# COALITION OF RAIL SHIPPERS

## Submission to the Rail Freight Service Review Panel

### 1.0 Preamble:

The Coalition of Rail Shippers (CRS) is pleased to have the opportunity to submit its comments and recommendations to the Rail Freight Service Review Panel in response to the Chairman's letter of November 9, 2009.

The CRS is a coalition of industry associations, whose members represent over 80% of the revenues of CN and CPR. The CRS provides input to the government and government agencies on railway matters affecting the large segment of Canadian industry that depends on effective, efficient and low-cost rail service to remain competitive in domestic and export markets. A list of the CRS member associations is attached as appendix 1.

When Parliament was considering Bill C-8, amending the *Canada Transportation Act,* the CRS strongly advocated that an independent review of railway service be undertaken. CRS members were gratified that the government agreed to undertake review beginning within 30 days of Bill C-8 becoming law.

### 2.0 Background:

Canada's rail freight network is not subject to the usual influences of competition and market forces. The economic leverage enjoyed by rail carriers over their customers is the fundamental issue underlying most service problems encountered by rail shippers. Effective regulatory intervention may be the only surrogate for the benefits of a normally functioning competitive marketplace.

The broad support for this service review and response of the government to undertake such a process is an indication that widespread problems do exist. It is important that the review be conducted in a thorough and unbiased manner and CRS is supportive of the structure of the review, the terms of reference, and the scope of work.

### 3.0 Scope of the Review:

The project has been structured in two phases. Phase one is the data gathering and analysis phase, undertaken by consultants hired directly by Transport Canada. During phase two, a three person panel, will review the findings of phase one and then obtain direct input from various stakeholders concerning rail freight service levels. Subsequently their findings will be submitted to the Minister of State for Transport.

The four consulting assignments in phase 1 of the review have examined various aspects of rail service. The quantification of service problems throughout the rail based supply chain, the independent survey of regulatory oversight of other industries and rail in other countries, the identification of "best practices", and the independent shipper survey will provide a base for the development of recommendations by the panel in phase 2 of the review. The terms of reference of the review are well known and the CRS will not repeat them here. In making this submission, the CRS is mindful of the exhortation in the Panel's *Call Letter for Submissions,* dated November 9, 2009, asking for "*submissions for improving the rail-based logistics system".*

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## 4.0 The Elements of Railway Service:

Railway service generally includes the following elements:

1. An adequate supply of serviceable and clean cars for loading, delivered at the rate required by the shipper.
2. On-time delivery of empty cars for loading, prompt pick-up when loaded.
3. Consistent, reliable transit times, whether the shipment is handled by a single railway or interchanged to one or more other railways.
4. On-time delivery of loaded cars to the consignee delivered at the rate that the consignee needs.
5. Prompt pick-up of cars once emptied.
6. Accurate billing.
7. Accurate assessment of demurrage based solely on shipper or consignee delays and not due to "bunching" of cars or other delays caused by the railway.
8. Attentive customer service and communication with customers on service problems.

There are some subtleties within the above-mentioned elements that need to be highlighted. The issue that cars need to be "delivered at the rate required by the shipper (or consignee)" is very important. If a shipper needs cars at the rate of three per day, five days per week; then 15 cars once per week, is not satisfactory. The shipper or consignee may not have trackage adequate for 15 cars, the staff to unload 15 cars within the free time allowed to avoid demurrage, and the manufacturing process may be disrupted.

Another issue within these elements is arbitrary changes to switching service with inadequate notice that the changes are being made. This can have a major impact on the manufacturing processes of shippers and consignees. In a normally functioning competitive market, this is something that would be negotiated between the buyer and seller and not arbitrarily imposed by the seller.

## 4.1 Comments on Phase 1 Analysis and Assessments:

The phase 1 consultants' reports have confirmed the prevalence of wide-spread, chronic service problems.

**Project 1: Analysis of Transit Time and Fulfillment of Shipper Demand - QGI**
This report by QGI uses railway provided data to evaluate railway performance in terms of car supply and transit time. It particularly looks at consistency in meeting shipper demand.

The results support shipper complaints of chronic inconsistency in service as found in the NRG shipper survey (Section 6.3), the CITA benchmarking survey, and as reported by the large number of complaints to Transport Canada from shippers in many industries. It should be noted in the car supply section of the QGI report, that intermodal car supply and cars supplied outside the electronic car ordering systems are excluded from this analysis. A significant gap in car supply data is data related to shipper supplied cars. As the chemical and petroleum industries supply virtually all their own cars, car supply analysis for this significant industry is missing from this report.

