

The Hottest Ticket in Town: M&A Events in the Rail Industry Today



- Moderator: Heather Devine, CTLA Past President, Alexander Holburn, Toronto, ON
- Speakers:
 - Ian MacKay, Counsel, Conlin Bedard LLP, Ottawa, ON
 - Lucia Stuhldreier, Partner, McMillan, Vancouver, BC
 - Ian Breneman, Associate Counsel, Alexander Holburn, Toronto, ON
 - Toby Nash, Principal, Germer PLLC, Beaumont, TX

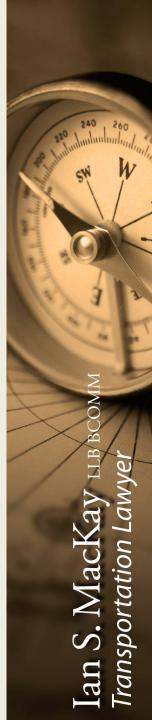




Canadian Transport Lawyers Association 2021 ANNUAL GENERAL MEETING & EDUCATIONAL CONFERENCE October 22, 2021

Railway Mergers, Pricing & the Common Carriage Obligation

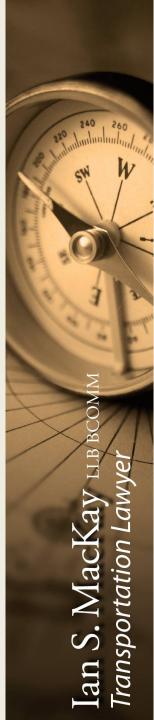
Presented By: Ian S. MacKay, LL.B., B.Comm. Ottawa, Canada



Statutory Level of Service Obligation

- Canada Transportation Act, S.C.1996, c.10, ss.113-116
- Canadian Transportation Agency Decision No. <u>2014-10-</u> <u>03</u> (Louis Dreyfus Commodities Canada Ltd. v. CN)

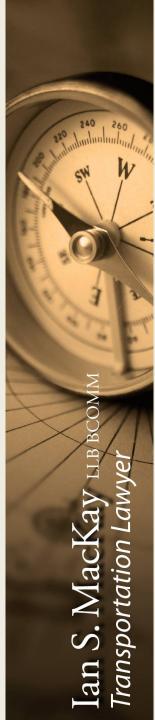
"Railway companies must furnish adequate and suitable accommodation for the carriage, unloading and delivering of traffic that meets the requirements of the shipper, as long as the shipper has properly triggered the level of service obligations. In this regard, the railway company must comply with those obligations unless it demonstrates that it cannot reasonably do so." (Para 34)



Precision Scheduled Railroading

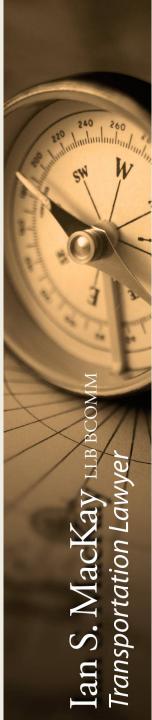
•CN and CP first railways in North America to implement "Precision Scheduled Railroading" (PSR)

- Now practiced by all Class 1 railways except BNSF
- •As marketed to customers, PSR is a way to make the railway more efficient.
- •As marketed to investors, PSR signifies a laserbeam focus on Operating Ratio (O/R), that is cost/revenue



Operating Ratio & CP/KCS Merger

- Investing \$US31Billion requires a strong business case William C. Vantuono, Railway Age Podcast interview with MidRail LLC Chairman Gil Lamphere, May 18, 2021
- End-to-end combination creates new "single-line offerings": Great for railways; of marginal value for shippers.
- Common carriage obligation already requires railways to interchange traffic with one another where they connect



Trends in Railway Pricing

"Our studies show that since 2004 railroad rates have risen by 30 percent in inflation adjusted terms. And traffic peaked on the railroad network – in terms of carloads and tonnages – in 2006. To underscore the point: In the last 15 years since 2006, our economy has grown by more than 50 percent, nearly 8 trillion dollars of enhanced economic activity, and yet railroads are carrying less freight today than they were in 2006 while rates have gone up. There just might be a connection."

