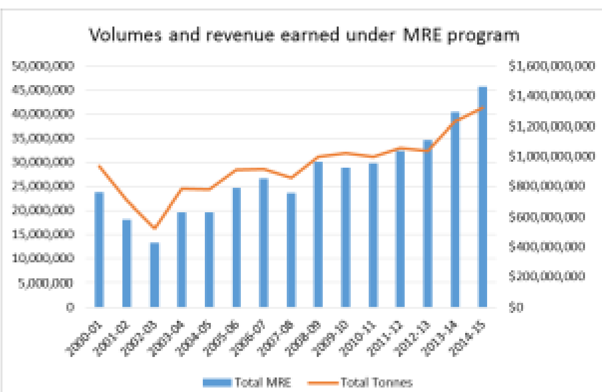
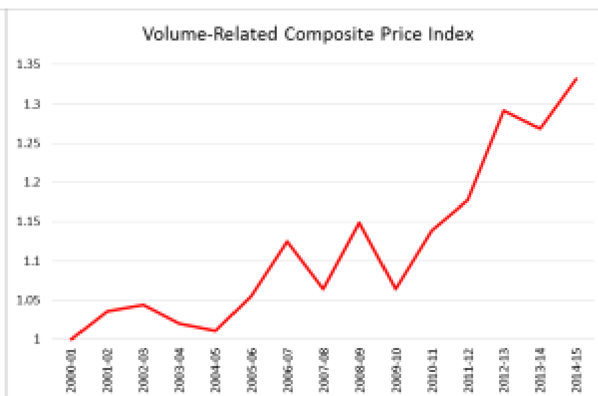
What You Need to Know About the Maximum Revenue Entitlement (MRE)

Does the MRE cap the amount of money railways can make on moving grain?

No. The MRE is not a revenue cap. The MRE should really be thought of as an average maximum revenue per tonne-mile that can be earned by CN and CP for shipping grain from western Canadian origins to export positions. Therefore, the more tonnes that are moved, the greater the revenue earned by the railways. The MRE formula further allows for the rate to increase if the length of haul is longer than it was in the base year (2000-01) when the MRE was first established. This compensates the railways for extra costs associated with a longer distance haul. The MRE formula includes an inflation index, called the Volume-Related Composite Price Index (VRCPI), which is adjusted annually to reflect unit cost changes for railway labour, fuel, material and capital costs. The regulations also allow the VRCPI to be adjusted to reflect the costs incurred by the railways to obtain and maintain railcars that replace government hopper cars. The VRCPI has historically increased at 2% per year.





Some have falsely argued that once the revenue ceiling is hit, the railways will naturally move the commodities that will actually make them money and grain rail service suffers as a result. In reality, while the MRE does guard against exorbitant rate hikes, it provides the railways with full flexibility to vary the rates in ways that encourage efficiencies, as they do with rate incentives to ship in longer trains, or to respond to market forces such as extra or reduced volumes, seasonal demands or capacity constraints. When some rates are reduced to encourage certain behavior or movement, others are simply increased as an offset, allowing the railways to earn the maximum revenue per tonne under the MRE formula. Because the MRE dictates a per tonne rate, the more grain moved, the more revenue earned.

In the absence of a true competitive market, and with the structure of the Canadian grain supply chain and the distances required to move grains and oilseed product from country to export, the MRE is intended to keep Canada competitive in global markets and to provide a degree of price protection to grain producers – while ensuring a reasonable return to the rail service providers. Over the last 13 years, total railway revenue per tonne-mile has increased an average of 2.26% annually, while revenue for grain subject to the MRE has increased by an average of 2.24% annually.[1]

> *"Market powers are particularly an issue (for) commodities that are highly dependent on rail – the so-called "captive shippers" – where the railways and their customers do not meet as equals in the market place."* – ***Dr. Paul Earl and Dr. Barry Prentice University of Manitoba – Western Grain Exceptionalism***

Why does the grain sector require unique protection?

Canada's grain value chain operates in a unique environment that requires extra tools so that it can operate in a similar manner to other sectors.

First and foremost, (1) the high number of elevator points that are serviced by only one rail carrier and (2) the vast distance between elevators - in of themselves are two very unique characteristics of the grain sector. Each of these locations is captive and is subject to the monopoly powers of the railways. Without the ability to negotiate with competitors, there is no way for grain shippers to ensure a competitive, commercial rate for rail service.

