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Shippers' Coalition

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WESTERN CANADIAN SHIPPERS' COALITION

SUBMISSION TO THE RAIL FREIGHT SERVICE REVIEW PANEL

30 APRIL 2010

The Western Canadian Shippers' Coalition (WCSC) is appreciative of the opportunity to present our views to the Rail Freight Review Panel concerning service on the Canadian rail freight network.

Our coalition is comprised of companies and associations involved in the transportation of Canadian natural resource-based products including: barley, cement, chemicals, coal, lumber, metals, newsprint, oilseed products, pulp & paper, sulphur, wheat, and wood pellets. WCSC members (please see Appendix 1) provide over 320,000 direct and indirect jobs in communities across the country and ship in excess of \$35.5 billion worth of product annually.

WCSC members are almost completely dependent on the rail freight network and keenly aware of the impact service levels have on their ability to compete internationally. Our membership is diverse and not all share the same specific concerns, however, characterized broadly, rail service related issues affecting our members tend to fall into two categories: car supply and transit times.

CAR SUPPLY:

There has been a good deal of evidence provided concerning the issue of car supply. The "Survey of Shippers" conducted by the NRG Research Group revealed that shortfalls in car supply account for three of the top six over-arching complaints shippers

have about rail service, including: on time delivery of cars at origin of shipping; on time delivery cars at destination; and reliability of car supply, including the timely release of cars into the system. More specific concerns also focussed on car supply with: the timely placement of cars at origin for loading; the timely pick-up of empty cars; and the accuracy of forecasting demand comprising three of the five main issues identified by shippers. (Survey of Shippers, NRG, pg. 4)

WCSC members are also aware of cars being kept in storage by carriers even while shippers are experiencing shortfalls in car supply.

The “Fulfillment of Shipper Demand and Transit Times” report prepared by QGI supports the findings of the NRG work. In the area of car supply for grain shippers, only when annualized do the numbers for CN and CP approach acceptability. However, annualized numbers do not tell the relevant story from a shipper’s perspective. Insufficient or unpredictable car supply can be a key factor in costly delays in goods arriving at port. When a vessel sits at anchor, unable to load because a train has yet to arrive, demurrage charges of anywhere from \$5,000 to \$100,000 per day accrue to the shipper. The manner in which rail cars are provided on a daily basis is a critical performance matrix when measuring railway performance on car order fulfillment. Unfortunately, railways do not track car supply performance on a daily basis, a fact which is as instructive as it is disappointing. QGI had to settle for weekly statistics and even they told a much less positive story than the annual results. On page 49 of the QGI report, fig. 21 notes that when car order fulfillment is evaluated on a weekly basis, grain shippers are provided with the number of cars they have ordered only 50% of the time. On page 50, fig. 22 confirms that some weeks the prospect of receiving only 90% of the number of cars required is less than 30% for CN and 35% for CP.

When evaluating car supply to merchandise shippers, due to differences in the car order programs of CN and CP, it was not possible for QGI to combine performance numbers. Taken individually, according to fig. 30 on page 59 of the report, only 46% of CN customers received 90% of the cars they ordered. Even when a 1 day buffer was included, only 68% of customers received 90% of the cars they ordered. Calculated on

the same basis, only 37% of CP's customers received 90% of the cars they ordered and even with the addition of a one day buffer, only 50% received 90% of the number of cars ordered according to fig. 34 pg. 61.

The impact on shippers of this car supply performance is as profound as it is expensive. We have already spoken to the consequences of unpredictable car delivery in terms of vessel demurrage charges, but they are not the only by-product. At origins shippers are forced to schedule overtime crews to accommodate erratic car arrivals. Full-time staff is also required to identify and follow up on frequent car shortages and in many cases make alternate, more costly last-minute arrangements. There is also the added indignity and potential cost of railway demurrage charges when cars arrive in numbers too great for the shipper's loading capacity (known as bunching) and as a result sit idle and empty. Shippers' personnel are also required to closely monitor this aspect of railway performance in order to contest resultant charges which are frequently inaccurate. Additionally, railway plans to make up shortfalls in car supply, to the extent that they exist, are largely ineffective.