While the report summarizes the success of the railways in meeting annual demand for cars in the 90% range, the need is for the right number of cars to be delivered on a daily basis. While the railways were unable to supply much data on daily fulfillment, The QGI report notes that even on a weekly basis, *"each railway provided grain shippers with at least 90% of the cars they*

*had ordered at a specific location only half the time", (page 12).* Similarly the QGI Report notes that CN was successful in delivering at least 90% of cars ordered on a weekly basis to only 68% of their merchandise customers and CP supplied at least 90% of cars ordered on a weekly basis to only 50% of their merchandise customers.

The transit time analysis confirms the lack of consistency that generally exists for most shippers and the tables on pages 20 and 21 of the QGI report provide a good summary of the high degree of variance. Unlike the Car Order analysis, the Transit Time Analysis includes the terminal to terminal time of intermodal movements. The table and chart on CN includes the following information.

CN Carload Traffic

- Average Length of Haul - 1078 miles
- Typical Transit Time – 117 hours
- Maximum in range – 159 hours
- Minimum in range – 76 hours

The transit time range is defined as a range of times covering an estimated 75% of shipments in each of the three groupings, i.e. Bulk/Grain, Carload, and Intermodal.

The consultant calculates a *coefficient of variance (CV)* for these analyses and the above sample has a CV of 30.7. For Bulk/Grain traffic the CV is 24.6 and for intermodal traffic it is 18.5. The lower the CV, the more consistent is the transit time performance.

For CP, the CVs are as follows:

- Bulk/Grain – 29.9
- Carload – 33.9
- Intermodal – 19.9.

The report looks also at railway terminal time and loading and unloading times. There is considerable variability in these elements of the car cycle as well, with some of the responsibility with the shipper or consignee and some with the railway. It notes that loading and unloading times were shortest and most consistent for grain and coal within the bulk group and for finished vehicles within the merchandise group.

**Project 2:**

**2a: Description of Canada's Rail Based Freight Logistics System by QGI Consultants**

This consulting report provides a comprehensive overview of the rail based logistics system looking at the obvious rail network, equipment, and overall operations, but also at car order and car distribution systems, and interchange between railways. It highlights the problems that can occur at origin, in-transit, and at destination and the impacts of these problems on the railways and their customers. It particularly notes the need for effective communications from shipper to the railways with regard to car orders and from the railways to shippers, consignees, and other stakeholders in the supply chain. It notes that shippers may suffer in the markets they serve if reliability of delivery is compromised by rail service problems.

The overview of the rail system provides useful background and context for stakeholders in understanding the elements of the railway system and the impacts of failures.

**2b: Analysis of Operating Practices by QGI Consultants**
In this study, the consultants identify the "best practices" that they believe should exist in a supply chain, including communication between supply chain partners on demand and capacity, considering processes for effectively integrating supply chain partners' operations, and attempting to optimize the "output and profitability of the entire supply chain". The analysis identifies the existing practices that sub-optimize system efficiency and make a series of proposed solutions to improve operating practices across the entire supply chain. The CRS endorses these "proposed solutions".

**Project 3: Survey of Shippers & Other Stakeholders by NRG Research Group**
The survey of 262 shippers by NRG Consultants states that: *"overall satisfaction is low".* The NRG report quantifies the level of dissatisfaction. The seriousness of chronic service failures for shippers is highlighted by the NRG finding that *"62 percent (of rail shippers) said they suffered a serious financial impact as a result of poor rail freight service".*

The findings of NRG are consistent with what CRS and the Government has heard directly from Canadian shippers.

**Project 4: Service Issues in Other Regulated Industries by CPCS Transcom ltd.**
This study investigated railway regulation in the United States and in other regulated industries in Canada. CRS members find it to be the least relevant of the four projects. The basis for many of the recommendations contained in the report is an assumption that sufficient competition exists in Canada's rail freight system: "*An important question is whether shippers should have recourse to regulatory remedies in markets for transportation services where sufficient competition exists as a protection" (page 40).* Were "sufficient competition" present in our rail freight network, this review would not have been required, nor would the railway-supplied data in the other reports have validated concerns over unacceptable service levels to the extent they have.

Investment professionals are well acquainted with the situation: "*The railroad competitive environment is arguably the envy of most industrial sectors, boasting limited competition and steep barriers to entry. In many cases, there are only two Class I operators in any given region. Canada (the North) is no exception in this regard, with CN and CP both enjoying a comfortable duopoly that prevents excessive competition ....Customers are therefore left with few alternative options if they dislike incumbent services and/or prices. We also note that monopolies often exist in certain (typically remote) regions where only a single operator maintains rail infrastructure, further enhancing the local firm's underlying pricing power. Finally, given the immense barriers to entry in the railroad business (i.e. capital cost, land availability, etc.), the trend has long been toward consolidation versus new entrants sprouting up, leading us to believe these competitive dynamics are expected to persist for the foreseeable future".*
(Raymond James Financial Inc. report to investors May 2009, "The Canadian Railroads", pages 9 and10) Excerpts of the *Raymond James Report* are attached as Appendix 2

Shippers are already functioning at a severe market disadvantage and will be hard pressed to find any value in further eroding the few legislative protections that work in their favour. The CPCS suggestions for further regulatory reduction are out of step with the actualities of Canada's rail freight network.