Chairman Martin J. Oberman, Surface Transportation Board, Speech to North American Rail Shippers Association Annual Meeting September 8, 2021



Operating Ratio & Pricing

•As a mature industry, most Class 1 railways focus on existing customers to increase revenue rather than market growth

•PSR Railways are focused on high margin traffic (to maintain O/R) not differential pricing

•CN focused on "same store" pricing and "Upscaling Yield" of low margin customers Luc Jobin EVP & Chief Financial Officer May 29, 2015

•"...we're focused on same-store sales and we're focused on the revenue to cost ratio, which is a reverse of that operating ratio, but per unit, per customer." JJ Ruest, CN 2Q 2020 Earnings Call



Post Merger Pricing Questions

•Will high-margin shippers be targeted for bigger rate increases?

•Will low-margin shippers be "yield managed" upward or dropped?

•Is a railway that focuses only on high margin shippers meeting its common carriage obligations?

Ian S. MacKay LLB BCOMM Transportation Lawyer

Thank You

Mr. Ian S. MacKay, LL.B., B.Comm. Barrister & Solicitor 200 Laurier Ave. W., Suite 700 Ottawa, Ontario, Canada K1P 5Z9 email: info@mackaytransportlaw.com Phone: (613) 782-5755 Web: www.mackaytransportlaw.com

Merger Review under the *Canada Transportation Act* s. 53.1 – 53.6

- Applies to proposed transactions that involve a "transportation undertaking"
- No requirement for notice or review unless the transaction triggers the pre-notification requirements under the *Competition Act*
- If those requirements are triggered, simultaneous notices/submissions to Commissioner of Competition and Minister of Transport
- Initial issue for Minister: does the transaction raise "issues with respect to the public interest as it relates to national transportation"?
- If no public interest issues:
 - Notice to the parties within 42 days
 - No further requirements or review under the Canada Transportation Act
 - Competition Act continues to apply

Merger Review under the *Canada Transportation Act* s. 53.1 – 53.6 (continued)

- If Minister determines there are public interest issues,
 - transaction requires cabinet approval
 - bifurcated review (competition/transportation both under the Canada Transportation Act)
 - Minister makes recommendation to cabinet
 - Order in council

Potential lessons from other modes

- Air Canada's proposed acquisition of Air Transat
 - Process took approximately 19 months
 - Commissioner's Report: transaction likely to result in substantial anti-competitive effect
 - Explicitly excluded consideration of efficiencies as not part of the Commissioner's mandate under the CTA
 - Based on Transport Canada's Public Interest Assessment approval granted in February, 2021
 - European Commission did not approve

Potential lessons from other modes

- Minister took a broad approach
 - efficiencies considered on an overall network basis and as one of multiple factors
 - at the same time imposed conditions that may tend to reduce some of those efficiencies:
 - continued head office and increased employee count
 - maintenance contracts in Canada
 - Price monitoring
 - impact of COVID was clearly a concern
 - required some measures intended to remove barriers to entries of potential competitors

How would a major railway merger fare under the transportation merger review provisions?

- No similar public interest consultation has been held in connection with any rail mergers
- The last major public intervention by the Commissioner of Competition was in 2004 (CN acquisition of BC Rail) – before the current review provisions were enacted
 - Consent Agreement went beyond price monitoring and purely temporary measures to preserve *existing* access to competing carriers for connecting movements beyond the BC Rail network
- What happens when there is no *lessening* of competition but the effects on captive shippers are the same (increased rates and reduced service)?

