

***THE CANADIAN CHEMICAL PRODUCERS'
ASSOCIATION***

***SUBMISSION TO THE CANADA
TRANSPORTATION ACT REVIEW PANEL***

OCTOBER, 2000

EXECUTIVE SUMMARY

The Canadian Chemical Producers' Association represents 75 manufacturers of industrial chemicals which use chemistry to upgrade Canada's natural resources into high value-added products for export and for use by other key players in the national economy. Chemicals is an important component of the "industrial products" category of rail traffic and an especially important component of rail transborder traffic. Almost 50 of CCPA's member companies use rail transportation and for half of these companies, transportation costs exceed 10% of selling price, ranging up to 30-39% of selling price.

The 1987 *National Transportation Act* introduced expanded interswitching, Competitive Line Rates (CLRs) and Final Offer Arbitration (FOA). Expanded interswitching works well and it is used regularly by 20 of our member companies. Despite considerable initial promise, CLRs have not proven to be useful to CCPA members or other shippers. By 1993, the National Transportation Act Review Commission reached the conclusion that the major railways "have effectively declined to compete with each other through competitive line rates (CLRs), and as a result the provision is largely inoperative in Canada."

In 1996 the *Canada Transportation Act* (CTA) worsened this situation. It introduced the substantial commercial harm test which applies to extended interswitching, CLRs and some other shipper remedies. This test deters shipper use of competitive access remedies since it has real potential to expose them to considerable litigation and associated costs. As a result, many captive shippers, including CCPA member companies, have no rapid, cost-effective means of obtaining rail competition. These companies are subjected to Ramsey pricing by the railways which means that their freight rates are considerably higher than if they were in competitive situations. This seriously hinders such companies competing in both domestic and global markets.

This is a real issue for CCPA because among its member companies using rail transportation. 24 have rail dependent plants. They list 45 such plants at 34 locations across Canada -- 17 in Ontario, 9 in Quebec, 7 in Alberta, 3 in British Columbia and 1 in Manitoba. Only 17 out of these 34 plant locations have rail competition through interswitching arrangements or direct competitive access. Many other shippers are in similar situations. They have made their needs for more rail competition known through vehicles such as the 1998 Grain Handling and Transportation Review, the subsequent Consultations on the Implementation of Grain Handling and Transportation Reform, and the Canadian Transportation Agency's 1998 Ekos Research survey.

The railways argue that continuous gains in railway productivity are insufficient to overcome railway prices and revenues that have not kept up with costs and hence, they are unable to support increased competition. There is no basis for this argument. The railways have made tremendous productivity gains and retained at least half of those gains. Shippers have also benefited from the productivity gains through lower prices but this has been uneven--captive shippers subjected to Ramsey pricing have not had their fair share of the benefits. The productivity gains and the aggressive pursuit of new business opportunities have provided the railways with record profits. This is sustaining record levels of capital investment. And investment analysts are very positive about today's Canadian railway performance and the prospects for the future.

In the United States, railways make similar arguments about why they must retain Ramsey or revenue-based pricing. Professor Robert E. McCormick, however, demonstrates in Appendix "A" to this submission that the railways' ability to engage in revenue-based pricing would not be eliminated by greater competition. He asserts that:

"Free and open competition will not destroy the ability of railroads to charge revenue-based differential rates, but in fact will ensure that the optimal overall level of rates is achieved. The optimal overall level of

rates is one that provides revenues adequate to raise sufficient capital and provide efficient service to shippers. Competition is the best, and really, the only vehicle whereby optimal revenue-based prices can be set."

Hence, there is no reason why in this review process, railway competition should not be stimulated and competitive options should not be provided for captive shippers. CCPA is a participant in the Shippers' Summit which has made a number of recommendations to the Review Panel, including recommendations on competitive access mechanisms. CCPA supports the Shippers' Summit recommendations which include the following:

- Retention of the current elements of the national transportation policy set forth in section 5 of the CTA which are relevant to the objectives of competition, efficiency and low cost in the delivery of transportation services.
- Simplification and clarification of the provisions of the CTA related to running rights so that the Canadian Transportation Agency has the power to grant limited running rights to any person in appropriate circumstances.
- Adoption of the Competitive Access Rate (CAR) mechanism to simplify CLRs and make them effective.
- Retention of the current interswitching provisions which are used regularly by 20 CCPA member companies relying on rail transportation. Confirmation of the Agency's power to set maximum interswitching rates which provide the flexibility for negotiation of lower rates when that makes commercial sense.
- Repeal of subsections 27 (2) and (3) and Section 112 of the CTA. These subjective provisions deter shipper use of competitive access

mechanisms and their retention is not justified by any substantiated concerns about railway viability.

- Support for the Bill C-34 amendments concerning the sale and discontinuance of rail lines with recommendations for extending certain amendments currently limited to grain dependent branch lines to all rail lines.
- Restoration of the Agency's powers to review the effects of proposed rail mergers or combinations through public hearing processes which take into account the public interest.
- Support for the Bill C-34 amendments to the Final Offer Arbitration provisions which are being used more and more by shippers as a negotiating tool and in actual submissions to the Agency.

