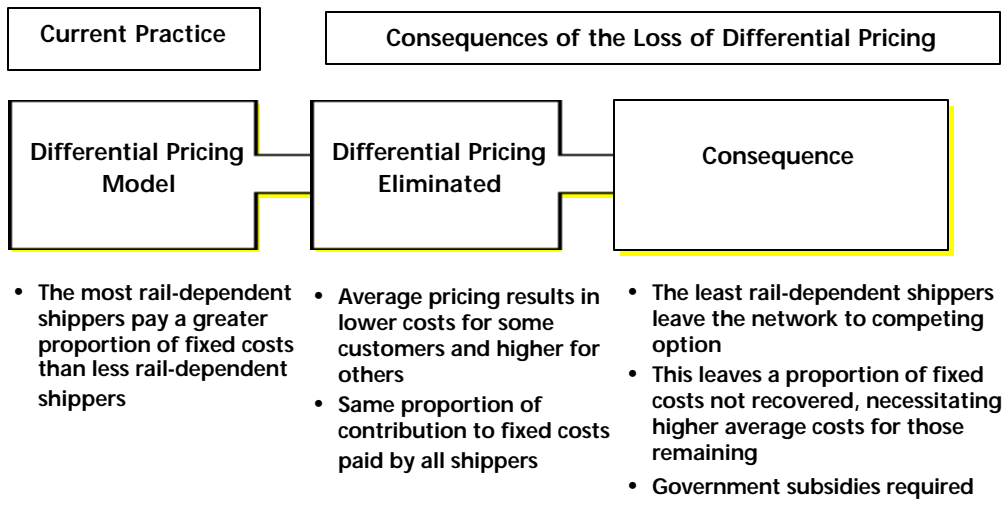
3.1 Differential pricing: a key element in recovering system costs

Railroad investments in fixed plant and equipment are four times higher than the average of other industries and three times higher than the trucking sector. Today, CN invests roughly \$1 billion annually in capital improvements. The high fixed costs – the right-of-way and the equipment running on it – are incurred whatever the volume of traffic in the system.

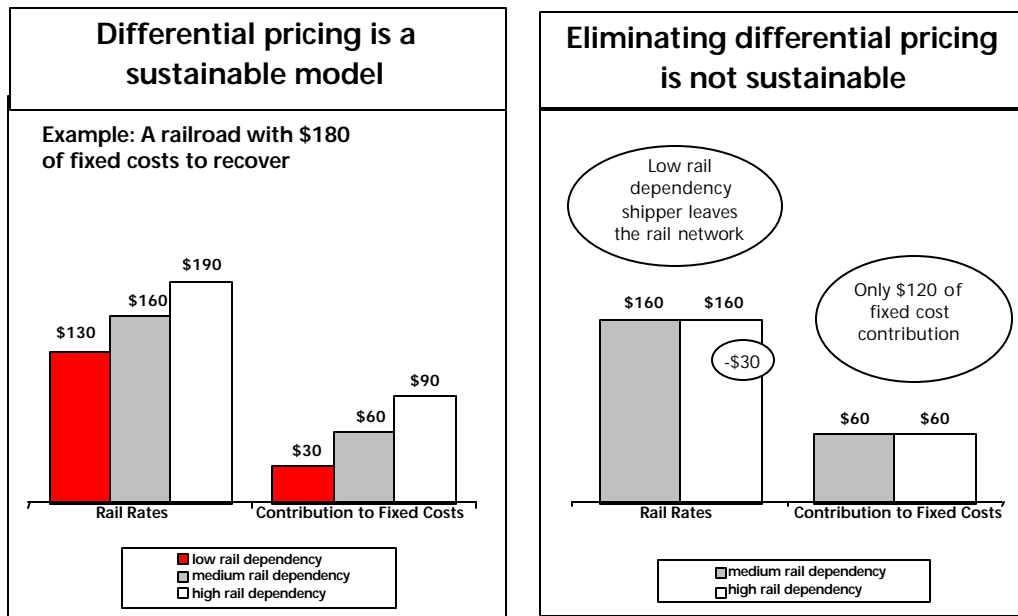


Ensuring the investment needed to cover high fixed costs and improve service depends on a railroad's ability to achieve revenue adequacy, in other words earning the cost of capital. In this period of sustained economic growth, CN is now beginning to earn its cost of capital, but CN is far from earning its cost of capital over a full economic cycle. To achieve both full cost recovery, and the lowest rates for shippers, railroads rely on differential pricing. This approach requires pricing in accordance with demand rather than by cost formulas. Differential pricing is a standard practice in most North American industries with high fixed costs. It optimizes contribution to fixed costs for the benefit of all stakeholders, and especially the most rail-dependent shippers as the following charts demonstrate.

