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Law

Jean D. Patenaude
Assistant General Counsel

935 de La Gauchetière Street West
Montreal, Quebec, Canada
H3B 2M9
Telephone: 514-399-5496
Facsimile: 514-399-4296
E-mail: Jean.Patenaude@cn.ca

Affaires juridiques

Avocat général conseil

935, rue de La Gauchetière Ouest
Montréal (Québec) Canada
H3B 2M9
Téléphone : 514-399-5496
Télécopieur : 514-399-4296
Courriel : Jean.Patenaude@cn.ca

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VIA EMAIL: consultationsd@otc-cta.gc.ca

Mr. Dale McKeague
Director, Industry Determinations
and Analysis Directorate
CANADIAN TRANSPORTATION AGENCY
Ottawa, Ontario
K1A 0N9

Dear Mr. McKeague:

**RE: REVIEW OF METHODOLOGY USED BY THE CANADIAN TRANSPORTATION AGENCY ('AGENCY') IN
DETERMINING COST OF CAPITAL FOR FEDERALLY REGULATED RAILWAYS**

This is in reference to the Agency's letter of August 14, 2009 in connection with the above captioned matter. CN welcomes the Agency's decision to conduct a review of its methodology for determining federally regulated railways' cost of capital and CN is pleased to participate in this consultation.

As requested in the Agency's communication, following are CN's comments in respect of the draft Terms of Reference for the Agency's consultant to review various methodologies.

1. In setting out the Objectives at page 4 of the draft Terms of Reference, the document states that the consultant will be asked, amongst others, to provide 'an assessment of the potential impact of such models if they were to be implemented by the Agency'. It is not clear what impact is being referred to, CN suggests that this direction to the consultant be more precise by asking for an assessment of the impact of such models **on the estimate of the railway's cost of capital** if they were to be implemented by the Agency.
2. CN agrees fully with the three evaluation criteria presented at page 5 of the draft Terms of Reference. Under the first criterion, however, the document states that the objective being pursued is to 'provide regulated railways with a fair and reasonable return, thereby providing railways with continued incentives to invest and protecting shippers from abusive rates.' The cost of capital to a railway is the return that investors expect to earn on

alternative investments that are equivalent in risk to their investment in the railway. On this basis, a railway's cost of capital is what it is and Courts have confirmed that it does not need to be modified out of deference to its impact on customers. CN submits, therefore, that the underlined part of the statement does not properly form part of the objective in setting a railway's cost of capital and should be removed from the draft Terms of Reference.

3. Phase I of the Work will involve an examination of approaches adopted by up to five regulatory bodies including two responsible for regulating rail transportation at a national level. The wording is such as to leave it to the consultant to choose which regulatory body to select. CN submits that, as part of the selected regulatory bodies, the consultant should be specifically required to consider the methodology currently used by the US Surface Transportation Board ('STB') for regulated railways. Indeed, other than the Agency, the STB is the body most relevant for both Canadian Class I railways as the US environment is clearly more comparable to the Canadian environment, both from a market and operating perspective and both railways also operate in the US. In addition, Canadian railways are competing for capital in the same markets as their US counterparts.

In the same manner, the National Energy Board (NEB) has just completed an exhaustive cost of capital review and issued decision RH-1-2008 in March of 2009, in respect of Trans Quebec & Maritimes Pipelines Inc. Given this recent review, CN suggests that the consultant be requested to include the NEB as one of the other two Canadian regulators whose approach should be examined.

Finally, in respect of the approaches taken by the other regulatory bodies, CN suggests that the document should require the consultant to explain the selected bodies' approaches on the basis of their comparability.

4. Also in Phase I, the Note on page 6 specifies that the consultant will be required to consult with experts for the selected regulatory bodies and that the views expressed by these experts will not be for attribution in order that they can provide views independent from the organizations to which they belong. As the consultant will be reviewing the methodologies or approaches used by the selected regulatory bodies, it is not clear why those bodies' experts' views should be obtained independent of the organization itself. Indeed, it is the organization that establishes the methodology and sets the cost of capital rate; the organization's expert is only one of the inputs in those determinations. Without attribution, it will be impossible to determine the qualification of the person making the comment and therefore to determine the weight to be attributed to such comments making all comments of equal value. If the Agency considers it necessary for the consultant to consult with experts, then it is CN's submission that it would be more valuable for the expert to consult with experts or academics totally independent from the bodies whose approaches will be reviewed.

5. Paragraph E) in Phase 2 reiterates that the consultant will be required to provide 'an assessment of the impacts of implementing each approach.' CN reiterates its comments in paragraph 1 above.
6. Appendix C provides a description of the Agency's current cost of capital methodology. CN submits that this description should be a factual description only and that, in order to ensure that no specific direction be suggested to the consultant, no rationale or underlying justification should be provided. For this reason, CN suggests that a number of statements be eliminated from the Terms of Reference documents and that others be formulated into questions as follows:
 - a. Page 7, second last paragraph, last sentence should be eliminated.
 - b. Page 8, first paragraph, last sentence commencing with 'The reason...' should be eliminated.
 - c. Page 8, second paragraph, last sentence should be eliminated.
 - d. Page 8, paragraph numbered 2, under **Capital Structure**, CN suggests that the 3 bullets should read as follows:
 - Should it be determined on the basis of Market value or Book value?
 - Should deferred taxes be given weight in capital structure and if so what cost rate should it be assigned?
 - What should be allowable non-rail debt?
 - e. Page 8, under **Capital Structure Cost Rates**, CN suggests that the 4 bullets should read as follows:
 - Cost of debt – should it be based on historic cost of debt reflected in most recent fiscal year, **an estimate of the current cost of debt based on market values** or some method of projecting future debt costs?
 - Cost of equity – should it be calculated using various methods, a single method or a **weighted combination** of two or more methods?
 - Market risk premium component of CAPM – what period should be used and should it be based on Canadian data exclusively or Canadian and US data?
 - Should there be a grain risk premium and if so should it be determined annually?

Referring to the process proposed to be followed, it is recommended that a meeting with the consultant be organized early in the review process and CN undertakes to make its key personnel available for such a meeting. CN notes that the proposed timetable provides for a thirty-day period for comments on the consultant's Final Report. Given the number of methodologies being reviewed by the consultant, CN is concerned that thirty days may not be sufficient to allow for meaningful comments and suggests that the time period be extended to 45 days.

CN reiterates its appreciation for the Agency's decision to proceed with a review of its methodology for determining the cost of capital and appreciates the opportunity to provide comments on the draft Terms of Reference.

Yours truly,

A handwritten signature in blue ink, appearing to read 'Jean D. Patenaude', with a stylized flourish at the end.

Jean D. Patenaude
Assistant General Counsel

JDP/