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In the matter of a public hearing by the Surface Transportation Board into the proceeding entitled *Methodology To Be Employed in Determining the Railroad Industry's Cost of Capital*, STB Ex Parte No. 664

PRESENTATION OF THE CANADIAN TRANSPORTATION AGENCY TO THE SURFACE TRANSPORTATION BOARD - AN OVERVIEW OF THE RECENT CANADIAN EXPERIENCE

Good morning Chairman Nottingham, Vice Chairman Mulvey, and Commissioner Buttrey. My name is Christa McClellan and I am honoured to appear before you today to talk about the Canadian Transportation Agency's cost of capital methodology as it may relate to railway companies operating in Canada. I am accompanied by Mr. Ron Ashley from the Agency's Legal Services Directorate.

The Agency was established on July 1, 1996, under the *Canada Transportation Act*, as the continuation of the National Transportation Agency. As a quasi-judicial tribunal, the Agency is responsible for administering laws that govern the economic regulation of various modes of transportation in Canada that fall under federal jurisdiction.

In this respect, the Agency is the licensing authority for market entry and exit in the Canadian airline and railway industries and to some extent in its marine industry.

It also acts as an adjudicator over a variety of carrier tariff and service complaints, notably in the air and rail sectors, and has a mediation mandate that assists in the resolution of certain commercial disputes that may arise between carriers, shippers, passengers and others.

Further to your invitation for the Agency to appear before you today, I would like to present a brief overview of the history of cost of capital development at the Agency as it applies to the Canadian railway industry. I will then provide a description of where the Agency is presently situated in terms of costing methodologies it uses and will provide a summary of how they are applied.

In 1980, a predecessor to the Agency, the Canadian Transport Commission, established a Technical Committee that examined in detail issues that were of concern to the industry - that is, to railways, shippers, and governments - regarding its methodology for calculating railway cost of capital. At that time, the Commission was heavily engaged in railway costing matters given its responsibility for assessing and paying the cost-based subsidies that were available to railways. As you can appreciate, many millions of dollars in subsidy monies were at issue and central to the distribution of these funds was the regulator's appreciation of a railway company's cost of capital in the costing of its operations.

As part of its review, the Commission held a public hearing which, after 44 hearing days, culminated in a July 1985 Decision pertaining to the Cost of Capital Methodology for Regulated Railways.

This Decision tackled - in great detail - many of the sensitive issues that are inherent in the capital costing exercise. I will not spend your time today in repeating what these were. However, of possible interest to your present deliberations is the Commission's treatment in that Decision of cost of common equity rates for Canadian federally regulated railways.

Here, the Commission ruled, somewhat to the chagrin of some of the parties that appeared before it, that it would not rely on any one particular method to calculate the cost of common equity; rather it would continue to use a number of methods – tempering the results of each method and its potential application based upon the regulator's informed judgement.

The three methods endorsed at the time were: the Discounted Cash Flow (DCF) Method; the Capital Asset Pricing Model (CAPM) and the Risk Premium Method. - which I will discuss in a moment.

Following the issuance of that 1985 Decision, there were enormous changes in; (1) the structure of the Canadian railway industry, (2) how railways operated within that structure and (3) the applicable regulatory laws. Notably, by 1996 there was also, (4) a total elimination of railway operating subsidies. Given these changes, it became evident that certain components of the *1985 Decision* were either no longer relevant or required reformation. As a result, in the fall of 1996, and subsequent to the coming into force of the *Canada Transportation Act*, the Agency initiated a review process of the *1985 Decision*.

A consultative hearing was held involving both written and oral evidence or argument so that in March of 1997, the Agency issued its 1997 Cost of Capital Methodology Decision.

Following some of the rationale advanced in the *1985 Decision*, the Agency concluded that the outcomes of the three previously mentioned equity costing models would continue to be assessed annually, and a weight would be given to the most appropriate model or a combination of models. This position was reiterated in the Agency's 2004 Decision, further to a subsequent review of the relevant methodologies.

This leads me to addressing why or how it is that the Agency maintains an interest in railway cost of capital rates. As the economic regulator under Canadian laws, the Agency annually determines the appropriate cost of capital rates for three separate statutory applications:

Firstly, cost of capital rate development is a key component within the cost calculations undertaken by the Agency in establishing the western grain volume-related composite price index under subsection 151(1) of the *Canada Transportation Act* (maximum grain revenue entitlement). As you may be aware, further to what is viewed as a grain shipper protection legislation, there is a yearly limit on the overall revenues that Canada's two main federal railways, CN and CP, may derive from their transportation of Canadian export grains.

