What You Need to Know About Interswitching

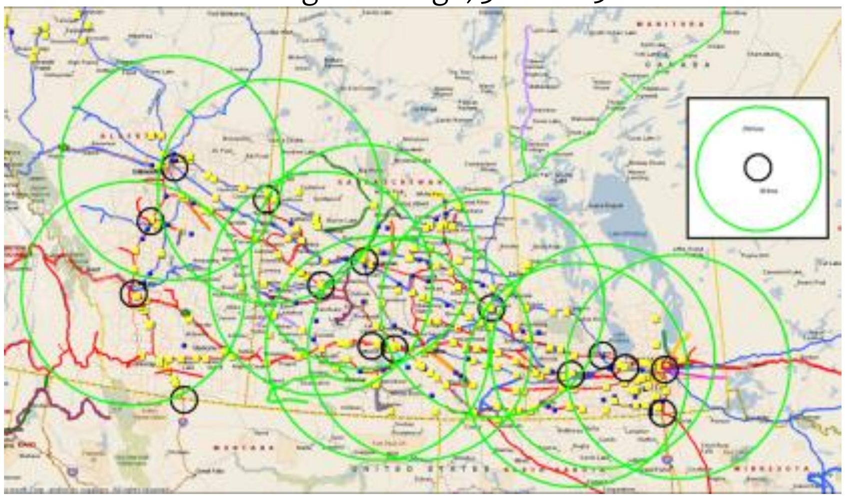
Myth - Extended interswitching included in C-30 achieved its objective to clear the grain backlog and is no longer needed by grain shippers.

False. Grain elevators often exist in an environment where they are captive to one rail line. In this monopoly environment, grain shippers are unable to use market forces to obtain a reasonable service level and price. It is this lack of competition that governments have tried to manage through a suite of tools that include the maximum revenue entitlement (MRE) and the Canadian Transportation Agency arbitration process.

Interswitching is another tool that is used to encourage market forces within the rail industry. The extension of interswitching rights to a 160 km radius was put in place in August 2014 and commits a rail carrier to pick up cars from a shipper, and move product to a junction with another railway. Extending the radius to 160 km better reflects the large expanse of the prairies and the nature of grain transportation in Western Canada. The original 30 km radius is intended for urban centers and moving product at port. It encompassed very few grain loading facilities - 6% were within 30 km of eligible interchanges. Extending the interswitching limit to 160 km has opened the door for significantly more grain facilities to use pseudo-competitive forces to leverage railways for improved service and freight rates.

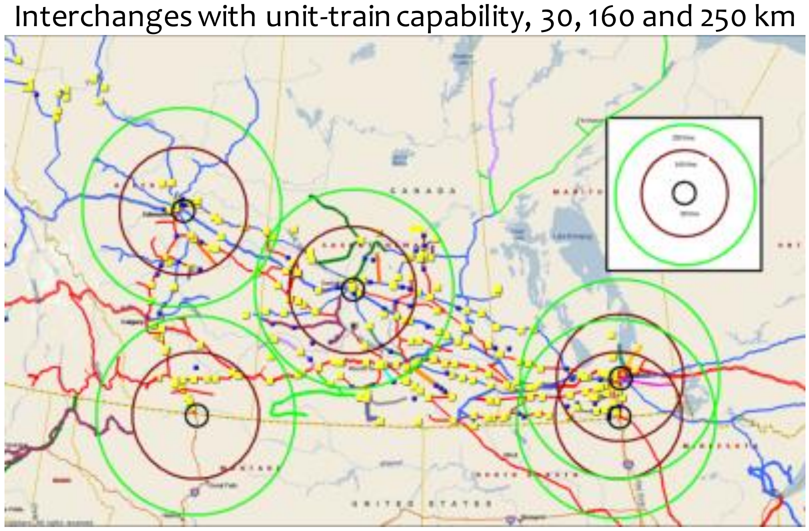
Every grain elevator in western Canada should have practical access to an interchange to encourage competition between railways. At 160 km, 92% of grain elevators are within interswitching limits. Since 90% of grain by rail shipments from western Canada moves to Canadian ports, which are serviced by CN and CP, each elevator should have access to these two carriers. An interswitch limit of 250 km would give all facilities (other than Peace River area) access to both CN and CP.

Interchange coverage, 30 and 250 km



For interswitching to be an effective competitive mechanism for the bulk grain business, it must be effective for the movement of unit trains. Today, more than 80% of grain by rail from western Canada moves in unit trains of 100+ railcars. Only three CN-CP interchanges in the west are unit-train capable. Expanding the limits to 250 km will allow trains to move through interswitching from about 70% of western grain facilities.

Interchanges with unit-train capability, 30, 160 and 250 km



Maps prepared by Quorum Corporation

Myth - Grain shippers are not significant users of interswitching, it does not need to be extended.