In conclusion, CCPA urges the Review Panel to accept these recommendations in the interests of improving the competitiveness of Canadian shippers in both domestic and export markets. Many of these shippers do not have the competitive transportation options available to their competition, especially competition from those U.S. shippers who can access more locations on tidewater, an inland waterway system and a substantial interstate highway system. In contrast, many Canadian shippers, including CCPA members, are truly rail dependent and they need effective rail competition in order to continue making positive contributions to the Canadian economy.

INTRODUCTION

The Canadian Chemical Producers' Association (CCPA) represents 75 manufacturers of industrial chemicals accounting for almost \$16 billion in shipments annually. These companies use chemistry to upgrade Canada's natural resources into high value-added products which are both exported to

global markets and used by other key players in the national economy. In doing so, the industry purchases raw materials and goods from other important industry sectors such as oil and gas; mining, metals and minerals; forestry; and agriculture. Two industries consume almost half of industrial chemicals output, plastic products and transportation equipment, reflecting the importance of chemicals in the production of motor vehicles, auto parts, packaging and construction materials. The sector also has important downstream linkages to the electrical and electronics, textile and clothing, food and beverage, and construction industries. The chemical industry provides 83,000 direct jobs across Canada and supports a further 220,000 jobs in other sectors of the Canadian economy.

Transportation safety is a priority for CCPA members. They implement our Responsible Care transportation code of practice which is designed to ensure that chemicals and chemical products are transported in ways that minimize risks. They also implement our distribution code which covers members' activities including the movement of goods from suppliers for conversion or resale. Both major railways as well as firms in the trucking industry are Responsible Care partners. They implement the codes of practice and work in partnership with CCPA members in the TransCAER program which supports the Responsible Care codes. TransCAER is aimed at reducing the number of transportation incidents and their impact. The focus of this submission is, however, on commercial rail transportation issues arising from the *Canada Transportation Act* ("the Act") and the terms of reference for the Canada Transportation Act Review Panel ("the Review Panel"). These issues include whether amendments are needed to the national transportation policy set out in section 5 of the Act; proposals for enhancing competition in the railway sector in the broader context of increasing North American integration and ensuring cost effective service for shippers over the long term; the manner of setting interswitching rates; and the need to sustain high levels of capital expenditures in the rail sector to enhance productivity and promote innovation.

Chemicals is an important component of the "industrial products" category of rail traffic which also includes automobiles and parts, refined petroleum products and metals. Industrial products accounted for 15% of total rail traffic volume in 1998. Chemicals is the largest contributor to the industrial products traffic category, accounting for 35% of this traffic. It is also an especially important contributor to transborder rail traffic, the fastest growing traffic category for Canadian railways as they acquire or make working arrangements with railways in the United States. Chemical rail shipments to the United States are second only to forest products in terms of tonnage and rank third in value behind automotive products and forest products. As for rail imports from the United States, chemicals ranks first in terms of tonnage and trails only automotive products in value.

The comprehensive review of the CTA is very important for CCPA member companies because over 40% of their shipments, in terms of value, move via the rail mode to key domestic customers; to North American customers throughout the United States and into Mexico; and to Canada's ports for shipment to global markets. Close to 50 of our 75 member companies rely upon rail transportation and for half of these companies, transportation costs exceed 10% of selling price, ranging up to 30–39% of selling price. One-third of the companies in this grouping spend 50% or more of their freight budgets on rail transportation.

While chemicals is a keystone of the Canadian economy and a major exporting sector, we are a relatively small player in the global market, representing just 1.5% of the \$2.2 trillion chemical industry worldwide. Customers in all markets are demanding on-time delivery at the lowest possible cost. In contrast to chemical producers in most other competing countries, the Canadian industry must ship longer distances to major markets and key production sites. Those in Alberta, for example, are located far from tidewater. Moreover, in many situations they lack the competitive options available to U.S. shippers through the extensive interstate highway and inland waterway systems. As a result, Canadian chemical producers must place a very strong emphasis on achieving

the best possible transportation rates and services in order to retain and expand their market shares.

CANADA'S RAIL LEGISLATION AND INTRAMODAL RAIL COMPETITION

The 1987 *National Transportation Act* (the "NTA") introduced provisions intended to foster more effective rail competitive access for captive shippers. These provisions, which were designed to allow shippers to have access to more than one rail carrier, consisted of increased interswitching limits with allowance for extended limits, and competitive line rates (CLRs) for shippers located beyond interswitching limits. In addition, while not categorized as a competitive access mechanism, the legislation introduced a final offer arbitration process devised to provide speedy dispute resolution of rate and service issues. It also provided for confidential contracts between individual shippers and railways, a provision which has been a resounding success for both shippers and rail carriers.

Shippers responded very favourably to the NTA. There is no question that the expanded limits for regulated interswitching did enhance competitive access. In 1992, the then National Transportation Agency reported that CN and CPR interswitched between 130,000 and 140,000 cars each year from 1988 to 1990, of which 60,000 cars per year fell within the expanded limits. Initially chemical shippers were also positive about CLRs because they promised competitive access with minimal regulatory process or litigation costs, but this promise was not fulfilled. National Transportation Agency "shipper surveys" conducted between 1988 and 1995 consistently found the CLR provisions to be beneficial to shippers in their negotiations with the railways, even though only two CLRs were actually established by the Agency pursuant to legislation. And in its 1993 report to the Minister of Transport, the National Transportation Act Review Commission (NTARC) stated:

"The NTA, 1987 contains a number of devices intended to encourage competition, such as competitive line rates (CLR), final offer

arbitration..... However, while these devices appeared to be well regarded, we saw little evidence that they were being broadly used, although shippers claim that they are important bargaining tools."