A second area of application for the Agency's regulatory costing mandate relates to its setting of railway interswitching rates. This is a cost-based rate-setting function granted the Agency under section 128 of the *Canada Transportation Act*. Briefly described, these rates are established under Canadian law in order to give some shippers a choice of railways for their line haul transportation needs. The law prescribes that the rates set by the Agency in this regard shall not be less than the variable costs of moving the traffic.

Thirdly, cost of capital rates are set annually for CN and CP by the Agency as a costing component where necessary in proceedings before it for other regulatory purposes - that is - for matters that come before the Agency other than the two applications previously mentioned. Thus, cost of capital becomes important if the Agency is called upon to determine railway costs further to an application by one railway company for railway running rights under section 138 of the *Canada Transportation Act* or as part of a shipper's application for competitive line rates, under section 132 of the statute. There may also be instances where a specific cost of capital rate would be developed for a railway company involved in a proceeding.

Regarding the Agency's actual development of cost of capital rates, there are four distinct steps.

First, the Agency determines the net rail investment of relevant railway assets which, in terms of amount, represents the gross book value of all railway assets less accumulated depreciation. An amount for working capital is included. The Agency will also examine the capital structure of the railway in that it assesses the

combination or combinations of the various types of capital funds used to finance the net rail investment. Typically, this involves a breakdown of railway capital that is obtained through the issuance of debt, through deferred taxes, and through shareholders' equity.

Secondly, there is, of course, a differing cost of financing associated with each type of funding. The cost of debt is taken as the actual cost of debt, averaged by weight according to the various debt instruments employed. Deferred taxes are set at zero percent in the valuation process (this is consistent with the 1985 Decision).

In turn, the cost of shareholders' equity is estimated through the use of accepted financial models including the CAPM and/or the DCF Model and/or the Equity Risk Premium model.

An income tax allowance is added to the return on equity in order to establish the before tax value of the shareholders' return. No income tax allowance is granted on interest as it is income tax deductible.

Finally, the proportion of each type of funding within the capital structure is used to weight each appropriate cost rate. The Agency then tallies each of the structure inputs leading to a cost of capital rate in percentage terms. Finally, this blended rate is then applied to the net book value of the assets being costed, and results in the cost of capital being represented in dollar terms.

Regarding the determination of a railway company's cost of common equity rate, over the ten years since the *1997 Decision* referenced earlier, the Agency has concluded that the CAPM produces an estimate that best reflects the state of relevant capital markets and is a better indicator of changes in financial markets through the risk-free rates.

With respect to the risk-free rates used in the CAPM as they apply to the valuation of the company's equity, consistent with the *1985, 1997 and 2004 Decisions*, the Agency uses both short-term (1-3 years) and long-term (10+ years) Government of Canada bond rates as proxies for the risk-free rates of return.

With respect to the valuation of the company's equity, conventionally a market risk premium is used in the assessment of CAPM. Here, the Agency calculates the market risk premium by examining the difference between the historical market returns on stocks and bonds. This information is obtained from the "Report on Canadian Economic Statistics", published by the Canadian Institute of Actuaries. The Agency examines a moving 45-year time period.

In estimating a beta for CN and CP reflecting a component of stock price variability over time, the Agency relies on the S&P/TSX Composite Index as its data source and favours the use of a five-year measurement period. The frequency of data measurement is weekly or monthly and the beta is adjusted for the mean-reverting tendency.

In the end, and certainly since the coming into force of the *Canada Transportation Act*, the Agency has given primary weight to the Capital Asset Pricing Model in its assessment of equity valuations. In its most recent decision which was published in 2004, the Agency concluded that the CAPM remains a better indicator for cost of common equity *forecasts* and for *long-term expectations* finding that - at least relative to the other models being examined, notably DCF - the CAPM produces a lower risk of error over the long term as it relies less on conjecture or speculation when compared to that within other models.

I want to thank you again for the invitation to appear before you today. This is an important hearing - one which forms an important part of your board's overall mandate. We in Canada have found that cost of capital determinations are just as contentious as they are complex. I trust that my brief presentation today has provided some insight on how your Canadian counterpart has wrestled with this issue over the years.

If your staff does not have copies of the Agency's Decisions, I have spare copies with me should you wish that they be formally filed with you. I would be pleased to respond to any questions you may have.

Thank you Chairman Nottingham, Vice Chairman Mulvey and Commissioner Buttrey.