TRANSIT TIMES:

Compounding the difficulties of managing inadequate and untimely car supply is the substantial inconsistency in the amount of time required to transport goods to destination. The CNR bulk/grain transit times take between 73 hours and 130 hours for a 1,030 mile haul with merchandize traffic taking as little as 76 hours and as much as 159 hours for a 1,078 mile haul (QGI pg.90, fig. 48). CP trains can take as little as 69 hours or as many as 142 hours for an 877 mile haul for bulk/grain and as little as 85 hours and as many as 194 hours(8 days) for a 754 mile haul of merchandise traffic (QGI pg.104 fig. 62). Notwithstanding the inordinately long maximum transit times, the most frustrating aspect of this performance for shippers is the unpredictability which plays havoc with logistical plans and customer "want" dates.

It is the shipper who bears the brunt of this erratic performance and as previously noted, ocean bound freight is subject to costly charges for vessel demurrage. With delivery times for inland traffic nearly impossible to predict, some larger shippers who are well

enough resourced have been forced into the added expense of leasing or constructing storage facilities nearer to customer locations in order to help assure inventory delivery within a reasonable and predictable time period. The added cost of such arrangements marks another hurdle in shippers' efforts to remain competitive. For those trying to match a competitor's ability to provide just-in-time delivery, the disadvantage is profound and they are usually unable to compete for that business.

Absent effective competition the car supply and transit time figures may not be surprising however there are legislative provisions in place to help assure appropriate service to shippers. The efficacy of the shipper protection measures in the Canada Transportation Act (CTA) must be examined in the wake of the degree of shipper dissatisfaction recorded in the NRG survey and supported by the data in the QGI report.

LEGISLATION:

The CTA requires both CN Rail and CP, among other things, to provide adequate and suitable accommodation for the handling of:

all traffic offered for carriage on the railway; (emphasis added)

and

without delay, and with due care and diligence, receive, carry and deliver the traffic (Canada Transportation Act Division IV Section 113(1)).

While the Act is explicit in setting out the obligations federal rail carriers have to shippers; it is less so in establishing what will occur in the event of a failure to fulfill those obligations. Instead, the free market system is expected to provide sufficient motivation for carriers to perform adequately as is evidenced by our National Transportation Policy which (in part) states:

competition and market forces, both within and among the various modes of transportation, are the prime agents in providing viable and effective transportation services (Canada Transportation Act, National Transportation Policy Section 5(a)).

Difficulty arises when there is no “competition” and “market forces” are in reality market dominance by rail carriers which represent the only option for shippers whose products are rail dependant.

MARKET DOMINANCE:

Raymond James Financial Inc. is a typical investment firm which provides detailed market research into the financial health, past, present and future of various business sectors in order to make recommendations to clients as to potential investment value. In May of 2009, they published such an analysis of Canadian railways (please see Appendix 2). In part, this is what they had to say:

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.

One of the attributes of an attractive investment is the ability of that company to control its costs. WCSC members have experienced the impacts of this strategy. By minimizing the amount of power and number of cars in operation CN and CP derive a dual benefit: operating costs are minimized; and demand is enhanced even in down markets because of equipment shortages. And without another carrier competing for shippers there is no impetus for CN and CP to put any focus on customer satisfaction and consequently there is no impediment to the type of service levels that adversely affect all Canadian commodity producers who ship by rail.

THE AGENCY:

Legislators were aware of the inherent market dominance of CN and CP when they passed the Canada Transportation Act (CTA). In an effort to temper the railways' monopoly position, the Act empowered the Canadian Transportation Agency (the Agency) with specific authority over rail freight service issues.

Section 113 of the CTA is clear in terms of the service levels required of carriers. Enforcement of the provisions of section 113 is assigned to the Agency and provided under section 116(1):

On receipt of a complaint made by any person that a railway company is not fulfilling any of its service obligations, the Agency shall

- (a) conduct, as expeditiously as possible, an investigation of the complaint that, in its opinion, is warranted; and*
- (b) within one hundred and twenty days after receipt of the complaint, determine whether the company is fulfilling that obligation.*

Considerable authority to act on their findings is granted the Agency under section 116(4):

If the Agency determines that a company is not fulfilling any of its service obligations, the Agency may

(a) order that

(i) specific works be constructed or carried out,

(ii) property be acquired,

(iii) cars, motive power or other equipment be allotted, distributed, used or moved as specified by the Agency, or

(iv) any specified steps, systems or methods be taken or followed by the company;

