Western Canadian Wheat Growers Association

Submission to the Canada Transportation Act Review

June 30, 2015

The Wheat Growers welcome this opportunity to provide the following comments with respect to the review of the *Canada Transportation Act.*

Introduction

This submission will be divided into five parts. First we will comment on the National Transportation Policy encapsulated in the current *Act.* We will then address the Order-in-Council that was issued in March 2014 to deal with the grain shipping crisis that occurred in the 2013-14 crop year. In part 3.0 we will provide our views on measures needed to improve rail service. In part 4.0 we will put forward measures that will lead to greater investment in rail shipping capacity. In part 5.0, we will propose measures that increase competition in the rail sector. We will conclude by summarizing our recommendations.

1.0 National Transportation Policy

The Wheat Growers are strong advocates of open and competitive markets. In all instances, a competitive marketplace is the preferred market structure, as it helps to ensure customers are well-served.

The Wheat Growers are pleased to see this view expressed in our National Transportation Policy as set out in section 5 of the Canada Transportation Act:

1.1 National Transportation Policy

5. It is declared that a competitive, economic and efficient national transportation system that meets the highest practicable safety and security standards and contributes to a sustainable environment and makes the best use of all modes of transportation at the lowest total cost is essential to serve the needs of its users, advance the well-being of Canadians and enable competitiveness and economic growth in both urban and rural areas throughout Canada. Those objectives are most likely to be achieved when

> *(*a*) competition and market forces, both within and among the various modes of transportation, are the prime agents in providing viable and effective transportation services;*
>
> *(*b*) regulation and strategic public intervention are used to achieve economic, safety, security, environmental or social outcomes that cannot be achieved satisfactorily by competition and market forces and do not unduly favour, or reduce the inherent advantages of, any particular mode of transportation;*
>
> *(*c*) rates and conditions do not constitute an undue obstacle to the movement of traffic within Canada or to the export of goods from Canada;*

(d) the transportation system is accessible without undue obstacle to the mobility of persons, including persons with disabilities; and

(e) governments and the private sector work together for an integrated transportation system.

The Wheat Growers endorse the above statement of our national transportation policy. In particular, we support the notion that "competition and market forces" are the "prime agents" in providing viable and economic transportation services. As well, we note the national policy indicates that "regulation and strategic public intervention" are to be used when satisfactory outcomes are not achieved through competition and market forces.

1.2 Competitiveness in grain transportation

The Wheat Growers note that we have excellent competition in the grain trucking business. Barriers to entry are relatively low for new trucking entrants, and consequently competition and market forces are the prime agents in providing us with viable and affordable trucking service. Investment in the trucking industry rises relatively quickly to meet increases in market demand. There is no need for government intervention, outside of safety regulations.

While the trucking industry is characterized by many operators, strong competition and adequate and timely investment, this is not the case in the western Canadian rail sector. The vast majority of farmers must ship their grain through elevators that are situated on a CP or CN line, or a shortline that is served by either CP or CN. Of the 326 primary elevators in western Canada, only six are served by both CN and CP. In effect, we have two monopolies operating side-by-side.

The lack of competition, and the resulting underinvestment in grain shipping capacity, has led to several instances of poor railway shipping performance throughout the history of the prairie grain economy.

In our view, introducing competition in the rail sector would be the best means of improving service and investment in grain transportation. However, in the absence of adequate competition, regulatory measures are necessary to prevent the abuse of market power, and to create an operating environment that best approximates the economic outcomes that would occur if a competitive market were in place. This approach – of introducing "regulation and strategic public intervention" to achieve satisfactory outcomes – is consistent with the objectives set out in the National Transportation Policy,

The lack of competition, capacity and accountability in the western Canadina rail sector has led to numerous instances where the grain industry has been poorly served. In times of grain shipping capacity shortfalls, this manifests itself in steep grain price discounts (i.e. high basis levels) to farmers. As a result, farmers end up shouldering the cost of system failures. Estimates vary, however in the 2013-14 crop year, the direct cost borne by farmers for the railways' failure to perform was at least $2 billion, and likely significantly more. This is a loss that will never be recovered.

2.0 Emergency grain shipping action

2.1 Order-in-Council, March 2014

The Wheat Growers strongly supported the action taken by the federal government in March 2014 in issuing an Order-in-Council instructing the railways to each ship a minimum of 500,000 tonnes of grain on a weekly basis. In our view, this measure was necessary to address the huge backlog in grain shipments – in excess of 75,000 railcar orders or more than 7 million tonnes of grain – that existed at the time.

When the Order was issued year-to-date grain shipments were 2% below the pace of the previous year, even though the size of the crop was 34% larger. We realize it was a cold winter, however we note that at the time of the Order, rail shipments of oil were well ahead of the previous year's pace. This demonstrated to us that the railways were deliberately shortchanging grain in order to handle other traffic. It was also indicative of an attitude that there was no urgency to haul grain and that they could simply haul it later. As Hunter Harrison, CEO of Canadian Pacific stated at the time regarding the importance of intermodal shipments: "*Because that's one commodity that we're sensitive to. If you miss, you miss. It's not like grain or it's not like coal, [where] if you're a little bit late you're still going to haul it.*" [1]

In our view, the Order was crucial to address the railways' inability and/or unwillingness to ship satisfactory volumes of grain on a timely basis.