In the intervening years since the NTARC report, and particularly since passage of the CTA, chemical shippers have concluded that CLR's are of very little use, both in terms of actual applications to the Agency and their use in the negotiating process with railways. This is partly due to changes to the legislation which are discussed on the next page of this submission, and partly because the railways have made it clear that they are not interested in competing for this traffic. Indeed, even in 1993 the NTARC said that the major railways "have effectively declined to compete with each other through competitive line rates (CLR's), and as a result the provision is largely inoperative in Canada."

Some have suggested that the lack of use by shippers of competitive access mechanisms like CLR's is merely evidence that the marketplace is working. That is not the case. Between passage of the CTA and the end of 1999, companies made 13 submissions for Final Offer Arbitration (FOA) and 18 Level of Service applications in contrast to no applications at all for CLR's or extended interswitching. While the FOA and Level of Service provisions of the CTA are often helpful to shippers, neither of them was designed by policymakers to provide captive shippers with quick, expedient access to a competing railway at minimum transaction costs.

The CTA introduced a number of legislative changes to both the rail competitive access and dispute resolution provisions of the NTA. While CLR's and regulated interswitching were retained, a new and intrusive test was introduced by subsection 27(2) that requires the Canada Transportation Agency (the "Agency") to be satisfied that a shipper would suffer "substantial commercial harm" before it could grant any relief. This is a key weakness in the CTA as it exists today. While Agency guidelines for the interpretation of "substantial commercial harm" are of some help, there has not been any precedent-setting interpretation of the

test. It presents a formidable barrier to shippers in terms of uncertainty and possible exposure to extensive litigation costs.

Provisions requiring all rates established by the Agency to be "commercially fair and reasonable to all parties" were also added to the legislation, a further legally cumbersome and unnecessary barrier for shippers. In addition, the CTA reduced shippers' options for relief by removing the general complaint provisions of the NTA, as well as provisions dealing with public interest and mediation, leaving shippers with extremely limited avenues of recourse when disagreements with the railways arise.

It is increasingly clear that the CTA's competitive access amendments were a move in the wrong direction. They support the railways in reaching individual decisions not to compete for certain traffic in order to help maintain their power to apply differential pricing or Ramsey pricing to captive shippers, a pricing approach which is extremely detrimental to the competitiveness of those shippers. There is ample evidence of this which is discussed in the next section of this submission.

EVIDENCE OF BARRIERS TO INTRAMODAL RAIL COMPETITION

In his report to the Minister of Transport on the 1998 Grain Handling and Transportation Review, a comprehensive review of the handling and transportation system for prairie grain and grain products which included 147 meetings with over 1,000 stakeholders and other interested parties, the Hon. Willard Z. Estey stated:

"Many of those appearing before the Review, with the exception of the railways, maintained that there is no competition in the real sense of that

term between the two railways in the delivery of transportation services across this industry in western Canada".

and

"Many shippers expressed to the Review a desire to see the reduction or elimination of the barriers to greater access. "

Mr. Justice Estey recommended "that the provisions of the CTA relating to various methods of seeking access to other connecting rail lines be simplified and clarified so as to better serve the national interest in obtaining competitive and efficient transportation by rail. The general object of this recommendation is the opening up of the Canadian rail system to competition by and between all competent railway operators, including short-line railways..."

After receiving this report, in 1999 the Minister of Transport initiated Consultations on the Implementation of Grain Handling and Transportation Reform to develop the necessary operational details to implement Mr. Justice Estey's recommendations. The Consultations failed to achieve this goal for rail competition. The Stakeholders' Report on the Consultations states the following:

"With the exception of the railways, virtually all participants were of the view that additional measures are required to increase competition in the railway system. The uncertainty lies in the question of what measures would be most effective in achieving this objective."

In the end, the participants agreed to leave the rail competition issues to be addressed in the CTA Review Panel's interim report to be delivered by December 31st, 2000.

While both the consultation processes referred to above focused primarily on grain shippers, they also heard from many shippers in other sectors of the economy. The conclusions they reached on rail competition are consistent with other examinations of competition issues. For instance, in 1998 the Agency

engaged Ekos Research to survey a range of organizations interested in rail transportation issues. Interviews were carried out with 20 carrier representatives, 81 government and 82 shipper representatives. Ekos reported that among shippers and governments, there was a strong perception that the most significant problems facing shippers do not relate to the administration of the CTA. Instead, the problems were seen as stemming from the reluctance on the part of the national rail carriers to compete with one another, and the belief that negotiations with carriers were one-sided when shippers have no alternative forms of transportation.

Ekos Research reported that most shippers and governments expressed concern over the extremely limited ability to take advantage of the CTA's competitive access provisions. Excluding carriers, most survey participants agreed that interswitching does contribute to competition and upon the need for prescribed interswitching rates. Shippers and governments agreed that the CLR provisions should be retained but there was a strong tendency to view them as being ineffective due to the barriers in the CTA and the apparent lack of willingness by railways to quote rates. All survey participants felt there was a continuing need for the Level of Service provisions although shipper and government respondents were most likely to support this. The continuing need for final offer arbitration was endorsed by most shippers and governments and less so by carriers. Finally, shippers and governments stated that the CTA's substantial commercial harm requirement had negatively impacted upon the negotiating position of shippers and had decreased shippers' scope for recourse to the Agency.