(b) specify in the order the maximum charges that may be made by the company in respect of the matter so ordered;

(c) order the company to fulfil that obligation in any manner and within any time or during any period that the Agency deems expedient, having regard to all proper interests, and specify the particulars of the obligation to be fulfilled;

(d) if the service obligation is in respect of a grain-dependent branch line listed in Schedule I, order the company to add to the plan it is required to prepare under subsection 141(1) an indication that it intends to take steps to discontinue operating the line; or

(e) if the service obligation is in respect of a grain-dependent branch line listed in Schedule I, order the company, on the terms and conditions that the Agency considers appropriate, to grant to another railway company the right

(i) to run and operate its trains over and on any portion of the line, and

(ii) in so far as necessary to provide service to the line, to run and operate its trains over and on any portion of any other portion of the railway of the company against which the order is made but not to solicit traffic on that railway, to take possession of, use or occupy any land belonging to that company and to use the whole or any portion of that company's right-of-way, tracks, terminals, stations or station grounds.

It is reasonable to question why, in the presence of such clear, detailed and succinct legislation shippers tolerate the levels of service identified by the consultants.

The answer lies in part with the railways and their approach to customer dissatisfaction. It is the practice of our national carriers to aggressively defend themselves against both formal and informal shipper complaints. It requires a very determined, well-resourced shipper to succeed in a formal complaint about railway service levels and informal complaints have rarely been effective. Nor is a vigorous defence the only challenge confronting shippers wishing to use of the Level of Service provisions.

The WCSC also believes that part of the problem lies in Agency's interpretation of the current Level of Service provisions contained in the legislation. Over time the notion that a railway company's obligation to provide service is not absolute is generally attributed to a 1959 Supreme Court of Canada Decision. At issue was whether or not the Pacific Great Eastern Railway Company had breached its statutory duty to provide service to a sawmill owned and operated by A.L. Patchett & Sons Ltd. Access to the mill was being prevented by a picket line. The conductors refused to cross the line and Patchett was thereby denied rail service. The decision turned on whether the mill owner or the railway was responsible for obtaining an injunction against the picketers. In finding for the railway, Mr. Justice Rand, for the majority cautioned:

It should not be necessary, but to prevent any misconception of implication from these reasons, I add this: the only question dealt with is the duty of the railway toward the company in the precise situation presented. As between these parties, on whom did the responsibility lie to take the initiative against the de facto obstruction to the ordinary operation of the company's private siding? (emphasis added)

In his reasons for supporting the majority decision the Honourable Justice stated:

...a railway, for example, is not bound to furnish cars at all times sufficient to meet all demands; its financial necessities are of the first order of concern and play an essential part in its operation, bound up, as they are, with its obligation to give transportation for reasonable charges. Individuals have placed their capital at the risk of the operations; they cannot be compelled to bankrupt themselves by doing more than what they have embraced within their public profession, a reasonable service. Saving any express or special statutory obligation, that characteristic extends to the carrier's entire activity. Under that scope of duty a carrier subject to the Act is placed.

The Patchett case was decided in a different regulatory environment and in different economic times. The rational underpinning this kind of thinking is no longer applicable. Regrettably, the Agency continues to apply "Patchett" without regard for the admonition

from Justice Rand himself, that the facts were unique to that case. This has resulted in the setting of service requirements that have no relationship to shippers' needs in today's marketplace.

The notion that railway operations take precedence over those of producers must be reconsidered. The efficacy of the rail freight network is better served when its components experience equal market power, with no aspect holding dominance over another. The railway monopoly position has resulted in erratic transit times and inadequate car supply. It has also lead to some unfortunate behaviour with which too many shippers are familiar.

CUSTOMER RELATIONS:

