

SUBMISSION
BY
THE CANADIAN ASSOCIATION OF RAILWAY SUPPLIERS
TO THE
CANADA TRANSPORTATION ACT REVIEW PANEL
NOVEMBER 2, 2000

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The Canadian Association of Railway Suppliers represents companies which supply a broad assortment of equipment and services to Canadian railways and export markets.

As an advocacy group, the Association promotes the economic viability of the rail mode within Canada, often working in close collaboration with our customers and colleagues in the Railway Association of Canada. A heightened interest in collective action on the part of the railway supply community is evidenced by the growth in our membership in recent years. In less than four years our numbers have increased from twenty-six to a current level of one hundred and twenty-four.

Our membership includes a wide variety of large, medium, and small businesses. Member companies employ some 50,000 workers in communities from coast to coast in Canada - Trenton, Nova Scotia to Vancouver, B.C.

Member companies include manufacturers of rolling stock, maintenance of way equipment, signals and communications equipment, and other goods and services needed by railways. Among our members you'll find the names of such well-known builders of locomotives and railway cars as General Motors, General Electric, Bombardier, Alstom, National Steel Car, Trenton Works, Greenbrier/Gunderson, and Thrall Car, as well as the makers of all sorts of components such as air brakes and wheels. We also count lessors of rolling stock, such as Procor, GATX Canada, and First Union Rail among our membership.

We have also recruited a number of "non-traditional" suppliers - firms that do not make or furnish "railway-only" items, but for which the railways are a sufficiently significant portion of their business that they have seen fit to join our cause. Examples would include Stelco, Algoma Steel, Ipsco, Husky Oil, Grand & Toy, Xerox, and Goodyear.

At the risk of pointing out something which may seem obvious, anything which has the potential to negatively impact the financial viability of the railway industry and its ability to meet its large capital expenditures/investments will heavily impact the supplier community - there is a ripple effect. While we don't expect the Canadian railways to pay a premium for the goods and services they purchase from Canadian suppliers, we do believe that a healthy Canadian railway supply sector is in their best interest, just as a healthy Canadian railway sector is essential to the interests of our members. It's a two-way street. Our message to the panel on this score is simple and straightforward - don't do anything to harm our customers!

Our members would support the view that de-regulation has worked for the railway industry and its shippers and suppliers. Canada boasts a pair of formidable Class 1 railways as well as an active short line and regional railway industry, whose growth and successes to date have been fostered by the CTA, which facilitated network restructuring.

Canada's railways play a vitally important role in getting Canada's goods to market. This is increasingly true since the signing of the North American Free Trade Agreement (NAFTA). Some 40 per cent of Canada's export trade now moves by rail. Clearly, if Canada wishes to increase its share of global trade, and since transportation costs represent such a significant part of the costs of moving Canadian goods to world markets, a competitive and productive railway transportation system must be developed and maintained. Public policy must avoid imposing unnecessary costs, particularly tax costs which result in making Canadian railways less competitive than their U.S. counterparts.

In addition to getting Canada's goods to market in a timely and cost-effective manner, the rail mode is the friendliest toward our environment. Trains account for far fewer emissions into the air than other forms of transport. Railways are, on average, five times more fuel-efficient than big trucks - each freight train can take 275 trucks off already congested roads. With the proper public policy regime in place to encourage investment in the newer, more efficient locomotives which have even lower emission levels, our railways are well-placed to make a major contribution toward helping Canada meet its environmental commitments.

Canadian railways need to continually modernize their equipment in order to compete in the North American market place. Railways are far more dependent on capital investment than other industries, with 25 per cent of revenues going to capital spending. Our taxation policies and regulatory regime must be geared to facilitate these investments.

We are particularly pleased that the terms of reference for the Canada Transportation Act review include "the overall effectiveness of the current legislative and regulatory framework in sustaining the high levels of capital expenditures required to enhance productivity and promote innovation". Our comments will deal largely with this aspect, particularly the shortcomings in the current Canadian Capital Cost Allowance regime for railway equipment, including that provided by leasing companies. The leasing issues impact directly on members of our Association, and we will deal with these more extensively later in this submission.

We are pleased that in this year's budget, the Government proposed increasing the CCA rate for locomotives, railcars, and railway suspension devices acquired by railways from 10 per cent to 15 per cent. While this is a half-step in the right direction, it does not fully redress the existing disparity with other modes of transport in Canada. Moreover, the change still leaves the Canadian tax depreciation rate for railway assets far below that of US railway competitors, and is not reflective of true economic obsolescence.

We don't ask this Review Panel, or the Government, to simply take our word for it. With respect to the Canadian CCA for railway equipment, a 1998 study conducted for Transport Canada by the IBI Group, which we're sure would be available to the Review Panel, drew a number of interesting conclusions:

*The Canadian railway industry is significantly disadvantaged with regard to tax depreciation compared with:

-the U.S. railroads, for whom the present value of tax depreciation is some 70 per

cent higher than in Canada;

-other Canadian transport sectors, particularly those competing with the railways. All have significantly higher CCA rates than the railways and all receive tax depreciation benefits much more closely aligned with their U.S. counterparts than are the Canadian railways;

-other Canadian capital intensive industries, which benefit from a tax depreciation treatment more generous than that of Canadian railways, and more closely aligned with their U.S. competitors than is the case for the Canadian railways.

*The disparity between the tax depreciation regimes in Canada and the U.S. is significant. Identical rail investment projects require a 23 per cent higher level of earnings in Canada than in the United States to yield the same rate of return. This can only retard capital spending for modernization and growth by Canadian railways as compared with U.S. railways.

