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BC Rail In Depth Report ~ Patrick Brown

North to Alaska

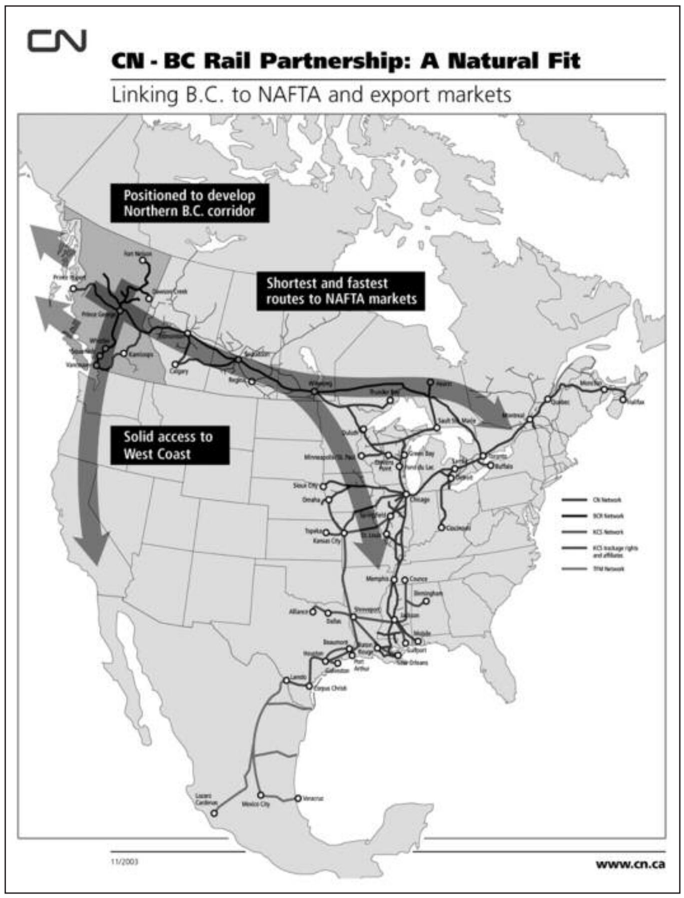
When CN bought BC Rail from the provincial government, they not only achieved a monopoly on rail freight traffic for most of the interior of British Columbia, but also sewed up the two major route possibilities for a future railroad to Alaska. Given CN's ambitions for a railroad empire spanning all the North American Free Trade area, did they pay enough?

The CN purchase was announced on November 25, 2003 and completed on June 14, 2004. On December 17, 2003, the BC Government released the final version of the 'Fairness Report,' written by the consulting firm Charles River Associates (CRA) of Boston, Massachusetts.

According to the report: '...Province and its advisors designed and managed the partnership process in a fair and impartial manner and ensured the best proposals were put forward for con-sideration. The report concluded that the Province will receive fair value from CN for the opportunity to operate the freight railway.'

The publication of CRA's report, as 'fairness consultant,' was clearly intended to sell the deal to the public.

With respect to the bidding process, CRA went into considerable detail in describing the procedure and what had occurred, and the reasons why certain shortcuts appeared to have been taken. The report also noted complaints from competing bidders, but said the process was fair.



With respect to the price, CRA justified it by a number of analyses, including a CIBC World Markets estimate of Total Enterprise Value (TEV), comparisons with prices paid for other railroads both in North America and abroad, and Discounted Cash Flow (DCF) analyses of projected income streams from BC Rail as it was presently constituted.

But as former Transportation Minister Judith Reid remarked at one point: 'CN is looking at this from the viewpoint of North America.' She was more right than she realized. CN was buying a key part of a long-term continental strategy, not just a railway with access to lumber, mining, and petroleum customers.

Alaska Bound?

There are presently two railways in Alaska: The narrow-gauge White Pass and Yukon, from Skagway to Whitehorse, and the Alaska Railway, from Fairbanks to Anchorage.

CRA's report made no mention of possible future Alaska links, despite the fact that the idea (first floated in 1860, see box) has recently achieved significant momentum, as shown by the following quotes and events.