These views were mirrored in CCPA's 1998 survey of its own member companies. That survey found that some members having large volume shipments to offer at locations within regulated interswitching limits do benefit from rail competition. The railways are prepared to offer these members competitive rail rates and to work with them to continuously improve service. Other members, however, particularly those captive to one railway with no other

viable transportation options, reported deteriorating service levels and tough negotiations. Significantly, over 80% of our members reported that they need more competitive rail options. Specific results from CCPA's rail survey are referenced in relevant sections of this submission.

In our view, the results of the current review process should include removal of the barriers to competitive access introduced by the CTA; enhancements, where necessary, to the existing competitive access and dispute resolution mechanisms to make them more useful to shippers; and introduction of new approaches to competitive access to help overcome failures of the current mechanisms.

TODAY'S NORTH AMERICAN RAIL SYSTEM

The North American rail system has undergone a substantial transformation since passage of the NTA in 1987, and the changes have accelerated in the period since the CTA came into force in 1996. This latter period has been marked by a consolidation of Class I railways in the United States, a process accompanied by acquisition of U.S. rail assets by Canadian railways supplemented by operating agreements with other U.S. railways. North-south rail traffic has increased by more than 50 percent since 1987¹ but it is still substantially less than the east-west traffic volumes which are also growing. The Canadian railways suggest that they are finding it increasingly difficult to improve productivity and operate profitably in this new rail environment, an argument which CCPA rejects other than in one respect concerning railway taxation. This section of our submission explains why the Review Panel should very carefully examine the railway submissions on these matters.

In Canada, mainline rail carriers are increasingly concentrating on long haul, high-volume corridors. Regional and short line railways are focused on the light to medium density lines. Between passage of the CTA in 1996 and the end of

¹ Data in this section is sourced from Transportation in Canada, the Annual Reports required by S.52 of the CTA

1998, more than 7,200 kilometres of track were transferred by the two major railways to short lines, a four-fold increase over the previous 10 years. Transfers of significant trackage in Ontario, Quebec and New Brunswick have transformed CN into a spinal network for much of eastern Canada. CPR had already moved in this direction. Today, only about 60 percent of the rail network east of Winnipeg is represented by CN and CPR, while the remaining 40 percent or so now consists of a system of Class II carriers, with well over half operating as feeders to the Class I system. Those developments have substantially improved the Class I carriers' profitability and the effectiveness of their investment plans. The Railway Association of Canada reports that for CN and CPR, partnerships with the short lines have enabled them to increase traffic density on main lines and to better focus capital investment on their strengths in the long haul freight sector.

Since 1986, the Canadian rail freight industry has undergone a full business cycle. It achieved strong revenue growth in the mid-1980s, experienced a revenue slowdown from 1988 to 1989, followed by a financial downturn in the early 1990s, entered a period of recovery from 1993 to 1996, and finally achieved record revenues and operating profits in 1997 and 1998. In many respects, this mirrors the performance of the chemical industry and other sectors of the Canadian economy. By 1997, the profit margin of the two Class I railways was seven percentage points higher than in 1986, which was also a year of relatively good performance for the railways. In dollar terms, operating profits increased \$486 million, reflecting higher railway profitability in recent years than a decade ago.

This is not surprising because the railways are capitalizing on many new business opportunities and positioning themselves to capture even more such opportunities in the future, especially in the rapidly expanding transborder market. Just a few examples of the many initiatives of this type follow.² Last year, CPR signed deals with U.S. railways giving it access to a population base

of about 80 million people, including a direct run into the cores of New York and Philadelphia, and access rights to Boston, Baltimore, Washington, Atlanta and even Miami. It has positioned itself as one of only two railways allowed access to New York City and become a key player in the intermodal market between that city and the U.S. Midwest. One of its aims under these deals is to take truck traffic from major U.S. interstate highways. CPR's traffic to and from Mexico increased by 25% in 1999, much of this coming from a new NAFTA-targeted rail service called CPR-MEX. The company says that the potential for growth in the Mexican market is tremendous.

Among other initiatives, CN is aggressively pursuing development of its Canadian National-Illinois Central-Kansas City Southern "alliance" to boost revenue growth across all business segments by improving service between Canada and the strategic Texas, Missouri and Mexican markets. Last year, for example, the company won the contract to move General Motors aftermarket automotive parts to key facilities based on its consistent and timely service package. Both CN and CPR are working with U.S. states in a government-initiated program designed to reduce highway congestion and to make more effective use of border gateways. In commenting on this program, the Railway Association of Canada said that the potential for rail to carry more of North America's freight load is significant.

This year's track sharing agreement between CN and CPR will also provide new business opportunities by expanding the reach of each railway. Standard & Poor's Ratings Services said that the deal is "going to be a nice little pickup in business for each of them in eastern North America." Both railways should be able to use the agreement to offer viable alternatives to trucking for important U.S. and Canadian markets. The positive financial and business performance outlined above has helped to allow the two railways to significantly increase capital investment and boost productivity performance. CN's capital investment increased by 79 percent between 1992 and 1999. The Illinois Central

² See Journal of Commerce July 31 – August 6, 2000, p.18; The Globe and Mail, December 31, 1999, p.B3; and recent

transaction alone was a \$2.3 billion deal. CPR has also experienced a capital investment surge of more than \$3 billion between 1995 and 1998. Its 1998 investment program of \$1.1 billion is described as the largest in Canadian railway history.