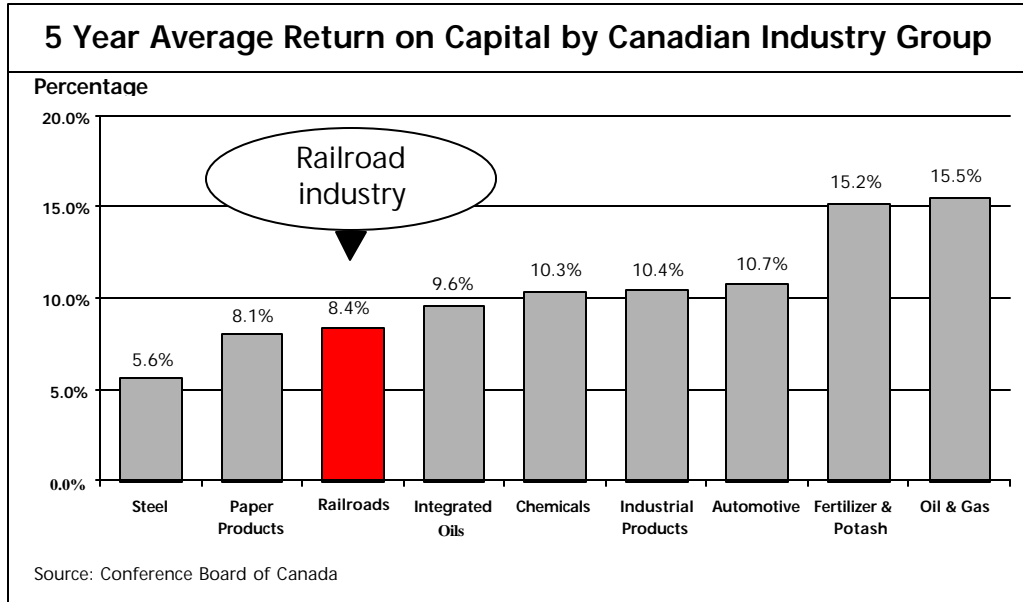
Differential Pricing



In the long run, the inability to price according to demand would lead to lower levels of service and either higher rates or subsidies.



Even with differential pricing, the rate of return on capital in the rail industry is lower than in most other major industry groups.



Any initiative, including those that would prevent the railroads from having the opportunity to recover their cost of capital would result in a deterioration of the rail network, undermining service quality and efficiency. Without an efficient rail service, Canadian shippers would have fewer transportation options, inhibiting their ability to compete effectively in the NAFTA marketplace.

4.0 Perspectives on Competitive Rail Access Issues

Cost recovery and investment are key to a competitive rail system. It is within this context, and against a background which demonstrates that deregulation is working, that the CTA Review Panel must consider any competitive access proposals.

4.1 Defining access

In his report of December 21, 1998, *Grain Handling & Transportation Review*, Justice Estey recommended, that any "person" should be allowed access to a railroad's right-of-way. This has become the trigger for extensive discussion and a wide variety of proposals concerning what is termed open access.

The term open access requires definition and clarity on five key variables:

- **Ownership structure** – Is it based on the current vertically integrated North American model, or on a separation of infrastructure and operating entities?
- **Access pricing** – Is it keyed to market-based full cost recovery, or an indirect subsidy to shippers through low access fees?
- **Access reciprocity** – Will all railroads have fully reciprocal rights to each others' lines, or will access rights favor some railroads and not others?
- **Shipper protections** – Will access replace existing shipper protections or become another layer of shipper protections?
- **Government subsidies** – Is the access regime based on fully commercial principles or does it require significant public subsidies to operate?

The definition of any access model is complex and would result in a dramatically different framework than the one in which Canadian railroads currently operate.

4.1.1 Access lessons from around the world

Coincident with the debate here in Canada, open access regimes have been adopted in other jurisdictions around the world. Of particular note are those in Australia, the United Kingdom and the European Union. While industry structures vary in these jurisdictions, results to date indicate significant government subsidies are still required. Furthermore, these are considered perfect competition models where customer protections are not necessary.

