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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Ex Parte No. 664

**METHODOLOGY TO BE EMPLOYED IN DETERMINING THE
RAILROAD INDUSTRY'S COST OF CAPITAL**

**SUMMARY OF THE TESTIMONY
OF THE
CANADIAN TRANSPORTATION AGENCY**

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submitted by the

CANADIAN TRANSPORTATION AGENCY

The principles used in determining the cost of capital rates were established by the Canadian Transportation Agency's (the Agency) predecessor, the Canadian Transport Commission, in the July 31, 1985 Decision of the cost of capital methodology (1985 Decision); by the Agency in its Decision No. 125-R-1997 dated March 6, 1997 (1997 Decision), in the matter of issues pertaining to the Agency's cost of capital methodology; and by the Agency's Decision No. 52-R-2004 issued on February 2, 2004, in the matter of issues related to the Agency's determination of cost of common equity rates for Canadian regulated railway companies.

The Agency determines the appropriate cost of capital rates to be used:

- 1) in the composite price index calculation under subsection 151(1) of the *Canada Transportation Act* (maximum grain revenue entitlement). These rates are determined in March of each year for application in the upcoming crop year.

- 2) as a costing component in the setting of interswitching rates, which is a rate-setting function granted the Agency under section 128 of the *Canada Transportation Act*. These rates are determined in June of each year for application in the upcoming calendar year.
- 3) as a costing component in proceedings before the Agency for regulatory purposes other than for calculating the composite price index and establishing interswitching rates. These rates are determined annually for the Canadian National Railway Company (CN) and the Canadian Pacific Railway Company (CP). This is an historical rate. These rates would also be used in respect of other Canadian federally regulated railway companies if the Agency decided, after consultation with parties, that it is appropriate. Or, if necessary, a specific cost of capital rate will be developed for the railway company involved in a proceeding.

The determination of the cost of capital rate is segmented into four distinct steps:

- a) determination of net rail investment;
- b) determination of capital structure;
- c) determination of capital structure cost rates, which includes the cost of common equity; and,
- d) calculation of the cost of capital rate.

In regard to the determination of the cost of common equity rate, for the past ten year's, the Agency has concluded that the Capital Asset Pricing Model (CAPM) produces an estimate that better reflects the state of relevant capital markets and is a better indicator of changes in financial markets through the risk-free rates.