F.D. 30400, et al. = Pages 6942 thru 7000

BEFORE THE

INTERSTATE COMMERCE COMMISSION

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In the Matter of: :

SANTA FE SOUTHERN PACIFIC CORPORATION : Finance Docket

-- CONTROL -- : 30400 et al.

SOUTHERN PACIFIC TRANSPORTATION :

COMPANY :

- x

Hearing Room A

12th & Constitution, N.W.

Washington, D.C.

Monday, January 14, 1985

The hearing in the above-entitled matter was convened, pursuant to notice, at 9:00 a.m.

BEFORE:

JAMES E. HOPKINS,

Administrative Law Judge

APPEARANCES:

As Heretofore Noted

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NUMBER	IDENTIFIED	RECEIVED
SFSP-C-89	7159	
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P R O C E E D I N G S

JUDGE HOPKINS: Let's go back on the record. Mr. White, would you call your next witness?

MR. WHITE: Mr. Darnell, please.

Whereupon,

C. H. DARNELL, JR.

was called as a witness in the above-entiled by counsel for Texas Mexican Railway Company and, having first been duly sworn by the Administrative Law Judge, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. WHITE:

Q Mr. Darnell, would you, since you have not prepared a verified statement in this case, take a moment and tell us your title, your educational background, and your employment history at the Texas Mexican Railway.

A My name is C. H. Darnell, Jr. I am President and Chief Operating Officer of the Texas Mexican Railway Company, with headquarters at Laredo, Texas. I've been employed by the Tex Mex Railway since 1950.

As my background, I am a civil engineer, graduate from Texas A&M University. I began my employment with the railroad as a draftsman and instrument man in the engineering department in 1950, in

January.

I was promoted in 1954 to Assistant Chief Engineer; subsequently, to Engineer, Maintenance of Way; Chief Engineer in 1964; in 1970, V. P. of Operations and Chief Engineer; later on, Executive Vice President; in 1980, President and Chief Operating Officer.

Q Sir, you are a member of the board of directors?

A Also a member of the board of directors. I am a registered professional engineer in the State of Texas and a registerd public surveyor in the State of Texas.

Q Sir, did you have occasion to study the verified statement prepared by Mr. Martinez?

A Yes.

Q Did you also, in preparation for today's hearing, study his work papers?

A Yes.

Q Do you adopt the verified statement prepared by Mr. Martinez?

A Yes.

Q Is it true and accurate, to the best of your knowledge and belief?

A Yes.

MR. WHITE: You may cross-examine.

CROSS EXAMINATION

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BY MR. BLASZAK:

Q Good morning, Mr. Darnell. My name is Mike Blaszak; I work for the Santa Fe, and I represent the Applicants.

I've got just a few questions which all concern Mr. Martinez's verified statement which is subtitled "Operational Data." I think that is just what you were referring to.

A Yes, sir.

Q Mr. Martinez said on page 1 of his testimony that the Texas Mexican has all necessary resources to commence trackage rights.

How many locomotives does Texas Mexican have available for this purpose?

A For this purpose? We have a total of 16, three of which are used in Laredo Yard, three in Corpus Christi Yard, and the rest in road service. We have a new one on order to receive in May of this year, and that would be a total of 17.

I think we have enough to take care of it.

Q Would Texas Mexican offer its present service following acquisition of trackage rights if they were awarded?

A No.

Q Would you tell me just briefly what that

service is right now?

A Our service between Laredo and Corpus Christi?

Q Yes, sir.

A We run one train a day each day, six days a week. And that is more or less the whole thing. And on the weekends, we run one out on Saturday, two on Saturday, excuse me, and one coming back on Sunday.

On Monday, we only run out towards Corpus out of Laredo.

Q Where do you have the switch engines assigned?

A In Laredo and in Corpus Christi.

Q So it's your opinion that Texas Mexican has sufficient power at this time to --

A Yes, sir.

Q Were you here when Mr. Ramos testified on Friday?

A About a half an hour of it. I had to catch a plane.

Q Mr. Ramos said at some point that two to three more crews would have to be hired by the Texas Mexican in order to protect the trackage rights operation. Do you agree with that assessment?

A It's very possible. We hope to make it with two, but if it's necessary, we have the people in

involved.

Q You say you have the people? Are those furloughed Texas Mexican employees?

A Yes.

Q Going to page 2 of the statement, Mr. Martinez said that the schedule of a train going from Corpus Christi to San Antonio one day and returning upon the crew's rest is projected for six days a week.

Do you know whether that projection was for six trains in each direction or for three rounds trips with six trains total?

A Six trains total.

Q So it would be three round trips?

A Yes.

Q Have you, or do you know if Mr. Martinez has calculated a projected average size for this train?

A Yes. According to his work papers, he did.

Q What is that size?

A Twenty cars.

Q Does the plan contemplate the Texas Mexican's crews will be able to get over the trackage rights line and perform necessary terminal work at San Antonio within 12 hours, or do you propose to have Southern Pacific perform -- or Santa Fe Southern Pacific perform certain terminal work?

A We propose to have Santa Fe Southern Pacific proposal to do the terminal services in San Antonio.

Q So your crew's work would be limited to cutting off the train and putting the engines in the houe?

A Yes.

Q Mr. Darnell, have you observed the condition of Southern Pacific's line between San Antonio and Sinton?

A No, I didn't. No, I have not.

Q Were you here when Mr. Ramos testified concerning the condition of that line?

A No.

Q Are you aware there are numerous 10-mile-an-hour slow orders on this line?

A Yes.

Q Do you have any idea what the extent of those slow orders is?

A Not at this moment; no, sir.

Q Do you know how many trains the Southern Pacific presently operates over this line?

A One a day.

Q There is a statement on page 2 of the operational data, which is page 19 of the filing, to the effect that traffic over this line -- I believe the line

referred to as Corpus Christi to San Antonio -- is of light density. Hence, no signficant scheduling problems are anticipted.

Do you see that?

A Yes, sir.

Q Do you happen to know -- well, let me ask you first, do you think the statement applies both to the Southern Pacific and to the Missouri Pacific line between Sinton and Corpus Christi, or just to the Southern Pacific, or what is your understanding of that?

A That statement, as I understand it, applies only to the trackage between San Antonio and Sinton. The SP runs another train out of Victoria into Corpus which does not traverse its track.

Q So you wouldn't agree that the railroad between Sinton and Corpus Christi is a light density line?

A Relatively speaking, it is. Missouri Paciic runs the train today in and out. The SP runs one in and out.

Q In and out, do you mean in and out of Corpus Christi?

A Yes.

Q Do you know how many the Missouri Pacific operates between Sinton and Odem?

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A No, I do not.

Q Do you think it's more than one a day?

A Oh, yes.

Q We discussed a couple of minutes ago, the Applicants providing terminal services for Texas Mexican trains if the trackage rights are awarded.

Can you tell me what terminal services Texas Mexican would require at San Antonio, and go through it in some detail?

A Upon arrival, depending on whether we house the engines or not, the SP would do that for us. They would service the engines. We don't think they would have any need for fueling because we can make a round trip with the internal fuel.

They would have to see that the water cooler is relatively clean and so forth, and maybe the daily inspection of the engine.

Q Does Texas Mexican contemplate operation of cabooses, or do you contemplate operating without cabooses?

A We will operate with cabooses.

Q And the same services would be required for cabooses, I take it?

A Yes.

Q How about switching and classification of

cars? What did you have in mind there? Would the train come blocked to San Antonio, or would SPSF have to switch it?

A We could block it out of Corpus or -- well, it would probably be just Katy deliveries anyway.

Q You don't believe that you would be handling any interchange for the Missouri Pacific or for cars for local industries in San Antonio?

A That's problemmatical. We might or might not, depending on what the interchange is.

Q Do you happen to know whether, for the purpose of completing the Texas Mexican's financial exhibits, Mr. Martinez made any assumption concerning the level of trackage rights charges which SPSF would impose on the Texas Mexican, were these rates awarded?

A I think his work papers reflect $0 a train mile.

Q Would that be just for operation over the line, or would you think that would include the terminal services at San Antonio?

A It would not include terminal services; no.

Q Were any assumptions made concerning the charge that SPSF would make for terminal services at San Antonio?

A Not in his work papers, no.

Q How would the Texas Mexican perform agency services at San Antonio?

A I don't know that we would need any agency services in San Antonio. It's just an interchange point.

Q Would Texas Mexican rely on SPSF to perform initial terminal inspections of southbound trains to San Antonio?

A Yes.

Q Would it rely on SPSF to repair light and heavy bad order cars?

A Yes.

Q Would it rely on SPSF for any sort of freight claim or loss and damage service?

A That's handled by the destination carrier. If it's determined before it comes to us, then SP would handle it. It's handled by the destination carrier.

MR. BLASZAK: Thank you, Mr. Darnell. That's all I have.

JUDGE HOPKINS: Mr. Delaney?

BY MR. DELANEY:

Q For the record, my name is John Delaney. I represent the Railway Labor Executives Association.

Mr. Darnell, if I could ask you just to focus on San Antonio Yard. Do you presently have any

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employees there?

A No.

Q Do you plan on having any employees there?

A No.

Q Do you anticipate the diversion of traffic from Southern Pacific to mean less work for Southern Pacific employees?

A I have no idea what that would represent.

Q You haven't performed any studies to that effect?

A No.

MR. DELANEY: That's all I have, Your Honor.

JUDGE HOPKINS: Thank you.

Mr. White?

MR. WHITE: I have only one question, 'Your Honor.

REDIRECT EXAMINATION

BY MR. WHITE:

Q Mr. Darnell, you were asked if you are familiar with Mr. Martinez's calculations of the cars to move on the trains running under trackage rights, and you answered 20 cars.

Is it your understanding, sir, that is a startup estimate?

A Oh, yes. That was a sample that apparently

Mr. Martinez took from some of our waybill abstracts to get an idea of what the traffic was that was available now during this 10-month study.

We expect to improve on that considerably.

MR. WHITE: That's all I have, Your Honor.

JUDGE HOPKINS: Anything further?

MR. BLASZAK: Just one more.

RECROSS EXAMINATION

BY MR. BLASZAK:

Q Mr. Darnell, do you have any idea what the ultimate traffic handled by these trains would be after the trackage rights are operating for a while?

A According to Mr. Martinez's figures, something around 50 cars. It may be more or less.

Q You don't anticipate that it would exceed it to the point where you would need two trains a day or increase your frequency of service?

A We hope it does.

Q But right now, you don't see it?

A At this moment, no.

MR. BLASZAK: That's all I have, Your Honor.

JUDGE HOPKINS: Is that all, Mr. White?

MR. WHITE: That's all, Your Honor.

Your Honor, I move the admission of Mr. Martinez's verified statement.

JUDGE HOPKINS: Any objection?

MR. BLASZAK: I have no objection, Your Honor.

JUDGE HOPKINS: It will be received.

MR. WHITE: And, Your Honor, I also move the admission of the verified statements of Professor Corrada-Bravo and Mr. Solis.

JUDGE HOPKINS: any objection?

MR. BLASZAK: No objection.

JUDGE HOPKINS: They will be received in evidence. The exhibits, et cetera, of the Texas Mexican Railroad will therefore be received in evidence.

JUDGE HOPKINS: Off the record a minute

(Discussion off the record.)

JUDGE HOPKINS: Back on the record.

MR. RAKER: Your Honor, KCS calls as its first witness, Richard C. Levin.

Whereupon,

RICHARD C. LEVIN

was called as a witness in the above-entitled case by counsel for the KCS Railway and, having first been duly sworn by the Administrative Law Judge, was examined and testified as follows:

DIRECT EXAMINATION

BY MR. RAKER:

Q Please state your name and business address.

A I am Richard C. Levin, and my business address is 37 Hillhouse Avenue, New Haven, Connecticut.

Q And what is your occupation?

A I'm a professor of economics and management at Yale University.

Q And, Professor Levin, have you submitted two verified statements in these proceedings?

A Yes, I have.

Q Is one of those verified statements contained in the volume designated KCS-14?

A Yes, it is.

Q And is that the verified statement which indicates that it was verified by you on November 15, 1984?

A Yes, that's correct.

Q And have you previously submitted corrections to that verified statement, which corrections are set forth in KCS-16?

A Yes, that's right.

Q Do you have any further corrections or other modifications which you wish to make at this time?

A I have one correction on page 35 of my verified statement. In the fourth line from the bottom of the page, strike the words "canned goods and wine." After the words "paper products," insert a comma and an

"and."

Insert a period on the next line after "petroleum products," and strike "and assembled motor vehicles."

Q Would you read the full sentence as you wish to have it corrected to read?

A Yes. "Among the commodities moving in substantial volume in the transcontinental southern corridor, rail has a substantial cost advantage in the long haul transport of certain paper products and many chemical and petroleum products."

Q As corrected by you, both with regard to the corrections contained in KCS-16 and the corrections which you just read into the record, is this verified statement, to the best of your knowledge, true and correct?

A Yes, it is.

Q And do you adopt it as your testimony in this proceeding?

A I do.

Q Now, with regard to the other verfified statement that you have submitted, Professor Levin, is it contained in the volume designated KCS-12?

A Yes, it is.

Q And does that statement indicate that it was

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verified by you on September 5, 1984?

A Yes, that's correct.

Q Are there any corrections or other modifications that you wish to make to that statement?

A No.

Q To the best of your knowledge, is that statement true and correct?

A Yes, it is.

Q Do you adopt it as your testimony in this proceeding?

A Yes, I do.

MR. RAKER: Your Honor, that completes my direct examination of Professor Levin.

JUDGE HOPKINS: Thank you.

Mr. Martin, are you handling this?

CROSS EXAMINATION

BY MR. MARTIN:

Q Professor Martin, my name is Eden Martin. I am one of the attorneys for the Applicants.

A How do you do?

Q I am going to ask you some questions about, first, KCS-12 which is the September 5th statement, and after going through that, I'll ask you some questions about KCS-14 which is your November 15th statement.

MR. RAKER: May we go off the record just a

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moment?

JUDGE HOPKINS: Off the record.

(Discussion off the record.0

JUDGE HOPKINS: Back on the record.

BY MR. MARTIN: (Resuming)

Q Professor Levin, let's start with KCS-12 and I would ask you to turn to page 8, if you would, please.

By the way, I take it that you have corrected copies of both statements with you?

A Yes, I do.

Q Do you also have copies of the work papers that have been produced for us?

A That's correct.

Q I'd like to call your attention first to page 8 of KCS-12 and, in particular, in the paragraph that starts on that page where you say, you make the following statement that: "Absent effective competition, the ratemaking freedom conferred by the Staggers Act is a license for the exercise of monopoly power."

And you continue: "Without competition, deregulation will generate excess profits for railroads," and then completing that sentence.

Do you see that passage in the testimony?

A Yes, I do.

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Q Now, I take it that you are assuming, at least for purposes of this analysis, that the Interstate Commerce Commission is not going to be regulating rates to prevent excess profits; is that correct?

A The Interstate Commerce Commission is not, according to the Staggers Act as I understand it, regulating profits of railroads. So that it will not explicitly set rates with that particular objective in mind.

Q Well, I certainly am not going to cross-examine you about whether that's correct as a matter of law. I simply want to make it clear that your assumption in what follows here is that the Commission would not be regulating rates with a view toward preventing excess profits.

That's the assumption that the rest of this analysis is predicated upon, is it not?

A I don't think that that is the assumption made here; that it really has anything to do with specific conduct of the ICC.

I think I am making a statement that if there is not regulation in the absence of competition, the railroads would tend to earn excess profits.

Q If there is not regulation.

A That's right.

Q Okay.

Now, in referring to monopoly power as the power to generate "excess profits," do you mean profits in excess of a competitive level?

A Well, one has to be careful what one means by competitive level in this context. It's a very open-ended term. Do you have a particular definition of "competitive level" in mind?

A I was using it in the same sense you used it on page 6, in the middle of that first incomplete paragraph, where you say: "It is inefficient for a monopolist to raise its rates above a competitive level."

And as you used that term there, I take it that what you are referring to on page 8 is that excess profits are profits in excess of a competitive return?

A That's right.

Q That is to say, profits in excess of returns earned elsewhere in the economy on investments of approximately the same risk. Isn't that essentially what you mean?

A That is a good definition for this context. I would accept that.

Q So it's profits in excess of the cost of capita in light of the risk.

A That is reasonable; yes.

Q Now, you would not mean by excess profits, just as an example, a return in the range of 5 percent if the cost of capital were 15.

A Yes. One has to be, again, careful about judging particular rates of return and be cognizant of the time period over which is looking.

But, in general, the answer to that question would be no.

Q Now, on page 8, the language that we have just focused upon, you use the term "monopoly power," and then on page 9 in the middle paragraph and elsewhere in your statement, you refer to "market power."

Am I correct that, as at least as you have used the terms in your testimony, the terms "monopoly power" and "market power" are not synonomous?