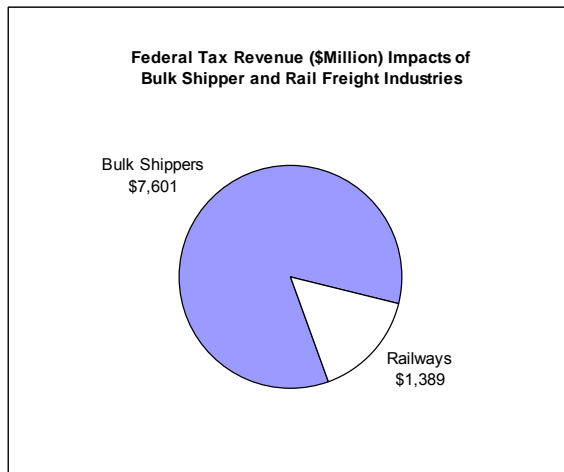
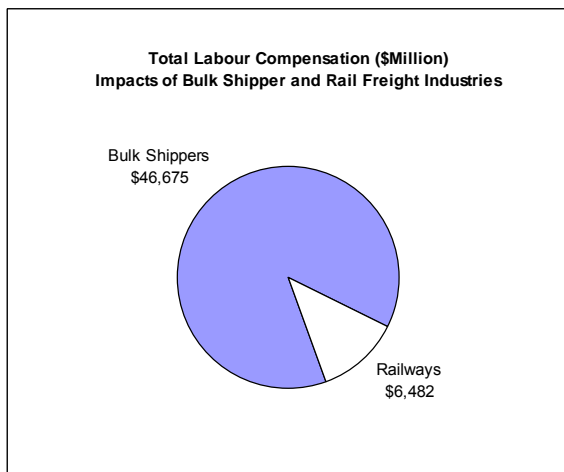
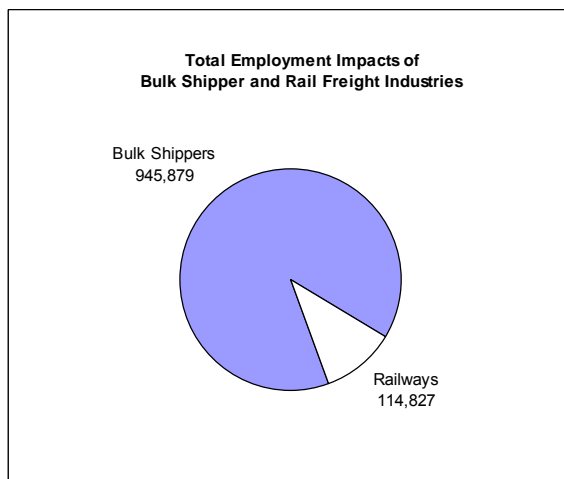
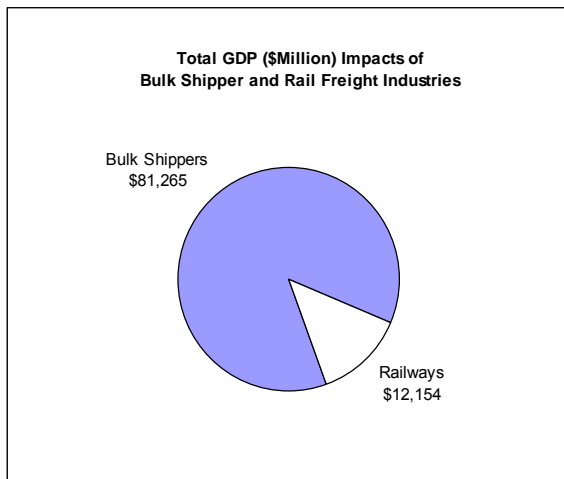
It is common for shippers seeking answers to questions about care arrivals, billings and other logistical matters to wait inordinately for a response or be disregarded altogether. And poor treatment of railway customers by carriers is not confined to refusals to return phone calls. Intimidation is a significant issue that has touched many shippers. Larger, more sophisticated and better-resources companies tend to shrug off such tactics, but for smaller operations it can be a very serious issue. One such operator said: "My biggest fear is that the train will just keep on going without stopping. They've done it before." Page 53 of the "SURVEY OF SHIPPERS" prepared by the NRG Research Group notes that 20% of shippers who considered launching a formal complaint dropped the idea because of concerns about possible retaliation by the rail carrier and 22% who had actually initiated proceedings dropped them for the same reason.

IMPACTS:

Canada is a trading nation whose positive trade balance and economic well-being depend largely upon the health of its commodity exports (the majority of which are rail-dependant). This raises the question: Is the impact of the market dominance identified in the Raymond James report confined to the corporate world, or does it have broader impacts and thereby become a matter of concern to a larger group? Recent federal, provincial and municipal investments in freight transportation infrastructure serving our West Coast Asian Gateway enhance the public's stake in the relationship between

shippers and rail carriers. A comparison of the potential downstream impacts of railways and shippers on key economic indicators may help to quantify the potential extent of the problem. Typically, Gross Domestic Product (GDP), Employment, Compensation from Employment and Federal Tax Revenue are considered relevant categories when considering the societal benefits that flow from industry.