## 5.0 CRS Core Principles for Consideration in the Panel's Recommendations:

The CRS recognizes that a wide range of solutions may be put forward and understands the importance of each recommendation to individual stakeholders. Some will be structured to meet the unique needs of a specific shipper group while others may have more a more holistic application. In evaluating all stakeholder submissions, the CRS recommends the Panel consider the following "core principles" be addressed in its recommendations put forward to the Minister.

### 5.1 - Performance Standards Focused on Core Elements of Customer Service

The consultant reports to the Panel, whether they were based on stakeholders' experiences or based on quantitative analysis of facts, revealed that railways do not structure operating plans or design systems to deliver appropriate, consistent customer service to rail freight customers. Failures were highlighted in everything from ordering equipment through to service at the final destination. The CRS proposes that performance standards focused on core elements of customer service be established 1) to ensure that expectations with respect to customer service are understood, 2) to ensure that railways allocate resources to improve their performance in areas that matter most to customers, and 3) to ensure that other members of the supply chain fulfill their obligations.

### 5.2 – Ongoing Independent Monitoring of Railway Service

The CRS applauds the quantitative analysis approach taken during the Rail Freight Service Review. It is widely recognized that through a common set of objective information, all supply chain stakeholders (including government) can determine where the system fails and focus solutions on areas that will produce the greatest overall benefit. Continuing independent monitoring and performance measurement of the railways and other participants in the supply chain is critical in order to measure service effectiveness as it relates to performance standards and form the basis for determining when consequences for non-performance apply. Continuing, independent monitoring of rail suppliers is of fundamental importance in rebalancing the bargaining power in what is <u>not</u> a normally functioning competitive market.

The communication by the railways of changes in operations, especially "first mile – last mile" is a serious problem that impacts shipper costs and production schedules. It would be useful for the Rail Service Monitor to evaluate the railways' communications performance as it relates to service changes.

Timely reporting, probably by website, coupled with periodic published reports (say monthly) would be an integral part of the independent monitor's function.

### 5.3 - Consequences for Non-Performance

Performance standards will serve to focus attention on the core elements of customer service that matter most to customers. Independent monitoring and performance measurement will establish if actual performance matches the expectations established through performance standards. This would be a reasonable replacement for the current regime where the railways unilaterally "assess" shipper performance and impose penalties. In order to ensure that railways are sufficiently motivated to *deliver* customer service, there must be consequences in place for non-performance. In a non-competitive environment, it is necessary to establish and enforce consequences for non-performance as the risks that exist in competitive environments (i.e. lost business) do not exist. There needs to be re-balancing of consequences for non-performance that focuses on the non-performer.

**5.4 – Dispute Resolution**
While some of the dispute resolution and other shipper protection provisions of the *Act* may be helpful in resolving service and other disputes, they can be expensive and time-consuming.

In a competitive marketplace, "commercial" dispute resolution (CDR) would be a normal part of the negotiating process between a willing buyer and a willing seller. In the case of rail freight, the development of an equitable CDR will require government oversight to ensure balance between the rights and obligations of both shippers and railways. The CRS notes that in 2008, in an attempt to head off Bill C-8, railways entered into discussions with shippers regarding the development of a CDR. These discussions were unsuccessful.

It is critical that any CDR be a voluntary process requiring the agreement of both parties. A truly neutral, effective and timely resolution process should have no difficulty attracting willing participants.

**5.5 - Statutory Review of the Canada Transportation Act**
In 2007 and 2008, the *Canada Transportation Act* was amended by two Bills passed by Parliament. As noted above, Bill C-8 dealt directly with amendments to the protection provisions for railway shippers. Bill C-11 dealt with other issues in the *Act* and received Royal Assent on June 22, 2007. One of the provisions of Bill C-11 extended the period for a statutory review of the *Act* to eight years from five years.

The shipper community opposed that change and, as the *Act* is the enabling legislation for all commercial matters affecting the railway industry, and as technology, markets, and service needs evolve rapidly, it is the view of the CRS that the oversight of railway service issues requires that the *Act* be subject to statutory review within a five year period. This would be consistent with ensuring that the *Act* is kept current for issues relating to service as well as for other commercial matters.

**6.0 Concluding Remarks:**
The Service Review is an important initiative with the potential to significantly improve the competitiveness of Canadian rail freight shippers.