2.2 Bill C-30, *Fair Rail for Grain Farmers Act*

Bill C-30 codified the Order-in-Council and mandated railway grain shipping volumes on a weekly basis, subject to a periodic review to determine whether the mandates remained necessary.

The Wheat Growers recommended the Order be suspended once the grain shipping backlog was substantially reduced and basis levels had returned to normal. We recognized the Order was an extraordinary action, necessary to deal with an emergency situation, and was not intended to be a long-term measure. The Order was lifted at the end of March of this year.

The Wheat Growers recommend that the provision to impose a grain shipping Order remain in place. It is our fervent hope that such a measure is never again necessary, however we believe it is important to keep this safeguard measure in place, in case the railways ever again choose to neglect the interests of the grain sector.

While the Order was absolutely necessary to restore adequate service to the grain sector, we recognize that it was a rather "blunt instrument" in that it stipulated a weekly grain shipping volume for each railway without specifying minimum shipment thresholds by corridor. As a result, shipments to customers in certain corridors (notably the U.S. and eastern millers) were shortchanged. The Wheat Growers recommend that the government have the authority to set minimum thresholds in each corridor, so that all customers receive an acceptable level of service.

[1] *Globe & Mail*, March 12, 2014

In addition, we recommend that any grain shipping Order be expressed in terms of tonne-miles rather than tonnes. Our concern is that expressing the minimum shipping mandate in terms of tonnes, as was the case under Bill C-30, resulted in the railways concentrating initially on short-haul movements, to the detriment of farmers in Saskatchewan and the Peace River district. Establishing a shipping threshold on a tonne-mile basis would reduce the origin bias inherent in a threshold that is based solely on tonnage.

The Wheat Growers also recommend the penalty to be paid by the railways for the failure to meet a weekly minimum shipping mandate be set at a meaningful level. Currently the amount is set at $100,000 per weekly violation, which is a paltry amount when you consider the weekly freight revenue earned by each railway is well in excess of $100 million apiece. The penalty rate should be set at a level that encourages compliance. We recommend $1 million per violation.

As we indicate, our hope is that the federal government will never again have to resort to using such an extraordinary measure, and that other regulatory measures (as we outline below) will be sufficient to ensure our grain shipping needs are met. However our past experience demonstrates the railways cannot be counted upon to adequately serve our interests. Thus, we urge the Review Panel to recommend retaining this safeguard provision in the *Act*, subject to the modifications we are recommending.

3.0 Measures to Improve Rail Service

The current shortcomings in rail service are largely attributable to the lack of balance in the market power of the railways versus grain shippers. Grain shippers in any given area are often captive to a single railway and thus have very little negotiating power.

To date, the existing provisions of the *Act* have not been successful in addressing this imbalance, and as a result, railway performance is failing to meet the needs of grain shippers and the farmers they serve. We propose several measures to improve this level of service:

3.1 Strengthen the level of service provision

The railway service obligations under the *Act* must be strengthened. The requirement for the railways to furnish "adequate and suitable accommodation" for the carriage and delivery of traffic is too vague and weak. The *Act* must make it clear that the responsibility of the railways is to provide rail transportation services that meet the needs of shippers and their customers.

The Wheat Growers recommend that section 115 (2) of the Act be amended to read as follows:

> *115 (2) For the purposes of section 113 and 114, a railway company shall fulfill its service obligations in a manner that meets the rail transportation needs of the shipper.*

In our view, this wording makes it clear that the onus is on the railways to meet the needs of the shipper. Such clarity is needed so as to avoid costly and lengthy legal disputes over what is meant by "adequate and suitable accommodation".

3.2 Allow for the arbitration of penalty provisions in rail service agreements

The arbitration provisions relating to service agreements as delineated in section 169.31 of the *Act* must make it clear that penalty provisions are among those "operational" terms that are subject to arbitration. In our view, service agreements are of little value if shippers are unable to obtain reciprocal penalty provisions. We recommend the *Act* be amended to allow for arbitration of performance standards and the penalties for failing to meet those standards. Specifically, we recommend that section 169.31 (1) (a) be amended to read as follows:

> *169.31 (1) If a shipper and a railway company are unable to agree and enter into a contract under subsection 126(1) respecting the manner in which the railway company must fulfil its service obligations under section 113, the shipper may submit any of the following matters, in writing, to the Agency for arbitration:*
>
> (a*) the operational terms that the railway company must comply with in respect of receiving, loading, carrying, unloading and delivering the traffic, including performance standards***, penalty provisions*** and communication protocols;* [bold emphasis added].

3.3 Extend the service agreement provisions to shortline railways

Shortline railways are also captive to either CN or CP and as such have little negotiating power relating to terms and conditions of service. It is the case too that shortline railways often serve a number of small shippers who lack the resources needed to negotiate satisfactory service agreements with the mainline railway. To address this situation, the Wheat Growers recommend shortlines be given access to the same level of service provisions that are available to shippers situated on mainlines. Specifically, we recommend CN and CP be required to enter into a service agreement with a shortline railway upon request, and that the shortline have access to the arbitration provisions of the *Act* if it is unable to reach a satisfactory agreement with the mainline carrier.