In September of 2009, professors Peter Dungan and Steven Murphy at the University of Toronto produced a report (see attachment) comparing the contribution to the national economy of Canada's railways with that of four key bulk shipping industries: Oilseed & Grain Farming; Coal Mining; Wood Products Manufacturing; and Pulp & Paper and Paper Products Manufacturing. The results are summarized in the following charts.



In terms of contribution to Canada's Gross Domestic Product, the industries listed exceeded the impact of railways by nearly a 7:1 ratio. In total employment the ratio is 8:1; for labour compensation the ratio is 7:1 and for federal taxes paid, the ratio is 5:1. Bearing in mind that these industries only account for a portion of the bulk commodities shipped and the railway numbers are inclusive of all traffic carried, the national ratios will be much greater yet.

We are not suggesting that there is a linear relationship between CN/CP service levels and the national economy, but it is useful to note that the impact of inadequate service levels may have collateral effects that extend beyond the rail freight shipping community.

REMEDIES:

LEVEL OF SERVICE REMEDY

We believe that in order for the level of service provisions to be as effective as the legislature intended, change is necessary. There is a body of precedents that have combined to dilute the efficacy of the current level of service provisions (referenced earlier). Perhaps the most noteworthy is Decision 488-R-2008 where, in an attempt to quantify the meaning of "adequate and suitable" (CTA - 113(1)), the Agency ruled that:

[122] The evidence shows that some car orders requested on a weekly basis were confirmed at rates below 60 percent. The Agency finds that this is not a reasonable level of performance and this is consistent with its previous findings. Having determined that 100 percent may be unachievable and 60 percent is unacceptable, the Agency finds that confirmation of at least 80 percent of the cars requested is an acceptable and reasonable level of service standard. Setting a minimum level of 80 percent will increase the predictability of car confirmations, which will allow shippers to plan their operations accordingly.

One wonders how the Agency would find the planning of their operations if it had to endure a 20% absenteeism rate from employees.

It is not reasonable to expect any operation to function competitively when vital transportation fails to arrive one in five times. Nor is it the norm for any other mode of transportation to function as unpredictably as Canada's rail freight system. Imagine the chaos at airports if passenger planes arrived and departed with the same inconsistency as rail freight cars. And how long would any airline survive the erratic transit times of a CN or CP?

Shippers have the right to expect 100% of the cars they order to be provided. They also have a legitimate expectation that their goods will arrive at destination in a predictable and consistent fashion. This should be the standard. It is particularly true for facilities that are completely captive to one carrier. In the absence of transportation that accommodates all that they produce, there is no option other than the curtailment of operations. During occurrences of force majeure and operational delays, 100% may not be achievable. Following such a circumstance, it is incumbent on the carrier to provide an incremental increase in service within a window that ensures no harm to the shipper in terms of destination requirements. For example, after a period when a shipper receives no cars the carrier should then provide cars sufficient that the original shipper demand is met. In such a case, the level of service must be adequate to restore the original shipment within the period required at the destination and that subsequent shipments do not suffer consequent delays. Where there is a failure by the carrier to meet this service standard, the Agency should be empowered to invoke any of the actions granted it under section 116 of the CTA.

EXPARTE ORDERS

Up until 1996, the Agency was explicitly empowered to make ex parte orders to provide immediate relief when shippers requested it in a level of service complaint. This explicit power was taken away in the 1996 legislation. WCSC submits that an explicit power of the Agency to grant ex parte orders should be restored.

Although the WCSC understands that the Agency does attempt to expedite level of service matters, it is of utmost importance to shippers, particularly in situations where poor service is an critical issue or where a denial of service has been threatened, to be

able to obtain immediate relief. This is particularly the case if there is some urgency in requiring the shipments to be picked up or delivered at a certain point. For example, if a ship is waiting to be loaded with our member's commodity and service is not being provided and vessel demurrage costs are an issue, then immediate and emergency relief would be warranted.

We believe that providing the Agency with this relief would also provide shippers with more leverage in their discussions with railways. That is, if after a course of period the railway does not provide the required service, then a shipper may proceed forthwith. Obviously, the Agency will require evidence of the seriousness of the situation and the urgent requirements of the shipper prior to providing relief.