Given this strong performance and positive outlook for the future, it is not surprising that the railways are finding favour with investment analysts. In June, analysts with Newcrest Capital Inc., Salomon Smith Barney and HSBC Securities Canada Inc. were described as finding much to like about CN, even without the proposed combination with BNSF.³ CN was given high marks for having the lowest operating ratio in the rail industry, the best balance sheet, the best growth prospects, a better service product and strong dedication to cost cutting. While its share prices do not yet fully reflect the value seen by analysts, the same is true of many strong companies in the so-called "old economy" and investors are likely to return to those companies as the current fascination with growth stocks continues to fade. Canadian Pacific Ltd. is described by analysts as "firing on all cylinders" with strong increases in share prices this year.⁴ The rail business is making its contribution. Analysts at Odium Brown Ltd. comment that aggressive cost-cutting has led to record profits at CPR.

While acknowledging this strong financial performance to some extent, CN and CPR, through the Railway Association of Canada, argue that continuous gains in railway productivity are insufficient to overcome railway prices and revenues that have not kept up with costs, and they complain that in this respect, they are worse off than their U.S. counterparts. Other than their points about impacts of railway taxation in Canada, the railways' productivity arguments are highly suspect. As demonstrated by the review in this submission of the transformation of the Canadian rail system into a network of main lines and feeder short lines, the CTA does not pose a barrier to rail rationalization and associated productivity gains. In addition, CN and CPR have achieved substantial workforce

issues of Railway Association of Canada Interchange.

³ The Globe and Mail, June 2, 2000, p. B 12

adjustments which are still continuing. Between 1986 and 1998, employment in their Canadian operations fell by 34,000 employees, a 47% reduction in workforce. In 1986, labour costs represented 43% of the total costs of Class I railways, compared with an average of 39% in the transportation sector as a whole. By 1997, the labour cost share in rail freight was reduced to 36 percent, about the same as in total transportation, and it has continued to fall.

The results of this extensive restructuring show up in the productivity data. With 1991 as the base year, productivity performance allowed the rail industry to achieve total costs in 1998 which were \$2.1 billion lower than they would have been without the productivity improvement. These savings are significant as they represent 32 percent of the industry cost base. As for prices, in 1998 the average rail price was 7 percent lower than in 1991.⁵ While this indicates that shippers did receive some of the benefits of railway productivity gains, total rail freight cost reductions for shippers in this period were \$1.1 billion, indicating that the railways have been able to retain about half of the productivity gains.

As for comparisons with U.S. railways, much of the data is reported on a revenue per ton-mile or revenue per tonne-kilometer basis which introduces distortions into the analysis. There are claims, however, that U.S. railway prices are the lowest in the developed world, due in part to the highway and barge competition which is largely absent in a country like Canada.⁶ Major CCPA member companies believe that when they are in direct competition for chemical markets with U.S. manufacturers, one way or another the U.S. producer can obtain freight rates which allow them to beat the competition into any North American market. In a recent STB filing, for example, CSX reported that a large U.S. chemical manufacturer began to switch the previously all-rail (CSX) shipments of one of its products to barge. CSX responded with new lower contract rates and retained the business. The same chemical manufacturer also switched previously CSX

⁴ The Globe and Mail, Report on Business, August 18, 2000.

⁵ The Statistics Canada/Transport Canada rail freight price index is based on confidential data provided by the railways. It is based on revenue per tonne-kilometer and includes confidential contract rates, without rebates. "Rail Freight Rates in the Post – Staggers Era" by R.L. Banks & Associates, Inc. and Fieldston Company, Inc. (April, 1998) explains why revenue per ton-mile (and hence, revenue per tonne-kilometre) can be a misleading surrogate for real freight rates.

⁶ See, for example, Louis Thompson, "U.S. Rails: A World Apart", Journal of Commerce, July 29, 1998.

rail direct shipments of caustic soda to barge/truck and barge/short haul rail. For these shipments, CSX could not match the alternative rates and either lost the business or was reduced to a short haul. This type of rate leverage based on the barge system is not available to Canadian chemical shippers.

Turning to railway taxation, some provincial governments have taken initial steps towards easing Canadian taxes on locomotive fuel and railway rights of way. In the federal Budget 2000, the government made a commitment to reduce the corporate tax rate applicable to companies including the railways from 28% to 21% over the next five years. The budget also increased depreciation rates on railway locomotives and freight cars from 10% to 15%. The railways point out that this still leaves them with a less competitive tax system than their U.S. competition. CCPA agrees that the railways should be placed on a level tax playing field with their U.S. counterparts. They would receive broader and stronger support from the shipping community on this issue if they would commit themselves to providing rail competition for all shippers.

To sum up, the financial and productivity records demonstrate that Canada's Class I railways can operate profitably in today's North American rail environment. The effects of the business cycle they have faced over the past 10 years are no different than those faced by other Canadian industries like chemicals which are subject to global competition. Railway arguments about revenue and profitability levels compared with their U.S. counterparts, government regulatory barriers or workforce adjustment requirements do not stand up as justification for the maintenance of "Ramsey pricing" or the rejection of improved competitive access for shippers. As we have said, however, we do support a competitive tax system for Canadian railways compared to their U.S. counterparts.