3.4 Ensure the needs of producer car shippers are met

Producer cars represent an important shipping alternative for farmers. While not used frequently (accounting for about 3% of total grain shipments), producer car shipments nevertheless represent a valuable check against excessive basis levels offered by grain companies. Currently the Canadian Grain Commission accepts requests for producer cars by farmers and places these orders with the rail companies.

During the grain transportation crisis in the 2013/14 crop year there were extremely lengthy delays in getting producer car orders filled by the railways. This means farmers were often out of contract in meeting their obligations to customers. Even in the current crop year, producer car shipping orders, most notably on CP lines, were often not filled for several months.

The Wheat Growers are not advocating that producer car shippers receive preferential treatment. We merely ask that if railcar rationing occurs, then the backlog of producer car orders should be comparable to the backlog of car orders placed by other shippers. This ensures all shippers "suffer equally" and that an important competitive alternative (i.e. producer car shipments) is not lost.

The Wheat Growers recommend the Canadian Transportation Agency be empowered to order the railways to take measures to reduce the backlog of producer car orders, should the backlog become excessive relative to the orders of other shippers. In making its determination of any such order, the Wheat Growers recommend the Agency consult with, and receive the advice of the Canadian Grain Commission.

3.5 Extend the rail siding dismantlement provisions to include rural sidings and spurs

Under section 146.2 of the *Act*, there is a requirement for any railway company to maintain a list of any urban sidings and spurs that it plans to dismantle, and to offer that siding or spur to the federal or provincial government, an urban transit authority or a municipality prior to dismantling the siding. Furthermore, a railway company cannot take steps to dismantle this siding or spur until at least 12 months have elapsed since the siding or spur was added to the list.

The Wheat Growers do not understand why this provision only applies to urban sidings and spurs. In our view, the needs of rural shippers are just as important as the needs of urban users. We recommend that section 146.2 be amended such that these dismantlement provisions also apply to rural sidings and spurs. Such a provision will enhance competition by helping to ensure viable rural spurs and sidings remain available for use by producer car shippers, grain dealers and other buyers of grain.

4.0 Measures to increase rail shipping capacity

Most businesses operating in competitive industries would suffer a significant loss of market share and reduced profits if they limited capacity building. CN and CP do not bear such consequences. They operate in an environment where company decisions to shrink capacity (or decisions to ensure capacity does not increase at the same rate as demand growth) leads to improved operating ratios and increased short-term profits. The railways are behaving as if they expect to have no idle capacity at any time throughout the year. However, this is not an acceptable *modus operandi*, given the seasonality of grain and other industries they serve, and given that the economic prosperity of Canada is so dependent on reliable rail service. Canadians do not tolerate shortages of electricity, fuel, water or other vital components of our economy. We should not tolerate shortages of rail capacity.

To increase rail shipping capacity, the Wheat Growers recommend that action be taken in each of the following areas:

4.1 Implement an incentive-based revenue cap

Ultimately, the Wheat Growers would like to see a rail operating environment where no form of rate (or even service) regulation is required. This is the case in the trucking industry and all other markets characterized by good competition. On the other hand, those markets that exhibit a lack of competition are often characterized by poor service and excessive prices. In such markets, "regulation and strategic public intervention" are necessary to provide better outcomes.

Over the long term, the Wheat Growers would like to see competition in the rail sector increase, and expansion in the livestock and processing sector to occur, such that the proportion of our grain production shipped by rail diminishes, and rate regulation is no longer required. Given the trade agreements that Canada has signed (or may enter into), we believe there is good potential for growth in our livestock and processing sectors. We also see the possibility of further rail linkages with BNSF that might enhance rail competition. If these developments occur, then we can see the day when it would no longer be necessary to regulate grain freight rates. However, we recognize that we are likely years, if not decades away from such a happy circumstance.

Consequently, the Wheat Growers support the continuation of the Maximum Revenue Entitlement (MRE) for grain. We consider this "revenue cap" as an important measure to safeguard against price-gouging on the part of the railways. We note that over 70% of western Canadian grain, in raw or processed form, is shipped from the prairies by rail. Given that almost all of this rail traffic is moved by CN and CP, measures must be in place to ensure freight charges are not in excess of rates that would apply in a competitive market.

That said, we believe several improvements can be made in the design of the MRE that would enhance service and encourage greater investment in capacity building. One such improvement would be to modify the MRE so that the railways would have an incentive to add more shipping capacity in the peak post-harvest shipping period.

In February 2014, the Wheat Growers put forward a proposal for an incentive-based revenue cap, which would provide the railways with an incentive to add more surge capacity in the September to January shipping period in those years when there is high demand for rail services, either due to a large crop or heavy customer demand. The purpose of this proposal is to provide the railways with greater incentive to add capacity when we need it the most. This proposal is attached as an Appendix.