While all shippers are captive to the railways to varying degrees, grain shippers are particularly hamstrung in that they have no negotiating leverage at their disposal. The grain sector is obliged to move each years' production to port or for processing before the beginning of the next crop year. Other shippers have some flexibility to scale back production and reduce shipments to put pressure on the railways to secure better rates, grain shippers do not.

It is also important to note that despite paying the majority of the shipping fee, grain producers have no ability to negotiate with railways to secure competitive rates. The MRE is critical to ensuring the primary producer has some measure of protection.

Would grain get better service if it paid more to the railways?

No. Canada's rail system is not driven by normal market forces and the two major railways wield significant market power. Of the current 370 primary and process elevators in the

[1] Rail Freight Service Review: Final Report (January 2011).

grain handling system, only four are served by both Class 1 railways. This situation can be described as the operation of two monopolies. Where a business has no effective competition, there is no motivating factor for improving the provision of service, even with higher rates. The fundamental issue of railway market power and its negative effects on commercial relations was clearly identified in the Rail Freight Service Review in 2010, and the Panel noted: "there are no practical ways to directly increase rail competition".[2]

The assertion, by some, that grain shippers would see improved service if they paid higher freight rates is patently false.

What's the evidence?

- Grains and oilseeds shipped within Canada (i.e. to destinations other than export port) and to the U.S., along with some special crops, are not covered by the MRE. Freight rates are higher for these shipments, but the service is not better than for shipments covered by the MRE.[3]
- Almost all other commodities moved by rail have seen their rail rates climb over the years but service continues to deteriorate.
- Many Canadian grain shippers are also active in the U.S. where rates are significantly higher, with no evidence of better performance over Canadian service levels.

> *"Paying a higher freight rate means only that the commodity is making a larger contribution to the railways' fixed or constant costs. In the grain sector, (..) there is no practical or competitive alternative for grain transportation so the business and volume will always be there."-* ***Crop Logistics Working Group MRE Sub-Committee Report***

Does the MRE discourage railways from reinvesting into grain related rail infrastructure?

No. The MRE has built-in flexibility that accounts for changes in inflation on items such as labour, fuel, and importantly, on material and capital purchases.

The MRE structure, in fact, encourages railway investment to improve railway efficiencies. Those efficiency improvements accrue entirely to the bottom-line benefit of the railways. Reductions in the numbers of leased railcars, locomotives, and train crew employees, in fuel consumption rates, in track ownership and maintenance requirements, and in many other railway operational activities translate directly into cost savings for the railways. There is no off-setting reduction in the revenue that the railways earn under the

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[2] Rail Freight Service Review: Final Report (January 2011).

[3] In fact, non-regulated shipments often struggle with poorer service than shipments falling under the MRE. See detailed weekly reports by corridor here: http://www.agtransportcoalition.com

MRE when they experience a significant improvement in operating efficiency in the handling of grain. Railways earn the same revenue per tonne today as they did in 2000-01, adjusted for inflation, but do so at significantly reduced cost per tonne because of efficiency improvements in the grain handling and transportation system. Hence, the railway margin for grain has been greatly improved!

Since the MRE base year, 2000-01, the number of elevators has reduced to 370 from 876, and the number of 100+ car elevators has more than doubled, from 51 to 135. During that time, grain companies have invested billions in elevator storage, rail track and handling/loading equipment at country and port elevator facilities to be able to increase unit train shipping and loading/unloading speed and capacity. The outcome is a shift from mostly single-car shipments in the 2000-01 year to today, when approximately 80% of all western Canada grain shipments originating in trains of 100 cars or more to single destination unloading facilities. Unit train movement results in much quicker car turn-around times and reduced railway handling of railcars between load and unload points. This has allowed railways to reduce car and locomotive fleets, reduce yard and road crews and associated management activities and remove tracks throughout the west.

Additionally, the MRE allows for railway revenues to increase to compensate for additional railcars brought into the fleet to replace government grain cars that are being retired. Between 2000-01 and 2014-15, railway fleets in western Canadian grain were reduced by more than 2500 cars.[4] In the last two years alone, the VRCPI has been increased by an additional 2% above the inflation adjustment to compensate CN and CP for almost 5,000 leased railcars brought into their fleets to replace removed and retired government grain cars. These adjustments alone will increase the railway revenue earned in 2015-16 by about $25 million, effectively compensating the railways for their incremental leased cars, including maintenance, to the tune of USD$530 per car per month, a competitive market rate for leasing jumbo grain hopper cars. The railways are encouraged through this mechanism to replace aging, inefficient government grain car fleet with high capacity, modern hopper cars.

