

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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**STB Ex Parte No. 761
STB Ex Parte No. 722**

**HEARING ON REVENUE ADEQUACY
RAILROAD REVENUE ADEQUACY**

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SUPPLEMENTAL WRITTEN TESTIMONY OF CN

The U.S. rail operating subsidiaries of Canadian National Railway Company (collectively herein “CN”) respectfully submit these supplemental comments following the hearing on revenue adequacy on December 12-13, 2019. CN’s supplemental comments address three issues. First, CN emphasizes the importance of a stable regulatory regime and explains why significant changes to the backbone of the rail regulatory structure can disrupt the railroads’ access to financial markets. Second, CN explains that, as a publicly traded company, it needs to compete with other publicly-traded companies to obtain new capital and to retain capital. Third, CN provides some additional information to respond to the Board’s questions about interswitching¹ in Canada.

¹ In Canada there are two forms of interswitching: (1) interswitching available to facilities located within 30 km (18 miles) of an interchange point between two railway companies or (2) long-haul interswitching. In these comments, CN references only the first form of interswitching, which is the most widely used in Canada.

I. BOND AND EQUITY INVESTORS CONSIDER THE STABILITY OF THE REGULATORY REGIME BEFORE MAKING INVESTMENTS

CN has a focused capital allocation strategy. As Mr. Bernd Beyer, CN's Vice President and Treasurer, explained at the hearing, CN thinks about three possible uses for its cash flow. "One is to invest it in terms of capital investment or M[&]A, [to] grow the company. The other is to repay debt, or build cash, [to] manage the balance sheet. And the third one is to return it to the shareholders by way of dividends or share buy backs." Tr. at 399 (Dec. 12, 2019). CN approaches these decisions by first looking at the proposed capital investments and proceeding with those that CN believes will best serve the business. *Id.* Using this process, CN invests heavily in its network every year in maintenance and in efforts to improve safety and resilience and expand capacity. In 2019, CN invested \$3.9 billion CAD in capital investments. Once CN has completed its selection of capital projects to pursue for the year, CN evaluates whether it needs to borrow or repay debt. To do so, CN reviews its debt ratio, which it uses to maintain its desired credit rating. *Id.* at 400. Once those two steps are completed, CN makes any necessary payments to its bond investors and returns any remaining cash to its equity shareholders by way of dividends and share buy backs *Id.*

As CN emphasized in its opening written testimony, CN relies upon a stable regulatory environment to enable it to make reasoned decisions about the risk and uncertainty inherent in any potential long-term investment versus its expected return. Potential changes to the underlying fundamental regulatory structure—such as those proposed by the Rate Reform Task Force ("RRTF") for carriers deemed

long-term revenue adequate—could discourage investment and make it harder for CN to compete with other industries to raise necessary capital in financial markets. This is especially important for the rail industry given the large amounts of expenditures required to maintain and improve existing infrastructure. In 2018, CN dedicated approximately 72% of its net income to capital investments.

Investors are important to CN’s continued ability to fund important capital projects, which improve network resilience and capacity and rail service. These investments benefit CN’s customers and the rail network. A substantial portion of CN’s investors are long-term investors on the bond markets. Long-term investors, in particular, look for stability in their investments. When deciding whether to make an investment, one of the things these investors consider is the stability of the returns from the investment taking into account the underlying regulatory regime of the industry. In fact, credit rating agencies, on whose assessments long-term bond investors rely, cite “adverse regulatory developments” as one of the three key factors that could lead to a ratings downgrade. *See Credit Opinion: Canadian National Railway Company*, Moody’s, June 26, 2019.

As Mr. Group testified at the hearing, a survey of 171 investors revealed that 99% of respondents would be at a minimum “somewhat less likely to invest” in the railroad industry if the STB enforced constraints on pricing for rail carriers that were deemed long-term revenue adequacy. *See Wolfe Research Exhibits at 15*. Of those 99%, 58% would be “much less likely to invest.” Mr. Group’s research confirms

that investor behavior is closely linked to regulatory action, and that investors do take regulatory change into account in their decision-making.

CN is particularly concerned that the revenue adequacy proposals in the Rate Reform Task Force report could make railroads appear to be riskier investments and thus less attractive to investors. Indeed, as Mr. Group testified, “long-term revenue adequacy is the single biggest concern that investors in railroad stocks have.” Tr. at 103 (Dec. 13, 2019). The possibility of significant change in the regulatory scheme could adversely impact the ability of a railroad to attract and retain capital in financial markets by making a railroad be perceived as a riskier investment with increased uncertainty. For example, if the rail industry is perceived as being at risk of potential earnings regulation, bond investors may seek to offset that risk by demanding higher returns in the form of increased interest rates. Higher interest rates on bonds would increase a railroad’s costs and the cost of capital, and thus would leave less capital available for investments necessary to maintain and improve the freight rail network. Similarly, as Mr. Group testified at the hearing, equity investors are less likely to invest in the rail industry if they believe there is increased regulatory risk that would cap or limit a railroad’s ability to earn an adequate return. Proposals like the Revenue Adequacy suggestions from the RRTF could undermine a railroad’s ability to make investments to improve safety, network resilience and customer service, and to plan for future demand.

