OVERCOMING RAIL INFRASTRUCTURE CAPACITY CONSTRAINTS: Implications for Competition

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A very significant increase in demand for rail transport has arisen over the past several years from the economic revival of China – both a demand for the outbound movement of resource products, especially from western Canada, as well as a demand for the inbound movement of manufactured goods in containers through the west coast of North America. This increase in demand follows a long period in which the railways of North America have rationalized their excess railway infrastructure following the deregulation of the industry in the 1980s and 90s[1].

The combination of the above two developments implies that the freight railways of North America find themselves with the need to increase rail infrastructure capacity significantly in key corridors, to meet the future anticipated demands. This paper outlines the approaches by which CPR is overcoming its rail infrastructure capacity constraints – both through increased direct capital investment, and through co-production agreements with CN and other railways. It also indicates the implications of these developments for rail shippers, and for competition among railways.

[1] CN is perhaps unique in this regard having been in public ownership for so many decades without the pressure or opportunity to rationalize, and now finding itself in the enviable position of having less infrastructure capacity constraints that the other private Class 1 freight railways.

I DIRECT CAPITAL INVESTMENT IN RAIL INFRASTRUCTURE

Following the expectation of regulatory stability implied by the federal government, with the tabling of Bill C-44 amendments to the Canada Transportation Act in March 2005, CPR began a major expansion of its track network in its western corridor extending from the Port of Vancouver to the Prairie region. The expansion completed in the fall of 2005 involved 25 projects:

- 12 projects between the Port of Vancouver and Calgary, and 10 projects between Calgary and Moose Jaw, to extend sidings and lay sections of double track;

- 3 projects between Edmonton and Calgary to extend sidings and build a new siding.

The private investment made by CPR was $75 million in British Columbia, $67 million in Alberta, and $18 million in Saskatchewan and will result in a 12% increase in rail capacity in the western corridor, or more than 400 freight cars per day. This $160 million expansion program was in addition to capital investment of approximately $760 million in 2005 across the CPR system as a whole.

A further potential multi-million capital expansion program is planned for western Canada for the period 2006-2009. The majority of this investment would be concentrated on the CPR mainline between Vancouver and Moose Jaw, and involve siding extensions, new sidings and sections of double track. The impact of such investments would be to accommodate longer trains and to increase the number of trains per day on selected CPR-network segments, and serve the shippers of grain, potash, coal and marine containers.

It should be noted that this rail investment in capacity expansion is increasingly being coordinated with port and terminal partners in Vancouver, as well as with highway authorities in the western

Provinces, all with a view to optimizing the overall surface freight transportation capabilities and to reduce overall costs.

II CO-PRODUCTION WITH OTHER RAILWAYS

Co-production is a form of commercial access in the North American rail industry that has existed for many years. It covers various types of commercially-negotiated agreements between railways to expand rail infrastructure capacity and improve system efficiency without impacting rail labour. Agreements include components such as:

- Directional running: When two railways have parallel routes each being used in both directions, an agreement can be negotiated to run the trains of both railways in one direction on one route and in the other direction on the other route.

- Haulage rights, overhead operating rights, or running rights in Canada; trackage rights in the US: The use of a rail line of one railway by another railway for a fee.

- Rationalization of duplicate, underutilized yard facilities and rationalization of duplicate, underutilized rail lines.

- Reciprocal access to two different bottleneck locations: Such arrangements are also imposed by interswitching regulations in Canada, up to a distance of 20 miles.

- Yard-to-Yard interchange: This involves interchanging traffic within yards rather than at intermediate and more inconvenient locations.

- Reciprocal access over line-haul segments on a corridor: This refers to joint use of segments of line over a given corridor when there is more than one route.

The overall impact of co-production agreements is increased rail infrastructure capacity and improved service to shippers. While the details vary from one agreement to another, each is meant to achieve a combination of purposes related to better service to shipper, including:

- Increased line capacity;
- Elimination of redundant infrastructure or facilities; and,
- Provision for alternative operations at times of accidents or weather incidents.

Commercially negotiated access agreements using co-production have existed in the Canadian and US railway industries for many years. Co-production agreements are also sometimes imposed by the Surface Transportation Board (STB) in the US as a condition of approval of a merger[2]. Examples include trackage rights given to BNSF over the lines of UP as a condition for approval of the UP-SP merger, and the joint service areas accessed by CSX and NS as part of the break-up of Conrail. The following is a list of recent CPR co-production Agreements in Canada and the US.