4.2 Allow MRE adjustments to be rail-specific for railcar investments

Under the current formula for calculating the MRE, an investment in railcars for the movement of grain by either CN or CP results in an upward adjustment of the revenue cap. However, the adjustment increases the entitlement for ***both*** railways, not just the railway making the investment. This is absurd. A capital investment made by any rail company should benefit that railway and should not result in a windfall gain for a competing railway.

The Wheat Growers recommend the determination of the MRE be amended such that any upward adjustments for grain-related investments in rolling stock are only for the benefit of the railway company making that investment.

As an aside, the Wheat Growers note the railcar grain hopper car fleet is aging, with some cars exceeding 40 years of age. In our view, the responsibility for replacing this fleet (and locomotives) rests entirely with the railways, as part of their level of service obligations.

4.3 Remove container shipments from the MRE calculation

Under the existing MRE rules, any revenue earned by a railway relating to container shipments of grain to port is counted against its MRE cap. Given that container freight rates are much higher than hopper car freight rates (on a per tonne basis), this provision acts as a disincentive for the railways to ship grain by containers. In effect, shipping a high number of grain containers (along routes that are subject to the MRE) causes a railway to reach its revenue cap faster than shipping that grain by hopper car.

The Wheat Growers recommend that container shipments be removed from inclusion in the MRE calculation.

4.4 Review of the MRE

The Wheat Growers recommend that a review be undertaken to assess the overall adequacy of compensation to the railways under the MRE. Our goal is to ensure rail freight rates charged to shippers (and passed through to farmers) are comparable to the rates that would prevail in a competitive marketplace. In our view, the MRE should be set at such a level that provides the railways with a normal rate of return on investment, including adequate compensation to encourage the railways to add capacity to meet future demand.

We note the last review of railway costs and returns in shipping grain was conducted in 1998 as part of the Kroeger review process. It was this review (and the earlier recommendations of Justice Estey) that led to the establishment of the MRE in the 2000-01 crop year. Given that it has been more than 15 years since the MRE cost base was last reviewed, we consider it timely to conduct a review and ask the Review Panel to make that recommendation.

The review should take into account the productivity gains the railways have achieved since 2000-01 and a determination as to how much of these gains should be shared with farmers through a reduction in the revenue cap. Further, the Wheat Growers recommend an independent assessment be undertaken comparing railway returns on grain shipments to returns on the shipment of other bulk commodities (such as potash, coal, oil and forest products). Such an assessment would assist in determining whether the returns the railways earn from shipping grain are at an appropriate level or not.

4.5 Provide the Agency with the authority to increase shipping capacity

The Canadian Transportation Agency should have the authority to “call out” for additional capacity from railway operators (including the 14 grain-related shortlines operating on the prairies) whenever the backlog of shipping orders to CN and CP exceed a predetermined level. In short, we need the ability for other railway operators to add capacity to the network, in the form of locomotives, crews, cars or trains, whenever CN or CP are unable or unwilling to provide adequate shipping capacity.

We note, for example, that OmniTRAX had idle locomotive capacity at the height of the grain transportation crisis in the 2013-14 crop year. If OmniTRAX had been allowed to obtain grain business on the lines of CN rail, it could have leased some railcars and moved grain to Churchill in advance of its shipping season. Allowing for such movement, would have added much-needed system capacity without impairing CN operations. In our view, this is the type of safeguard measure that is needed for those (hopefully rare) occasions when CN and CP do not have adequate capacity to meet our needs.

4.6 Encourage the diversion of petroleum product shipments to pipelines

The Wheat Growers recommend steps be taken to move more petroleum products by pipeline rather than by rail. Shifting more petroleum shipments to pipeline will make more capacity available to haul grain and other commodities which can be moved more safely and economically by rail. While we recognize the regulation of pipelines is not covered by the scope of your review, we urge your Review Panel to recognize the need to reserve as much rail capacity as possible for bulk commodities, such as grain, that cannot move economically over long distances by any other means. As such, we recommend that your report highlight the need for government regulators to expedite the approval of oil pipeline construction.

5.0 Measures to strengthen rail competition

As we stated at the outset, introducing greater competition in the rail sector (indeed, to any marketplace) would be the best means of achieving satisfactory outcomes. While we may not see the entry of a major new rail player anytime soon, we do believe there are measures that can be taken that would help strengthen competition in the grain shipping business. We provide the following recommendations:

5.1 Maintain Interswitching distances at 160 km

Bill C-30 included a provision that extended the railway interswitching distance to 160 km. This provision is due to expire in August 2016 unless it is extended. The Wheat Growers recommend the interswitching limit of 160 km continue and be made a permanent feature of the legislation.

Interswitching allows a shipper to access the lines of a competing railway if it is located on a rail line that is within 160 km of an interchange with a class 1 railway (e.g. CN, CP or BNSF). In our view, interswitching introduces a modest but important element of competition, and we recommend that this provision continue.