REVENUE-BASED PRICING IN A FULLY COMPETITIVE RAIL REGIME

The railways' primary argument against providing and improving competitive access for all shippers appears to be that for reasons of viability, they require the ability to engage in revenue-based pricing, commonly referred to as differential pricing or Ramsey pricing, with shippers which remain captive to one railway. This means that captive shippers pay rates far above competitive levels. In the United States, members of the American Chemistry Council have sufficient captive and non-captive locations within their companies to permit comparisons to be made. They find that rail rates from captive points are 15% to 60% higher than from competitive points, with an average premium of approximately 25%.

Introducing rail-to-rail competition through competitive access mechanisms should reduce this premium but it would not eliminate it. In other words, the railways' revenue-based pricing practices would not be destroyed by a regime of greater competition. One reason for this is that in Canada, competitive access invariably means providing a choice of one additional railway for a captive shipper which, in effect, transforms a monopoly situation into a duopoly. Grimm states that while two firms in any industry will in most instances compete to some degree with each other, a rivalry will generally be more vigorous when a third firm is present, with customers receiving more options, better service and lower prices.⁷ Levin has developed simulations on the social benefits of increasing competition in concentrated rail markets.⁸ He has demonstrated that, under various assumptions concerning demand elasticity and revenue/variable cost ratios, the social benefit of adding a second, equal-sized competitor to a monopoly market ranges from 6.8% to 18.9% of the revenues in that market. Adding a third railway in a two railway market yields social benefits of from 2.4 % to 6.6% of revenues. This suggests that as theory predicts, duopolists do limit the extent of their competition.

⁷ Verified Statement of Curtis M. Grimm. Comments of The Kansas City Southern Railway Company in STB Ex Parte No. 582 (Sub-No.1), Major Rail Consolidation Procedures.

⁸ Levin, Richard, "Railroad Rates, Profitability, and Welfare under Deregulation," Bell Journal of Economics, Vol. 12, Spring 1981, pp. 1-26

In the current STB hearings, the U.S. American Chemistry Council demonstrates that providing rail competition for every shipper captive to one railway would not financially ruin the railways. Statements by Professor Robert E. McCormick and Professor Thomas M. Corsi are attached to the American Chemistry Council submission. For ease of reference, copies of these statements are attached to this submission as Appendices "A" and "B" respectively. Professor McCormick's statement explains that just as in other deregulated industries such as telecommunications, increasing competition will further revitalize the rail industry and provide new incentives for it to expand and develop new markets. He demonstrates that contrary to statements by railways opposing further competition, the ability to engage in revenue-based pricing will not be eliminated by providing greater competition. At page v of his statement, Prof. McCormick asserts that:

"[F]ree and open competition will not destroy the ability of railroads to charge revenue-based differential rates, but in fact will ensure that the optimal overall level of rates is achieved. The optimal overall level of rates is one that provides revenues adequate to raise sufficient capital and provide efficient service to shippers. Competition is the best, and really, the only vehicle whereby optimal revenue-based prices can be set."

Professor McCormick provides a number of examples of multi-tier and demand-based pricing in fully competitive industries including airlines, hotels and publishing. He shows that rail customers are not a static "revenue base" with unvarying demand but rather, provide a fluid grouping of markets to be captured and developed under the incentive of marketplace competition. As Professors McCormick and Corsi discuss, there are many new and expanding markets for the railways to pursue. Expanded intermodal service as part of the internet revolution and tightened supply chain management is just one of them.

It is noteworthy that when Reply Comments were filed in the STB hearing, Professor McCormick's statement was referenced favourably by trade associations and individual companies from a wide range of industry sectors including the National Industrial Transportation League, electric utilities, grain shippers and a major pipeline company.

In the U.S., a recent analysis by L.E. Peabody & Associates confirms that increased competition at captive shipper locations, combined with better customer service, would increase railroad profits by some \$4.9 billion by 2005.⁹ In Canada, enhanced competition would help to ensure the continued financial health of the railways by further spurring the trend towards innovation and greater emphasis on customer service commenced by the 1987 *National Transportation Act*.

RECOMMENDATIONS FOR ENHANCING RAIL COMPETITION

CCPA is a member of the Shippers' Summit which brings together national and regional associations whose member companies are major users of rail freight services. The Shippers' Summit proposals for enhancing Rail Competition have been provided to the Review Panel so they will not be repeated in detail here. For ease of reference, a copy of the Shippers' Summit position is attached as Appendix "C". CCPA fully supports the Shippers' Summit recommendations .

The Shippers' Summit competitive access recommendations have been developed because many shippers which are captive to the rail mode and are served by a single railway at origin or destination have no economically competitive means to ship their products. These shippers must have access to more than one railway to obtain the benefits of competitive rates and services. Within CCPA's membership, for example, a 1998 survey showed that 47 companies rely on rail transportation. They identified 45 rail dependent plants at

⁹ L.E. Peabody & Associates, "The Effects of Increased Competition and Improved Service on the Railroad Industry", (Sept. 1999).