*The use of the U.S. tax depreciation regime as a benchmark is appropriate because:

-the Canadian and U.S. tax depreciation systems are closely aligned for all industries considered - except for railways;

-there is intense and pervasive competition between the Canadian and United States railways. The tax depreciation disparity makes the competitive position of the Canadian railways more difficult, in pricing and supply of modern equipment;

-the same is true of all rail-dependent Canadian industries competing with U.S. industries in an increasingly integrated North American marketplace.

*Technical and market obsolescence, rather than physical longevity, has become increasingly important in the determination of the useful life of rail assets.

While the extent of the disparity is somewhat lessened by the budget's modest changes to CCA for equipment purchased by railways, the overall conclusion reached by this Transport Canada study would be unchanged: i.e. that an appropriate defensible tax depreciation regime for Canadian railways should yield tax benefits comparable to those enjoyed by their U.S. counterparts. They concluded that a CCA rate of 30 per cent would achieve this.

In addition to coming up short on the CCA for Canadian railways, the Budget provisions did not address in any way the disparity in the Canadian CCA rate for financing railway equipment requirements through leasing. Canadian lessors continue to be competitively disadvantaged vis-à-vis foreign leasing companies, meaning that most Canadian railway asset leases will continue to be done with foreign lessors. There is a consequent loss of tax revenues which could be flowing to Canada.

The vast majority of railcars are leased, rather than purchased, by North American railways. Over 85 per cent of the railcars built in North America in the 5-year period from

1994 to 1998 were acquired by entities other than railways (generally leasing companies). Since the budget did not change the CCA rate for lessors, the Federal Budget measure will be of no consequence for the majority of new railcars which will be put into domestic railway service by Canadian railways.

Assuming an average \$80,000 cost for the 293,630 North American-built railcars acquired by lessors or other private owners during the 1994-1998 period, we're looking at capital investments with a value of some \$23.5 billion. The most recent industry forecasts indicate that some 50,000 railcars will be built per year during the next two to three years. Despite the apparent opportunities, leases for this equipment are expected to be written by leasing companies outside Canada, since the CCA environment effectively precludes Canadian lessors from participating in the railcar market.

The Canadian government's current general tax policy is for CCA rates to approximate economic life of assets. While it is difficult to argue with this policy on a conceptual basis, government policy must also take into account competitive factors faced by companies operating in Canada, taking steps where necessary to reduce erosion of the Canadian tax base.

In contrast to Canadian lessors, U.S. lessors are greatly encouraged to participate in the railcar market as a result of the significantly higher U.S. tax depreciation rate applicable to such equipment. On average, a U.S. lessor will have fully depreciated an investment for railcars used in Canadian domestic service in less than 15 years, while a Canadian lessor will have approximately 13.3% of the asset's original value still on its books. The Canadian investor is not enticed to invest in railcars when alternative transportation equipment such as vessels or trucks provides a better investment.

Hampered by the inadequate CCA on railcars, Canadian based lessors are compelled to quote higher lease rates to potential customers than their U.S. competitors. The following illustrates comparable 10-year operating lease rates that result in identical investment returns applied to the same newly-built railcar, operating in the same service:

U.S. leasing company to U.S. customer \$725 per car per month
(7 year tax write off – equivalent to CCA of 30%; car utilized in U.S. service)

U.S. leasing company to Canadian customer \$790
(15 year straight line write off; car utilized in Canadian domestic service)

Canadian leasing company to Canadian customer \$829
(13% CCA; car utilized in Canadian domestic service)

In today's highly aggressive business environment, Canadian leasing companies cannot attract business with uncompetitive lease rates. Poor tax depreciation combined with the increased risk of technological obsolescence, means that Canadian lessors have no motivation to invest in railcars. Canadian railways which need modern railcars to move Canadian goods to the global market therefore make the only viable economic decision, which is to lease such equipment from foreign lessors.

Canadian lessors of rail equipment are very few in number - most of what was once a

thriving industry has been lost to the U.S. - and are investing very little capital in this equipment type. Most have American parents or affiliates, and the current financial realities force them to structure deals through the U.S. wherever possible.

Canada has an opportunity to increase its taxable income base if the Canadian railcar leasing industry can improve its competitiveness. As the number of railcars increases in the north/south flow, Canada has the potential to tax the Canadian investor, whereas in the current situation Canada collects little, if any, income taxes on foreign leases on railcars used by railways in Canada.

There is a significant outflow of capital from Canada as Canadian railroads finance their fleet requirements through U.S. lessors. An increase to the CCA rate for railcars equivalent to the US tax depreciation rate will result in more taxable income and other tax revenues for the Canadian government.

The rail and financial sectors are serving a global marketplace, and are both competing fiercely in their own markets. Under current government policy, Canadian railcar lessors cannot compete, thereby resulting in less economic activity and loss of tax revenues for Canada.

Both Canadian Class 1 railways have the ability, through their U.S. properties, to structure their acquisitions of rolling stock to minimize the impact of the Canadian CCA. CN and CPR can, and do, meet their needs for freight cars and locomotives by using their Illinois Central and Soo Line affiliates, respectively, wherever possible to take advantage of cost savings. This is a fact of life, but isn't a good thing for either the Canadian railway supply sector or for Canada in general.

We ask the Review Panel to recommend further changes to the CCA to provide more equitable treatment of the various modes of transportation and to ensure that the Canadian Capital Cost regime is made competitive with its U.S. counterpart.