II. RAILROADS NEED TO COMPETE IN FINANCIAL MARKETS TO ATTRACT CAPITAL AND ALSO TO RETAIN CAPITAL

A publicly-traded railroad competes not only to bring in new bond and equity investors, but also to retain the capital that has already been invested in the railroad's bonds and stock. As Professor Murphy testified at the hearing, railroads are "always competing to retain capital. That is, you're competing against the investors who would rather put that money to use elsewhere." Tr. at 95-96 (Dec. 13, 2019). Thus, if there is increased uncertainty from new proposed regulations that could tend to decrease a railroad's expected rate of return on its investments, the investment opportunities in other industries begin to look more appealing, and "firms are going to have the economic incentive and their investors are going to demand that money flow elsewhere, where it has a higher rate of return." *Id.* at 96.

In other words, the fact that a railroad today might have sufficient capital to fund needed investments and award dividends or stock repurchases to investors does not negate the fact that the railroad will constantly need to compete in financial markets with other investment options in other industries to retain the capital it has and attract new capital in the future. A railroad's financial strength, or the fact that its accounting return on book value as measured by the Board may be deemed to exceed the rail industry's cost of capital calculated by the Board, does not lessen the competition a railroad faces in the financial markets.

Thus, as Mr. Beyer explained, "the fact that we are paying a return to our owners is not an indicator of whether or not we are revenue adequate." Tr. at 400

(Dec. 12, 2019). If CN were to reinvest all of its cash flow into capital expenditures on an annual basis, “an investor in CN would never receive one dollar, because it would always just be reinvested and therefore it wouldn’t be an investment that people would want to make.” *Id.* Like dividends, share buybacks are, therefore, as Mr. Beyer explained “a normal part of the business,” prevalent both in the rail industry and “among other industries.” *Id.* Were a railroad to never return any amount in dividends or share buybacks to its investors, those investors would pull any existing investment out of the rail industry and put their money into a different industry that offered a return not subject to an earnings cap.

Similarly, were the Board to impose a cap on earnings at, for example, the cost of capital, investors would know the maximum earning a railroad can expect to receive.² Given that investors’ downside risk remains unchanged, they can be expected to demand more return on their investment in the railroad, in which case the railroad would be incentivized to invest in an unregulated area or to return the cash to the investors so that those investors can make different investment choices.

In short, any dollar invested in a railroad in the financial markets can just as easily be pulled out and invested elsewhere if the company does not offer an attractive rate of return on that investment. For this reason, the proposed approaches in the RRTF to long-term revenue adequacy are unworkable public

² Professors Kevin Murphy and Mark Zmijewski presented data at the hearing that shows that railroads earn a Return on Invested Capital minus Cost of Capital well below the median of other companies in the S&P 500, with whom railroads compete for capital. *See* Murphy and Zmijewski Exhibits at 19, Ex Parte 722 and Ex Parte 761 (filed Dec. 10, 2019).

policy that would tend to increase risk and uncertainty of investing in the rail industry, which will make it more difficult for a railroad to attract the necessary capital to fund its needed infrastructure improvements and which would not ultimately benefit the customers and supply chain participants that rely on the rail network. This is an outdated approach that the Board should firmly reject.

Instead, the Board should focus on providing effective individualized remedies to allow a rail customer an avenue to challenge a rate that it believes is unreasonably high in light of the particular characteristics of the movements at issue. CN has proposed a general framework for a potential voluntary alternative dispute resolution (“ADR”) program that would include a targeted ADR avenue for small rate disputes. *See* Comments of CN, *Final Offer Rate Review*, STB Docket No. Ex Parte 755 at 25-27 (filed Nov. 24, 2019). CN reaffirms that proposal and joins the call of the AAR for the Board to embrace smart simplification of its rate remedies, and to explore ways to improve arbitration alternatives for smaller rate disputes.

III. THERE ARE 69 INTERSWITCHING POINTS IN CANADA.

During the hearing, the Board members asked about the number of interswitching locations in Canada in comparison to those in the United States. There are 69 CTA interswitching points in Canada for CN. *See* <https://www.cn.ca/-/media/Files/Customer-Centre/Shipping/9001-CTA-Interswitching-Points-Canada.pdf>. CN does not maintain data on the total number of interchange locations in the United States. CN notes that, in 2013 in Ex Parte 711, the AAR presented evidence that there were approximately 1500 interchange points in the

United States that would be eligible for competitive switching under the NITL's proposal.³

Respectfully submitted,

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³ See Reply Comments of the Association of American Railroads, V.S. Ireland and Case at 8, STB Docket Ex Parte No. 711, *Petition for Rulemaking to Adopt Revised Competitive Switching Rules* (filed May 30, 2013).