FINAL OFFER ARBITRATION (FOA)

The current FOA provisions have been used by shippers with success. As stated by the CTA Review Panel, the FOA remedy works, albeit at great expense. For the purpose of mitigating that expense for smaller shippers, the following changes are proposed. Currently there is an expedited remedy that allows for FOAs to take place in 30 days in most instances when the amount at issue is under \$750,000.

Notwithstanding this expedited relief, the issues and complexities of FOA remain the same. Part of the purpose of the expedited FOA is to allow for matters that might not be as significant in dollar value to be dealt with more quickly than a non-abbreviated FOA.

The WCSC submits that the expedited FOA provisions should be amended to increase the maximum amount at issue to \$5,000,000. The appropriateness of the expedited process is less a question of the amount in dispute than of the complexity of the matter. The shipper is in the best position to judge the complexity of the issues relating to its traffic. It is also submitted that the 30-day process should be amended to ensure that there is an opportunity to appear before the arbitrator for a hearing and that this hearing is not limited to circumstances where the arbitrator considers submissions or further information necessary. While the expedited process omits the written interrogatory phase, the parties should still have the opportunity not only to make submissions but

also to test each other's evidence through cross-examination. This would ensure the fairness of the expedited process.

PUBLIC INTEREST REMEDY

One of the remedies that did not survive the 1996 changes to the legislation was the Public Interest Test (please see Appendix 3). Briefly stated, the Agency was empowered, acting on a complaint to investigate whether or not the actions of one or more rail carriers was prejudicial to the public interest. The Agency was required to investigate, among other things, "whether the rate, act or omission is such as to permit the carrier to take unfair advantage of a situation in which there is no alternative, effective, adequate and competitive transportation service."

The WCSC believes, for the reasons set out earlier that the Public Interest Test should be restored.

ONGOING SERVICE MONITOR

The report by QGI quantifying rail freight service levels revealed short falls that may even have surprised the carriers. However that data is only a snap shot of an 18 month period in time. It is understandable that under the glare of a review process both CN and CP will commit to improvement, but once that attention subsides, it is questionable as to how long the commitment will endure. WCSC members believe it is critical that ongoing monitoring and open reporting of railway car deployment versus car orders, transit times and recovery times be a legacy of this review. It will be important for the required data to be verifiable and be reported in a very timely manner.

ABROGATION

It is our understanding that during the negotiation of a private contract it is not unusual for a railway to include clauses whereby a shipper must agree not to pursue any action against the railway under the Act. Obviously it would be imprudent for a shipper to sign such a contract, but given the dominant position of rail carriers, many do. WCSC members believe that making this practice an offense would help as a deterrent.

CONCLUSION:

The Rail Freight Service Review has, through the work of the consultants and using railway data, quantified levels of service that are unacceptable. This poor performance has produced a number of negative impacts on the entire rail freight network. There doesn't seem to be any doubt that the railways can do better. In fact both CN and CP have insisted recently that they are doing better. The question is, if so, for how long? Without a change in the dynamic between shippers and our national carriers, it is difficult to imagine any permanent improvement. The Rail Freight Service Review offers an opportunity to provide much-needed balance in the relationship between railways and the rest of the rail freight network. WCSC members believe the recommendations contained in this submission will lead to that balance.

APPENDIX 1

WESTERN CANADIAN SHIPPERS' COALITION MEMBERSHIP LIST

Alberta Newsprint Company
Alpac Forest Products Inc.
Canadian Forest Products Inc.
Canadian Oilseed Processors Association
Carrier Lumber Ltd.
Coal Valley Resources Inc.
Canadian Wheat Board
Dunkley Lumber Ltd.
Lehigh Cement Ltd.
Marsulex Inc.
Millar Western Forest Products
Sherritt International Inc.
Sinclar Enterprises Ltd.
Sultran Ltd.
Teck Resources Ltd.
Tolko Industries
Western Coal Corporation
West Fraser Mills Ltd.
Wood Pellet Association of Canada

The WCSC was founded in 1995 in an effort to provide western resource-based shippers with a voice in Ottawa on the subject of rail freight transportation.