34 locations across Canada-- 14 in Ontario, 9 in Quebec, 7 in Alberta, 3 in British Columbia and 1 in Manitoba. Only 17 of these plant locations have interswitching arrangements or direct competitive access which provide the benefits of competitive freight rates and services.

The Shippers' Summit submission includes recommendations for limited running rights and a Competitive Access Rate to simplify the CLR provisions. CCPA is reviewing these recommendations with representative member companies to assess how they might make use of such provisions in legislation. The results of that review will be provided to the Review Panel as soon as it is available.

This section of our submission provides CCPA's perspective on specific elements of the Shippers' Summit position.

The National Transportation Policy

The national transportation policy set forth in section 5 of the CTA provides a useful overview of the objectives of the legislation. In our view, the policy statement remains relevant today and there is no pressing need to amend it at this time. The 1993 NTARC report did, however, recommend some changes to streamline the policy statement and the Review Panel may wish to revisit those recommendations in the course of its deliberations.

In addition, earlier this year the Vancouver Port Authority brought together a group representing producer, shipper, academic, rail, air, truck/transport, airport and maritime representatives to develop a vision statement for transportation in Canada. With one major exception, CCPA suggests that this vision statement should be considered by the Review Panel in relation to the national transportation policy since it does bring together a broad cross section of participants. Our one major reservation relates to the treatment of competition in the vision statement.

Regarding competition, CCPA strongly supports without change the elements of the existing policy statement which are relevant to the objectives of competition, efficiency and low cost in the delivery of transportation services. These elements consist of the following parts of the current section 5:

- The reference to "a safe, economic, efficient and adequate network of viable and effective transportation services"
- The wording describing a transportation network "that makes the best use of all available modes of transportation at the lowest total cost is essential to serve the transportation needs of shippers and travellers"
- The statement that "objectives are most likely to be achieved when all carriers are able to compete, both within and among the various modes of transportation"
- Paragraph (b) of the current policy statement which states that "competition and market forces are, whenever possible, the prime agents in providing viable and effective transportation services "

These elements of the national transportation policy are critical for shippers. For instance, the Canadian Transportation Agency has relied upon them in upholding the fundamental right of shippers to choose their own routings for the movement of their goods, to choose which carrier or combination of carriers will carry those goods, and to obtain the best prices in making these decisions.

Limited Running Rights

CCPA supports the Shippers' Summit recommendation for limited running rights. It is generally consistent with the running rights recommendation made by Mr.

Justice Estey in his Final Report on the Grain Handling and Transportation Review. Recommendation 8 of that Report states the following:

"It is recommended that the provisions of the CTA relating to various methods of seeking access to other connecting rail lines be simplified and clarified so as to better serve the national interest in obtaining competitive and efficient transportation by rail. The general object of this recommendation is the opening up of the Canadian rail system to competition by and between all competent railway operators, including short line railways. Competency shall be determined by the Agency."

Mr. Justice Estey then made a number of recommendations for broadening the application of the current running rights provisions.

The thorough discussion and debate concerning running rights in the consultations carried out on behalf of the Minister of Transport by first, Mr. Justice Estey, and then by Mr. Arthur Kroeger, demonstrate that a number of shippers and other participants in the transportation system are interested in making greater use of them. The Shippers' Summit recommendations for limited running rights upon application to the Agency, with the Agency having the power to develop the scope of the running rights order, to establish the compensation to be paid for running rights and to deny such an order where appropriate, would permit this. Mr. Justice Estey referred to his recommendations as offering "open access" to the rail system but we believe that is a misnomer. The Shippers' Summit recommendations would leave the Agency with considerable power to determine when and how running rights should be ordered, resulting in far less than "open access" to the rail system.

Competitive Access Rate (CAR)

CCPA's 1998 survey of its members showed that since 1996, only two of them had raised the possibility of a CLR with railways during negotiations. The rest

had given up on CLRs in the firm belief that the railways do not wish to compete for their business using this competitive access mechanism. Our members did, however, urge that the CLR mechanism should be re-designed in an attempt to make it more effective. The CAR mechanism, developed by the Canadian Fertilizer Institute, does that. Basically, it provides a simplified process for obtaining a fair rate to a competitive interchange.

If captive shippers located on short line railways could designate the juncture of the short line and the connecting major railway as the origin of traffic for the CAR, this would make CARs available to such shippers even when the short line railway is provincially incorporated.

Our member companies are far from unanimous on whether the simplified CAR approach would work to stimulate competition. Some believe that it would create new competition between originating and connecting carriers while others feel that basically, the CLR mechanism cannot be fixed. All of our members do agree, however, that CAR should be given an opportunity to test whether it can deliver the competitive access originally promised by the CLR mechanism.

Interswitching/Extended Interswitching

CCPA strongly supports the Shipper Summit comments on the vital role of interswitching in providing competitive access for captive shippers. Within CCPA's membership, 20 out of 47 member companies relying on rail transportation regularly make use of the interswitching provisions. The Review Panel should be aware that in the U.S. Surface Transportation Board's current hearings on Major Rail Consolidation Procedures, some major U.S. shippers and the Department of Transportation have recommended either adoption of Canada's interswitching system or a similar system, and commented positively on other aspects of competitive access and dispute resolution in Canada. A compendium of these comments appears in Appendix "D". In the U.S., of

course, shippers who advocate some form of the Canadian system advocate implementing it in a way that guarantees rail competition for all shippers.