A No. I have essentially -- I think ordinarily one uses them more or less interchangeably. If there is a distinction here, I don't think I was particularly conscious of it in drafting this testimony.

Sometimes we think of market power as the ability to simply influence the price of a product, in which case it would be possible to have the power to influence the price of a product without having monopoly power in the sense of earning excess profits.

Q Okay. So as I understand the distinction,

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what you are suggesting is that a railroad can have some market power which is the ability to charge a rate above variable cost, but not enough market power to generate monopoly profits which would be those in excess of a competitive return. Is that correct?

A Yes. To be precise about it, in an industry as I have discussed here, the substance, really, of the point is this: In an industry with large fixed costs and with costs that are joint to a number of different products, such as a railroad physical plant, it is possible to have power over the price of individual commodities; as economists say, face a downward sloping demand curve for the product or service and, at the same time, not have overall for the whole railroad entity, enough market power to generate returns in excess of competitive level.

Q I don't mean to suggest with the next couple of questions that there's anything controversial about this. I am simply trying to clarify it the way you used the terms. And having laid that foundation, we can go on.

A Let me add, I am not sure when I wrote this, I was as careful to distinguish market and monopoly throughout the testimony as you are suggesting. In clarifying this, I think the substance of the point

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still holds, that railroads in general very often have some power and influence over price, and the question is whether that power and influence over price is sufficient to generate excessive returns.

Q I appreciate that clarification. Let me just ask one followup question, to be sure the record is clear on this.

Let's suppose a situation where there are lots of railroads serving the origin and destination, lots of barges, lots of motor carriers, and as a result the competition is about as closely to the purely competitive as you get in the real world.

I ask you to assume that. That being the case, you would expect to see railroad I's prices forced down by competitive pressures to something close to variable cost, would you not?

A Probably, to some level, that approach is not necessarily variable cost. In the long run, there would presumably be exit of firms if full costs on that particular service couldn't be covered.

I think the point would be long-run incremental costs of that particular product or something like that would be a better characterization.

Q Be forced down to long-term incremental costs.

Now, you've used the term "variable costs" in

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your testimony and you have referred to ratios in terms of variable costs. Now, for purposes of analysis, recognizing that they are not calculated the same, can we think of variable costs and incremental costs as approximately the same?

A Well, if there are some capital investments that are distinctly related to the particular service or class of service in question, then those would count in to sort of long-run cost concept, long-run incremental cost concept, but would not be included in variable cost.

To the extent that they are specific investmenmts that can be associated with a particular service, then they aren't the same.

Q My questions at this stage are not designed to -- and I will not follow up with you on how you calculate either incremental cost or variable cost, but there is some cost floor called incremental cost that prices would be forced down toward in a very competitive market.

A That is correct and I tried to make that point, that it's possible to have --

Q And if I understood your answer in response to my earlier questions, it would not be a misuse of the term "market power" to use it to describe the ability to price somewhat above that cost floor. Is that correct?

A Yes. Market power connotes the ability to influence the market price in some respects.

Q So a railroad that could price 5 percent above that cost floor would have some market power, albeit not very much, and a railroad that had the ability to price 10 percent above that cost floor would have a little more market power.

Is that fair?

A I don't know that I would define market power exactly that way. But let's say that in both cases there would be some market power; yes.

Q I'm simply trying to clarify one of your earlier answers, that the ability to exercise -- let's call it market power -- to charge a markup above cost does not mean the same thing as the ability to earn monopoly profits. Isn't that correct?

A That's fine.

Q And that's essentially the thrust of several pages of your testimony?

A That's right.

Q Okay. I ask you to turn to page 10. In one of your earlier answers you referred, I believe, to the ideas that are spelled out in the top of the page; that is to say, that railroads have a large proportion of fixed and unallocable joint costs.

Under such conditions, railroads must earn revenues substantially in excess of variable costs in order to remain viable in the long run.

Do you see that testimony?

A I take it that you are -- I know that you are very familiar, from your publications, with notions of differential pricing and Ramsey pricing?

A Yes, I am.

Q You understand those concepts and the analysis that underlies them very well, I am sure.

A I do.

Q Now, that is essentially, is it not, the practice whereby a railroad would charge prices in the most competitive markets down towards a variable incremental cost floor and charge higher prices where demand elasticities are less.

Is that not essentially what those pricing principles mean?

A I would have to disagree with your statement of that, in that you said price low where competition is intense and price high where elasticity is low.

The Ramsey price principles relate to the elasticity of demand. That is often a correlation between the elasticity of demand and the degree of competition. But the principle is not price low where

there's lots of competition and price high where there is no competition.

But the principle is pricing in relation to the market elasticity of demand for that product. And so in that sense where elasticities are low, Ramsey prices say that prices should deviate from marginal cost more than where market elasticities are high.

Q So that a more accurate way to make the statement is not in terms of competition, but in terms of inelasticity of demand, that markups should vary inversely with elasticity of demand.

Is that a correct proposition?

A Markups should vary inversely with elasticity of demand, I hate to be technical, but in cases where there is no cross-elasticity of demand between the products we are considering.

Q But essentially, as I understand your statement here and elsewhere, that is an appropriate way for railroads to price, given the fact that they have fixed costs and unallocable joint costs.

Is that correct?

A That is right. There is one important qualification one has to make, and that's why I emphasized market elasticity of demand in my answer.

Sometimes railroads argue as if it were the

elasticity of demand facing the firm, facing the particular railroad that mattered for the implementation of Ramsey price principles.

That's not correct. It's the elasticity of demand in the market. So to the extent that there is inter-railroad competition or intramodal competition, Ramsey prices would be set with an eye to the market elasticity of demand and not necessarily be set, if one were regulating, be set lower because there was intramodal competition in one market and the absence of intramodal competition in another market.

Q I want to focus for just a minute on the sentence, "Under such conditions, railroads must earn revenues substantially in excess of variable costs in order to remain viable in the long run."

As I understand what you are saying here, that not only differential pricing in relation to market demand elasticities is important to recover cost, but you are saying it's necessary for railroads to remain viable in the long run. That is, to stay in business.

Is that your belief?

A That's correct. To the extent that some new investment in physical plant facilities is required, railroads have to generate the earnings in order to warrant that, and those earnings are, by definition,

going to be in excess of variable cost.

Q And that's what you said in the long run. We were not talking about a railroad that is going out of business next month. We are assuming, for purposes of your analysis here, that a railroad is going to be in business for the long run.

If it is going to be in business for the long run, then it has to, as you say in the next sentence, generate the funds sufficient to maintain, replace, and improve capital assets. And that's what you mean by "stay viable."

A That's right.

Q Just to be clear on this, if a railroad like KCS or any other railroad for that matter had zero market power, zero ability to price above incremental or variable cost, could it stay in business for very long?

A I suppose it depends what you mean by "very long." If all of the railroad rates -- all the KCS could do is recover variable costs on all of its services, it would, I would presume, seek to exit the railroad business rather than replace depreciated capital assets.

Q And if it didn't seek to go out of the railroad business, it would be forced out ultimately, would it not?

A Very possibly.

Q It couldn't survive in the long run.

A Very possibly.

Q Okay. Now, this sentence, this same sentence, you refer to needing an adequate contribution to fixed and joint costs in order not only to maintain, but you say replace capital assets.

Is it your testimony that if assets are going to be replaced in the long run, if they are, then the costs that a viable competitor must recover are the costs of replacing those assets as the wear out?

A I testified on that subject before before this Commission.

Q I know you have.

A And my views are essentially unchanged. I think that, in principle, railroads must be permitted to, and must in order to remain viable in the long run, earn adequate returns on the replacement cost of their assets.

However, it's important to recognize that not every specific physical asset in a railroad system would warrant economic replacement. The railroads were old, they were built a long time ago, many batch lines, lots of physical facilities would not be replaced under competitive conditions. And therefore, the appropriate

base of capital assets that could be valued at replacement cost may be smaller than the total stock of capital in the railroad.

Q And in some of your testimony, you used a 10 percent discount factor to reflect that, have you not? You've assumed 90 percent of replacement cost.

A Yes. That was sort of rough-gauge calculation I made in -- it wasn't testimony actually. That was an article in the Bell Journal of Economics and a similar article in American Economic Review in which, you know, as a gross adjustment to the value of the railroad capital stock, took off 10 percent.

Q So what you're saying is railroads were built a long time ago, and if you replace them today, you might not replace certain branch lines, and even as to trunk lines you might not replace them in exactly the same way.

A That's for sure. There's parallel trunk lines through much of the Midwest, for example, not all of which would warrant replacement economically.

Q But if you did replace them, if you were going to stay in business for the long run and if you were going to replace particular assets, then the relevant costs for purposes of competitive viability are replacement costs; correct?

A That's correct.

Q And those replacement costs include depreciation expense.

A Well, I'm not quite sure what that means. If we are talking about replacement costs, we don't build it up out of accounting categories. We would value the assets at the replacement cost, which means essentially looking at technically the cost of putting into place capital assets that would provide the same services at least cost to the capital assets we have presently in place.

Q I don't mean to make this more complicated than it is. Essentially, you understand that capital costs include the wearing out of an asset which economists and accountants sometimes refer to as depreciation and they also include the return on investment.

The only point of my question was to make it clear, if it is your belief, that when we talk about replacement cost and capital cost, we are talking about current level of both depreciation or the wear-out expense and the return on investment.

Is that not correct?

A I think you are confusing the notion of replacement cost, which is a stock measure that measures

the value of the capital stock, with what annual charge would be appropriate to show up as a charge against in that in a period income statement, which would be depreciation and some return on the capital.

So it's not -- replacement cost is a valuation idea. It's a notion of how much it would literally cost to invest in the facilities. And the depreciation charges are an annual charge to amortize that investment over time.

Q And the investment to be amortized in making that calculation, is that the replacement cost level, taking account of whatever excess capacity there might be or differences in construction techniques?

A One gets into an area, I think, of some controversy here. There are different ways, there are different kinds of economically appropriate depreciation schemes, depending on the particular problem.

So what is a proper depreciation scheme for a new investment may very well depend on future demand characteristics in the market.

One possibility discussed in the literature is to charge depreciation as -- to charge it annually as the true economic depreciation in the asset; that is to say, the net change in its replacement cost from year to year. That's one possibility.

But another would be to write off an asset that took account somewhere, inter-temporal variations in demand. So sort of inter-temporal Ramsey pricing with respect to setting depreciation schedules. And both those ideas are possible.

Q And there are lots of other ways to recognize the wear-out costs, are there not?

A That's right.

Q My question does not address which of those techniques is right. My question is this: In applying any one of those techniques, the relevant cost of the asset cost that is wearing out is the replacement cost rather than the book value which might be 30 years old or 10 years old or some historical number in the past.

A That would be, from the standpoint of economic policy, the appropriate number to look at.

Q Okay. Now the next sentence in the middle of the page, you now shift to talking about tradeoffs between achieving short and long-run efficiency.

Up above we were talking about liability of the railroad. We are now talking about efficiency. And I take it you are now using that term in the sense of overall economic efficient allocation of resources. Is that right?

A That's right.

Q And if I understand the point of these several sentences, you are saying that a railroad or the railroad industry cannot achieve what you refer to as long-run efficiency unless railroads price in excess of variable or incremental costs.

Is that correct?

A Yes. I am saying that if returns are not sufficient to cover these long-run replacement costs, then there would be a deterioration of the capital and so forth, and that would be dynamically inefficient or inefficient in the long run because the facilities that should be serving the public would not be.

Q So long-run efficiency as well as viablility, requires that railroads be able to price above variable cost. And that, in turn, requires that they be able to exercise some market power. Isn't that the point of tis page?

A Sure. This testimony, my previous writings, and the writings of many leading economists in the area.

Q Okay. Now, just below that sentence you say that -- and I'm starting the quote in the middle of a sentence: "Excessive competition can lead to subnormal earnings and the subsequent long-run deterioration of physical plant and service quality."

Do you see that sentence?

A Yes.

Q Now, if I understand you correctly, you are saying that competition is good to the extent that it prevents monopoly power and excess profits, but that it is excessive if it prevents a railroad from earning a normal return.

Is that a fair summary?

A That's right, in the long run. Of course, there are going to be short-run periods of adjustments and fluctuations, episodes in the business cycle where no one in the economy is making so-called normal rates of return.

But if you look over the long pull, that statement is correct.

Q And again, normal here, we are talking about the cost of capital in light of the risks.

A That's right.

Q Now, at page 18, you use a slightly different term, and this is about four lines from the top. The term you use there is destructive price competition that would prevent the achievment of adequate revenues.

I take it that -- and I will give you a minute to get the context -- but the term "destructive competition" as you used it at page 8 is essentially the

same as "excessive competition" as you've used it on page 10?

A It's more or less a term of art. "Destructive competition," meaning pricing down to variable costs, not generating earnings sufficient to cover fixed costs.

Q So you are saying, just so I'm clear on it, that market power is bad if there is so much of it that it becomes monopoly power and generates excessive profits, but some market power is essential to long-term viability and long-term efficiency.

A Yes.

Q And the next sentence -- and I'm sorry to take so much time on this page, but I think it's important. The next one will go faster.

A Back on page 10?

Q Yes. I'm back on page 10. Just under the excessive competition sentence, you say that it is therefore essential to consider whether competition will depress profits below those necessary to assure the long-run viability of railroad service in the area.

Do you see that?

A Yes.

Q And then you go ahead and express your belief that the KCS's IRMA proposal will not impair long-run

viability of the merged carrier; right?

A That's right.

Q But your belief is that other railroads' request for trackage rights, particularly the long trackage rights, might very well lead to excessive competition of the sort that would prevent long-term viability.

Is that your view?

A Yes.

Q Now, in any event, you are saying that the Commission in doing its job must consider whether any trackage rights proposal and, for that matter, whether the KCS's IRMA proposal would create so much competition as to eliminate the market power that it needed to cover all costs and attain long-run viability.

That's the Commission's job in this case, one of its jobs; true?

A That is one of its jobs, that's right.

Q And it should make that inquiry with respect to all trackage rights applications and the KCS's IRMA proposal as well?

A That's right.

Q And if the Commission concluded that trackage rights would, in fact, preclude the merged carrier from covering all of its costs, including all of its capital

costs, and that those trackage rights would make long-term viability impossible, then it's your judgment that those applications should be denied, is it not?

A If financial viability of the merged entity were impossible under any particular condition or set of conditions, then my view would be it would be unwise for the Commission to impose them.

That does not prove the negative. It doesn't mean that the Commission should approve the merger necessarily.

Q I understand. But what you're saying is that if it would be possible for the merged carrier to attain long-term viability to cover all of its costs without the trackage rights conditions, that the granting of trackage rights or the granting of the IRMA proposal, if the Commission concluded that those conditions would make it impossible for the merged carrier to attain long-term financial -- long-term viability to cover all of its costs, then those conditions should be denied in your judgment?

A I think that's the question I just answered.

Q I think it is.

A If it's a different question, I didn't understand it.

Q It's not intended to be.

Let me ask you to turn to page 12. I apologize if this is repetitive. We have been talking in terms of market power, and I want to ask you some questions now about monopoly power, recognizing the distinction you have already made.

About ten lines up from the bottom you refer to subjecting shippers to excessive monopoly power in the future.

A I'm sorry. Where is that?

Q The sentence that starts, "In this case, there remains the concern that longer run changes in the relative costs of modes may render shippers subject to excessive monopoly power in the future." Do you see that? "In such circumstances' and then you talk about source competition mitigating and so forth?

A That's right.

Q I think in answer to one of my earlier questions you said that perhaps throughout the testimony you hadn't used market power and monopoly power in quite the precise sense we are now. I take it that here you mean that any monopoly power should not be imposed upon shippers, but -- and what that really means is excessive power.

A If we take the more precise definition that we have arrived at as the frame of reference here, then it

should either read "excessive market power" or simply strike the word "excessive" and say monopoly power. Either way would do.

Q Now, another couple of questions on monopoly power. Back on page 6 -- I think I've already referred you to this sentence -- you said, "It is inefficient for a monopolist to raise its rates above a competitive level." And I think you have made it clear that that's the level where the railroad covers all of its costs, including its fixed and unallocable joint costs?

A Let me try to be precise without trying to put it in the context of the sentence. In the -- when I emphasized this tradeoff between short and long run inefficiency, it is in some sense -- there is some misallocation whenever a railroad raises its rates above long-run incremental costs.

The tradeoff comes in because you have to raise your rates above long-run incremental costs in order to be financially viable. That's why it's a tradeoff. So that perfect short-run efficiency would have you -- or perfect efficiency in the absence of the constraint that you have to raise revenues in excess of the sum of all of your incremental costs, requires you to adopt a second-best standard, and that's why we sometimes speak of the competitive level as the level

that would generate competitive rate of return. Then this context I think actually -- technically, if you think in purely short-run terms, it is just raising rates above marginal cost -- does, you know, reduce the quality of service over and above -- or the quantity, I'm sorry, of service over -- beneath the level of the competitive market.