Fraser Canyon Directional Running Zone

In Canada, one of the most prominent co-production agreements was negotiated between CPR and CN in 2000 that includes the highly successful directional running zone through the Fraser Canyon in British Columbia.

In effect this agreement has created a system of double track for a significant stretch of infrastructure in the interior of BC through which both CPR and CN have single tracked rail. CPR and CN negotiated an arrangement whereby a portion of CN's track would be used along the Fraser Canyon for running both CN and CPR freight traffic headed west to the Port of

[2] The term co-production is not used in the US but the concepts are identical.

Vancouver. In exchange, CPR's track in the same area along the Fraser Canyon is used to transport freight headed east. Essentially, both railways have eliminated the need to accommodate two-way traffic on their single lines in this area of the Fraser Canyon without building new double-track infrastructure that would have added significant cost to the system. As a consequence, this section of combined infrastructure has been able to accommodate an increased number of trains at faster speeds.

Since the agreement was struck, traffic has increased significantly in the interior of BC leading to new capacity constraints on CPR's system. While new capacity is being created by CPR elsewhere in its western corridor, this agreement with CN is an excellent example of railway innovation to maximize capacity in advance of having to add the significant cost associated with building altogether new rail infrastructure.

Georgian Bay Directional Running Zone

More recently, CPR and CN have negotiated a directional running agreement over about 100 miles of parallel CPR and CN track in Ontario between Waterfall, near Sudbury, and Parry Sound. The two railways operate eastbound trains over the CN line and westbound trains over CPR's line, improving network fluidity in this corridor.

Haulage rights, trackage rights and yard rationalization in the US north-east

In June 2004, CPR and Norfolk Southern (NS) reached commercial agreements – components of which were subject to regulatory approval – that permit an exchange of haulage and trackage rights, specifically:

- CPR is able to move NS freight traffic between Rouses Point and Saratoga Springs, NY, under a haulage arrangement. NS

operates its own trains over CPR's line between Saratoga Springs and Binghamton, NY, under a trackage rights arrangement. The arrangements generate higher revenue for CPR and provide NS with a substantially shorter route to Quebec and the Maritime provinces;

- CPR's freight traffic between Binghamton and Buffalo, NY, moves in NS trains under a haulage arrangement, replacing a trackage rights agreement under which CPR operated its own trains between the two cities. The arrangement reduces CPR's operating costs and generates additional revenue for NS;

- CPR operates over a new NS route using existing rail lines between Detroit and Chicago under a trackage rights agreement. It is the shortest rail route between the two cities and provides CPR with a faster, lower-cost lane;

In addition, the agreements will permit yard consolidation and rationalization:

- CPR has ceased yard operations in Buffalo, shifting all freight marshalling to the NS yard there;

- Similarly, NS has shifted its yard operations in Binghamton to CPR's East Binghamton yard.

Extension of haulage and trackage rights in the US north-east

In November 2004, the earlier agreement between CPR and NS was extended to a third-party agreement including CN. Under this agreement, CN-NS traffic destined for the eastern US moves in CPR trains on CPR's line between Rouses Point, NY, and Saratoga Springs, under a freight haulage arrangement between CPR and NS. This CN-NSR traffic then moves in NS trains over CPR's line between Saratoga Springs and the NS connection near Harrisburg, Pa., under a trackage rights agreement between CPR and NS.

The new agreement cuts 330 miles off the earlier routing used by CN and NS, which saw freight traffic handled more circuitously through the Buffalo, NY gateway. The three-party arrangement gives CN and NS a seamless, direct north-south routing over CPR's lines south of Montreal that shortens transit time by as much as two days for some 20,000 annual shipments. It also increases freight traffic density and revenues on CPR's wholly owned subsidiary, the Delaware and Hudson Railway.

Operating and Haulage Rights between Coho, British Columbia and Edmonton, Alberta

On November 12, 2004 CPR and CN negotiated a commercial access agreement in which CN has agreed to grant CPR overhead operating rights over their Ashcroft subdivision between Coho and Kamloops, and to provide haulage of CPR trains over their line from Kamloops to Edmonton.

This slot-sharing arrangement allows CPR to move eight trains a week of bulk commodities over CN's line between Edmonton and Coho, a distance of about 560 miles. Under the arrangement, trains are equipped with CPR locomotives and cars, and operated by CPR crews or CN crews depending upon the line segment. At Coho, CPR trains enter the already-established directional running trackage that sees all westbound trains of both railways move through the Fraser Valley on CN's line and all eastbound trains move on CPR's line.