CCPA recommends that the Canadian Transportation Agency should have the power to set "maximum" as opposed to "actual" interswitching rates. This would continue current practice whereby the parties participating in specific switches can negotiate lower interswitching rates when it makes commercial sense to do so.

Repeal of Subsections 27(2) and (3) and Section 112 of the CTA

CCPA supports the Shippers' Summit recommendation to repeal these sections of the legislation, particularly subsections 27(2) and (3), which deter shipper applications to the Canadian Transportation Agency. The provisions of the Act dealing with CLRs, joint rates, extended interswitching and level of service obligations require applicants to satisfy the Agency that they would suffer substantial commercial harm if the relief sought is not granted. Because there are no binding legal precedents, the Agency has drafted guidelines on factors it may consider under subsection 27 (2) and they are helpful. The guidelines are, however, no substitute for a sound, precedent-setting legal interpretation of the subsection.

Analysis by the Agency shows that the substantial commercial harm test has influenced the types of applications made to it by shippers. Generally, shippers have been forced to use remedies which are more costly and expose them to extensive litigation. The records of the Level of Service applications brought by the Wheat Board, Eagle Forest Products Limited Partnership and Naber Seed and Grain Co., Ltd. demonstrate that substantial commercial harm will be litigated. At the same time, the strong improvements in railway financial viability discussed in this submission demonstrate that the railways do not require this protection.

Sale and Discontinuance of Rail Lines

By 1998, 10 out of the 47 CCPA members relying on rail transportation had plants located on short line railways. When some of those short lines were created, serious issues arose which would have benefited from consideration by the Canadian Transportation Agency. Bill C-34 has made appropriate amendments to the CTA on the sale and discontinuance of railway lines which will enable those types of issues to be addressed by the Agency in the future. CCPA supports the Shippers' Summit recommendations to extend specific Bill C-34 amendments currently limited to grain dependent branch lines to all rail lines, and to address other deficiencies in the CTA.

Role of the Canadian Transportation Agency

CCPA supports the Shippers' Summit recommendations to restore the public interest provisions of the CTA as well as the Agency's jurisdiction to review rail mergers or combinations. As the Shippers' Summit document indicates, those provisions will be especially important if the expected new round of North American rail restructuring takes place once the U.S. STB's merger rules are revised. Such mergers will certainly affect Canadian shippers and as future combinations materialize, they will require means to ensure that promises to maintain or enhance competition are kept and that promised efficiencies do materialize.

CCPA believes that the Competition Bureau should continue to review the effects of proposed rail mergers or combinations. We also believe that there is a need for the Agency to have a role as well, while avoiding overlap with the Competition Bureau to the maximum extent possible.

On May 17th, the Minister of Transport asked the House of Commons Standing Committee on Transport to initiate an examination of the then proposed CN/BNSF combination. In doing so, he said that the Standing Committee would provide Canadian stakeholders and other interested parties with a public forum to express their views and opinions, and that the Standing Committee was to determine whether the proposed combination would be in the public interest and consistent with national transportation policy. Prior to 1996, this is exactly the mandate that the Agency would have exercised under its merger review powers. CCPA recommends that those powers should be restored to the Agency.

Final Offer Arbitration (FOA)

As mentioned elsewhere in this submission, FOA is being used more and more by shippers as a negotiating tool and in actual submissions to the Agency. While the FOA provisions were used only nine times under the NTA between 1988 and 1996, they were used on a further 13 occasions up to the end of 1999.¹⁰ CCPA endorses the Bill C-34 amendments to the FOA provisions and does not believe that further amendments should be considered at this time.

The Agency has commenced publishing summaries of its FOA decisions dealing with procedural challenges. They will increase the understanding of shippers seeking to make use of these provisions. They will also identify the numerous preliminary objections which the railways have raised in FOA cases, at least partly in efforts to frustrate the FOA remedy. Documenting these matters will allow future consideration of whether additional amendments to the FOA provisions are needed to curtail this practice.

CONCLUSION

¹⁰ Canadian Transportation Agency, Annual Report, 1999, pp. 44-46.

In its 1993 report, the National Transportation Act Review Commission (NTARC) set the tone for its recommendations by stating that "today we know that our transportation industries cannot be protected from domestic and international competitive pressures without paying a heavy price elsewhere in our economy, and at the cost of undermining of our export industries." It also said that it should not be necessary for Canada to choose between Canadian carriers and the success of exporters--the country should be able to have it both ways.

CCPA believes that these conclusions generally remain valid today. In our view, if the railways are permitted to continue Ramsey pricing with captive shippers, Canada's export economy will pay a heavy price as those shippers decline under global market pressures. It is no use saying that U.S. shippers are subject to the same conditions. They have many transportation options outside of the rail system and moreover, legislative proposals for enhancing rail competition in that country are likely to find favour following this year's presidential election.

There is no need for this detrimental outcome to occur. As Professor McCormick has demonstrated in his statement appended to this submission, revenue-based pricing (i.e. Ramsey pricing) will not be eliminated by providing rail competition for captive shippers. It can be applied in a competitive marketplace and we do not take issue with that. CCPA urges the Review Panel to take this into account and to adopt the recommendations for Limited Running Rights, the Competitive Access Rate and the other proposals made by the Shippers' Summit participants.