Q I think I understand what you're saying. Your point -- and other economists have made the same point -- is that perhaps from a purely best economic solution, the government ought to step in and subsdize the shortfall between marginal costs and average cost.

A That's right. That's the same kind of argument.

Q But the government has chosen not to do that so far.

A And there are large numbers of institutional reasons why that particular solution would not be very desirable.

Q So that being the case -- and I ask you to assume that the government is not going to step in and subsidize that difference -- that being the case, then long-term viability, long-term efficiency, the so-called second-best solution, requires that the railroads be permitted in their prices to cover all other costs,

including their fixed and unallocable joint costs; is that not correct?

A Yes.

Q And if they can't do that, they're not going to stay in business. That was the thrust of your earlier testimony. So that's the competitive solution in the absence of government subsidy.

A That's right.

Q Now, do you have any information today that the Santa Fe is earning monopoly profits, supracompetitive profits anywhere on its railroad system?

A I haven't studied specific parts of its railroad system, so I don't have such information, no.

Q So you don't have any information either that Santa Fe as a whole, taking its entire system into account, or any segment of the system is earning monopoly power. You just don't know.

A That's right.

Q I take it the answer is the same with respect to the Southern Pacific?

A That's right.

Q Do you know how far below a competitive level of return Santa Fe's earnings are today, or for 1984?

A I don't know what the properly defined replacement costs of Santa Fe's assets are, so I don't

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know precisely how far below competitive standard Santa Fe is. This is one problem in assessing revenue adequacy of railroads. We don't really have a proper denominator for that calculation yet developed.

Q I take it you haven't seen the Commission's recent decision in the docket involving revenue adequacy of railroads where they attempt to develop what the return would be on a current replacement cost basis?

A No, I haven't seen that.

Q In light of that last answer, I will go through quickly the next questions. I think I know what the answer is, but I want the record to be clear.

I take it that you are aware that there are some cities, metropolitan areas that are served today by the Santa Fe where no other railroad serves those metropolitan areas.

A Yes.

Q Now, do you know whether that fact has led to any monopoly profits for the Santa Fe Railroad?

A Well, the overall -- the point here is that the overall earnings of the Santa Fe, even though it has some pockets of substantial market power, do not, at least on the evidence we have to date, appear to be excessive. It doesn't say they won't be after the merger.

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Q I understand. But now let's focus on those so-called pockets of substantial market power. Do you know of any segment of the railroad or segment of the Santa Fe's business where those pockets, as you put it, of substantial market power have generated monopoly returns either in total or for a segment?

A I haven't studied that.

Q And the same is true for the Southern Pacific?

A Yes.

Q Have you done a study to determine whether there are any particular commodities -- and I'm not focusing on geographical areas or segments but commodities -- as to which Santa Fe is earning a monopoly return today?

A We have identified some commodities for which rail has a very substantial cost advantage. Some of those commodities move out of captive points to the Santa Fe, but I haven't done a specific study of the rates and the relation of the railroad rates to cost on those commodities, no.

Q So assuming that you are right that there is some degree of market power with respect to some of those commodities, you haven't done a study to determine whether those commodities generate monopoly profits for the Santa Fe Railroad?

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A I have not.

Q Or the Southern Pacific?

A No.

Q Now, on page 13 you say, and this is in the middle paragraph, "In general, however, the most serious anticompetitive impact will be felt in the transcontinental Southern Corridor that links the rapidly growing sunbelt regions from California to the southeast."

Do you see that?

A Yes.

Q Have you performed any study to determine whether the rates paid by all of the shippers in that Southern Corridor after the merger would produce revenues in excess of the total cost of operating and maintaining the corridor over the long term?

A We don't have data on rates paid after the merger, since the merger hasn't been fully effectuated. And so as a consequence, I haven't studied that specific question, but I have looked at the dominance of the railroads in the hauling of a number of important commodities in that corridor and the cost advantages of railroads over other modes in the hauling of those commodities. And the conclusion I would draw from that is that there is substantial scope for the exercise of

considerable market power in that corridor.

Q Yes. But my question is not now on market power, but it's on monopoly profits and excess profits. You haven't done a study, as I take it, estimating what the revenues for the railroad would be after the merger occurs in light of the costs properly measured. You haven't done a study to determine whether over the Southern Corridor the merged carrier would be able to extract monopoly profits from the shippers over that corridor, have you?

A I haven't, but the Santa Fe has. And the Santa Fe's own study report given to its board of directors, that I believe is an exhibit in this case, said -- it claimed that this merger would lead to substantial increases in profit over and above the cost savings that are associated with the merger. And I can only conclude from that that Santa Fe management agrees with my conclusion that there would be scope for substantial increase in rates.

Q My question is not whether there would be increased rates. My question is whether the increased rates which you foresee occurring would be sufficient to produce monopoly profits over the Southern Corridor from all of the shippers who pay revenues for the use of that corridor?

A I have not done a specific study of that.

Q So far all you know, for all you know, the revenues that the merged carrier would earn on that Southern Corridor might be below the level needed to attain long-term viability.

A They might be below; they might be above. I haven't studied that specific -- I haven't approached the question in that specific way.

Q Now, on page 14 you start discussing the IRMA and how it works. In this section and the subsequent section that starts at page 15, this discussion carries over to 16 and 17 -- I'm going to ask you about what you say at 16 and 17.

On the bottom of page 16 you say that the IRMA would "constrain the market power of the merged carrier," but on page 17 you say that the IRMA "would not prevent them from earning adequate revenues." Is that your view?

A Where are you referring to on page 17?

Q "Not persuaded by the contention of the primary applicants that the SP and the Santa Fe cannot earn adequate revenues in head-to-head competition. The IRMA proposal has distinct advantages."

A I don't think that that sentence says what your question implies.

Q Perhaps it doesn't. Let me take you over to page 18 where the paragraph continues. In the last sentence, the last couple of lines of that paragraph say that "The IRMA would not constitute a major obstacle to the SPSF's achievement of revenue adequacy."

I take it what you're saying is it is your view it would not prevent the merged carriers from attaining revenue adequacy over any segment of their railroad; is that right?

A Revenue adequacy I think is a concept that relates to the whole railroad as opposed to a segment.

Q Covering all of their costs, including their joint and unallocable fixed costs -- fixed costs and their unallocable joint costs, excuse me. That's what I mean. I think that's what you mean, isn't it?

A I think I've lost track of precisely what the question is.

Q You're saying that the IRMA would not prevent the railroads from covering all of their costs over any particular part of the railroad.

A I don't think I specifically said that. I think the way I put it is I think it's highly likely that the merger unconditioned leads to substantial scope for market power in the Southern Corridor. I believe based on previous work that it's quite likely that that

would generate more than adequate revenues for the entire system; but I have not done a specific study of that question.

I also believe that the IRMA would constrain the ability to exploit market power in the Southern Corridor. It would not constrain it so severely as to make the merger -- the merged entity nonviable.

I think I believe all of those things.

Q Thank you.

It would not be a major obstacle, but it would be a constraint.

A It would be, that's right.

Q It would be an obstacle but not a major one?

A That's a way of characterizing it. Yes, I think I agree with that.

Q On page 14 in describing how you understand that the IRMA would work -- this is in the next to the last paragraph toward the tail end of the paragraph -- you say that the charges for the IRMA, the amounts the KCS would pay for the IRMA, as proposed, would cover variable cost plus a reasonable return on capital, right?

A Yes.

Q But it wouldn't cover fixed cost, would it?

A I'm not sure what you mean in this context by fixed cost. Some of the capital is surely fixed -- wear

and tear on the track.

Q Isn't your understanding that the charges for the IRMA, as proposed, should cover all track maintenance charges -- all track maintenance costs, excuse me?

A All track maintenance costs? Well, obviously not all since the railroad will only be a partial user -- the KCS will only use a fraction of -- only be imposing some fractional percentage of usage on the track.

Q You're aware, I'm sure, that in ICC costing some maintenance is treated as variable, and some maintenance is treated as fixed.

A Yes.

Q Now, my question is is it your understanding that the IRMA charge is intended to cover not only the variable portion, but some part of the fixed portion as well?

A If you're asking me what specifically is in the KCS application as to the nature of the IRMA charge, I guess I don't know the answer to that question, I'm afraid. Whether it covers fixed maintenance charge I don't recall. There is some return of rental rate on the property, I know that; and I'm not sure about the rest.

Q Let me ask you this. Apart from what it's intended to cover, do you believe as an economist that it ought to cover not just the variable part of track maintenance but the fixed part as well?

A Well, the problem is if you can be precise about what the fixed part of track maintenance is, then I might agree with you on principle. But in principle here, the appropriate maintenance to cover is the maintenance of the -- the maintenance that can be allocated to that particular line segment.

Q I apologize, because I think my question was awkward. Let me try it another way. Is it your view as an economist that the charge for the IRMA should make not contribution to the fixed part of the track maintenance costs?

A I have trouble with the question only because I have trouble conceptualizing what the distinction between fixed and variable components of maintenance costs really are as opposed to what railroad Form A says they are, because it is a difficult -- in that context a difficult question to answer.

In economic terms, in theory there would be a maintenance expenditure required on the line segments over which the KCS would have the IRMA arrangement, and on those segments some pro rata share of the maintenance

expenditures would seem appropriate.

Q That's true also with respect to depreciation of equipment?

A Depreciation of equipment only if the equipment were used by the KCS. And as I understand it, KCS will arrange its own car supplies so that when it uses other people's cars it will pay per diems.

Q Would the IRMA charge, as proposed, permit KCS in turn to turn around and charge the shippers rates which were only slightly above the level of variable cost plus a reasonable return on capital; in other words, the amount of the charge that they have to pay the merged carriers -- permit them to charge their shippers rates that were only slightly above that variable cost level and still make a profit?

A It would, but remember, we have built in a reasonable return on capital here, so we're not talking about pricing at strictly nonviable levels.

Q But we haven't built in the fixed cost and the unallocable joint costs, have we, not specifically?

A We have built in, as I pointed out, presumably some substantial component of fixed cost in the rental rate on the property. And I have to confess I don't know exactly how the maintenance expenditures are handled, but what we haven't done, I suppose, is build

in systemwide costs apart from this particular line segment.

Q And that would be true of systemwide costs that are essential to operating a particular line segment to the extent they are, isn't that so?

A Yes, but remember, KCS has to cover those costs in its own system as well, so that they would not have an incentive to price right down to the level of the rental rate it's paying to the level of the IRMA charge that it is paying to the SFSP. So there would be a floor, and it's not clear that you go exactly to that floor. If you did, it would not be in KCS' interest to haul the traffic. Certainly KCS will earn some margin that will permit the same margin to be earned by the SFSP.

Q But it's possible that that margin would not be adequate, isn't it, to cover all of the costs of the merged carrier over that particular segment?

A As you pointed out, all of the costs are not specifically allocable to that segment, so we are being kind of vague here in the sense that both railroads have a problem that they have to cover over their whole systems, something in excess of allocable costs. And there would be no incentive for either railroad to price in such a way that would forbid that.

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Q I don't mean to prolong this unduly. It's certainly true that there are some fixed costs of office buildings back in Chicago that are not specifically allocable to the Southern Corridor, but isn't it also true that there are some fixed costs that are specifically allocable to that Southern Corridor, such as track costs, rail costs, way costs? There are some fixed costs that are allocable to that Southern Corridor.

A That's what I said, yes.

Q And my question is this: Isn't it the case that the IRMA proposal as it has been advanced here and as the compensation has been proposed would not necessarily permit the merged carriers to recover all of the costs properly assignable to the Southern Corridor, including those fixed costs that are essential to operate over the Southern Corridor?

A I think I answered before that I'm not sure about the specifics of the pricing that is proposed in the document, no.

Q Okay. I won't ask you any more about that. Page 19 and 20 where you're discussing long haul trackage rights as distinguished from the IRMA, on page 20, the first full paragraph you say that "There is a substantial body of opinion that the disadvantages of trackage rights multiply as their distance is

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increased." And then you refer down the page to those disadvantages.

Do you see that discussion?

A (Nods in the affirmative.)

Q Do I understand correctly that you agree with this?

A To the extent that I have knowledge of railroad operations -- and I don't have detailed knowledge of railroad operations -- I agree with what I have found to be rather convincing arguments, made largely by railroad operating people, about the problems.

Q We're now talking about the disadvantages of trackage rights as contrasted with the IRMA proposal.

A Well, of course, there haven't been a lot of people talking about the relative advantages of the IRMA and trackage rights, because this is a new idea or a relatively novel idea.

Q But in your discussion here, you're focusing now on trackage rights as distinct from the IRMA.

A Yes.

Q And you're identifying disadvantages that apply to the trackage rights.

A That's right.

Q One of those, as you have stated on page 20 just below that sentence we were focusing on, is the

operating difficulties; and I'm going to ask you now to explain what you mean by that. What are you talking about when you talk about operating difficulties?

A Okay. Well, I do go into some detail in the testimony, not great detail, but in which I point out that trackage rights do impose extra costs on the landlord and inconvenience and possibly the use of some redundant resources.

There are costs of simply arranging sort of efficient schedules and minimizing the number of what I call train meets along a segment of track. And, for example, that is one that is clearly related to distance, because the number of train meets that would be required over a given 24-hour period, let's say, for a given density of traffic is going to increase more than proportionately with distance. That is just a simple mathematical calculation.

Q But I take it that your view is not only that these operating difficulties and other disadvantages that you refer to are bad from the applicants' standpoint, but that they are hurtful to the public interest. Is that the thrust of your last line at the top of the next page?

A Absolutely. To the extent that they slow the trains, you know, you have more delays because of

greater meeting time between trains. There's a social cost attendant to do that that the shipper would bear. There's real resource expenditures that might be required to arrange yard operations in such a way as to allow two railroads to operate in the same yard. So that there are costs.

Q I understand you're talking about costs and resources that the applicants are going to bear, but why do you think it is costly from the public interest standpoint? That is my question.

A Well, any real resource expenditure is an expenditure of society's resources, and to the extent those could be more productively employed in some alternative use, it's a social cost. So if you could run an efficient yard operation with one railroad for less total resource cost than you could run that same yard operation with two railroads moving their switch engines around in the yard, there is some incremental social cost associated with that arrangement. There's a question whether the benefits conferred by the arrangement outweigh the cost, but there surely is some additional social cost in the use of trackage rights.

Q At the top of page 21 you're talking about these burdens. You say, "Even if the landlord were fully compensated," extra resources could be more

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productively employed elsewhere. When you say "Even if the landlord were fully compensated," I take it you're saying the landlord should be fully compensated for these additional burdens?

A I'm not really making that point here, although I don't disagree with you on that point. The point I'm making is precisely this point about private and social costs here; that even if all of the private costs were covered for the landlord, there would still be some social costs attendant to the extent that extra resources are used that could be used elsewhere.

Q But you wouldn't disagree with the proposition that the landlord ought to be fully compensated for whatever those additional burdens of cost are?

A I have been through that also in previous testimony and, provided you get the definitions right, once again, I believe the landlord should be fully compensated. Full compensation, however, does not imply compensation for the lost monopoly profits which trackage rights are addressed to remedy.

Q If such monopoly profits exist.

A That's right.

Q You haven't identified a single place, have you, a single area of the merged carrier or a single shipper who would be paying monopoly profits to the

merged companies, have you, in your testimony?

A I haven't identified a single shipper.

Q A single group of shippers?

A I have identified a group of commodities in a particular geographic region that would be subject to substantial market power.

Q Market power but not monopoly power. I want to come back to the distinction you made earlier in your testimony. I agree with you that you have asserted situations where there would be increased market power, but I want the record to be clear that you haven't identified a particular segment of the railroad or a particular category of shippers who would be paying monopoly profits to the merged carrier; isn't that correct?

A I have not shown or studied in particular the question of whether the contribution to the overall earnings of this system from having essentially a railroad monopoly of Southern Corridor transportation would be enough to make the overall earnings of this firm in excess of adequate revenues. But that is -- I believe that such substantial market power with such a large geographic area for such a large group of commodities essentially as I have shown here, what appears to be about 80 percent of the rail traffic base

in the Southern Corridor subject to substantial increases in rates, then in my opinion that is very likely to lead to overall earnings for the system in excess of competitive returns.

Q That is an opinion that you have expressed, but nowhere in your testimony -- would you point to me a particular place in your testimony or any of the appendices to your testimony where you have studied what the profits would be of the merged carrier on any part of the system in relationship to the cost of capital?

A I cannot point to that. I have pointed to the severe anticompetitive effects of the merger, and to complete the balancing test required for the Commission, I suppose it would be desirable to see -- to make some projections about rates, but I have not done that.

Q I don't mean to argue with you, Professor Levin, but earlier you said that a competitor in a competitive market is entitled to earn a competitive return, is he not? He's entitled to earn his cost of capital. He's not a monopolist unless he exceeds his cost of capital, is he?