Haulage Rights between Thunder Bay and Franz, Ontario and associated line rationalization

Again on November 12, 2004 CPR and CN negotiated a haulage arrangement, with CN freight moving over about 300 miles of CPR track in Ontario between Thunder Bay and a junction with CN at Franz using CPR's route north of Lake Superior. This arrangement has also permitted the rationalization of about 200 miles of CN secondary track in Ontario between Thunder Bay and Longlac, but CN maintains transportation service to affected shippers.

Port of Vancouver

In October, 2004 CPR and CN announced a series of co-production agreements to improve rail operations for Port of Vancouver freight traffic. The agreements jointly increase capacity on key sections of track in the Vancouver area to improve the fluidity of rail operations over existing infrastructure. They will improve service to shippers using Canada's largest, busiest and most diversified port. The co-production agreements provide:

- Improved access for CPR to intermodal facilities at Fraser Surrey Docks using a shorter route over CN's main line;

- Reciprocal access to the North and South shores, with CPR potash trains having direct access to Neptune Terminals and CN sulphur trains having direct access to Pacific Coast Terminals;

- The option for CPR to operate longer, heavier trains to Vancouver's North Shore under existing access agreements;

- A reciprocal interchange at CN's Thornton Yard and CPR's Coquitlam Yard; and

- Further interchange enhancements for North Shore freight traffic that include former BC Rail traffic.

The recent agreements at the Port of Vancouver demonstrate the commitment by CPR and CN to provide the level of service and efficiency that will help shippers take advantage of the significant growth in trade with Pacific Rim nations, strengthen Canada's vital import-export economy, and bolster the competitiveness of this key British Columbia port. By working cooperatively to make rail service more efficient, both railways will also improve network and equipment utilization and increase productivity on existing infrastructure.

III IMPLICATIONS OF DIRECT INVESTMENT AND CO-PRODUCTION

Direct capital investment in CPR rail infrastructure enables CPR to serve its existing shippers better and to handle "organic growth" in traffic volumes – "organic growth" represents the increase in volumes of existing CPR shippers, and is the result of the success of such shippers in their markets and not simply a redistribution of market share between competing railways. As such there are no competition concerns related to direct investment.

Co-production agreements do not reduce the choice of shippers to alternative rail carriers, nor do they have any impact on the level of competition between the parties to the agreements. Nevertheless, they do represent collaboration among competitors, or what are sometimes referred to as alliances or "strategic alliances", and as such they do need to conform to the Canadian Competition Act and/or the appropriate antitrust legislation in the US.

The balance of this paper will examine competition law as it relates generally to strategic alliances or collaboration among competitors, and demonstrate that competition concerns about railway co-production agreements are unwarranted.

IV CANADIAN COMPETITION LAW RELATING TO STATEGIC ALLIANCES

The current Canadian Competition Act in Part IX identifies what constitutes a Notifiable Transaction – essentially a merger or acquisition of sufficient size – and the requirements for firms or persons to inform the Commissioner and provide information. Co-production agreements between CPR and CN as currently constituted do not meet the requirements for notification, and indeed notification is not provided to the Commissioner.

The authority does however exist for the Commissioner to conduct an inquiry into co-production agreements under very specific

circumstances defined in section 10 of the Act. However, it is considered extremely unlikely that co-production agreements could reasonably be construed as comprising an offence in the long list of relevant offences[3]. It is difficult to imagine, for example, that the Commissioner would consider co-production agreements as a criminal conspiracy between CPR and CN under section 45. The only other remote possibility would be to consider co-production agreements as specialization agreements. However, the Act does not provide the authority to review such agreements unless an application for registration is made by one of the parties, and to date there has never been an application to register a specialization agreement by any party.

Overall, under these circumstances, it is reasonable to assume that co-production agreements as currently constructed, do not raise concerns under the current Act.

Nevertheless, there was uncertainty on the part of some business interests regarding the legality of strategic alliances and, as a consequence, the Director of Investigation and Research issued a policy statement that provided general guidance[4]. Highlights included:

- Most strategic alliances do not raise issues of competition;

- The few that may raise competition issues involve a test of market power – the ability to increase price or reduce output over a sustained period;

[3] Examples of offences related to competition include: criminal conspiracy, bid rigging, false representations, deceptive telemarketing, pyramid selling, unreasonable low pricing to lessen or eliminate competition.

[4] "Strategic Alliances under the Competition Act", Director of Investigation and Research, Competition Act, November 1995.

- Where strategic alliances involve behaviour particularly injurious to competition, an inquiry may be initiated under the conspiracy provision section 45.