On December 11, 2000, US President Bill Clinton had signed the *Rails to Resources Act of 2000*:

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'The President is authorized and urged to enter into an agreement with the Government of Canada to establish an independent joint commission to study the feasibility and advisability of linking the rail system in Alaska to the nearest appropriate point on the North American continental rail system.

'There is authorized to be appropriated to any fund established for use by the Commission as described in subsection (a)(1) $6,000,000, to remain available until expended.'

A Transport Canada 'Issues Paper' of 16 Mar 2001 stated: 'The US Congress has allotted $6 million to establish a bilateral commission to study the 2000 km rail link from Fort St John, BC to Fairbanks, Alaska. ... The Yukon Government supports the rail project, and [Alaska] Senator Murkowski has met with Minister Collenette to discuss the project.'

The paper projected a link from the Alaska Railway near Fairbanks to Prince George or to Fort St James on BC Rail's Dease Lake extension.

A Canadian Arctic Railway (CAR) presentation to a *Canadian Transportation Act* review panel on March 26, 2001 in Whitehorse outlined a plan to develop a standard gauge railway throughout the Canadian Arctic. At the moment, CAR said, it is working on connecting Fairbanks with railheads in northern BC, which, said CAR, could be completed in 48 months. They claimed support from the Interhemispheric Bering Strait Tunnel and Railroad Group, US Federal Gov-ernment, Russian Gov-ernment, Alaskan State Government and Gov-ernment of the Yukon Territory.

Representatives of mining companies, legislators from Alaska and from Canada's Yukon Territory, and rail experts attended an international conference in Fairbanks on October 10-11, 2001. Yukon Parliament member Larry Bagnell was quoted in the *Fairbanks News-Miner*, 'It's a great long-term project. It'll change the face of the world.'

Further talks were held recently in Juneau with Colin Kinsley, Mayor of Prince George; after talks with Yukon Premier Dennis Fentie, Prime Minister Paul Martin has reportedly agreed to provide Canadian funding for the joint commission study. Fentie, speaking in Calgary in January 2004, said that BC Rail is the logical connection at Fort Nelson.

1898: Railroading, Aliens, and the Flexible Border

'There will come a time when Alaska will be one of the wealthiest possessions of the American domain.' This was W M Sheffield, writing in *Cosmopolitan* in 1899.

He wasn't only referring to the gold fields, and he was writing in support of building a railroad to Alaska from the lower forty-eight. The White Pass and Yukon Railway was under construction, starting in 1898.

As the gold explorers turned east from Skagway into BC (Atlin) in the winter of 1898, the BC Parliament in Victoria passed the *Alien Exclusion Act* (Jan 1899), depriving Americans from holding or acquiring any claims in BC. (Contrast this with our welcome to US corporations today.)

'The British Columbia mounted police have not been free from suspicion of maintaining a somewhat elastic border line that has been more than once stretched to include districts of great mineral wealth. Such a charge has, indeed, been definitely made by the miners driven from Atlin to the Porcupine claims.' wrote Sheffield.

The new opportunity for CN was also trumpeted in the BC Legislature on February 12 this year: 'One of the consequences of this new rail partnership was heightened interest by the Yukon Territory and the state of Alaska in having CN link up with the Alaska state railway to provide a continuous link to the southern 48 states. ...the key lesson for us is that by entering into the CN partnership we at least make possible, for the first time since the extension of BC Rail was terminated in the 1970s, that it again could be started north from Fort St James, Fort Nelson or both to open up the mineral and forest resources of the northern half of our great province'—G. Halsey-Brandt (Liberal/Richmond Centre).

On February 17, R. Harris (Liberal/Skeena) echoed Halsey-Brandt: '... we now have a rail operator, in CN, that has the capacity to expand.'

Not Just a Branch Line

But CRA's assessment of the railway's worth was based almost completely on its present business rather than its future potential. It made the case that almost all of BC Rail's customers sell their products outside the province. But according to the Fairness Report, the majority of 2002 BC Rail freight traffic (60%) remained on the BC Rail network; 37% was forwarded to other railroads, and only 3% of traffic originated on a different railroad and terminated on BC Rail.