A I'm not sure what you mean by entitled to. I can imagine competitors who operate inefficiently, and they have not right to --

Q He's entitled to try. You can't call him a

monopolist so long as he hasn't earned returns that exceed the competitive level; that is to say, the current cost of capital.

A Yes, but, you know, we have antitrust laws in this country, and the purpose of those laws is essentially to regulate the extent to which firms can -- do, in fact, compete. Typically speaking, we don't allow in the general economy mergers in a market where there are only two firms to merge, to monopolize that market. And this is a case of that happening.

It seems to me that the fact that the two railroads are essentially over a large part of the United States going to create one railroad is a very strong argument that the loss in competition is very severe.

Q You say it's a case of that happening, and that "that" is monopolization, and yet I keep coming back to it. Can you show me any place in your testimony where you can identify a single segment of either the existing railroads or where you believe a segment of the merged railroad would earn profits in excess of a competitive level?

A I keep being troubled by your use of "single segment" in that question, because I have identified a number of segments where there is scope for very

substantial margins of revenues over variable costs, and I have identified those in the testimony -- the chemical traffic that flows from the Gulf Coast to California being perhaps the most substantial example of scope for very large rate increases. But I have not quantified the overall contribution to profit that that traffic would bring.

Q And having not quantified it, you can't say today here that after the merger, if there are no conditions, that the merged carrier would in fact be earning monopoly profits on traffic over the Southern Corridor, can you? That's my only question.

Q Well, I have some experience looking at these problems, and I wouldn't say in an unqualified way, as you just said, that I can't say. I believe I can testify on the basis of the opinions that I have of the railroad system as a whole that this is a lot of traffic. A lot of it is potentially quite lucrative traffic because it's not intermodally competitive. And in my opinion there would be a very substantial increase in contribution. Certainly it would be a better first guess to say that there would be a very substantial increase in the bottom line earnings of this railroad, of the Santa Fe-Southern Pacific, over and above the cost savings than it is to submit, as the Santa

Fe-Southern Pacific did, pro formas which reflect no rate increases.

Q Let me try it one more time. I'm not asking you about whether there will be an increase. I'm asking whether you have done a study based upon which you can testify to this Commission that whatever that increase is, it will be sufficient to produce monopoly profits for the merged carriers over the Southern Corridor.

A I have not done a study.

Q On page 23 you say, at the top of the page, that you believe that the Union Pacific's proposals might cause the two applicants to abandon their merger plans. Do you see that testimony?

A Yes. From the bottom of 22 and the top of page 23?

Q Yes. Would you explain the basis for that link?

A I think the basis for that belief is laid out here in the sense I think there are two substantial problems with the UP application relative to the KCS application. One is because its long haul trackage rights and because of the attendant cost associated with those, I believe that they will -- that the cost savings that are projected by the applicants will be somewhat attenuated, perhaps severely attenuated, by the UP's

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presence of its system. So that on the cost savings side, there would be a reduction in cost savings. And then on the revenue generating side I believe that the Union Pacific, which is a strong railroad with a strong foothold already in the California market, serving many of the same shippers that are served in the Southern Corridor, although serving them to different destinations, both at the east end, the chemical traffic on the Gulf Coast, and at the western end, of course in the Los Angeles area and the Bay area, serving those shippers in terms of their transcontinental Central Corridor traffic, I believe that the UP would be essentially a much more aggressive and much stronger competitor and in that sense tend to take away a greater fraction of the traffic base from the Southern Pacific-Santa Fe and, hence, be a much more serious threat to the financial viability of the entity than with the KCS.

Q As a result of that what you're saying is that if the UP's proposals were granted in substantial part, you think that the applicants might well be advised to call it off?

A Well, if I look at it from Santa Fe's perspective, I ask would I rather be competing with the Southern Pacific or the Union Pacific, and my answer

might well be the Union Pacific worries me because they are a very strong, very well managed railroad.

Q I wasn't asking you to make that comparison. What I was asking you is that if you were advising the Santa Fe, in your best economic judgment do you think that if the UP proposals were granted in substantial part, you might very well advise the merged carriers to call it off rather than go forward?

A I might. That would have to be studied from the standpoint of -- from a standpoint which I have not studied the question. But it is possible.

MR. MARTIN: Just a minute, Your Honor?

JUDGE HOPKINS: Surely.

(Pause.)

BY MR. MARTIN: (Resuming)

Q Okay. I would now ask you to turn to your second verified statement that is contained in KCS-14, dated November the 21st. Okay. The first section of the text of your KCS-14, after we get past the introduction, has to do with market definition, starting at page 2. I want to ask you about a statement that you make on page 3, eight or nine lines down, the sentence tha starts, "A substantial body of econometric evidence, however, consistently supports the view that the service offered by competing modes does not, for many products

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shipped over long distances, provide a close substitute for rail transportation."

Do you see that sentence?

A Yes, I do.

Q Now, wouldn't you agree, though, that for some products, competing modes can be close substitutes for rail over long distances?

A Yes, I would agree.

Q Wouldn't you also agree that for other products, competing modes can be a close substitute over shorter distances?

A Sure, that's true.

Q Now, in the next paragraph at the beginning you say, "The extent of intermodal competition is quite often relevant to defining a market." Isn't that another way of saying that often rail and motor carriers are part of the same transportation market?

A I would say often they are.

Q And where that is so, and the Commission should not exclude from its consideration of the market motor competition where it is so.

A If one uses the standard criterion like the Justice Department's 5 percent test, there are going to be cases where truck and rail by that test would be in the same market.

Q On page 4, for example, the top of the page, about the third sentence, you say, "Truck is a close substitute for rail in the long haul transport of produce, but a less close substitute in other areas." Do you see that?

A Yes.

Q You're not suggesting that produce is the only commodity where rail and trucks are close substitutes?

A No. This is an example.

Q On page 5 in the first full sentence you say that source competition may sometimes "provide workable and relatively efficient results." By that I gather that you mean constrain railroad pricing, true?

A I think there are two questions there. I do mean that workable and relatively efficient means would constrain railroad pricing.

Q And where that is so, then source competition, I take it, would have to be taken into account as part of the assessment of the market, would it not?

A In those cases, yes.

Q Let me ask you to flip over now to page 13. At the bottom of page 12 and on 13 you are referring now to econometric literature on truck-rail substitutability. Do you see that discussion in the bottom paragraph on 12 and 13 and on beyond that?

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A That's right.

Q At the bottom of page 13 a couple of lines up from the bottom you say that these econometric studies show that over the most relevant ranges of modal attributes, the elasticity of demand for rail is relatively low. For most commodities, and especially for longer hauls, the elasticity of demand for rail is less than one.

Do you see that?

A That's right.

Q Are these econometric studies upon which this conclusion is founded based on data from the post-Staggers Act period, that is, post-1980?

A No. Unfortunately, data availability lags rather considerably in this part of the government. So, for example, the census of transportation, the most recent one available is 1977, and the most recent studies use that data.

Q So the data that you're referring to in these econometric studies goes back to the 1977 period rather than the post-1980 period?

A Yes. Various sources of data have been used in these studies, some from '77, some earlier, but mostly in the '70s.

Q Thank you.

On page 14 in the first full paragraph you explain that the economic textbooks tell us that when the elasticity of demand in a particular market is less than one, a monopolist would always have the incentive to raise price. Do you see that?

A Yes.

Q Why haven't the railroads raised their prices to the level where they could earn monopolistic profits if the elasticity of demand is so frequently less than one?

A Because the sentence says a monopolist would have the incentive to raise price. If you have -- if you are in a situation where the market elasticity of demand for rail services is below one, but you have competition among two, or three, or four carriers, there is no prediction in that case that the price would necessarily go up.

The point is if you take a duopoly situation in a market with elasticities below one, one prediction that you can make is that when you merge and there's only one carrier in the market, prices will rise to the elastic range of the demand curve.

Q In other words, where you really have monopoly power you would raise your prices?

A No. Market power in this sense, if we're

going to distinguish the term: You would raise the prices in this particular market where you have some perceptible power over price in that market.

Q Can one infer from the absence of monopoly of profits, if it could be shown that railroads today are not earning monopoly profits in any significant markets, could one infer anything about the elasticity of demand in those markets?

A No, not directly, because there is intramodal competition in a very large number of railroad markets.

Q So you're talking now about elasticity of demand for railroad service in general rather than the particular railroad service?

A Rather than the services of a single railroad, yes. We're talking about in a market which we define as some product within a geographic area, we are measuring now the elasticity of demand for that product. If there are two firms competing, the elasticity of demand that is perceived by a single firm is going to be much higher than the elasticity of demand that prevails in the market.

Q You are not here saying that because the elasticity of demand for rail service is less than one, therefore, there are any particular railroad monopolists, are you?

A No. Quite the opposite. The inference, which is a legitimate inference, is that in such markets with the elasticity less than one, if you were to create a railroad monopolist, you would find prices rising to the elastic range, and if you look at data -- if data were available at a sufficiently disaggregated level that we could look at and estimate elasticity of demand in particular captive markets, I would be willing to -- I would be very surprised if one didn't find that the elasticity of demand turned out to be greater than one.

Q Let's talk about the disaggregability or level of aggregation of the data. On page 15 you say that the estimates of demand elasticity are not based on, as I read it, are not based on data for the transcontinental Southern Corridor.

Are the data upon which these estimates are based national data?

A It would be a misreading to say they are not based on data for the transcontinental Southern corridor. What they don't do specifically is distinguish the transcontinental Southern corridor in the methodologies. There actually are in the set of studies which are cited, each one has a somewhat different data base and somewhat different methodology, and in all of them, transcontinental Southern corridor shipments are involved.

Q Included?

A Included.

Q But I take it that there are not any estimates for demand elasticity that are specific and focused upon the transcontinental Southern corridor, is that what you mean by this sentence?

A Yes, that's the point.

Q Just down the page you say that these econometric studies show that there is an inverse relationship between modal shares and demand elasticity.

Do you see that?

A That's right.

Q Again, I take it that that conclusion is not based, is it, on data that is specifically focused upon transcontinental Southern corridor?

A No, it is not, but the robustness of the findings of these studies using very different kinds of traffic samples I think suggests that. You know, it provides at least a strong basis for inferring that demand characteristics for transportation are similar throughout the country.

Q I'm not going to argue one way or the other with you. I just want the record to be clear so that the Commission can assess it. The data we are talking about here is national data, not regional data.

A In some cases it is regional. For example, in the Friedlaender & Spady article, they do disaggregate by regions, but in the standard west-south official territory split that ICC used for years and if anything, I think the results there tended to be fairly systematically showing that the west, in the west, demand elasticities tended to be lower than elsewhere in the country, in part because it is dominated by longer hauls and commodities --

Q You are talking about west of the Mississippi?

A Yes.

Q You don't have it for the southwest?

A Not specifically.

Q Now, in the next to the last sentence on 15,

you says "Where railroads carry a large share of the traffic in a given market, other things equal, the elasticity of demand for rail tends to be low."

Do you see that sentence?

A Yes.

Q Other things aren't always equal, are they?

A Of course not, but all kinds of relational statements we make in economic reasoning rely on that. If you want to relate A to B, C, D and E always matter, but you still can make statements about relationships between A and B.

Q Here, though, you refer to a tendency and not an iron clad rule, as I read the senterce. You are not saying that a high modal share for railroads always means demand elasticity is low, are you?

A No, that's right.

Q There could be areas where modal share is high and elasticity is not low, couldn't there?

A There could be.

My own work didn't reveal any to speak of. They tended to be quite a systematic relationship.

Q Studies and data, though, don't permit you to say that there aren't?

A No. As a matter of logic, it is certainly possible that the econometric results would, in fact,

indicate instances of markets where estimated demand elasticity was high in a market with large share.

Q I think the answer to my next question is clear, but forgive me if I get you to repeat. I think the record ought to be clear on it. And just to be clear, you are not testifying that the studies you referred to in these several pages show that the demand elasticity for Southern Pacific rail service today is less than one. You are not saying that.

A I'm clearly not referring to the elasticity of demand for a specific railroad. I do think it is possible to make an inference from the studies about the elasticity of demand in specific railroad markets.

Q But you are not talking about the SP market, and you are not talking about the Santa Fe.

A According to conventional principles, market definition, I don't think there is such a thing as an SP market or a Santa Fe market.

Q Let me broaden it. You are not talking about the specific market in which the Santa Fe and the Southern Pacific participate.

A I am not -- that is what I just said in the sense that those specific markets aren't the focus of these studies I referred to, but I do believe it is possible to make inference about those specific markets

based on the studies.

Q Now, page 21 is where you start talking about the intermodal evidence and about the tables. I would like to ask you some questions about this text and about these tables.

A You are in the intermodal section?

Q Yes, the intermodal section, and I will ask you some questions starting at page 24, if you would turn to that.

24, at the bottom of the page, is where you refer to Tables 5 and 6, which is the data that gave been tabulated by Mr. Liba. You may want to thumb to Tables 4 and 5, 5 and 6.

Actually, I apologize, Tables 7 and 8 are the tables that summarize those data, aren't they?

A Yes, they are.

Q Table 7, as you point out on page 25, shows that of 216 identified flows, there are 100 flows that show a rail share in excess of 50 percent.

A Yes.

Q You are not saying, are you, that in those 100 flows the individual railroads involved are necessarily monopolists.

A No, quite to the contrary. In fact, in most of those flows there are two railroads, the Santa Fe and

the Southern Pacific, serving the traffic, but one is saying that after a merger for a great many of these markets, essentially all of these markets, there will be a single railroad.

Q Can you tell me what the SP share today is in any of those 100 flows?

A What the SP share is? It is all in Mr. Lilla's traffic in the revised SPSP-20. Southern Pacific's share is, for example, around half of the rail traffic in a number of the flows from Los Angeles to the Southeast.

Q That would be the basis for your answer?

A (Nods in the affirmative.)

Q Page 26, Table 8 reports tonnages, and here, ask you point out on page 26, two-thirds of all rail traffic moves inflows with a rail share in excess of 50 percent, is that right?

A Remember, these are flows as defined by Carl Lilla.

Q Yes.

Just to be clear on what you have done with the numbers and what you understand the numbers to be, Table 8, line 1, shows 10.9 million tons of rail west to east.

A That's right.

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Q Can you tell me, based on Mr. Liba's evidence or any other evidence that you have before you, how many tons the motor carriers have, the figure that would be comparable to the 10.9 million rail figure in these flows?

A In the total tonnage?

Q Yes, in the total.

A I didn't calculate that number, nor did Mr. Liba. It is not particularly relevant to the analysis. What one does know is that in the, you know, where we indicate the tonnage inflows with rail share greater than 50 percent, we know by definition that at most the truck tonnage in those flows is less than 7 million.

Q But not in the total flows.

A But all that would tell you is how much truck movement there is in markets that are intermodally competitive. I don't know the answer.

Q You don't know the answer. Okay.

Page 27, here you are now dealing with Table 9 and 10, shares by commodity group.

A Yes.

Q Well, again, just to be sure that I understand how you have used the numbers, take Table 9, Line 1. I gather this shows that there are 598,000 tons in the 12 Southwest origin to 5 Southwest destination flow where

the rail share is over 50 percent.

A I'm afraid I didn't quite get the question.

Q Again, it is not doing anything more than trying to clarify what this means. The origin is 12 Southwest, the destination is 5 Southwest, and we have a bunch of commodities identified on that line, and what this says is that for that origin to destination --

A Oh, excuse me. There's a typo there that I have missed. That should be origin 12 Southwest to destination 5 Southeast. I am glad you pointed that out.

Q I hadn't noticed it.

A Otherwise it would be an intraregional flow.

Q Let's say with that correction what this represents is that there are 598,000 tons with a rail share of over 50 percent of these commodities moving from 12 Southwest to 5 Southeast, is that accurate?

A That's right. The total, the first column that is a number there, the 629, is the total rail tons in all the two-digit commodity groups that I studied, and the 598,000 represents the amount of traffic that moves in the designated commodity groups that are listed. It is the sum of those.

Q Take the 629. That is the total that you studied.

Do you know what the truck tonnage is that corresponds to the 629,000?

A I think that that number is calculable. It certainly is calculable from the data in my work papers, from the printouts from Reebie Associates, but I did not calculate it because I was only focusing on those markets with an absence of intermodal competition.

Q But as far as you know, not having calculated it, it is possible that the trucks have more total tons than the railroads from that origin to the destination with respect to the tonnage that matches the 629 for railroad.

A It is quite possible. I do recall looking at the numbers on the basis of Mr. Liba's commodity aggregations and noting that in a number of flows overall, quite a number of the flows under study here, rail had more than 50 percent of the total tonnage, and in some of them trucks had more than 50 percent. But again, that is aggregating over a number of markets with very different characteristics.

Q As I read your Table 9, it shows tonnage from the designated origin to the designated region or regions but does not show truck deliveries from different origin areas, is that correct?

A That's right. These are region-to-region

flows.