Each of the organizations in the Coalition of Rail Shippers will be providing their own submission containing specific recommendations consistent with the over-arching principles of this submission. Being mindful of the objective of achieving balanced accountability between shippers and railways, we urge the Panel to give full consideration to each of these efforts.

The Coalition of Rail Shippers appreciates the opportunity to submit these comments and its members are available to meet and discuss with the panel and the secretariat.

**Appendix 1**

# Coalition of Rail Shippers

## Members

- Animal Nutrition Association of Canada
- Association of International Automobile Manufacturers of Canada
- Canadian Canola Growers Association
- Canadian Dehydrators Association
- Forest Products Association of Canada
- Grain Growers of Canada
- Inland Terminal Association of Canada
- Pulse Canada
- Shippers Council of Canada, a coalition of:
    - Chemistry Industry Association of Canada
    - Canadian Fertilizer Institute
    - Canadian Industrial Transportation Association
    - Mining Association of Canada
    - Propane Gas Association of Canada (Shippers Group)
- Western Canadian Shippers' Coalition
    - Alberta Forest Products Shippers Association
    - Canadian Oilseed Processors Association
- Western Canadian Wheat Growers Association
- Western Grain Elevator Association

Canadian Industrial Transportation Association
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**Appendix 2**

Raymond James RJ Equity Research

# The Canadian Railroads

CP-TSX | CP-NYSE and CNR-TSX | CNI-NYSE

## Initiating Coverage: Hauling Less, Charging More—On Track to Mitigate the Pain

### Overview

We are initiating coverage on Canada's two publicly- listed Class I railroads: Canadian National Railway (CN) and Canadian Pacific Railway Ltd. (CP). We rate CN OUTPERFORM with a $55.00 target price and CP OUTPERFORM with a $50.00 target price.

The typical rumble of North American (N.A.) freight trains has become far less ominous in recent months. As the global recession has tightened its grip, the audible wake of these lumbering steel giants has been quelled by a dramatic contraction in freight volumes. According to the American Association of Railroads (AAR), year- to- date volumes are down a stunning 19.4% y- o- y. Not since 1982 has the sector witnessed such a steep drop in volumes carried.

Railroad equity values have suffered in concert. The S&P Railroads sub- index is down 43% over the past year, while the Canadian- based railroads are similarly battered, with CP and CN down 44% and 19% y- o- y, respectively, over the same period. With macro news still sour and valuation multiples scraping multi- year lows, investors appear to have largely abandoned the sector altogether.

However, not all is lost in our view. Notwithstanding the admittedly grim macro picture, we believe that several unique aspects about the Canadian rail sector will help it mitigate the pain. Specifically, we point toward the sector's: (i) goldplated pricing power; (ii) demonstrable productivity improvements; (iii) market share gains versus trucking; and (iv) depressed valuations already near their previous cyclical lows. Moreover, while not industry specific, dramatically lower fuel costs and a weaker Canadian dollar are also expected to provide substantial mitigating tailwinds. Finally, we would be remiss if we did not highlight the sector's early cyclical behaviour and tremendous long- term fundamentals, though we concede these arguments are often lost within the current economic environment.

Of course, not all railroads are created equal. Some are fairing relatively well, while others are suffering disproportionately. The main purpose of this report will therefore be to: (i) outline the mounting pressures facing the sector; (ii) review the key sector attributes that will help mitigate the pain; (iii) highlight the individual company characteristics that will differentiate performance; and (iv) identify which of the two Canadian rails we prefer in this context.

*Sources: Raymond James Ltd., ThomsonOne, CapIQ*

*Attractive Competitive Environment*

The railroad competitive environment is arguably the envy of most industrial sectors, boasting limited competition and steep barriers to entry. In many cases, there are only two Class I operators in any given region. Canada (the North) is no exception in this regard, with CN and CP both enjoying a comfortable duopoly that prevents excessive competition. This position is further sweetened by the fact that rail remains the only cost effective alternative for several freight categories, particularly those with heavier/denser physical attributes (i.e. coal, grain, potash) that require lengthy hauls (i.e. >700 miles) to port or market. In these instances, trucking—the primary competitive mode of transport—is unable to compete economically (see below for more). Customers are therefore left with few alternative options if they dislike incumbent services and/or prices. We also note that monopolies often exist in certain (typically remote) regions where only a single operator maintains rail infrastructure, further enhancing the local firm's underlying pricing power. Finally, given the immense barriers to entry in the railroad business (i.e. capital cost, land availability, etc.), the trend has long been toward consolidation versus new entrants sprouting up, leading us to believe these competitive dynamics are expected to persist for the foreseeable future. Taken together, we expect these enviable competitive attributes will help protect the positive pricing environment throughout our forecast horizon.