This guidance had the effect of lessening the risk that opportunities to create alliances beneficial for the economy might not have been pursued, and was a positive overall development.

However, in a discussion paper issued by the government of Canada in June 2003, proposals were made regarding reform of the criminal conspiracy provision, and the introduction of a new civil strategic alliance provision. The proposals included the following main components:

- An amended criminal provision that would explicitly define clearly egregious anticompetitive agreements;

- A new civil provision for review of agreements among competitors or potential competitors that may substantially lessen competition; and

- A clearance process to provide certainty and predictability to businesses.

The current section 45 of the Act makes it a criminal offence for anyone to conspire, combine, agree or arrange with someone else to unduly lessen competition. The intent of this section is to counter egregious anticompetitive behaviour such as price fixing and market sharing among competitors. Given the serious impact of this anticompetitive behaviour on the economy and, in particular on consumers, it is dealt with in criminal courts and carries sanctions such as fines and imprisonment.

However, because of the complexity of the evidence required in these criminal prosecutions, particularly economic evidence, it is widely recognized that the current provision fails to adequately deter such egregious behaviour. Consultations have revealed that there is

general agreement on the need to modernize the existing conspiracy provisions. However, participants felt that more discussion was required due to the complexity of the issues and the fact that section 45 is one of the cornerstones of the Act.

The 2003 discussion paper proposals for section 45 amendments are not part of current amendments contained in Bill C-19, and not part of the current round of public consultations, but officials have confirmed that they are the subject of further internal consideration by the Competition Bureau and will likely be the subject of further public consultation at an unspecified future date.

Nevertheless, it is of some interest to know how co-production agreements might be viewed under the 2003 proposals for a new civil strategic alliance provision. Since there is no specific definition of what would constitute a civil strategic alliance under the proposed amendments, it is necessary to review the elements as they might apply to co-production[5] .

To cause concern to the Commissioner, a co-production agreement would have to prevent or lessen competition substantially in a market. Evidence may not be based solely on concentration or market share, and relevant factors to be considered include:

- The extent of acceptable substitutes that are available – such as trucking;

- The extent to which effective competition remains;

- The likelihood of the removal of a vigorous and effective competitor;

- Whether there are gains in efficiency benefiting shippers that would not likely be attained absent a co-production agreement;

[5] See the 2003 discussion paper for details of the proposal.

- Any other factor relevant to competition in a market that would be affected by a co-production agreement.

While this list is not comprehensive, a co-production agreement is unlikely to cause concern unless:

1. A shipper has access to fewer rail carriers. This would be unusual, and could be alleviated by the provision of an alternative trucking service and transload facility with comparable pricing and levels of service. This is the situation with the co-production agreement concerning service between Thunder Bay, Longlac and Franz;

2. A shipper's transportation market was subjected to significant operational deterioration. Such situations would be alleviated by leaving pricing unchanged and ensuring comparable transit times;

3. A shipper has a reduction in the level of service as a result of the rationalization of facilities as part of an agreement.

Overall, there is little likelihood that co-production agreements would cause valid concern to Canadian competition authorities under the proposal for a new civil strategic alliances provision as currently drafted.

V US ANTITRUST LAW RELATING TO COLLABORATION AMONG COMPETITORS

Contrary to what is at times implied in the US political arena, the federal antitrust laws also apply to the US railroads and prohibit anti-competitive agreements among railroads to set rates, allocate markets, or otherwise unreasonably restrain trade. However, there are statutory exemptions applicable to the railroads, which are limited and narrowly applied, that exist to avoid dual and potentially conflicting regulation by the STB and the courts or other agencies.

The statutory exemptions are:

- Exemption from antitrust laws for "certain rate" agreements under 49 USC 10706. Currently, these rate agreements relate only to the charges, known as car hire, that railroads pay each other when using the equipment of other railroads. These are not relevant to co-production agreements;

- Exemption from antitrust laws for pooling agreements under 49 USC 11322. Currently, these pooling agreements relate to the central distribution of multilevel rail cars, boxcars, and TTX flatcars. These pooling agreements reduce the incidence of empty backhaul, increases the overall efficiency of rail operations, and do not permit the joint consideration of commercial matters, such as rates or other terms of service. Again, these are not relevant to co-production agreements;

- Lastly, exemption from antitrust laws is provided under 49 USC 11321 for transactions that are approved by the STB. These transactions include mergers, acquisitions, consolidations and combinations applied for under 49 USC 11323. It is this exemption that might have relevance for co-production agreements.