APPENDIX 2

The Canadian Railroads

Initiating Coverage: Hauling Less, Charging More—
On Track to Mitigate the Pain (excerpt)



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Attractive Industry Attributes—On Track to Mitigate the Pain

Notwithstanding the admittedly grim macro picture, not all is lost, in our view.

Specifically, we believe that several unique aspects about the Canadian rail sector will help mitigate the pain associated with the current downturn.

Specifically, we point toward the sector's: (i) 'gold - plated' pricing power; (ii) demonstrable productivity improvements; (iii) market share gains versus trucking; and (iv) depressed trading multiples near cyclical lows. Finally, while not necessarily industry specific, lower fuel costs and a weaker y - o - y Canadian dollar are also expected to provide substantial cost relief throughout our forecast horizon.

i) 'Gold - Plated' Pricing Power—All the Key Elements

Pricing power will be the most important variable that helps the railroad sector mitigate the pain, in our view. While lower y - o - y freight volumes appear to be a forgone conclusion, both CN and CP expect core pricing to actually *improve* in 2009, having already locked - in the bulk of their negotiated rates for the year. Investors might question the resilience of this pricing given how rapidly the economy has eroded, however, based upon 1Q09 results and our discussion with several customers, it appears that both operators are indeed maintaining a disciplined pricing strategy and higher rates are holding. Specifically, CP expects core pricing to improve by 3.0% to 5.0% in 2009, with approximately 80% of its contracts already negotiated (i.e. locked - in). Similarly, CN anticipates pricing will improve by 4.0% to 5.0% with approximately 70% of rates already locked - in as of 1Q09. Management teams generally expect similar gains in 2010, although we are inclined to believe gains will be capped toward the lower end of the range. Underpinning the rail's enviable pricing power are three key elements, in our view, namely: an attractive competitive environment, limited network capacity (with steep barriers to entry), and most importantly, disciplined pricing behaviour.

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. 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.

Limited Network Capacity

The evolution of limited network capacity is the second element supporting long-term pricing power, in our view. Prior to 1980, the U.S. rail industry was considered to be on the brink of ruin, plagued by government regulation that limited free market pricing and deterred consolidation. As a consequence, the sector was often characterized by intense competition, dismal returns on capital, and frequent bankruptcies. The *Staggers Act* of 1980 fundamentally changed this paradigm, by deregulating the sector and helping facilitate a long - overdue consolidation period. In a similar vein, the *National Transportation Act (1987)* and

the *Canadian Transportation Act (1996)* are largely credited with deregulating the Canadian railroad industry. Subsequent to these key pieces of legislation, the railroad sector on both sides of the border underwent a dramatic rationalization process that saw dozens of operators get swallowed up and thousands of track miles—at the time deemed overcapacity—ripped out of the system in order to improve efficiencies and the broader competitive environment. The operating and financial implications of this post - deregulation transformation have been significant. In the most recent economic upturn, several Class I railroads even found themselves operating near (or at) current capacity, limited by network bottlenecks (often urban) that resulted in congestion and reduced operating efficiencies. As a result, many operators were reportedly forced to shed lower margin work in order to free up capacity and/or increase network productivity (by reducing congestion). We also note that the sector is finally earning its cost of capital after decades of sub - par financial returns. Capacity constraints are admittedly not relevant in the current freight environment. In fact, both CN and CP have recently moved to store hundreds of locomotives and thousands of railcars in order to balance their supply with (evaporating) demand. However, as the economy stabilizes and traffic begins to re - accelerate, we foresee the return of higher utilization (limited capacity) as a key pillar behind the sector's long - term pricing power.

Longer - term, we also highlight the mammoth investment required to modernize N.A. rail infrastructure as supportive for long - term, unfettered pricing power. According to a study by Cambridge Systematics, the seven leading Class I railroads will need to invest \$135 bln in growth capital in the U.S. through 2035 in order to meet the U.S. Department of Transportation's long - term demand forecast. While sizeable in of itself, we note that this projection is specific to the growth capital required (to prevent massive network congestion), and does not account for the hundreds of billions that would also be required for maintenance capex. Accordingly, we believe an investment of this magnitude will help mitigate calls for government to re - regulate railroad pricing and

supports the view that rail operators will be blessed with tremendous long - term pricing power.