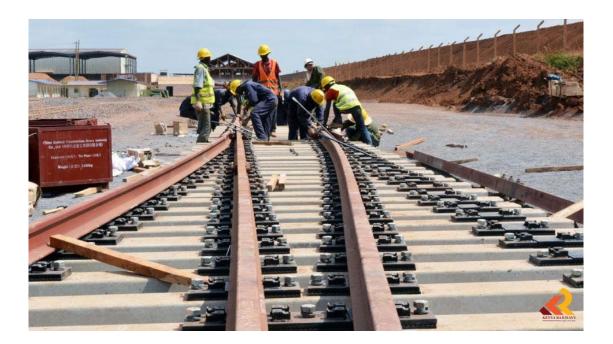


Due Diligence

- Ian Breneman
- Associate Counsel, Alexander Holburn Beaudin + Lang LLP
- Toronto, Ontario

Due Diligence: People

- Collective & employment agreements
- Union grievances
- Pension disputes and liabilities
- Multi-jurisdictional and multidisciplinary issues
- COVID-19 affecting the workplace



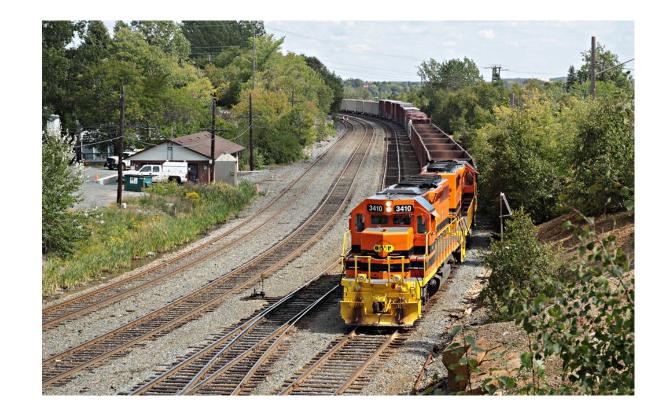
Due Diligence: Infrastructure

- Maintenance
- Construction
- Title and surface issues
- Expropriation and trespass claims
- Security & Cybersecurity



Due Diligence: Rolling Stock and Operations

- Regulatory requirements
- Environmental contamination
- Nuisance
- Sustainability efforts
- Patents



Due Diligence: Carriage Contracts & Obligations

- Regulated service obligations and rates
- Public tariffs and conditions
- Confidential contracts
- Cargo claims
- Contract claims



Due Diligence: Incidents and Claims

- Derailments
- Personal injury claims
- Taxation



The Railroads' Part of The Broken Supply Chain

- The railroads are one of the key cogs in the supply chain that moves goods from overseas factories to American addresses.
- As of October 15, 2021, 62 container vessels were at anchor off the coast of California.
- Congested "pipeline inventory."
- Container shipments temporarily suspended.
- US logistics infrastructure ranked 13th in the world by the World Bank.

Precision Scheduled Railroading (PSR)

PSR is a railroad strategy that uses departure schedules and point-to-point delivery methods to achieve low operating ratios and consolidate railroad networks.



Precision Scheduled Railroading

PROS

- Longer Trains / Higher Capacity
- Increased Speeds
- Increased Margins and Shareholder Value
- Increased Efficiency

CONS

- 25% Reduction in Employment – "Lean and Mean"
 - **Service Complaints**
- Rushed Inspections
 and Maintenance

US Rail Traffic Over the Northern and Southern Borders

- For over 25 years, Canadian train crews have crossed several miles over the border into the US to deliver trains to US rail yards.
- Different Rules for Mexican train crews.
- Protection of American Jobs in Cross-Border Rail Operations With Mexico Act.

POSITIVE TRAIN CONTROL

- Created in 2008 by Rail Safety Improvement Act
- Goal to prevent certain accidents.
- As of December 2020, PTC technology was in operation on all 57,536 required freight and passenger railroad route miles.



Using GPS, PTC evaluates train's W distance from end of authority limits

Warning given if engineer PTC triggers brakes if engineer doesn't slow train doesn't brake to stop short of limits