Q Do you know, were there any deliveries of commodities in line 1, say, to the 5 Southeast territory from other origins than 12 Southwest?

A Yes, there are.

Q Commodity 10, if I remember the way you used it in the text, is metallic ores, is that right?

A Yes, that's the standard transportation commodity code number.

Q And 11 was coal?

A Eleven was coal.

Q Do you know of any producers of those commodities at particular locations in the Southwest today that have a choice between the SP and the Santa Fe for originating traffic?

A I know that some of those shippers are served by only one railroad. They have a choice only insofar as they could short haul or use trucks to haul to the other railroad.

JUDGE HOPKINS: I think this might be a good time for a recess.

Let's take 15 minutes.

(A brief recess was taken.)

JUDGE HOPKINS: Back on the record.

If anybody wants to take off your coats

because of the condition of this room, you can go ahead and do it. The heat, to me, is impossible. And we can't do much about it except turning the heat off completely, which they will probably do.

Go ahead, Mr. Martin.

MR. MARTIN: Thank you.

A Yes.

BY MR. MARTIN: (Resuming)

Q Professor Levin, I would like to ask you to turn to page 28. We are discussing your Table 11. This is the table that summarizes the data in Tables 9 and 10.

A Yes.

Q The first line of Table 11 uses total eastbound tonnage moving by rail, but I am correct, I think, that nowhere in this table nor any other table in this group do you provide the motor carrier tonnage that would be comparable to the 9 million tons, total motor carrier traffic moving eastbound, is that correct?

A That's right.

Q And you also don't give truck deliveries from other origins to the particular destinations involved.

A Correct.

Q Or rail deliveries from the other origins, for that matter.

A No, I don't.

Q On page 28, you say in that paragraph that over 80 percent of all rail traffic moves in inter-regional flows with a railroad modal share in excess of 50 percent.

Do you see that?

A Yes.

Q Isn't that 50 percent of a universe that is the 100 percent which excludes TOFC and COFC traffic?

A It is over 80 percent of all rail traffic at this two-digit level, yes, and that excludes the TOFC, in that sense, excludes about 15 to 20 percent of the total traffic.

Q Thank you.

Now, in the next section starting at page 29, you discuss intermodal competition and comparative cost evidence. In the second paragraph on that page you say that you asked Paul Roberts, a well known authority on transportation cost, to provide a report on transportation cost by rail and truck for 24 specified commodities a various distances, correct?

A That's right.

Q And you got back a report from Professor Roberts, or his firm, which is the basis for your Tabls 12 through 18, correct?

A That's correct.

Q That's the report that you got back from Steven Still, I believe, on November the 29th, the one that gave you the final numbers?

A I'm not certain of the date.

Q I won't hold you to the date. But that is the numbers that you used here.

A The final numbers, right, came after the filing date. We had to submit a revision.

Q The original, just so the record is clear here for anybody who is following along, the original verified statement was changed by two new pages on 31 and 32 and revised Tables 12 through 18, correct?

A That is correct. And at the beginning of the testimony today, I made a couple of additional changes on page 35 that I had not noticed at the time I made the other changes.

Q That reflects changes in the numbers that you got from Dr. Rohert's firm?

A That is correct.

Q At the top of page 30 you explained that Dr. Roberts used for rail costs the URCS system, and for truck costs he used his own model of owner-operator costs.

A That's right. That's correct.

Q I will ask you first with respect to rail, and then I will ask you some questions about truck.

Did Dr. Roberts decide to use URCS rather than Rail Form A?

A Yes. He had available the URCS costing system and had been using it in his own work in the area of providing logistics assistance to shippers and so forth, and he felt it was most useful for this purpose.

Q He made the decision, though, and you didn't, is that correct?

A Well, I concurred in his suggestion to use the Uniform --

Q He made the decision as to which one he would use, did he not?

A I ultimately made the decision because I am responsible for this testimony.

Q I take it that you asked Professor Roberts to do these cost calculations because you are not a rail costing expert, is that fair?

A It is always difficult to answer these questions. I have done costing calculations using Rail Form A in the past for purposes of my research, but I specifically don't think of myself as a railroad costing expert, no.

Q And therefore you are not an expert on URCS,

which is the new Commission costing system.

A No, I am not.

Q Now, did he use URCS unit costs for the railroad industry as a whole, or specifically for the Santa Fe and the Southern Pacific? Or do you know?

A He used the costs associated with the particular region, transcontinental costs, but I don't believe they were associated with a particualr carrier.

Q Do you know what percents variability he used in his various unit cost applications?

A Some of the parameters are documented in my work papers. Any parameters that I haven't mentioned in the text or in the work papers I believe I don't know wha they were.

Q Did he make the decision as to which percents variability to use rather than you make the decision?

A Well, I don't recall decisions on percent variability specifically. Which one do you have in mind?

Q Like maintenance of way. Who made the decision as to what percent varibility to use for maintenance of way costs?

A Well, Dr. Roberts represented to me that the standard methodology was used in those decisions, so I don't know. It would be his decision.

Q Did he not tell you that under URCS different railroads will have different percents variability for different unit costs?

A He did not tell me that, no.

Q You didn't know that?

A That's right, I did not know that.

Q What cost of capital rate did he use in developing his rail costs?

A I believe he used the prime rate of interest.

Q Prime rate of interest?

A Yes.

Q Do you know what that is, what that rate number is?

A At the time that he did this, late 1984, it was in the 11 1/2 percent range, 11 percent range, something like that, maybe 11 1/2.

Q Did he adjust that to take account of income tax expense, do you know?

A I don't know the answer.

Q But you think he did not use the imbedded debt rate which, as you I am sure know, is the additional cost of capital rate that has been used for Rail Form A costing purposes?

A No, we did not.

Q You think he used the prime rate?

A I believe if we wanted to turn to my work papers, we would find a definite answer to that, but I think it is the prime rate.

Q Why don't we turn to your work papers, just so the record is clear. Tell me what the interest rate was that he used.

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A Well, I see here that the actual interest rate level is only specified in the work papers for the truckers and not for the rail. So I guess I'm not certain about the rail.

Q Okay. Do you know whether in doing the rail cost, you used betterment or depreciation accounting?

A I don't know the answer to that.

Q Okay. Let's take a look at Table 12.

A Page 12?

Q Table 12. We'll use the revised table. I may have a couple of questions later on to ask you how the changes occurred, but for the moment, let's use the revised table, just to see if we understand it.

I will refer, if it's all right with you to column 1 as the column that has the rail variable cost number of 500 miles, column 2 as the fully allocated, column 3 as the truck LR Av., which is long-run average, and column 4 as the truck SR Var., which is short-run variable cost; correct?

A Yes.

Q Now, focusing just on the rail for the moment, line 1 shows the number for canned fruits. Rail variable cost at 500 miles is 22.35. Do you see that?

A Yes.

Q Now, that number itself is the result of some

underlying calculations. From what underlying base numbers is it calculated?

A It's calculated by using all of the input parameters that you need to specify for the URCS system, and then there was a total movement cost calculated on that basis, and the total movement cost divided by the number of tons per move in order to get this number.

Q The input parameters do not appear in your verified statement. And while there is some material in your work papers, my question to you is -- and it's to test your understanding -- what is your understanding of the input parameters and the sources of the data that led to that number 22.35?

A Well, a number of parameters were discussed, for example, which I thought were relevant to this case. For example, what kind of backhaul experience to use, what kind of circuity factors to use, and things of this sort.

Those are among the parameters specified.

Q It's got, for example, fuel costs for a particular year, does it not?

A Yes.

Q Where do those fuel cost data come from ultimately?

A Where do they ultimately come from?

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Q Yes. What's the basic source of the fuel cost data that was used in developing this number 22.35?

A I'm not certain of that. I know that that is specified for the truck. I assume the same source is used for the rail.

Q Do you think the same source of the data is used for rail as the source that was used for truck?

A Well, I shouldn't speculate, I suppose. I'm not certain.

Q Do you know what the ultimate source of the data was with respect to maintenance of way that led into this 22.35?

A No, I don't.

Q Or maintenance of equipment?

A As I say, I'm not an expert in these matters and that's why I asked Dr. Roberts to perform these calculations.

Q How many tons per rail car are assumed in line 1 for canned fruit?

A Fifty, it says here. That was based on a waybill sampling to get an average.

Q And different numbers are used for different commodities; right?

A That's right.

Q Now, what updating methodology was used to

update the unit costs from 1980 to 1983?

A There, it's standard. Nineteen percent adjustment, as suggested by the Commission, was adopted uniformly.

Q Where does the Commission describe the 19 percent updating methodology?

A I don't know where. Dr. Roberts represented to me that that was the figure that was recommended for use to upate the costs.

Q Now, Table No. 12 shows in the next column, fully allocated costs.

A Yes.

Q And the difference between the fully allocated and the variable column is that the fully allocated has some fixed costs in it; correct?

A That's correct.

Q What basis of allocating the fixed cost was used in developing these fully allocated costs?

A Dr. Roberts maintained the standard URCS methodology was used. I can't answer it with any more specificity than that.

Q You are aware that there are different methods for allocating fixed costs? The car/car mile, the ton/ton mile, the dollar method, the ratio method? Do you know which of those methods was used here?

A No, I don't.

Q Or whether any of these methods was used? It might have been some other method as far as you know?

A He represented that he used the methodology as normally applies, as was the conventional practice, and that is essentially all I -- I wanted these numbers for illustrative purposes, and I relied on his expertise.

Q Do any of the numbers in the variable column or the fully allocated column make any provision at all for income tax expense?

A I'm afraid I don't know the answer to that.

Q Now, let me ask you about the truck costs. You say there he used his own model for truck cost?

A That's right.

Q Is this model in the record?

A A description of the model is in my work papers; yes.

Q But neither the model itself nor the description is in your testimony, is that correct?

A That's right. Not a full description specifying all of the equations. That does not appear in my testimony.

Q Did Dr. Roberts make the decision to use his own model in some of the other cost formulas for determining truck costs that are available, or did you

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make it?

A I made that decision. I know Dr. Roberts by his reputation, and I know that he has been working in particular on truck costing for some substantial period of time.

And I relied upon his judgment that in fact his model is a reasonable one.

Q Does his model develop truck costs for the entire country or for particular regions of the country?

A It's capable of doing either.

Q Now, the truck costs that are in this Table 12 are those truck costs that reflect national averages, or are they truck costs that are intended to reflect regional characteristics?

A I believe that where it was possible to relect regional characteristics, that was done.

Q Would you explain to me the adjustments that were made to take account of regional characteristics?

A I'm not certain. I think that data on backhauls, for example, while they were essentially averages that were used from Federal Highway Administration data, I believe had some regional variation and the appropriate region was used.

Q Were there any other adjustments made to take account of regional differences?

A I'm not certain. If there are any specified in my work papers, those are the only ones that I have any acquaintance with.

Q What fringe benefits, if you know, did Dr. Roberts take into account in developing his truck costs?

A These are owner/operator costs with an adjustment added on to represent the carriers' margin. And I don't know for certain how fringe benefits were handled in that context.

I think the operator got a -- we got a return that was essentially -- got paid essentially what would reflect an average return.

Q Let me ask the broader question. Is the average that it was intended to reflect the average for union driver wages or for total, including non-union driver wages?

A No. This is specifically owner/operator costs. I think it's specifically non-union is my understanding. So these are lower. These are relatively low truck costs, not so as to make them conservative for purposes of comparing to rail.

Q What tractor utilization factor did he use in developing his truck unit cost?

A I don't know.

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Q Do you know what trailer utilization factors he took into account?

A If you mean backhaul percents --

Q I don't mean that. I mean tractor utilization factors.

A I don't know the answer.

Q How about trailer utilization factors?

A I don't know.

Q How about miles per gallon of fuel?

A I'm pretty sure that's in the work papers, but I don't recall it.

Q Do you what insurance costs he took into account, if any?

A Again, I'm pretty sure that's in the work papers. There's a table in the correspondence from Mr. Still that laid a number of these things out and identified the data sources.

Q The table that they prepared and sent to you, which you then used? Is that right?

A Well, they sent to me to describe the various assumptions they had made; yes.

Q Do you know whether Dr. Roberts' truck model uses current equipments costs for trucks or whether it uses historical book depreciation numbers?

A You mean does it use current replacement

cost? Is that the question?

Q This is a model. This is not necessarily based on the national averages. This is a model; right? Don't models of this kind generally attempt to use current costs when they develop capital costs, including depreciation?

A I have to say I'm not sure that I know that answer to that question, whether models in general use current or --

Q Let's use this model then. Does this model assume new truck equipment or does it assume old truck equipment?

A I believe it is essentially a fleet average kind of basis that is used here. In fact, I know it is.

Q Do you know what the average age of the trucks is?

A No, I don't. I might add, to the extent that the historical costs are below current market values, of course, that is just going to bias downward the truck costs that are reported here, and therefore remove some of the apparent, some of the actual cost advantage that rail might have.

Q It would remove some of the rail advantage, wouldn't it? Is that what you just said?

A If rail has a cost advantage and if by use of historical costs, we are causing the estimated truck cost to be lower than true truck cost, then the results that come out would show a smaller rail cost advantage than actually exists.

So the numbers for my purposes then become conservative.

Q Dr. Levin, isn't it a fact that the rail numbers in columns 1 and 2, to the extent that they reflect equipment costs, use historical numbers, book numbers for the railroads, not current numbers?

A I know that that is true in the Form A. I'm not sure about URCS.

Q You're not sure about URCS. You don't know whether the URCS costs that are in here reflect current equipment cost or historical cost?

A I don't know.

Q Okay. Back to the truck. Column 3 has got long-run average costs; right? This is an average, not simply a variable number; am I correct? It's an average of all cost.

A It is comparable to the fully allocated cost basis except that there is less to allocate over. You know, it includes certain expenses that, you know, that they are fixed over a year or whatever, as opposed to

expenses that are movement-specific.

Q Your last answer identifies a point which I think is largely conceded; that truck costs are very largely variable. Is that correct?

A To a very great extent. Of course, there are some costs that aren't.

Q But it's much more variable than rail costs.

A I think the numbers reflect -- I don't know. It's not entirely -- it depends on what is defined in variable costs.

What is used as variable cost here, of course, is actually sort of intended to be kind of a rock-bottom notion of variable cost.

Q I'm not going to get into that just yet. I have some questions on the short-run variable. All I am going to ask you at the moment is that the long-run average cost has in it both a variable -- that is, to the extent you have long-run variable and fixed, to the extent there are any fixed.

That is why it is an average, isn't it?

A That's right. Well, it's not an average of that. Average -- it's an average with respect to -- that means unit costs were per-unit output. So that's slightly misleading.

But yes, that does include variable and fixed

costs.

Q That's what I'm trying to get for this purpose. It's not to go off on a tangent, but to establish that it's your understanding that these numbers have both variable and fixed costs in the average cost.

A Yes.

Q Now, does that number, column 3, long-run average cost, have 100 percent of the truck equipment costs in it?

A I'm not exactly sure what that means. It has 100 percent of the equipment costs in the sense of some assumptions made about the total annual haul that the truck would make.

Q Some truck equipment costs are variable and some are fixed; right?

A Yes.

Q And this column is intended to pick up both, isn't it?

A It is; yes. But, of course, the fixed costs, to the extent this is a movement, costs of a particular movement, obviously some assumption has to be made to take these annual charges such as interest and depreciation and allocate them to a particular movement.

That is done on the basis of an assumption of

how much, you know, how many miles, revenue miles are experienced in a year.

Q And that has been done in developing these numbers?

A That's right.

Q And therefore, 100 percent of the truck equipment costs are reflected in these numbers?

A In the long-run average cost, that's right.

Q In the long-run average?

A That's my understanding; yes.

Q It's your understanding. You don't know for sure?

A Well, to the extent that I read and interpret the documents that I have, yes, that's what I read.

Q Does it have 100 percent of the truck fixed plant costs in it, not now equipment, but fixed plant?

A Well, we are talking about owner/operators here, so we are not talking about large terminal operations.

Q To the extent that there are terminal operations, to the extent there are fixed costs, they are in here; right?

A Well, owner/operators don't have a lot of terminal costs.

Q To the extent that they exist, they are in

these numbers; isn't that correct?

A Well, I believe -- I think that's right; yes.

Q Now, on page 31, you discuss in your text comparison of column 3, which is the truck long-run average, and column 1, which is the rail variable. And you are now discussing Table 12. And just to be sure --

A Actually, we are discussing Table 12 through 16.

Q Correct. Pardon me. I would like to be sure that we understand the changes that have been made first. And then I will ask you about the revised table. And I will do it -- I think it is easier to follow for you as a comparison between column 3 and column 1, the way you do it at page 31.

Let's start with Table 1, the first line. I won't go through them all, but I think one will illustrate how it works.

MR. RAKER: Table 1?

MR. MARTIN: Line 1, Table 12, I'm sorry.