We note the effectiveness of this provision is limited by the short length of track at several interchanges. For example, some interchanges can handle car spots of 25 cars or less. These interchanges need to be modernized so as to allow for the interchange of 120 cars or more. The Wheat Growers ask the Review Panel to consider ways in which such improvements can be made, so the full competitive benefits of the interswitching provision can be realized.

5.2 Allow for traffic solicitation rights

The existing running right provisions of the *Act* only permit railway operators to apply for "transit rights" to operate over the lines of another railway. The Agency has ruled that these transit rights do not permit a railway operator to solicit business from shippers on another rail line.

The Wheat Growers recommend the running rights provisions in the *Act* be amended to give railway operators the option to apply for the right to solicit business from shippers in running right applications. As is the case now for transit rights, the Agency would make a determination as to whether granting the traffic solicitation rights would be in the public interest, taking into account how granting the rights might affect the operational efficiency of the mainline carrier.

Allowing railway operators to apply for traffic solicitation rights (in addition to transit rights) would add capacity, improve service and strengthen competition in those cases where CN or CP are not providing adequate capacity or service.

5.3 Encourage more north-south rail linkages

In our view, having improved ability to access the Churchill line or further connections with the BNSF rail network will strengthen competition, and will lead to improved service levels form CN and CP. The threat of being able to "take our business elsewhere" is always superior to regulation as a means of gaining adequate levels of service to meet our needs. The federal and provincial governments should undertake a review of the entire western Canadian rail and road network to determine where new linkages might help improve competition and market access for prairie farmers, and to consider what measures might be taken to facilitate these new linkages.

6.0 Summary

The Wheat Growers have proposed several measures designed to improve railway service, increase rail shipping capacity and strengthen rail competition. In our view, there is no single "silver bullet" that will create a well-functioning grain transportation system. Rather, it is a package of several policy and regulatory measures that together will lead to a more effective and reliable grain transportation system.

We summarize our recommendations as follows:

Grain shipping mandate

- As a safeguard measure, retain the provisions in the *Act* that authorize the federal government to impose a minimum weekly grain shipping Order on CN and CP. The existing provisions should be amended to set minimum grain shipping thresholds by corridor, and to express these thresholds on a tonne-mile basis, rather than a tonnage basis. The Wheat Growers also recommend the penalty for violating the weekly grain shipping Order be set at $1 million per violation.

Recommendations to improve rail service

- Strengthen the level of service provisions to make it clear that the obligation of the railways is to meet the rail transportation needs of shippers.

- Allow for penalty provisions to be an operational term that is subject to arbitration in service agreements between shippers and carriers.

- Extend the level of service provisions, including arbitration, to shortline operators. In effect, this would give shortline operators (who often serve a number of small shippers) the same access to the level of service provisions as shippers located on a mainline.

- Provide the Canadian Transportation Agency with the authority to order the railways to reduce any backlog in producer car rail orders such that the backlog is comparable to the backlog facing other shippers.

- Extend the dismantlement provisions that are now in place for urban sidings and spurs to sidings and spurs in rural areas.

Recommendations to increase rail shipping capacity

- Modify the Maximum Revenue Entitlement (MRE) to provide the railways with an incentive to add more shipping capacity during the peak post-harvest shipping period.

- Amend the MRE formula to ensure that any upward adjustment in the MRE due to a capital investment in rail cars accrues only to the railway making that investment.

- Remove container shipments from the MRE calculation.

- Conduct a review of the MRE cost base, such that the level of compensation provided to the railways is consistent with a normal rate of return on investment, including compensation that encourages the railways to add capacity to meet future demand. An independent assessment of railway returns on shipments of other bulk commodities should be undertaken, to help determine whether the returns the railways earn from shipping grain are at an appropriate level or not.

- Provide the Canadian Transportation Agency with the authority to call out for additional capacity (in the form of locomotives, crews, cars or trains) in instances where CN or CP are unable or unwilling to provide adequate shipping capacity.

- Encourage governments to take steps to expedite the approval of oil pipeline construction so that more rail capacity can be reserved for the shipment of grain and other bulk commodities.

Recommendations to strengthen rail competition

- Maintain interswitching distances at 160 km. Consider ways in which improvements can be made to interchanges so the full competitive advantages of interswitching can be realized.

- If they so choose, allow railway operators the ability to apply for traffic solicitation rights in applications for running rights over the lines of CN or CP.

- Encourage the federal and provincial governments to undertake a study of the entire western Canadian road and rail network to see where new north-south linkages might improve competition and market access for prairie farmers.

The Wheat Growers believe our recommendations are consistent with the objectives set out in the National Transportation Policy and, if adopted, will lead to the evolution of a grain transportation system that better serves the needs of farmers and our customers.

Thank you for your consideration of our views.

Respectfully submitted,

Western Canadian Wheat Growers Association

[Appendix attached]

APPENDIX

Western Canadian Wheat Growers Association

Proposal

Incentive-based revenue cap

February, 2014

Introduction

The Western Canadian grain industry is experiencing an acute grain shipping shortfall during the first six months of the 2013-14 crop year. Railway grain shipments have fallen well short of demand and are roughly on the same pace as the previous year, despite a 34% increase in prairie grain production.