If a co-production agreement were submitted for review as a transaction under 49 USC 11323, then it would be examined by the STB under legislatively prescribed public interest standards, including competitive and market considerations, with the opportunity for full participation of affected parties including the US Department of Justice. The STB must consider among other things, whether the proposed transaction would have an adverse effect on competition among rail carriers, and in order to approve the transaction the STB must find it in the public interest. Overall, Congress has determined that the regulatory agency with substantive expertise and responsibility for implementing national transportation policy is in the best position to evaluate proposed transactions in the railroad industry. The 2001 revisions to the STB regulations

pertaining to transactions, apply only to major transactions and do not apply to co-production.

Overall, while the STB retains exclusive jurisdiction to approve railroad transactions – including trackage rights and joint usage agreements which are the type of transactions related to co-production – and which are subsequently exempt from antitrust laws, nevertheless the STB continues to take into account policies embodied in the antitrust laws together with other public interest factors. It can therefore safely be concluded that any co-production agreements that are approved by the STB under 49 USC 11323 do not pose any competition concerns.

However, there is a provision under 49 USC 10502 that permits the STB to exempt a transaction, if it is of limited scope, without extensive review. This exemption authority allows for transactions to proceed quickly – rather than undergo the lengthy proceeding of a full review – but exemptions do not have immunity from antitrust laws.

According to 49 CFR 1180.2, a transaction is exempt if it is within one of seven categories:

"The STB has found that its prior review and approval of these transactions is not necessary to carry out the rail transportation policy and is of limited scope or unnecessary to protect shippers from market abuse".

Among the seven categories is the acquisition or renewal of trackage rights by a rail carrier over lines owned or operated by another rail carrier, that are based on written agreements, and are not part of a larger reviewable transaction. It is the acquisition of trackage rights that is the basis for many co-production agreements, and this was the basis for the trackage right exemption sought and approved by the STB in the case of the co-production agreement made between CPR and NS referred to in section II above. It should however be emphasized that an applicant can still apply to have a trackage rights

or joint usage agreement fully reviewed and thereby get antitrust immunity.

There is one exception to the above summary – the possibility that a co-production agreement involves haulage rights. Haulage rights differ from trackage rights in that the landlord railroad supplies the locomotive and/or crew. Haulage rights are not reviewed by the STB and therefore by default fall under antitrust laws. Haulage rights are therefore subject to scrutiny by the DOJ under guidelines issued in 2000[6] which state that "collaborations often are not only benign but pro-competitive".

Under the guidelines, co-production agreements involving haulage rights would be analyzed under the rule of reason and would not be agreements challenged as per se illegal – such as price fixing or bid-rigging. The rule of reason focuses on whether the relevant agreement:

"likely harms competition by increasing the ability or incentive profitably to raise price above or reduce output, quality, service, or innovation below what likely would prevail in the absence of the relevant agreement"

The analysis of a relevant agreement begins with an examination of its nature – haulage rights would generally fall under the category of lowering production costs – and if there were competition concerns then a detailed examination would determine whether there were was potential for anticompetitive harm, and subsequently examine the agreement is reasonably necessary to achieve pro-competitive benefits that likely would offset anticompetitive harms.

This US approach mirrors that of the proposed new Canadian civil strategic alliance provision discussed in section IV, and for the same reasoning identified in that section, there is little likelihood that

[6] "Antitrust Guidelines for Collaborations Among Competitors", Issued by the Federal Trade Commission and the US Department of Justice, April 2000.

haulage rights in the US as part of a co-production agreement would cause valid concern to the DOJ. As evidence of this conclusion, no haulage rights have been determined to violate antitrust laws by the DOJ to date.

Overall, it is apparent that co-production agreements between railroads in the US do not warrant competition concerns:

- They would either be extensively reviewed for any anti-competitive effects by the STB and only be approved if they fully met policies embodied in the antitrust laws and were in the public interest; or

- They would be granted an exemption based upon past experience of the STB that such agreements are of limited scope and do not pose a competition concern for shippers; or

- If they involved haulage rights that are not subject to review by the STB, then they would be subject to scrutiny by the DOJ under the DOJ/FTC antitrust guidelines for collaboration among competitors – scrutiny which has not determined that existing haulage rights agreements violate antitrust laws.

VI CONCLUSION

Current developments at CPR to overcome capacity constraints – either through direct capital investment or through co-production agreements with other railways – have positive implications for service to shippers. Furthermore, these developments do not raise valid competition concerns for shippers or the applicable competition authorities in Canada or the US.