BY MR. MARTIN: (Resuming)

Q Canned fruits is the first commodity. Column 1 gives you the number for rail variable cost, pre-correction. We are on the old table.

A Excuse me. I have to consult that.

Okay. I'm sorry.

0001 0106

Q Okay. On the original table, column 3 shows truck long-run average costs per 500 miles of 26.97 per ton, $26.97 per ton as an average?

A That's right.

Q And the rail variable cost over the same distance for the same commodity was the number in column 1, $12.52?

A In the original table.

Q In the original.

Now, let's go to the corrected table and see what happened to the number. Have you got the revised table there?

A That's right

Q In the revised table, the number for truck in column 3 has stayed the same, has it not? It's $26.97?

A That's right. No adjustments were made to the truck cost.

Q At least not for canned fruits; right.

A Not for any of the tables.

Q Not for any. Okay. Well, I'm not so sure about that, but let's take it for canned fruits for the moment. The number for rail variable has now gone to 22.35, has it not?

A That's correct.

Q So it's 26.97 for truck, 22.35 for rail

variable in the corrected table?

A That's right.

Q At page 30, you said that you would -- and this is right in the middle of the page -- use the higher, fully allocated rail cost for comparison with truck. Do you see that?

A Yes.

Q Now, if we do that, that's column 2, right?

A That's right

Q So now, for canned fruits, line 1, the comparison shows for truck 26.97 and for rail, fully allocated, 26.54.

A That's right.

Q Am I correctly interpreting the table?

A That's right.

Q So it's virtually the same for canned fruit for 500 miles?

A Very close.

Q Now, let's try another one which will maybe raise a question about the trucks worked. Let's talk about assembled passenger cars.

A I'm sorry. That is the one commodity that did change on the truck side.

Q Okay. Just to show that the other table -- to make clear that the other tables work the same way,

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let's talk about Table 13 which is now 1,000 miles.

Now, the old Table 13 for assembled passenger cars showed, if I am correct, for the truck $70.85 a ton; correct?

A That's right.

Q And for rail variable, $36.70, and rail fully allocated $43.59; correct?

A Correct; yes.

Q Now, let's go to the new table. New table 13, that is. The truck number hasn't stayed the same, has it?

A No.

Q It's now 131.20.

A Yes. I can explain these adjustments if you like.

Q Okay. What happened to change the number 98 to 131?

A The truck case is quite simple. All commodities, for all commodities it had been assumed that the loaded tonnage was 25 tons in the first set of tables. In the second set of tables, it was corrected because that would be a very large load of passenger cars to put on a truck, and it was corrected to 13.5.

And you can see that with a calculator, that the change in the cost reflects exactly the ratio of

0001 0109

13.5 to 25.

Q Who came up with the 13.5 number?

A It was an assumption made by Dr. Roberts. Basically, he took an average weight of a motor vehicle, a new motor vehicle, and the number of cars on an average truck auto carrier, and calculated the tonnage.

Q The truck number for 1,000 miles is 131.20 on revised Table 13?

A That's right.

Q And the variable number for 1,000 miles per rail is the column 1 number, 104.78?

A That's right.

Q And the number for rail fully allocated, which is the one that you believe is more appropriate as you say at page 30, is 124.46?

A Yes. I have to confess that I would have imagined this differential on assembled passenger cars to be larger between truck and rail than it turned out using the system.

Q It's actually very close, isn't it?

A It is in this table; yes.

Q Okay. Now, you started to mention a while ago something about short-run variable cost. Let me ask you a couple of questions about that.

At page 32 in both the original and the

revised page, you say that the short-run variable costs represent "what a trucker might expect as a minimal rate on backhaul rather than return home empty."

You remember where you said that in th text?

A That's right.

Q Now, isn't it a fact that truckers do sometimes take loads at rates that are below their long-run average cost, even though the haul is not a backhaul?

A Oh, sure; just as railroad sometimes carry traffic below fully allocated cost, even though it's not a backhaul.

Q So the point is, or you would agree that the practice by truckers of pricing below long-run average cost down to short-run variable cost is not a practice that is confined to backhaul situations?

A No. Nor is it a practice that the Commission can reasonably rely upon to provide adequate competition in their rail-dominated market because you can expect the trucking industry to continue to make depressed profits overall for a long, protracted period of time.

Q Is excess capacity a factor that will lead truckers frequently to price below their long-run average cost?

A That is commonly argued; that industries with

excess capacity will tend to price below --

Q Do you know whether the trucking industry, in fact, follows that practice where excess capacity exists?

A Well, there have been studies and papers written about that that tend to be supportive.

Q Is the trucking industry today characterized by excess capacity to any extent?

A I haven't looked at recent figures on capacity utilization in trucking, so I don't know the answer to that.

Q Am I correct that the revised tables show truck short-run variable cost below rail average or rail variable cost for virtually all commodities at virtually all distances?

A Yes. Recalling now, though, that the definition here is this sort of lower-bound backhaul rate and that is why in a sense, these data at least provide some suggestion as to why it's the case that truckers tend to participate in movement of most kinds of traffic, at least to some extent, because they are willing to cut their prices down to some floor, sometimes. They can't do it all the time

Q Now, you said backhaul, but I thought your prior answer was that this practice is not confined to backhaul situations.

A The practice of going below long-run average cost is, but there is a big range here between the short-run variable and the long-run average. And cutting all the way down to the floor is not something that a trucker would do, would wisely do very often for fronthaul traffic.

Q I just want to be sure my question is answered. You used the term "backhaul" in responding to my question, and I thought your earlier answer was that truckers will, in fact, price below long-run average cost in situations other than backhaul situations.

Wasn't that your testimony?

A They will price below long-run average cost, but not often as low as the short-run variable cost.

Q Okay.

A Incidentally, the truck number, truck variable costs are higher than rail variable costs for -- even that bottom line number if somewhat higher than the rail variable cost for a number of the chemical products that are listed in the table.

Q Thank you.

Now, using the column that you say on page 30 is the more appropriate one for comparison, that is, the rail fully allocated cost, isn't it true that for most of these commodities, at most of these distances, a

trucker could take the business at a level equal to rail fully allocated cost and earn some compensation over and above his average cost? Some compensation for the driver or for the owner?

A I'm sorry. Were you referring to a specific distance.

Q All of them. Maybe we can't generalize, in which case that would be an answer. But as a general matter, cannot one say from your tables, that truckers could take business at rates equal to the rail fully allocated number, and still make contributions above their short-run variable cost?

A That wasn't the question you asked before.

Q I apologize. Let's make it the one I just asked.

A The answer to the question you just asked is yes.

Q Thanks for catching me. For example, and I won't do this for very many, but just so we can show how to interpret the tables, take your revised Table 12, canned fruits. If I understand this table correctly, using the column that is most appropriate for comparison, column 2, rail fully allocated, the number if 26.54.

A trucker could take business at the rail

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fully allocated number of $26 and make about a $13 contribution over and above its short-term variable cost, if I'm reading your table correctly.

A That's right. And wind up just slightly below its long-run average costs.

Q Let's take assembled passenger cars again, just to make sure we are reading it right. A trucker could take the business at a rate equal to fully allocated rail costs -- if I'm on the right line, it is $79 -- and still make a contribution, about $40 over its truck short-run variable costs. Correct?

A That's what the numbers say. I confess some skepticism about the passenger car numbers.

Q Let's go to Tables 17 and 18. These are the tables that summarize the previous tables; correct?

A That's right.

Q And Table 17 compares the truck costs with the rail fully allocated, and 18 compares the truck costs with the rail variable; correct?

A That's right.

Q In light of your statement at page 30, that the appropriate one for comparison is fully allocated, long-run fully allocated, you believe we ought to be focusing on Table 17 rather than Table 18, don't you?

A No. For different purposes, we ought to focus

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on the two. Table 18 shows just what it shows. It essentially shows how, in the light of these numbers, if we take the illustrative numbers into consideration, it shows the sort of feeling on revenue to variable cost ratio that could be earned and still a railroad's pricing at the level of truck fully allocated costs.

So they are both useful for this analysis.

Q You believe they are both useful. You have made that clear. But you did say on page 30 that the appropriate column for comparison is line 1, fully allocated cost.

Therefore, isn't it fair to say that the table which summarizes those columns is the more appropriate table?

A I don't think I ever said it was appropriate.

Q You did. On page 30, six lines up from the bottom.

A Oh, I see; you're right. But above that, I said to be conservative, you know, that allocations are inherently arbitrary, and to be conservative I therefore used the higher one.

Q You said it was --

A I said what I said, and I still agree with it; yes.

Q Now, let's see if we understand Table 17

right. Canned fruits, 500 miles. Does this mean that the truck cost is 102 percent of rail, fully allocated cost at 500 miles?

A That's right.

Q Or just to pick another one at random, newprint. What this means is that the truck cost is 129 percent of fully allocated rail costs at 500 miles?

A That's right.

Q And so on down the page?

A That's right.

Q Now, at page 10 in your text, you make the observation -- and I believe you make it elsewhere in your verified statement -- that rail's relative cost decreases with the distance of haul. That is just at the end of that first paragraph, and I believe it is stated elsewhere and in your articles.

I'd like to ask you about that proposition in light of this data on the table. Would you like to anticipate my question?

A Go ahead and ask it.

Q Let's look at Table 18 because this is the one that uses relationships to rail variable.

A Sure.

Q In other words, canned fruit here, the truck cap is 121 percent of rail variable cost; right?

A That's right.

Q At 500 miles.

A That's right.

Q And it's 124 percent at 2,500 miles; right?

A Yes.

Q Now, let's take sodium compounds. If I am reading this correctly, what you are saying is that the truck cap produces a ceiling of 281 percent of rail variable cost for sodium compounds at 500 miles; is that right?

A That's right.

Q What is it at 1,000 miles?

A 235 percent.

Q And 1,500 miles?

A According to Robert's numbers, 217.

Q Let's get back to the farthest of all, where the railroad really ought to be getting a big advantage. What does that number show?

A 201. Again, I can explain this.

Q Well, let's first be sure we understand it. And then I will ask you to explain it.

If you drop on down the page, which of these commodities show rail relative cost decreasing between 500 miles and 2,500 miles?

A Actually, most of them do. Do you want me to

pick each one out specifically?

Q Take industrial gases. That shows 243 at 500 and 177 at 2,500 miles?

A That's right.

Q Okay. Why don't you explain how that shows the railroads have an increasing advantage at longer distances?

A It doesn't. And there's a reason. The URCS methodology, like most standard rail costing methodologies, certainly like Form A, does in fact show rail unit cost, cost per ton mile, let's say, decreasing with longer distances.

The truck model used by Dr. Roberts does not build into the first instance an essential decrease in cost with distance, although it is also true that since truck has a certain amount of pickup and delivery expenses, to the extent it has the pickup and delivery expenses and a few expenses that need to be factored in, I guess there is some small element of decline in the truck costs.

So if you just looked at Dr. Roberts' numbers and did not adjust them in the manner I am going to explain, you would see rail's cost advantage increasing with distance.

Now, Dr. Roberts does an adjustment to his

numbers to reflect the fact that as truckers take longer hauls, they tend to not come back without backhauls. That is to say, the backhaul percent that a trucker gets tends to increase with distance. He comes back full more often the longer he goes out. Otherwise, he would't accept the fronthaul move.

And what these numbers reflect is an adjustment done by Dr. Roberts, an adjustment to the backhaul percentage of truck at different distances.

Now, in my opinion, I think that the adjustment Dr. Roberts does almost certainly exaggerates the amount of improvement in the backhaul percentage that a trucker would experience at long distances.

Let me give you an example. You pointed to sodium compounds. When you point to some of these others that go in tankcars, like gases or some of the other chemical products, the backhaul percentage that is used by Dr. Roberts is based on this Federal Highway Administration data and it's essentially a 55 percent load factor. That is to say, 10 percent of the backhauls are full and 90 percent empty.

And this is based on a regional, but on an average experience of truckers. Now, the adjustment formula Dr. Roberts used actually drives that backhaul percentage up to 56 percent full at 2,000 miles, which,

while there is some logic in it being higher, it's probably -- that probaby is a serious overstatement of the truck backhaul experience on tank trucks for 2,000 miles.

The reasoning behind doing some sort of adjustment I think is clear. Trucks go out a long way: they are not likely to accept a move if they don't get some better backhaul, and they have more opportunity to triangulate moves and do things that would increase the percent of time that the trucks are loaded.

But as I say, I think that these numbers, to the extent that they get out of the range of 500 to 1,000 miles, tend to exaggerate the importance of this factor. The costs are based on an initial estimate of sort of system average costs at 700 miles, which is an average truck move as reported in the Federal Highway Adminstration calculations.

So the numbers in the 500 to 1,000 range are probably closer to the truth than the numbers in the further detail.

Q Professor Levin, you submitted a verification that said that this statement was true and correct to the best of your knowledge. And then later, you made some changes.

And I thought that your testimony was that

with those changes, it was true and correct. But you are now telling me that the last three columns on this table are not correct; that they reflect exaggerations and serious overstatements. Is that your present view?

A I testified that these are the numbers that come out of the models that I specified. I testified earlier in my statement that all these comparative cost studies and all costing models are inherently flawed.

I, in fact, don't believe there is any inconsistency. I am testifying as to the fact that if you take, if you consult a transportation expert such as Dr. Roberts, and he does his best job at estimating these costs, which he has done, he comes up with these numbers. And I am using them to illustrate certain points here.

Q Even though you now believe that they exaggerate the improvement in the backhaul percent and reflect serious overstatements?

A Well, I have to confess, that point I did not understand at the time I submitted the statement.

Q When did you discover this point in the course of your preparation for cross-examination?

A Oh, I guess shortly after the numbers were submitted. I inquired, I suppose, in late November or early December of Dr. Roberts as to why this anomaly

existed, and he explained this formula to me that he used to adjust the backhaul percent.

Q But you decided not to try to make any corrections to take account of the exaggeration, overstatement, or anomaly, whichever word one uses?

A These are the numbers that come out of Dr. Roberts' model. That's what I am testifying to.

Q Come out of his model?

A Yes.

Q You're not verifying that they're accurate. You're simply telling the Commission that they come out of his model?

A I can't verify that they're accurate because in my opinion, the costing is a very complicated business. I don't believe that any of the costs used by the railroads or the trucking industry, in fact, can be verified to be accurate, because there's all kinds of arbitrary assumptions and decisions that have to be made along the way. Percents variable and percents fixed and all of these things are imprecise.

Q Why do some of the numbers go up and some go down if there is a systematic mishandling of the backhaul percentages?

A Oh, because as I said, there are offsetting factors. The rail costs decline with distance. And the

question is, do they decline as rapidly, more rapidly or less rapidly than truck? The adjustment made to the truck numbers does vary by equipment type so that it's a larger adjustment for tankcars than it is for vans.

And for the rail cost, the percentage adjustment also varies, depending on the relative mix of terminal and long-haul costs involved in the move.

So that's why, in the case of canned goods, you're talking about essentially TOFC-type move for rail versus a van move for truck. You are making a minimal adjustment on the truck backhaul and a rather substantial terminal cost associated on the rail side for the TOFC.

So that is why that particular move goes the other way.

Q Now you are aware, and I think you said this, that the rail costs, as developed through either Rail Form A or UFCS, would take account of rail backhaul experience?

A Yes, they do.

Q So it's not as if it's only the truck and not the rail that reflects backhaul.

A But the rail backhaul experience is not adjusted by distance the way the truck is. The truck is adjusted. Rather large adjustments are made in the

backhaul percentage with distance according to Roberts' formula.

And, as I suggested, especially for tankcars, that is an overstatement.

Q And your belief, sitting here today testifying before this Commission, is that those numbers for backhaul are exaggerated in the case of trucks? They are not accurate?

A Exaggerated at long distances, especially for tank trucks. The other backhaul factors are in a much more plausible range, but the tank truck numbers, I think, are -- I find to be, although I don't have direct observations, I find it somewhat implausible that they come back full more than half the time.

Q So your conclusion, then, about that overstatement is based on your judgment rather than upon any study or analysis of data with respect to truck backhaul?

A Well, that's not quite fair either, because I do have a general knowledge of the nature of commodity flows between the regions in the United States, and so I am not basing that -- it's not an arbitrary statement.

Tank trucks fill up with chemicals and other liquids and I understand the economic geography of --

Q It's based on that general understanding that

you disagree with Dr. Roberts?

A Yes.

Q Not on any specific study that you have done in connection with this case or anything else?

A That's correct.

Q Now, on a slightly different subject, but still on Table 18, and again take canned fruits, this table shows that rails have a cost advantage over truck comparing average variable with rail variable at all distances; is that right?

A No. It doesn't say that there's a cost advantage over rail. Well, only in the sense that truck fully allocated cost is larger than rail variable costs; yes.

Q Table 18.

A Yes, Table 18.

Q Table 18 doesn't say anything about fully allocated. Table 18 compares rail variables with truck average; right?