According to the report, BC Rail forwarded traffic went mainly to Ontario and California; Quebec and Washington; Alberta, Oregon, New Mexico, Illinois, and Texas. CRA, after an extensive analysis of specific destinations, concluded that despite CN's domination of connections, BC Rail customers would still have competitive access to these varied markets.

However, CRA paid no attention to the importance of BC Rail to the long-term strategy of CN. CN is no longer just a Canadian railway, but in its expansion into the United States, has clearly indicated its ambitions to connect all the seaboards of North America. The BC Rail network clearly points to a future connection with Alaska, and as such is of far greater strategic importance to CN than just as a branch railway.

Comparing Railway Purchases

CIBC World Markets, engaged earlier by the provincial government, had looked at a number of recent railway purchases and calculated the price that was paid for each of

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these properties as a function of various financial measures, including revenue, earnings, Total Enterprise Value (TEV) calculated on the basis of market value of all shares, plus debt and less cash. This analysis was really from the perspective of an investment bank, and depended to some extent on the state of the stock markets.

CRA expanded this comparables analysis and also constructed an econometric model; it also developed a valuation of future expected cash flows, their present value adjusted for a range of known risk factors.

Railway purchases considered comparable included Freight Australia, Estonian Railways, and Mexico's TFM (all privatizations), and Utah Railway Company, Emons Transportation, Illinois Central, and Wisconsin Central. The latter two were both CN purchases.

According to CRA, the normal purchase price for a railroad would be in the range of 1.5 to 1.75 times its annual gross revenues. However, if the targeted railroad had strategic importance to the buyer, or a particularly good market position, this multiplier could be increased.

Illinois Central (IC), said CRA, had particular value to CN because its mainline runs from Chicago to New Orleans and the United States coast of the Gulf of Mexico. To quote CRA: '... failing to buy could have excluded CN from being a major North American operator. Ultimately, the strategic nature of the acquisition allowed CN to claim being one of the first North American Free Trade Agreement (NAFTA) operations and clearly warranted a premium on the purchase price.' CN paid $2.6 billion for IC, a multiplier of 2.7 times its revenues of a little less than $1 bn/yr. The premium paid for its strategic position would appear to have been about $1 billion.

The Wisconsin Central (WC) deal represented the purchase, according to CRA, of a reasonably profitable railway with a good 'strategic fit' with the combined CN/IC network, but not one of great strategic importance by itself. CN paid $1.2 billion for WC or 2.3 times its revenues of $548 million. This was an apparent premium of $500 million for its 'strategic fit'.

Based on this analysis, CRA concluded that CN's offer for BC Rail of $750 million, or 2.6 times its present revenues of $293 million, was fair. But neither IC nor WC, both mature railroads, would appear to have the potential for geographical expansion that BC Rail has.

Thus CN's purchase of BC Rail's freight operations, and its perpetual lease on the BC Railway Company's railbed to Fort Nelson and Dease Lake, effectively block all other railways' access to Alaska. This strategic advantage does not appear to have been valued adequately in CRA's comparative analysis.

CN could afford it. Its profit for the most recent years has ranged between $800 million and $1 billion US. ✐

Tax Credits: No Comment

CRA's Fairness Report did not comment on the $250 million CN paid for tax credits from BC Rail's accumulated operating losses (NOLs), saying that the actual value of these credits against Canadian corporate taxes to any given bidder would depend on the bidder's Canadian tax position. Similarly, CRA made no attempt to value the tax benefits which a new owner might receive from BC Rail's $1.2 billion in Undepreciated Capital Costs (UCCs). Clearly, however, these tax benefits would be of greater value to bidders with significant Canadian operations (CN, Canadian Pacific) rather than US bidders (Burlington Northern Santa Fe, Omnitrax).

If CN is unable to use the NOL tax credits due to rulings by the Canada Revenue Agency, the provincial government must refund the $250 million.

This agreement appears to have been redacted (blacked out) from the published contracts, but BC government budget documents say: 'BCRC and the Province have provided commercial indemnities to CN with respect to the purchase of the subsidiary and partnership, including indemnities related to tax attributes. BCRC and the Province, based on independent legal advice, believe there is a very low risk these indemnities will be called upon.'

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