World Experience with Open Access

	Australia	United Kingdom	European Union
Infrastructure Ownership	• Mixed	• Separated	• Mixed
Access Pricing	• Regulated at partial cost recovery	• Regulated at full cost plus profit	• Regulated at partial cost recovery
Government Subsidies	• Significant	• Very Significant	• Very Significant
Shipper Protections	• None	• None	• None

Given the top-rated performance of Canadian railroads and the questionable results of open access regimes elsewhere, there is an onus on proponents of open access here in Canada to demonstrate that such a system will improve efficiency and deliver economic benefits to all stakeholders while maintaining the competitiveness of Canadian railroads in the North American marketplace.

4.1.2 Key principles

In evaluating any access proposal, the CTA Review Panel must also ensure that the economic integrity of the rail system is preserved without subsidies. To this end, the following principles must be adhered to:

- **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
- **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, 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 and are entitled to full reciprocity rights to run on any other line including shortlines and regional railroads that are given rights to run on their lines. In particular it is critical 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 disputes and rate disputes in circumstances where there is no competition.
- **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.

4.2 Response to competitive access proposals

Access proposals advanced to date in Canada either violate or do not address these important principles.

4.2.1 Regional railroad concept

CN has actively participated in the creation of regional railroads and shortlines through private commercial transactions. We value and constantly seek to enrich these relationships. In addition, CN has actively partnered with long-established regional railroads such as British Columbia Railway and Ontario Northland.

The proposal for a regional railroad focussed on grain transportation, advanced by OmniTRAX in its public statement of September 15, 2000, is of a different order. It is a railroad that would be based on forced access to CN and CP systems and, as such, should be evaluated against the principles outlined above. A summary of the proposal and its weaknesses follows.

OmniTRAX : Comparison to Key Access Principles

OmniTRAX Proposes	Key Weaknesses
<ul style="list-style-type: none"> • Access to CN and CP: <ul style="list-style-type: none"> • To use one railroad to connect to another as a bridge • To serve their own customers to a point on the connecting railroad • To solicit customers on the other railroads' lines once accessed • Ability to arbitrarily change the terms of the commercial transaction between OmniTRAX and CN, and unilaterally change agreed upon revenue division with all railroads • The right to acquire lines from CN and CP at below market rates 	<ul style="list-style-type: none"> • No reciprocity with CN and CP – results in a local rail monopoly • Access fees not defined – no reference to commercial principles for setting rates • Loss of efficiency through traffic configuration • Violates the initial commercial transaction and long-term agreements • Violates generally accepted and respected commercial principles • Financial windfall gained through subsidies from CN and CP • No capital contribution for use of rolling stock • Amounts to confiscation

4.2.2 Interswitching and competitive access rates (CAR)

Two alternate proposals to expand access have also been discussed. The first, extended interswitching, proposes to simply move the current interswitching limit from 30 kilometers to some undefined limit. The second, competitive access rates (CAR), proposes to use the current interswitching rates and limit, then apply an average rate per ton per mile for the specific commodity handled, without any distance limit from the interchange.

Both proposals fail to meet the principle of full cost recovery. The reality is that current interswitching rates are not revenue adequate. They cover only a very small fraction of the fixed costs of the network. (This needs to be corrected in the current CTA review process). Extending interswitching would undermine, on a larger scale, the recovery of fixed costs through differential pricing. Differential pricing is crucial to optimizing fixed cost recovery and lower rates for all network users, especially those who are most rail dependant. The CAR proposal, through its reliance on average pricing, simply compounds the problem.

5.0 Summary

CN is firmly of the view that the principles that currently underlie Canada's legislative and regulatory system should be the basis for the future. Deregulation has significantly contributed to a safe, efficient, flexible, affordable and competitive rail transportation system for Canadian shippers. Canadian railroads, however, still face major challenges to sustain their financial viability through a full economic cycle.

CN's vision for the Canadian transportation system is that it must be a key contributor to Canada's competitiveness, particularly in NAFTA markets. The public policy imperatives to realize this vision and ensure railroad sustainability are continued deregulation, a National Transportation Policy that is effective for all modes, and taxation equity between modes of transport and between jurisdictions.

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