False. Grain shippers have made significant use of interswitching since the distance was extended in 2014. The greatest use of interswitching has been as leverage in negotiations with the rail lines. For example, a number of shippers report that after using the alternate rail line to move a number of shipments, the serving carrier came forward to offer better service and/or rates, thus eliminating the need to interswitch. On the books, it may appear that a relatively small amount of grain was moved through an interswitch. In reality, the very presence of an interswitch option achieved exactly what the provision is intended to do - create competition.

This underscores the real benefit of extended interswitching limits. While shippers may not choose to ship with the competitor, the fact that the option exists encourages a better level of service and more competitive pricing from the rail lines that exist in an effective monopoly without it. According to the Grain Monitoring Program, for the crop year up to May 20,2016 interswitching resulted in savings of almost $4 million and almost 1,300 additional rail cars put into service.

> *"As designed, extended interswitching should not only encourage more competitive freight rates through some actual movements initiated by a competing carrier, but also through simply the threat that this could happen if freight rates are allowed to grow to unreasonable levels."* ***James Nolan and Steven Peterson – University of Saskatchewan and Oak Ridge National Laboratory***

Myth - The 160km distance is unfair as US rail lines can access Canadian markets, but Canadian rail lines cannot access the US market.

False. Grain shippers are supportive of efforts to secure reciprocal access to the US market. The US Surface Transportation Board is undertaking a review of reciprocal switching (the US term for interswitching) and has indicated a decision is likely to come in 2016. The Government of Canada should encourage the US to offer similar access for Canadian rail lines in the US as US rail lines receive under the extended interswitching distances.

Myth - Interswitching rates are formulaic and do not reflect the actual cost to rail lines, discouraging rail lines from investing in improvements that will benefit grain shippers.

False. Grain shippers agree that railways need to be profitable, and support the railways' request that rates be compensatory. The Canadian Transportation Agency calculates interswitching rates using railway provided cost data, and these rates include all variable costs and a fair contribution to railway constant costs. Without this regulatory protection, interswitching rates would be set far above current levels reflecting railway monopoly pricing power. The current rates fully compensate the railways for interswitching services performed.

Myth - If interswitching is extended, the industry will no longer need other measures including the Maximum Revenue Entitlement (MRE).

False. Interswitching is only a partial solution to the lack of competition that exists in rail services. To ensure there is balanced accountability in the system, the government needs to maintain the suite of measures including the MRE and enhancements to level of service provisions.

For example, without limits on the amount railways can charge, the railways could introduce car allocation mechanisms that would add significant costs to shippers. Costs in the US to secure car supply were as high as $4000 per car in the winter of 2014 when capacity was extremely tight.

The nature of a dual monopoly setting means that shippers are captive due to the lack of competition. Interswitching is an important piece to introducing more competition into some parts of the system where there has not been competition before. However, shippers and ultimately farmers need the combined protection of the MRE as well as meaningful service level agreements to ensure grain gets to where it needs to be on time and on budget.

Grain shippers' requests related to Interswitching

Make it permanent:
Grain shippers welcome the one-year extension of the interswitching provisions. While this was an important step, shippers need the certainty that extended interswitching will be available in the long-term to make it an effective tool that moves meaningful volumes.

A permanent legislative change to extend interswitching will provide shippers the certainty they need to invest in infrastructure such as expanded sidings and improved loading capacity that may include access to interswitch service in the business model. Grain shippers have already invested over $1.2 billion in system-wide expansion and productivity projects since 2013, and long term interswitching will encourage continued investments.

Make it clear:
Many shippers today are unaware that they now fall into the new 160km catchment area for interswitching. Others may be aware that they are eligible but unclear about the rules and rates and as a result are reluctant to take advantage of the interswitch option.

Interswitching is a right granted through the Canada Transportation Act (the Act). To ensure it is a viable tool the Act should require railways to publish interswitch-service rates, produce maps that detail which elevators fall within which zones, capacities of interchanges and level/frequency of service. The Canadian Transportation Agency (CTA) can add further clarity by publishing regulations including eligibility for the interswitch block rate and guidance documents that outline how interswitching should operate.

Make it explicit:
The CTA should collect data to track the use of interswitching, by commodity, interchange, railway, service type (single or block). The CTA, shippers and the railways all stand to benefit from a better understanding of the volume of traffic that is sent through an interswitch.

This should be part of increased data gathering by the CTA, and should include operational data from the railways, e.g. car order placement, car spotting and interchange, to have real evidence on how interswitch traffic is being handled relative to line haul traffic.

Make it effective:
Regulations around interswitching must ensure that interswitch traffic is treated the same as line haul traffic. Interswitches should be eligible for reciprocal balanced Service Level Agreements. Regulations should also include a quick claim/complaint process for shippers to challenge interswitch service and rate concerns.

Furthermore, interchange sizes should not be reduced by railways, and should be expanded to accommodate modern unit train lengths to ensure that efficiencies in the movement of unit trains of the future are not lost through interswitch moves.