Disciplined Pricing Behaviour

Lastly, disciplined pricing behaviour is the third and most important variable underpinning the sector's pricing power, in our view. It is often said that the best lessons are the hardest learned; fortunately, the sector appears to have learned from past mistakes (i.e. price wars) that destroyed industry returns on capital and yielded no clear winner(s). As a result, management teams at both CN and CP (and other N.A. Class I operators) seem resolute in their commitment to avoid a repeat scenario, and now appear willing to trade lower volumes for higher prices. Looking back, pricing power has been on prominent display in recent years. Driven by the global thirst for commodities, burgeoning trade flow, and the sector's relatively tight capacity, N.A. rail operators have ratcheted up prices every year since 2003. Illustrating this trend, we note that CN and CP's average revenue per carload grew by a respective 4.0% and 5.6% per year (5 year CAGR) between 2003 and 2008. Similarly, both companies' respective yield (revenue per RTM) increased by 4.7% over the same period.

APPENDIX 3

National Transportation Act, 1987

- 59.** (1) The public interest referred to in
This section and in section 61 shall include the relevant matters required to be considered under section 60.
- (2) Where a person or organization has reason to believe
- (a) that the effect of any rate established by a carrier or carriers, or
 - (b) that any act or omission of a carrier, or of any two or more carriers, may prejudicially affect the public interest in respect of rates for, or conditions of, the carriage of goods within, into or from Canada, the person may request the Agency to investigate the rate, act or omission and the Agency shall make such investigation of the rate, act or omission and the effect thereof as in its opinion is warranted.
- (3) Where the Agency has, pursuant to section 48, received a submission for a final offer arbitration in respect of any matter and acted in accordance with paragraph 49(3)(b), the Agency shall be deemed to have received a request to investigate the matter under subsection (2).
- (4) Where, at any time after a person has requested an investigation, the person by notice to the Agency withdraws the request, the Agency shall forthwith discontinue the investigation.
- 60.** The Agency shall, in conducting an investigation under section 59, have regard to all considerations that appear to it to be relevant to the matter, including, without limiting the generality of the foregoing, such of the following factors as pertain to the request for the investigation:
- (a) whether the rates or conditions specified for the carriage of goods are such as to create
 - (i) an unfair disadvantage beyond any disadvantage that may be deemed to be inherent in the location or volume of the goods, the scale of operation connected therewith or the type of goods or service involved, or
 - (ii) an undue obstacle to the interchange of commodities between points in Canada or an unreasonable discouragement to the development of primary or secondary industries or to export trade in or from any region of Canada or to the movement of the commodities through Canadian ports;
 - (b) whether control by the carrier of, or the interest of the carrier in, another form of transportation service or any other business, or control of the carrier by, or the interest in the carrier of, a company or person engaged in another form of transportation

service or any other business is involved and is creating or contributing to the unfair disadvantage referred to in paragraph (a);

- (c) whether the rate, act or omission is such as to permit the carrier to take unfair advantage of a situation in which there is no alternative, effective, adequate and competitive transportation service; and
- (d) whether an existing confidential contract with another shipper for transportation of a substantially similar product under substantially similar conditions creates an unfair disadvantage by providing a lower freight rate or better shipping conditions that cannot be justified by any cost or efficiency factor.

61. (1) If the Agency, after the investigation, finds that the rate, act or omission in respect of which the investigation is made is prejudicial to the public interest, the Agency may, by order, having regard to sections 112 and 113, require the carrier to remove the prejudicial feature in the relevant rates or conditions specified for the carriage of goods or make such other order as in the circumstances it may consider proper.

(2) The Agency shall not under subsection (1) revise any rate, term or condition contained in a confidential contract.

62. (1) In conducting an investigation under section 59, the Agency may either hold public hearings or decide the matter on the basis of documents filed with the Agency.

(2) In conducting that investigation, the Agency may take into consideration the contents of any confidential contract that has been filed with or provided to the Agency without disclosing the contents of the contract.

(3) Where a rate charged to a shipper by a carrier is disallowed or varied pursuant to section 61, the carrier shall refund to the shipper an amount equal to the overcharges, plus interest at a rate specified by the Agency, from the date the shipper's request for an investigation was received by the Agency to the date of the refund payment.

(4) The Agency shall render its decision on an investigation under section 59 not later than one hundred and twenty days after the Agency receives the request for the investigation unless the parties agree to an extension.

63. A shipper who has requested an investigation of a matter under section 59 is not entitled to submit the matter to the Agency for a final offer arbitration under section 48.