Letting Market Forces Lead is Best for Canada's Railways and the Economy

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Regulatory interventions since 2008, including the Fair Rail for Grain Farmers Act *of 2014 passed in the wake of a grain transportation crisis, mark a departure from decades of incremental deregulation of Canada's railways, beginning with the* National Transportation Act *of 1967. History has shown how economic regulation that is too restrictive can produce seriously negative results, not only for railways but for the customers and economy they serve.*

Canada has one of the most efficient freight rail systems anywhere. Its railways move more than 70 per cent of all intercity surface goods—worth $250 billion—in Canada each year at low rates, and transport roughly half of the country's exports, by volume.

Enabling the success of Canada's railways is a regulatory regime that prioritizes commercial freedom and reliance on market forces over government intervention—a reality that can be traced back to the *National Transportation Act* (NTA) of 1967.

Before that, railway economic regulation in Canada involved increasingly restrictive regulation focused on freight rate control and uniformity, beginning with the first *Railway Act* in 1851. As regulation grew more controlling over the decades, it became disconnected from the evolving business realities faced by the railways, including competition from an emerging trucking industry. As a result, railways became inefficient and had difficulty undertaking much-needed capital investments to maintain and grow their networks.

In 1961, the MacPherson Royal Commission issued a seminal report proposing a complete dismantling of the then-existing regulatory framework. Recognizing that railways no longer operated as virtual monopolies, the report recommended replacing the existing regulatory restraints with competition. The commission saw this as the best way to achieve the most efficient rail system.

It took until 1967 for legislation reflecting the MacPherson recommendations to be enacted. The *National Transportation Act* (NTA) represented the beginning of a dramatic shift in the regulatory environment for Canada's railways. Rigid constraints on pricing were removed, allowing railways to compete more effectively. A series of subsequent reforms placed an increasing emphasis on market and commercial forces, while maintaining a number of protections to ensure balance between railways and shippers.

Figure 1: Canadian Railways—Revenue Tonne-Kilometres vs. Revenue per RTK

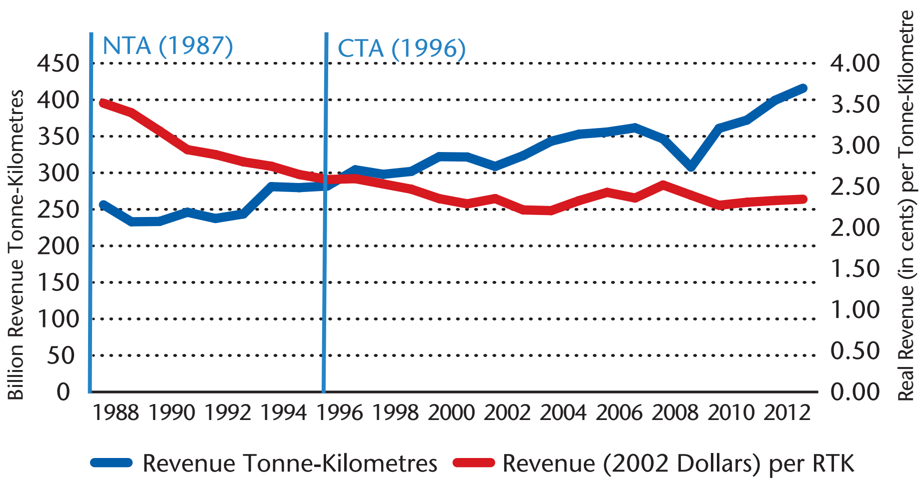
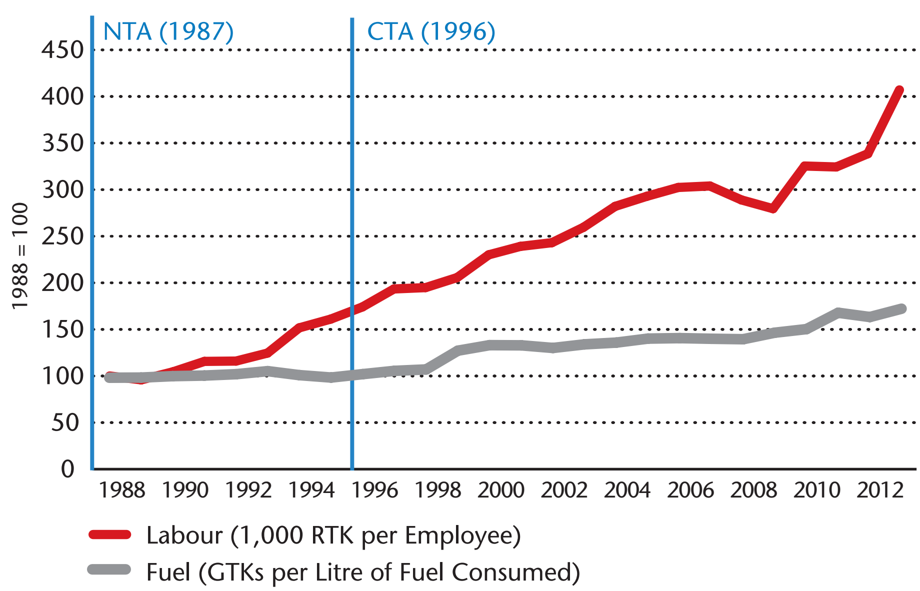