The shipping shortfall has resulted in plugged elevators and a lack of delivery opportunity for many prairie farmers. Even in cases where there is delivery opportunity, the basis (i.e. price discount) to farmers has widened significantly to reflect the limited shipping capacity.

Delays in shipping grain to port has resulted in grain companies paying penalties to ship owners for failing to load grain within contracted terms. The inability to reliably move grain into export position has also led to lost sale opportunities. Even customers within Canada (e.g. feedmills in the Fraser Valley) have experienced shutdowns or near shutdowns due to the lack of timely grain delivery.

The overall result is that farmers have missed out on profitable sale opportunities, and received a lower price for their grain than would be the case if adequate grain shipping capacity had been in place.

The Wheat Growers maintain that immediate measures must be taken by the federal government to address the grain shipping backlog.

Measures must also be taken in the longer term to avoid a recurrence of this severe shortfall in shipping capacity. While we recognize weather conditions during the 2013 growing season led to a record crop, it is the case that the advent of higher yielding varieties and the change in crop mix (i.e. more high volume crops such as corn), together with increased global demand for Canadian grain, all point toward the future need for significantly greater rail shipping capacity.

It is also apparent from the problems we see this year that greater surge capacity is needed in the post-harvest shipping period to meet the demands of the marketplace. The current structure of the grain revenue cap does not provide the railways with an adequate incentive to add shipping capacity during this peak demand period. The purpose of this paper is to address this shortcoming by proposing an incentive-based revenue cap.

Background

Under the Canada Transportation Act, the two main Canadian railways (CN and CP) are subject to a maximum revenue entitlement on shipments of grain and grain products from western Canada. This entitlement is commonly referred to as a revenue cap, although that is somewhat of a misnomer, as the revenue is not "capped", but rather is adjusted to reflect the actual volume of grain shipped. The maximum revenue entitlement for each railway is also adjusted to reflect the average length of haul for grain shipped during the crop year, and inflation (or deflation) in railway input costs.

Grain shipments subject to the revenue cap are those that are destined to west coast ports (Vancouver and Prince Rupert) and those destined to Thunder Bay and Armstrong (a station on the CN line directly north of Thunder Bay, enroute to central and eastern Canada). Rail grain shipments to the United States, to Churchill, beyond Thunder Bay / Armstrong, and to interior points within western Canada (e.g. the Fraser Valley) are not subject to the revenue cap and instead move under commercial freight rates.

The base year for the revenue cap was established in the 2000-01 crop year, following a costing analysis undertaken as part of the Kroeger review. This analysis essentially updated the cost figures calculated under the 1992 costing review, as mandated under the now-repealed Western Grain Transportation Act.

Formula for determining the revenue cap

The formula for determining the maximum revenue entitlement for each railway company is set out in section 151 of the Canada Transportation Act. The formula is as follows:

$$[A/B + ((C - D) \times \$0.022)] \times E \times F$$

where,

A is the company's revenues for the movement of grain in the base year;

B is the number of tonnes of grain involved in the company's movement of grain in the base year;

C is the number of miles of the company's average length of haul for the movement of grain in that crop year as determined by the Agency;

D is the number of miles of the company's average length of haul for the movement of grain in the base year;

E is the number of tonnes of grain involved in the company's movement of grain in the crop year as determined by the Agency; and

F is the volume-related composite price index as determined by the Agency.

The first term in the formula (i.e. A/B) effectively represents the average revenue per tonne (or average "freight rate") that each railway was deemed to earn in the base year. For CN, this was \$27.98 per tonne. For CP it was \$26.12 per tonne. The higher CN rate reflects the fact that the average length of haul for CN was greater in the base year than the average length of haul for CP. CN's average length of haul in the base year (term D in the above formula) was 1,045 miles. CP's average length of haul was 897 miles.

If the actual average length of haul (term C) for either railway in any given crop year happens to be equal to the length of haul in the base year, then the second term in the formula becomes zero (i.e. C – D = 0) and therefore no adjustment is made for the length of haul. If the average length of haul is either above or below the length of haul in the base year, then the revenue per tonne entitlement is adjusted by \$0.022 for every mile the average is above or below the base year. For example, if the average length of haul for CN in any given crop year was 1,055 (i.e. 10 miles above the average in the base year) then the revenue per tonne entitlement (i.e. base freight rate) would be adjusted upward by 22 cents per tonne (i.e. 10 times \$0.022). Similarly, if the average length of haul for CN was 1,035, then the revenue per tonne entitlement would be adjusted downward by 22 cents per tonne.

According to the Canadian Transportation Agency, the average length of haul for shipments by CN under the revenue cap has ranged from 930 to 1,040 miles over the past 13 years. The average length of haul for CP has ranged from 820 to 916 miles.[2]

The next term in the formula, variable E is the actual grain volume shipped by a railway company in a given crop year. In effect, the maximum revenue entitlement formula takes the average revenue per tonne entitlement (as adjusted for average length of haul) and multiplies it by the actual tonnes shipped. Thus, there is no "cap" on absolute revenue. The amount of revenue that each railway is entitled to receive is directly correlated to the volume of grain shipped.