A I'm sorry. I misspoke. I meant not truck fully allocated, but truck average cost; yes.

Q And that shows that the railroad has a cost advantage over the truck, making that comparison which is your Table 18, at all distances, does it not?

A Yes.

Q And yet it's a fact, isn't it, that the railroads do handle canned fruits at all distances despite that "cost advantage." Isn't that so?

A Now, you have me confused because I would have thought that a cost advantage would tend to dictate --

Q I think I misspoke. The trucks do handle canned fruits at all distances, even though they are at, according to this table, a cost disadvantage; isn't that correct?

A Well, they do handle, generally speaking, many of these products at all distances, although it's the case that if you look at a number of specific city-to-city or, I should say, BEA-to-BEA pairs, the five-digit commodity flows that were reported in Dr. Barber's testimony submitted on behalf of the Union Pacific, you see that canned fruits and canned vegetables, for example, Los Angeles to Dallas market, are 100 percent -- show up there as 100 percent rail.

Q Let's suppose that in addition to all of the other traffic that the railroad handles, it handles these commodities. And let's suppose that it handles these commodities at these distances, at these rate-to-cost ratios. Let's suppose that.

Isn't it possible, so far as you know, that a railroad could charge rates producing the ratios shown on your Table 18 along with all of the other rates charged on all of the other commodities not listed here and still not earn a return greater than its cost of capital?

A It is possible. Of course, there are other

commodities like these that -- this is a selected list from the Reebie data, but one could add to it. But it's true; it is possible that you cannot make an adequate contribution overall by charging these prices on these movements.

Q Okay. Now, let's just go back and be clear for a minute about what's in the railroad costs that are shown on Table 18. And this, I think, will be largely summary, but I want to be sure it's in the record. Frankly, I've forgotten what you said earlier.

The equipment costs that are in here are book costs for the railroad, are they not, book depreciation?

A I believe they are whatever is standard for the URCS system, and I believe that is book.

Q If we were to use replacement cost, as you earlier discussed, for railroads, what would happen to the ratios on Table 18?

A Well, if we changed -- we have an apples and oranges problem. If you change them for rail, you should change them for truck.

Q What if you did? What would happen to the ratio?

A It's hard to know since equipment costs are probably a larger share of truck costs than they are of

rail costs. It's very possible that the rail's cost advantage would loom larger.

Q But you don't know?

A Well, if the premise is correct, the conclusion is correct.

Q You don't know whether the premise is correct?

A No. I'm pretty sure that's right.

Q If we use replacement cost for fixed assets other than equipment, what would that do to the ratios on Table 18 for both rail and truck?

A I think that that could go either way. I wouldn't want to speculate. It depends very much on -- I thought you said earlier that the railroads have a much higher percentage of their capital tied up in fixed plant than do motor carriers.

A They do.

Q Wouldn't it therefore stand to reason that if you used replacement cost for fixed plant, that would have a much greater tendency to increase rail costs than motor carrier costs?

A I'm sorry. I thought you were referring to a case in which we use replacement cost for both fixed plant and equipment. In that case, it is ambiguous which way the effect would go.

Q On page 29, you indicated that you instructed

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Dr. Roberts to assume that rail would be 5 percent more circuitous than truck. This is three lines up from the bottom of the page.

A That's right.

Q Where did you get that 5 percent circuity factor?

A I first consulted my Atlas and tried to look at highway mileage versus rail mileage over essentially California to Texas. And that appeared to be a reasonable assumption.

Q California to Texas?

A Yes.

Q Does that appear anywhere, that comparison of mileages appear anywhere in your work papers?

A No, it doesn't. I basically, you know, looked at the Atlas and, you know, looked at the numbers and I don't believe I ever made a note of that.

Q Would you disagree with me, subject to check, that rail mileage from Los Angeles to Dallas is approximately 20 percent greater than the truck mileage?

A I don't believe it was L.A. to Dallas, but I looked at it. I think it was L.A. to Houston. In fact, I am quite sure it was L.A. to Houston. But I couldn't disagree with you without checking.

Q There is nothing in the record, is there, to support the use of the 5 percent circuity factor for rail as contrasted with, say, 10 or 20 or 30?

A No, except that -- what I just said, which is that I looked at mileages, Los Angeles to Houston.

Q What would happen to the ratios on Table 18 if you used a 10 percent average rail circuity factor rather than 5? How much would that increase the rail cost relative to truck?

A Well, for the costs that depend on mileage, which are not all of the costs, it would increase it by the ratio of 1.1 to 1.05.

Q But what would the impact of that be on the ratios on Table 18?

A Qualitatively, it would raise the relative rail costs.

Q But you don't know how much? You wouldn't know without doing the calculation?

A It is clearly less than 5 percent. And depending on how much of the total cost is mileage-sensitive, you know, 5 percent is obviously an upper bound.

Q Okay. At the bottom of page 33, you state in the last sentence there: Comparative cost evidence also indicated a very large advantage for rail in the

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movement of numerous rail dominated commodities. The cost advantage is sufficiently large to justify the conclusion that truck costs do not provide an effective line run cap on rail rates for movements of these commodities."

That was written, I take it, before the changes in your tables. Is that correct?

A It was, although that conclusion would be warranted on the basis of Professor MacAvoy's testimony concerning truck and rail cost for certain products, chemical and petroleum products in particular which are high-volume commodities in this corridor.

Q On page 35, we have now moved into a new section and at the beginning you say that your analysis of the preceding section has led you to conclude that the merger would have serious anticompetitive consequences.

And I take it that your reference there is to the preceding section of this verified statement, including the discussion of comparative cost evidence and Tables 12 through 18; is that correct?

A Yes. Also including all the market share evidence, both intra- and intermodal which I would give probably even greater weight to them, the comparative cost evidence.

Q It's based to some degree, isn't it, on the comparative cost evidence. Otherwise, you wouldn't put it in the verified statement?

A That's right

MR. MARTIN: Thank you. No further questions.

JUDGE HOPKINS: Justice Department?

BY MR. RATNER:

Q Dr. Levin, my names is James Ratner. As you may know, I'm with the United States Department of Justice. I'm going to first talk to you about what is in your verified statement in KCS-12. I will try to keep it separate to this, but I may bounce around a little bit also.

I may cover some ground that you've already been asked about, and I'll try to keep that as brief as I can.

Throughout your testimony in KCS-12, you refer to the concern -- I know it is on page 11, if you want to look at it, and it's also on page 23 -- you refer to a concern that if certain conditions are imposed on Southern Pacific and Santa Fe, that they may decide to just reject merging altogether.

Is this a concern from an efficiency perspective only if it would be better to allow the merger than to disallow it?

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A Precisely.

Q On page 4 of your verified statement, you describe that you're going to compare the IRMA with competing proposals of other responsive applicants.

Is the IRMA in competition with other applicants? Is an IRMA mutually exclusive of other remedies?

A No. In fact, you might argue it could be complimentary to some. For example, it could be viewed as complimentary to the Rio Grande's proposals to improve their access to northern California.

It's competitive with the UP's, only in the sense that putting three competitors in the southern corridor would actually increase the extent of competition in the corridor, and that, as I understand it, is the position that the ICC has essentially found to be not appropriate as a remedy in merger cases.

So I essentially -- that is the sense in which they are competing, given the ICC's prior determinations in merger cases. It would seem that one might imagine they would do only one or the other of the two proposals.

Q From an efficiency standpoint, is it necessarily so that having both UP's proposal and the IRMA would be harmful?

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A It's not necessarily so, although as you know this is kind of a complex balancing issue here of trading off improved service and competition for the shippers, so that shippers benefit from lower rates and better service, against the financial viability issue of the merged entity.

And to the extent there are three competitors in the market, while the service may improve and the price levels may improve from the shipper's point of view, there is more harm done to the attainment of the goal of financial viability.

So I think the presumption is that probably two competitors, two additional competitors in that corridor might be essentially more than could be borne and preserve the financial viability of the Santa Fe.

Q All right. Let's talk about long-run viability a little bit. On page 10, you use the term "excessive competition," I think, and on page 18 you use the term "destructive competition." Is that right?

A Right.

Q Is it your testimony that excessive or destructive competition is currently taking place between Santa Fe and Southern Pacific?

A I haven't done a specific study of that question. It is the case that there is -- that there

does appear to be strong competition between these carriers and neither one has -- it is surely the case that neither one has been judged to have been earning excessive revenues by virtue of the Commission's standards.

Q That's a different question, though, isn't it, as to -- what I asked is, is it your testimony that there is excessive competition or destructive competition that is currently taking place today between Southern Pacific and Santa Fe?

I take it the answer is you haven't studied that question at all?

A I haven't really studied that question specifically. I mean one does come across reports from shippers about, you know, the improved quality of service in this corridor since the Staggers Act, since there has been greater competition.

But as to the question of excesssive, no, I have not studied that specifically.

Q Is it your testimony that if Southern Pacific and Santa Fe continue to operate separately, that competition will depress profits below those necessary to assure long-run viability?

A No. I wouldn't agree with that. I think sort of general studies in the field of industrial

organization have led me to the conclusion that where you have oligopolistic competitors, in most cases while there may be episodes of price-cutting and price competition that depresses earnings in the short run periods, that in the long run I believe the Santa Fe and the Southern Pacific would essentially learn to take cognizance of each other's presence and their interdependence and I believe they will probably be able to earn adequate returns in the long run.

Q Is it correct that excessive competition or destructive competition that is pervasive over a period of time is really a description of market failure?

A Well, you use a lot of terms there. I'm not sure exactly what you mean by that.

Q Excessive competition and destructive competition are your terms. In terms of market failure, I mean a market in which competition in the long run will not be able to achieve an efficient result.

A Well, if in fact prices were depressed for a long time, below levels that would make possible the replacement and maintenance of capital, then yes. I think the quality of service would deteriorate, and that would not be efficient in the long run.

There aren't many examples of this happening in the real world, however, except in industries that in

overall severe decline where demand is going away and the firms are essentially disappearing.

Q What is the traditional remedy for market failure in economic literature?

A The old textbooks used to say regulation, but there is lots of alternative views on that subject today. It would be hard to summarize them briefly.

Q This is very similar to another question I asked you, but it is different. Is it your testimony that neither Santa Fe nor Southern Pacific will be able to maintain long-run viability unless they merge with each other?

A I think I answered that. I think it is quite probably that they would be viable in the long run.

Q Is it fair to say that both this testimony and your opposition testimony in KCS-14 indicate that the Santa Fe Southern Pacific merger may create significant anticompetitive potential?

A Yes.

Q Given that potential, is it correct to say that from an efficiency standpoint, the merger should be allowed only if there are substantial efficiencies from the merger which outweigh the harms associated with the anticompetitive potential?

A I'm not sure that's the total comparison. If

-- one still has to look at whether the conditioned merger is superior to outright denial.

Q Have you made any estimate of the amount of benefit that would accrue from this merger associated with the elimination of competition between Santa Fe and Southern Pacific?

A Benefit from the elimination of competition? I guess I would have to -- I would want to change your question around a bit. There may be benefits that are associated with cost savings and rationalization of facilities and scheduling and these sorts of things which are or may or may not be necessarily associated with the elimination of competition.

They can be, many of those benefits can be achieved without eliminating competition by granting one or the other of the responsive application's requests for conditions.

Q Assuming there were no responsive conditions to be granted, have you done a study of the extent to which eliminating competition between Santa Fe and Southern Pacific would generate efficiencies of benefits?

A I haven't done a study on my own. I have examined with some care Professor McAvoy's cost/benefit analysis. And as I have noted at various points in my

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testimony, he makes the mistake of relying on the TBS study which seriously underestimates the amount of traffic over which there is anticompetitive potential. And the numbers I have in here suggest that the traffic which might be subject to anticompetitive price increases would be at least five times as large as that estimated, as that assumed by Professor MacAvoy.

It's also the case that his calculations concerning the price increases that would be attendant upon grant of the merger are simply mistaken; that he made errors in his implementation of the projected variations model of oligopoly; errors of implementation, and there might be an error of judgment in assuming that the effect of the merger was to reduce the number of competitors from four to three, when in fact two to one would have been a more appropriate assumption.

So the conclusion is that MacAvoy seriously underestimates the social costs of the merger. I have not done a detailed study of whether the claimed benefits of about $200 million are correct or not.

Q On page 9, you refer to an instance where a parallel merger might eliminate competition but have benefits in terms of abandonment or downgrading or consolidation of terminals.

Do you see that?

A Yes.

Q Have you done any evaluation of the extent to which these benefits will occur in this merger?

A No. As I say, I really haven't studied that part of the case. As I understand it, Applicants are claiming roughly $200 million worth of savings from these sorts of sources, and that may or may not be an accurate number. I just don't know.

Q We have talked some about using an efficiency criteria. Is it correct that elimination of competition between Santa Fe and Southern Pacific could have a considerable distributional implication as well?

A Yes, it could.

Q Would you explain that a little bit?

A Well, the distributional impacts you would expect to flow from creating a monopoly where there previously was duopoly, of course, in the first instance is transfers from shippers to carriers.

So there would be some redistribution from shippers to carriers through higher rates as the Santa Fe Southern Pacific anticipates, not in what it submitted to the ICC, but in KCS-C-1, for example.

The other distributional impacts, of course, would be on carriers that presently interchange with the Santa Fe Southern Pacific, and there have been a number

of traffic diversion studies submitted in this case. KCS believes that something on the order of $27 million worth of traffic gross revenue would be diverted.

And the net competition lost is on the order of $5 million. Other carriers have impacts. The UP has a large diversion impact as well.

Q With respect to the transfer that occurs between shippers and the railroad, is it correct that the effect of competition generally keeps that distributional transfer from occurring?

A I'm sorry. Could you restate the question?

Q With respect to the distributional transfer you referred to between shippers and the merging railroad, is it correct that effective competition would generally keep that distributional transfer from occurring?

A If there were effective competition such as sought in the traffic conditions, then that transfer would not occur to the same extent. It's possible there would be some increase in the contribution earned on southern corridor traffic.

Partly, that would depend on where the trackage rights or rates are set, where the IRMA car hauling charge is set.

Q On page 12, you refer to longer run charges in

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relative costs of modes that may render shippers subject to excessive monopoly power in the future. And I guess you talked earlier about that the word "excessive" is redundant there.

Could you explain a little more fully how this process would work?

A Yes. Actually, this is quite an important point in terms of the ultimate disposition of this case because it would be one thing to point to the current earnings levels of the Santa Fe Southern Pacific and say look, we're not viable and we have depressed earnings, and therefore you ought to grant us this monopoly in order to make us viable.

Well, a very considerable danger exists there over the longer run. I mean it may be, for example, that the short run earnings of these companies are depressed party because it takes time for competitors to get used to the new regime and dereculation.

I mean it is a transitional effect. And in part because of the relative cost to the extent there is intermodal competition, that that imposes a certain level of discipline on the railroads. And that level, both of these factors, both the aggressiveness of competition intramodally and the importance of intermodal competition can change over time.

I have already suggested about how firms learn to live with each other in duopolies. But the other point is equally, if not more important. We could have another oil price shock or some other significant change in economic conditions. The highways deteriorate and one needs to put a massive investment in and finance them through highway taxes, for example.

These are perhaps not so long run considerations. They are certainly considerations that are relevant to the remainder of this century. And to be stuck with a monopolist serving the entire southern, southwestern portion of the United States could be a very serious price for society to pay to solve a short-run financial problem.

Q Is it correct that using your example of an oil price change or a fuel price change, that that may affect rail costs differently than the cost of other modes?

A The implicit assumption was that truck costs would rise relative to rail costs under a fuel price increase.

Q On the bottom of page 12 and at the top of page 13, do you see the sentence that begins, "In such circumstances"?

A Yes.

Q And you refer to reductions of competing rail alternative from two to one and three to two. Do you believe that there is little possibility of losses due to resource misallocation that can occur if a real merger reduces the number of firms who effectively constrain each other from four to three?

A Well, the efficiency losses occasioned by a reduction in the number of competitors don't change linearly with the number of competitors. They go with, essentially with the square of the number. So there is a bigger percentage of gain in recovery of dead-weight loss, let's say, in moving from one to two carriers than there is moving from two to three and so forth.

Q I understand that. I guess what I'm asking you is, in the situation where you are left with three competitors after the merger, is it your testimony that it is unlikely that there would be collusive activity or recognition of interdependence that could result in prices that ended up being welfare-harmful?

A Well, this is a tricky area when we get into how oligopolies behave. I mean in a standard industry that does not have the kind of problem of fixed and joint costs as pervasively as does the railroad industry, of course, we worry about industries with only three competitors.

0001 0196

We would be terribly concerned if a number of our major industries shook down to a level where there are only three firms. We would worry about the possiblity of them colluding or coordinating on rates, and that is the basis for the Justice Department's merger guidelines.

In the railroad industry, we do have this tradeoff problem. We generally accept higher degrees of concentration in railroad markets because there are substantial economies of scale and scope in the railroad industry.