Figure 2: Canadian Railways—Productivity Indices Canadian Operations



Source: Railway Association of Canada

Revisions to the NTA in 1987 further promoted competition, reduced regulatory burdens, and introduced new levers for shippers in their relationship with railways. Railways were permitted to enter into confidential contracts, while mediation and final offer arbitration became available to all shippers. Distances for regulated interswitching—the switching of traffic at regulated rates between a local railway's line and a connecting line-haul carrier's line—were extended to 30 km from four miles. "Competitive Line Rates" designed to further enhance competition, were also introduced.

The passage of the *Canada Transportation Act* (CTA) in 1996 introduced additional changes that reduced market exit barriers, allowing railways to discontinue or transfer portions of their networks to other carriers to become more efficient. This gave railways greater freedom to divest of the uneconomic portions of their networks, control costs and generate greater efficiencies. It also fostered sharp growth in Canada's "shortline" rail industry, which delivers traffic to and from mainline railways, and today originates more than 20 per cent of the Class 1 traffic. Around the same time, CN was privatized, creating competition between two privately held, publicly traded national systems (the other being CP).

During this period, railways evolved into highly productive enterprises capable of providing low-cost service while generating the revenues needed to reinvest into their respective networks. Shippers, meanwhile, gained access to a world-class railway system and lower freight rates.

Regulatory changes since 2008, introduced in the form of Bill C-8 (2008), Bill C-52 (2013) and Bill C-30 (2014), have amounted to the federal government stepping back from the direction initiated with the NTA in 1967.

Bill C-8 expanded the reach of existing shipper remedies by eliminating the test to determine whether a shipper has suffered substantial commercial harm. In addition, the Canadian Transportation Agency's authorities were expanded to include the power to investigate and order changes to ancillary charges.

New measures under Bill C-52 made it obligatory for a railway to offer a confidential service agreement to any shipper that requests one—to stipulate specific performance standards for receiving, loading, carrying, unloading and delivering traffic.

Under Bill C-30, the *Fair Rail for Grain Farmers Act*, passed in May, 2014, the agency now has the authority to specify operational terms in arbitrated service agreements, and must also advise the federal minister of transport on minimum amounts of grain to be moved by the Class 1 railways in a crop year. The legislation also extended the interswitching distance limit to 160 km from 30 km in the Prairies. (Bill C-30's measures are subject to a sunset clause, which can be postponed by Parliament.)

Overall, the effect of the changes since 2008 has been to modify the balance in the railway-shipper relationship to give shippers more powers. Regulation that restricts commercial freedom and intervenes in railway operations unnecessarily can do more harm than good. Regarding Bill C-30, the mandated quotas for grain volumes to be moved by Canada's Class 1 railways favour grain shippers possibly at the expense of other customers, but with no discernable benefit. Meanwhile, the extended interswitching limits significantly increase the rail traffic base subject to fixed regulated rates. Depending on how extensively these are used, they can mean increased costs for railways and transit times for shippers, and may siphon business away from Canadian railways and ports to the United States.

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Experience in both Canada and the United States shows how damaging intensive regulation can be, and how the commercial freedoms adopted in the latter decades of the 20th century have resulted in a revitalized rail industry. For its part, Canadian railway performance—in terms of rates charged, productivity and capital investment—has greatly improved under the regulatory freedoms introduced in 1967, 1987 and 1996.

With pricing freedom, real freight rates have on average declined significantly, dropping by 33 per cent between 1988 and 2013 (Figure 1). Over the same period, labour productivity grew rapidly, reflecting the railways' ability to utilize assets more effectively under a modernized regulatory environment. The industry also improved its fuel efficiency by 2.5 per cent annually between 1996 and 2013 by investing in fleet upgrades and introducing innovative management practices (Figure 2). The Canadian railway industry operating ratio—a key measure of efficiency, where a lower number is better—has been generally under 80 per cent, well below the average prior to 1996 which exceeded 90 per cent.

The railways' improved financial viability since the late 1990s has enabled and encouraged high levels of investment in Canada's freight rail system. Railways are among the most capital-intensive industries. Companies must have sufficient earnings to re-invest in infrastructure, replenish assets, serve traffic growth and promote innovation. Canada's railways have rapidly increased capital expenditures on their Canadian operations since the early 2000s, investing roughly 15 per cent of revenues annually, including $2 billion in both 2011 and 2012.

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There is a demonstrable link between how economic regulation of railways is carried out and the industry's performance. Regulatory reform in favour of commercial and market-based freedoms has proven to be the most effective approach, serving as the catalyst for a resurgent and successful rail industry.

Several measures in recent years have introduced new regulatory restrictions. While it is too early to judge their effect, history has proven how regulation can produce seriously negative results not only for railways but for the customers and economy they serve. In contrast, when regulation has relied primarily on commercial and market forces to direct the industry, Canada's railways and their ability to serve have thrived. P

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