Agency statistics over the past 13 years record that the grain volume shipped by CN under the revenue cap has ranged from a low of 7.3 million tonnes in 2002-03 to a high of 17.1 million tonnes in 2011-12. The grain volume shipped by CP has ranged from 9.1 million tonnes in 2002-03 to 16.4 million tonnes in 2012-13.

The next term in the formula, variable F is the volume-related composite price index (VRCPI). This index is a measure of price inflation (or deflation) of certain railway input costs including labour, fuel, materials and capital. The index was set at 1.0 for the 2000-01 crop year and is adjusted annually in a determination made by the Canadian Transportation Agency. For the 2013-14 crop year, the VRCPI is set at 1.2691. In other words, railway input prices have climbed by 26.91% since 2000-01.

[2] Canadian Transportation Agency. Western grain revenue cap statistics, 2000-01 to 2012-13. http://www.otc-cta.gc.ca/eng/publication/western-grain-revenue-cap-statistics

This means that the average maximum revenue per tonne that CN is allowed to charge in the 2013-14 crop year on statutory grain shipments is $35.51 per tonne (i.e. $27.98 in the base year

times 1.2691), assuming the average length of haul is the same as it was (i.e. 1,045 miles) in the base year. For CP, the average maximum revenue per tonne allowed in 2013-14 is $33.15 per tonne (i.e. $26.12 times 1.2691).

In summary then, the revenue cap calculation for each railway is based on the maximum revenue per tonne entitlement (as adjusted by average length of haul and inflation) multiplied by the actual tonnage shipped by each railway.

Wheat Grower proposal

The Wheat Growers propose an incentive be built into the maximum revenue entitlement to encourage the railways to add extra grain shipping capacity during the peak post-harvest shipping period (i.e. September to January). We propose the revenue entitlement for each railway be adjusted upward if the number of grain cars shipped by the railway during this period exceed a predetermined threshold by a certain percentage. The incentive entitlement could also be designed such that the incentive increases as the amount above threshold increases – in effect, the greater the shipments, the greater the incentive.

For illustration purposes, let's suppose the baseline car shipments is established for a railway company at 5,000 cars per week or 100,000 cars over the 20 weeks in the post-harvest shipping period. If actual shipments were say, 5% above 100,000 cars, then the revenue cap for that railway company would be adjusted upward, by say 1%. If actual shipments were 10% above the baseline threshold, then the revenue cap would be adjusted upward by 2% or perhaps by a higher amount if the decision was made to progressively increase the incentive entitlement.

In effect, we are proposing to amend the maximum revenue entitlement formula as follows:

$$[A/B + ((C - D) \times \$0.022)] \times E \times F \times G$$

where,

G is an incentive-based entitlement if grain shipments during the peak post-harvest shipping period are a certain percentage above a pre-established baseline.

The baseline threshold, the level at which the incentive is to be triggered, and the amount of the incentive are all to be determined. These parameters would be established and set out by regulation after the federal government consults with railways, shippers and farmers.

Some considerations in establishing an incentive-based revenue cap

In determining the appropriate incentive entitlement to incorporate into the formula, some issues need to be addressed. These include:

1) Setting an appropriate threshold base. In our view, the baseline threshold should be set at a level that is considered to be the "normal" level of shipments (in terms of volume of grain or number of cars shipped) in the peak post-harvest shipping period. Perhaps this could be set on the basis of a five or ten year historical average, adjusted upward by trendline increases in grain production or rail shipments. A determination would also have to be made as to the appropriate start and end date of the "peak post-harvest shipping period" so as to establish a suitable baseline threshold for each railway during that period.

2) Determining which shipments should be included in the threshold base. In our view, the threshold base should include grain and grain product shipments to all destinations, whether they are governed by the revenue cap or not. If the incentive entitlement were to be restricted to railcars shipped under the revenue cap, then that would act as a disincentive for railways to ship cars to other destinations, such as the U.S., eastern Canada or within western Canada. In our view, including all shipments as the basis for calculating the incentive entitlement will minimize any market distortions.

3) Determining the amount of the incentive. Depending on where the baseline threshold is set, a determination would have to be made as to when the incentive is triggered, and the level of that incentive entitlement. For example, the incentive may be set at 0% if shipments are less than 5% above normal. This would be considered normal variation. At 5% above threshold, the incentive may be 1%; at 10% it may be 2%, etc. The incentive scale could be linear or increase progressively as the amount of shipments exceeds the base threshold, subject to some overall maximum limit. A decision would also have to be made on the increment levels. In our view, the incentive entitlement should be graduated on fairly fine increments, so there is not a huge difference in entitlement between just hitting or just missing a certain threshold level.

4) Whether a railway company exceeds its threshold, and by how much, depends on whether there are sufficient car orders from grain companies and other shippers. In those years where there is a shortfall in crop production, or slow customer orders, there would be no need to add rail capacity and no incentive would be paid. In effect, variable G would equal 1.0 and there would be no impact on the revenue cap.

