Canadian National and Canadian Pacific: The Two Little Engines That Couldn't

Description

By Cameron Conway

Growing up just outside of Winnipeg, I remember vividly this time of year — when the trains would mark the time of the day.

In the fall, five or six times a day for weeks on end a **Canadian National Railway** (TSX:CNR, NYSE:CNI) train would drive through my town. It was not a subtle guest — it would shake the walls of my home and fill the air with its horn day and night. But no one was bothered because of what it carried: wheat, barley, and other grains.

The sight of trains predominantly loaded with cars full of grains has been replaced in our day by cars full of crude oil and other petroleum products. With the boom in the Alberta tar sands and recent discoveries in southeast Saskatchewan, crude oil has become one of the fastest-growing types of cargo for both CN and **Canadian Pacific Railway** (TSX:CP, NYSE:CP).

Since 2011, the amount of crude oil carried by rail has doubled. And each year, more and more of the rail line quotas are filled up with oil, chemicals, and even intermodals, leaving less space for grain and forestry (which had similar complaints during the spring).

Bumper crops
This shift in the rail sector has come to a head this year, with a record crop of both wheat and canola in the Prairies. The estimate is that 80.6 million metric tons of grains have been harvested this year thanks to good weather. But the rail companies have been struggling to deliver the grain from the elevators to the ports.

Back in early October, CN admitted that this would be a big year, with an estimate 20 million tons below what was harvested. That there was a "big harvest" predicted and the carriers were still unprepared is a problem when 95% of Canada's export grain travels by rail.

The race to foreign markets
During the first nine months of 2013, CP Rail moved 317,000 carloads of grain. Despite CP and CN

supplying 5,500 cars a week, it *still* wasn't enough to move the grains to port.

Grain industry experts believed that twice as many cars were needed during harvest peak — but that claim was dismissed by a CN spokesman, who told *The Globe & Mail*: "Throwing more hopper cars into the supply chain is not going to work. It's like morning rush hour on the freeway. You put too many cars on the road, the road gets plugged and everything else slows to a crawl".

That view may not have been well-received by the ports, which both have the room to handle more rail cars and are anxious to ship to hungry foreign markets.

Grain vs. other commodities
An underlying issue in this whole affair is that unlike oil, coal, potash, or lumber, there is a cap on how much western grain CP and CN can carry. It's called the Western Grain Revenue Cap Program, which essentially limits the amount of revenue the rail companies can earn moving western grain each year. Oil, intermodal, and chemicals are limitless and will fill up quotas more often.

This isn't the only legislation that can hurt CP and CN. Bill C-52, the "Fair Rail Service Act," was passed this May. From the text of the Act: "This enactment amends the Canada Transportation Act to require a railway company, on a shipper's request, to make the shipper an offer to enter into a contract respecting the manner in which the railway company must fulfill its service obligations to the shipper."

In plain English, basically what this legislation means is that the rail companies will be fined if they deliver late to a client that has a service agreement. CN and CP representatives wouldn't be permitted to simply shrug their shoulders and say "it is what it is" if they were late with a delivery. Or at least, because of this legislation, a shoulder shrug to a company with a service agreement in place is going to cost the rail companies up to $100,000.

The Foolish caboose
The abolishment of the Canadian Wheat Boards' (CWB) monopoly on wheat and barley created more players in the market. Whereas CP and CN once would only deal with the CWB, now they have numerous companies to deal with — and each one now has the legal right to enter into one of these new "Bill C-52" agreements, which could compound the existing problems CN and CP face.

With skyrocketing demand for oil tanker cars, increased wheat and canola production, and legislated caps and new service agreements, the rail companies could be in for a bumpy and pricey road when it comes to Western grains.

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