The MRE is unquestionably creating the type of revenues and investment paybacks that the railways need to reinvest back into grain related rail infrastructure.

Is grain paying its fair share of the railway sunk costs?

Yes. There is no evidence to show that grain movement is a money loser for the railways or that other commodities are cross-subsidizing grain movement. In fact, evidence shows that grain is foundational to the railways' profitability.

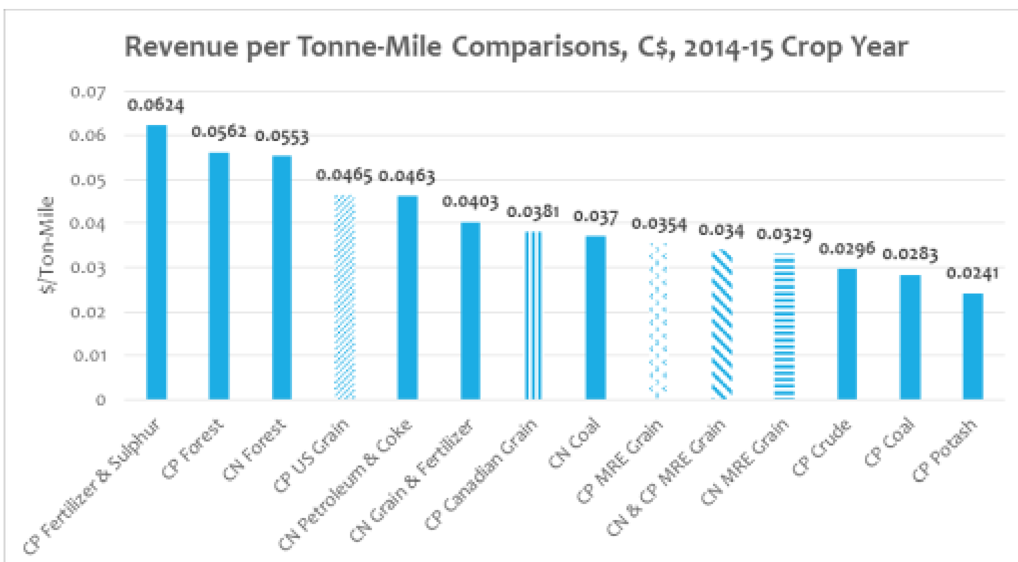
[4] Figures from the Western Grain Elevator Association using MRE-related calculation methodology of the Canadian Transportation Agency.

In 2014 CN Revenue was up 14% from the year previous, closely correlating with the grain revenue increase which was up 21% and operational revenue was up 19%. CP also saw a 5.5% increase in 2014. ***– The Crop Logistics Working Group MRE Sub Committee Report***

This correlation quoted above shows the railways are clearly profiting from grain. Studies have estimated the contribution grain revenues make to covering the railways' costs is significant. The Canadian Transportation Agency's most recent assessment in 2010 placed the number at 20.3%. Full public disclosure regarding railway costs related to the grain sector would quickly answer this question. Nevertheless, it is clear that the grain sector is carrying its own weight and then some on costs.

Removing the MRE will most certainly mean higher rates but not better service.

True. The chart below shows the revenue per tonne comparison of CN and CP's various customers. Because CP differentiates between what it charges for U.S. grain movement, Canadian MRE grain, and Canadian non-MRE grain, we are able to get an idea of what the railways would charge grain handlers in the absence of the MRE. This extra cost will be passed down to primary producers with no rail service improvement to show for it.



Grain shippers' request regarding the Maximum Revenue Entitlement

Make it effective:
Grain Shippers understand and appreciate that the MRE must be structured in such a way that the railways are fairly compensated for moving grain. Shippers want to ensure that the railways are given every incentive to invest in infrastructure and grow capacity. After all, both shippers and the railways stand to gain from investments in improved efficiency.

The WGEA is supportive of allowing the VRCPI to be calculated separately for each rail company. Currently, the VRCPI is calculated annually by the Agency as one number that is applied to both railways in their respective formulas. Therefore, if one railway makes a significant investment and the other does not, this is reflected in the formula for both railways. Practically speaking, a railway may not make any hopper car investment in a given year, yet still benefit from the investment by the other railway through the one VRCPI. The WGEA supports separating this formula on a per company basis.

For more information on the MRE, including the full report on the MRE by the Crop Logistics Working Group, and other grain rail performance issues visit:

www.wgea.ca