5) Consideration was given as to whether the formula should be adjusted downward if rail shipments fall below a certain threshold. While we see the merit in imposing a penalty for poor performance, it is our view that addressing such performance issues are better dealt with through service level agreements that the railways negotiate with shippers. In years where there was a short crop or weak demand, it would not be appropriate to penalize the railways due to a lack of car orders. Moreover, if the objective is to add railway capacity when it is needed most, then our view is that a "carrot" approach is preferable to a "stick".

6) It is recognized that the maximum grain revenue entitlement is determined "after the fact". That is, the maximum revenue cap that each railway is entitled to receive is

determined in the months following the crop year. This is necessary because the actual volume of grain shipped under the revenue cap, and the average length of haul cannot be determined until the crop year is concluded. Similarly, the "incentive entitlement" (variable G) contemplated here will be determined after the crop year is concluded. However, as is the case now, the railways will know precisely how much grain they are shipping on a weekly basis and will have the ability to adjust their freight rates throughout the crop year to take into account any incentive entitlement they may earn. That said, given the ability for the railways to continually assess volumes (and estimate future volumes), the freight rate charged to shippers will likely be reasonably consistent throughout the crop year (or at least not more variable than it is today), even though the revenue per tonne ***earned*** by the railways will be at its highest during the peak shipping period in those years when the extra shipping capacity is needed.

7) In determining the baseline threshold, and in deciding upon the incentive trigger and the incentive rate, the goal is to set these at such a level that the railways will devote greater resources (cars, crews and power) to shipping grain during the peak post-harvest shipping period, and that the benefits to farmers outweigh the added cost. As noted above, the purpose of this incentive-based model is to add shipping capacity if and when it is needed. It is not designed to address specific performance-based issues, which in our view, are better dealt with through penalties, bonuses or other measures negotiated as part of the service level agreements between shippers and railways.

Overall railway compensation under the revenue cap

It should be noted that this proposal is not about increasing the overall compensation to the railways for shipping grain. It ***may*** result in increased compensation to the railways if farmers and shippers determine, through their individual decisions, that they want to ship a larger than normal amount of grain during the peak post-harvest shipping period. If there is a short crop, or if customer demand is not present, or if farmers would prefer to hold on to their grain (for example, if they expect prices to rise) then the incentive-based component of the revenue cap (variable G) would not be triggered.

Admittedly, in years where there is a large crop and/or large customer demand, farmers will end up paying higher overall freight rates than they would under the existing revenue cap. However, the wide basis levels we are experiencing this crop year, the lack of delivery opportunity and the missed sales opportunities are undoubtedly costing farmers a great deal more than would be the case if there was a reasonable incentive for the railways to add capacity when it is needed the most.

A related, but separate issue is whether the compensation now provided to the railways provides an adequate and suitable return to the railways for their investment, and whether compensation on an ongoing basis will be sufficient to encourage the railways to add capacity to meet future demand. As such, the Wheat Growers recommend that a review of the overall adequacy of compensation under the revenue cap be undertaken.

We note that the last review of railway costs and returns in shipping grain was conducted in 1998 as part of the Kroeger review process. It was this review (and the earlier recommendations of Justice Estey) that led to the establishment of the revenue cap in the 2000-01 crop year. In light of the problems experienced this year, we consider it timely to conduct a further review with a view to updating the base numbers if necessary.

The review should take into account the productivity gains the railways have achieved since 2000-01 and a determination as to how much of these gains should be shared with farmers through a reduction in the revenue cap. Further, the Wheat Growers recommend an independent assessment be undertaken comparing railway returns on grain shipments to returns on the shipment of other commodities. Such an assessment would assist in determining whether the revenue the railways earn from shipping grain is at an appropriate level or not.

Summary

In proposing an incentive-based revenue cap, the Wheat Growers are seeking to encourage the railways to add more shipping capacity when it is needed. In many respects, it is an attempt to incorporate some “market signals” into the revenue cap. Long-term, it is our hope that railway competition increases (including expanded linkages with U.S. based railway companies), and that the livestock and processing sector in western Canada expand to such an extent that there is no longer a need for a revenue cap or any other form of railway rate regulation. We recognize such an ideal scenario is likely years if not decades away. In the meantime, the Wheat Growers see an incentive-based revenue cap as the best means to encourage greater investment in railway surge capacity, while ensuring farmers and shippers are charged rates that approximate those that would occur in a competitive rail market.

We recognize that several parameters of this incentive-based revenue cap model need to be negotiated among government, railways, shippers and farmers. At this stage, the Wheat Growers are seeking support for the concept and welcome any suggestions for improvement.

It must be emphasized that this proposal is not about increasing overall railway revenue. It’s about encouraging the railways to dedicate extra resources to shipping grain when the marketplace demands it. The question of whether overall compensation to the railways for shipping grain is adequate to meet future demand is a separate, albeit related, matter. An updated review of costs and returns under the revenue cap is needed to make this assessment.

The Wheat Growers recognize this model is but one of several measures that must be taken to address the shortfall in rail shipping capacity for grain. We contend however that an incentive-based revenue cap will be an important step toward a rail transportation system that better serves the future needs of farmers, shippers and our customers.

Western Canadian Wheat Growers Association