So I think it is true that there would be recognition of interdependence with three carriers. I think if there weren't some recognition of interdependence, three carriers would not be a viable solution.

Q Is it correct that recognizing your tradeoff, that when a merger reduces the rail competitors from four to three, the other side of the balance decide that there may be some anticompetitive behavior, is not something that we can ignore when there's just three?

A Well, we never should ignore it, because there may be a market that is sufficiently high density, that is a situation where you would not -- in which the benefits conferred by that third competitor, that they

outweigh the cost.

JUDGE HOPKINS: Mr. Ratner, you have several more, don't you?

MR. RATNER: Yes, I have a little bit more, Your Honor.

JUDGE HOPKINS: I think this might be a good time for the luncheon recess. We will recess until 1:30.

(Whereupon, at 12:30 o'clock p.m. the hearing recessed, to reconvene at 1:30 o'clock p.m., this same day.)

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AFTERNOON SESSION

(1:30 P.M.)

JUDGE HOPKINS: Let's get back on the record. Mr. Ratner.

MR. RATNER: Thank you, Your Honor.

Whereupon,

RICHARD C. LEVIN

the witness on the stand at the time of the recess, resumed the stand and, having been previously duly sworn by the Administrative Law Judge, was further examined and testified as follows:

CROSS EXAMINATION - RESUMED

BY MR. RATNER:

Q Dr. Levin, you referred to the IRMA price as a compensatory price in your testimony.

A I believe so; yes.

Q How is that compensatory price going to be set?

A My understanding would be that if the conditions were imposed in this case, that the parties, that is to say, KCS and SFSP, would first attempt to negotiate a price and bring it before the Commission for the Commission's consent.

I suppose if they can't reach terms, then the Commission would have to intervene and set a price.

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Q What are the factors that would be evaluated in the process of deciding what the appropriate price would be?

A Well, I think the principles recently enunciated by the Commission with regard to trackage rights over the Union Pacific bear on this case and, by and large, are appropriate; that one would attempt to cover all the variable costs of operation, cover the return on the property of the landlord carrier, and there are a number of methodologies for doing that.

It's not obvious that any one is in principle best, because in fact, in theory at least, they all should yield the same result, but in practice they don't. And if there are costs that are incurred in the nature of opportunity costs, extra resources required to handle the trackage rights, lost savings in yard operations or something of that sort, those presumably should figure in as well.

Q Do you see any difference between, in terms of cost savings, in terms of the process of setting an IRMA price and setting a trackage rights price?

A It's essentially similar, the only distinction being int he actual nature of services being provided. In the case of trackage rights, more services are being furnished by the tenant, and therefore the price for

trackage rights is presumably lower than the price for an IRMA.

Q Okay. If I understand you correctly, then, setting either trackage rights price or compensatory price is going to involve some process of estimating variable costs, capital costs, some additional costs that may compensate for imposition of some other burden, plus assigning a rate of return on capital.

How does all that differ from rate regulation?

A It doesn't differ very much at all from textbook rate regulation. It differs quite a bit from ICC practice of rate regulation as it took place before the Staggers Act and as it takes place since. Specific rates weren't always linked in the past to return on capital, and while there has been some movement in that direction with the new legislation, it is still not a traditional method of regulation.

Q Is it unfair to describe the process of setting the IRMA price as a process of determining what the competitive rate and picking that price?

A That's a little difficult because it would be essentially the competitive price for that portion of the service, but you have to remember other aspects of the service being provided by the tenant.

That is to say, in the case of IRMA, the marketing solicitation and the car supply.

Q On page 16 and into page 17, you discuss, I guess, a theoretical possibility that the IRMA service might not match the Southern Pacific Santa Fe service. Do you see that?

A Yes.

Q Where you suggest that Southern Pacific Santa Fe would discriminate against the IRMA service or the quality of service would be poor, what do you have in mind there?

A Can you refer me specifically to where --

Q It's the second sentence of the second paragraph on page 16 that I was specifically referring to.

A I'm sorry. I am looking at the wrong verified statement. Pardon me.

(Pause.)

I am raising a hypothetical objection that shippers might be concerned about the possibilities of discrimination against cars hauled for KCS's account under the IRMA. I think perhaps it is here or perhaps it's later in the testimony, I essentially talk about reasons why that hypothetical is unlikely to actually occur, because the efficient decision on the part of

SFSP presumably would be to handle those cars as if they were their own cars, rather than break up trains and artificially distort the service they're providing.

These would be specific single car, possibly multi-car movements, but presumably the kind of yard operations and the blocking and so forth that would take place would be similar to what would happen if Santa Fe were hauling it for itself.

Q I realize this is hypothetical, but would it be possible for Santa Fe Southern Pacific to discriminate against the IRMA process in the interest of discouraging shippers from using it all, hoping it would go away, and then successfully raising their own rates on similar service?

A It's always a possibility that tenants will be discriminated against. I think in this case, presumably if that were to happen, if conditions were granted in this case because of anticompetitive consequences and, in fact, there was systematic discrimination against the KCS that essentially undermined the achievement of the objectives that the Commission would have had in mind in imposing the trackage rights, you can be assured you would hear again from the KCS.

So I think the KCS would certainly have an incentive to come forward and protest if the conditions

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aren't being properly implemented. So I don't think it's a major concern.

There always is the possibility, just as there is with trackage rights.

Q Do you think the possibilities for discrimination are greater or lesser under the IRMA than they would be under trackage rights?

A Well, I think that in one respect, they are likely to be greater under trackage rights than under the IRMA, because as I say, you are going to be moving cars in the IRMA in Santa Fe trains, and when you discriminate against those cars in some sense, you may be discriminating against your whole operation; whereas with the trackage rights, the tenant has a train and to the extent you can slow him down in favor of your own, you can enforce discrimination a little more effectively.

I am not suggesting that Santa Fe would behave in that discriminatory manner. I'm just saying I think the possibilities are probably somewhat greater under trackage rights than they are under the IRMA.

Q On page 17, the first full sentence says: "The presence of a reasonable, even if imperfect, alternative to the SPSF gives shippers of rail-dominated commodities some leverage."

Do you see that sentence?

A Yes.

Q The quality of service offered by the IRMA directly affects how much of a constraint the IRMA will be on Southern Pacific Santa Fe's ability to exercise market power; isn't that correct?

A Certainly.

Q Isn't it correct that to the extent that the service offered by the IRMA is inferior, that could be translated into a price difference and the IRMA would be unable to constrain Southern Pacific Santa Fe over the extent of that price difference?

A To the extent that there are distinct service advantages of the landlord carrier, that could be reflected in a number of ways: larger market share for the landlord carrier, possibly higher rates to the shipper to compensate in one respect or another.

If KCS were at a severe service disadvantage, it would be a less effective constraint on market power; yes.

Q On page 20, you indicated there are currently a lot of active trackage rights agreements.

A That's right.

Q Does that mean that there is a market for trackage rights of sorts that is currently existing in the industry?

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A I suppose that there are. I think the majority of trackage rights are, in fact, voluntary arrangements negotiated by railroads. Some are obviously a legacy of quite a number of trackage rights arrangements that have been granted as conditions of mergers or by legislation such as is the case in trackage rights over Conrail.

But I think the vast majority are in fact private agreements.

Q So is it correct, then, that owners of railroads right now have a revenue opportunity that is available in terms of selling trackage rights to other interested parties?

A That's correct. But as I've testified before in this area, the issue that is relevant in this kind of case is whether a monopolist will willingly cede some of the monopoly earnings available to a private voluntary trackage rights agreement.

I've testified to some detail actually in the Union Pacific case about why there would be -- why you would not expect to see private voluntary transactions in a case where the host railroad had market power. He would basically demand a price for the trackage rights that was higher than any tenant would willingly pay.

Q Would you be more likely to see it in a case

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where there is some sense of intramodal competition already occurring?

A Sure. To the extent that the railroads are operating in a competitive context and jointly have very little power over price, where the host railroad is quite constrained, for example, by intermodal competition, then of course there might be a mutual interest in making arrangements more efficient, saving costs, even if they could not make it up in terms of charging higher rates.

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Q The next set of questions I will ask you applies to both the setting of an IRMA rate or a trackage rights rate.

In terms of allocative efficiency, what happens if the IRMA rate is set too high?

A If an IRMA rate were set so high that it effectively permitted both the landlord and tenant to charge an unconstrained monopoly rate over his territory, in fact, constrained them to do so because their IRMA price was so high that the only way that the tenant could get a margin to compensate for its costs would be to charge the monopoly rate to the shipper, that of course would be just as bad from the shipper's point of view as monopoly.

So there is a danger in setting the IRMA rate too high.

Q The IRMA in effect would not be an effective constraint on any market power?

A In fact, could perpetuate it, could sort of assure it.

Q Is that correct for the setting of a trackage right rental as well?

A Sure. Same principle would apply.

Q What happens in terms of allocative efficiency if the IRMA rate or the trackage right rate is set too

low?

A Well, if the IRMA rate or trackage right rate is set at noncompensatory levels, then it makes no contribution to the host carrier. There is in the long run sense, it could injure the financial viability of the host carrier and not permit it to replace its capital.

The short run effects would probably be beneficial to the shipper and, of course, to the tenant carrier, but in the long run you would have this efficiency cost.

Q Is it correct that, really, in both the short run and the long run there would be too much of the service provided based on the fact that the rental rate was too low?

A That's right. Presumably the tenant would wind up hauling too much traffic and pricing it too low.

Q On page 27, the first full sentence, do you see that sentence where you refer to the Applicants might find it more profitable after a merger to haul for itself rather than to haul through the IRMA.

If the IRMA rate is set properly, how can that be?

A If the IRMA rate is set properly, it shouldn't

be, but the IBMA rates are in some sense like any trackage rights price, too, a blunt instrument in the sense that you are going to set -- to simplify it administratively, you would set a single rate for a certain car type or something of that nature as opposed to fine tuning every specific, you know, the IBMA charge for every specific movement. So, as we know in that kind of context, it is possible, some classes of traffic with specialized needs or particular service requirements, the host railroad might find those more profitable to haul on its own and for other kinds of commodities might find it distinctly more profitable to haul it by IBMA.

Q On page 22, in the second paragraph, you refer to a -- and I realize you have been asked about this some, so I will try to be brief. Apart from the market power of the UP system --

A Where?

Q It is the second sentence.

A I see it, yes.

Q Could you clarify for me which Southern Pacific-Santa Fe shippers the Union Pacific has market power over, if any?

A You are referring not to the entire statement but to this first clause?

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Q Yes.

Am I incorrect in thinking that the first clause suggests that the UP does or may have some market power over shippers that would be affected by this merger?

A Yes, it may. I really haven't done a study of that in detail although I know that the Union Pacific serves, as I suggested before, a number of the points in particular in the Los Angeles area where it has an effective presence for central corridor shipments and in the Texas coast and Gulf coast area where the Missouri Pacific serves quite a few chemical plants.

Q Okay.

I am going to use the term "collusion," and let me just define it for you as to what mean by it and see if you have any problem.

By collusion I mean either legal or illegal, tacit or explicit, the process by which firms recognize their interdependence and adjust their price and service output according to the way the other firms are acting in the industry.

A Do you have a question.

Q Do you understand that as a concept of collusion?

A Well, I actually would have to differ with you

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I think on that because it sounds to me the way you -- as you elaborated on your definition, any recognition of interdependence might qualify as collusion, and in economic theory, for example, we distinguish collusive or cooperative solutions to problems among competitors, competitive relations among competitors from noncooperative solutions. In fact, a lot of economic research is based on standard models of noncooperative behavior of oligopolists. In particular, I use that sort of model in some of my railroad articles. Professor MacAvoy relied on it in his cost-benefit calculation.

Those models all take account -- in those models, the firms take account of the behavior of their rivals one way or another, which differentiates it from a purely competitive model in which firms are indifferent to reactions of competitors, they simply take the market price as something over which they have no influence.

So I would think that collusion only would apply -- you would only use the term collusion when there is some sort of explicit or tacit cooperation on establishing or maintaining a price as opposed to simply taking account of interdependence because I think firms tend to account of interdependence, and I wouldn't want

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to call that collusive behavior.

Q In terms of merger evaluation, as the number of firms in an industry is reduced because of a merger, one of the concerns -- am I correct that one of the concerns that we should have is a concern that whether there is explicit collusion or not, the likelihood of welfare loss associated with firms' pricing and output behavior increases?

A Yes. There can be adverse consequences from oligopoly behavior, whether it is collusive or whether it is noncooperative, and in fact, there are at least two economic theories that motivate, for example, the use of the Herfindahl index as a measure of market power, one of which owes its origin to George Steigler, has to do with relating to Herfindahl index to the probability of collusion, and another theory, quite independent, quite indifferent, that stems out of the work of Cournot and other game theoretic treatments of oligopoly in which even in a noncooperative context, the higher Herfindahl is associated with the higher level of welfare loss.

Q Given that situation, I am going to use collusion in the next couple of questions in terms of both cooperative and noncooperative behavior by firms in the industry.

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Do you understand me on that?

A I will accept your definition for the purpose of the answers.

Q Thank you.

Is there more likelihood for successful collusion as I have defined it between the Union Pacific and Santa Fe-Southern Pacific in the event that the UP is granted trackage rights than would exist if the IRMA is granted to the Kansas City Southern in terms of collusion between the Applicants and Kansas City Southern?

Do you have trouble following my question?

A No. I understand your question, but I have trouble answering it on the premise you just asked me to agree to because I think that in this situation, one would want to distinguish collusion from noncooperative oligopoly behavior with -- and make a rather important distinction. That is to say, the possibility of collusion, real collusion, cooperation, tacit agreement or explicit agreement between carriers like the Union Pacific and the Southern Pacific might be something to worry about. I think in particular if you consider the nature of the geographic configurations of these railroads.

It is certainly imaginable that granting UP

trackage rights might lead to a kind of market division arrangement where the UP and the SPSF tacitly agree to divide traffic, and the UP take the bulk of the traffic over the central corridor and the Santa Fe take the bulk of the traffic over the southern. That is a concern.

There is not much evidence in the record that relates to it at this point, but it would be a concern, yes.

Q Would there be any difference in terms of noncooperative behavior among firms?

A Well --

Q Between UP and KCS?

A There could be in the sense that one might expect the Union Pacific, if a noncooperative mode of behavior were adopted and the Union Pacific decided to compete very aggressively for Southern corridor traffic, it is at least possible that the Union Pacific might compete so strongly as to take away the bulk of the traffic from the host railroad, and with possible adverse financial consequences for the Applicants.

I think that is distinctly more possible in the UP case than the KCS case because -- and this does get a bit speculative, but if you think about the long run positioning of these two railroads, UP versus KCS, on KCS's IRMA, it is dependent on the financial

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viability of the Santa Fe-Southern Pacific. The Santa Fe-Southern Pacific is going to be hauling its trains. So it is dependent on decent service and maintained operations over those lines to even participate, and it certainly doesn't threaten to take over the whole operation.

I mean, the KCS is not going to by virtue of competing aggressively wind up driving the Santa Fe-Southern Pacific out of business because it would not be in its interests to do so.

Now, you could argue, you could argue that the UP's position might be to compete very aggressively and wind up purchasing the Santa Fe-Southern Pacific and monopolizing the Southern corridor and enhancing its position in the Central. It is at least imaginable, where I think it is not really imaginable in the Kansas City case.

Q I will try to use your terms to the extent I can.

What I would like you to do is compare the likelihood for cooperation between the merged Applicants and any recipient of either trackage rights or an IRMA and the situation where Southern Pacific and Santa Fe remain separate and do not merge, and I want to know if you have an opinion as to whether first, cooperative and

0001 0166

then noncooperative behavior which results in a welfare loss is more likely under one or the other of those situations.

A I think to the extent that Union Pacific is a financially stronger railroad than the Southern Pacific, that in some sense both the opportunities for collusion between the merged entity and the UP and the opportunities for predation on the part of the UP are probably greater than would be the case for collusion between an unmerged Santa Fe-Southern Pacific and predation -- well, certainly by the Southern Pacific, and I guess by the Santa Fe as well against Southern Pacific.

So the UP's very strength in the railroad system hence makes it I think, you know, it creates a certain risk in giving it this enhanced market position.

Q Okay. I am going to turn to the opposition testimony which is in KCS-14.

On page 6 and 7 you talk about the proper definition of relevant markets.

Do you agree with the Department of Justice merger guidelines concept of defining a market as including only those firms that effectively constrain each other?

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A That is an imprecise characterization of the merger guidelines, but I think that is a good general principle for defining markets.

Q Would you care to clarify what is imprecise about my characterization of the merger guidelines?

A Oh, well, there is -- I suppose I shouldn't be correcting the Justice Department on this matter, and I kow you know the merger guidelines perhaps better than I, but there are specific tests that are offered in the merger guidelines in the spirit of that general principle, for example, including products in a market where it would not be possible -- I'm sorry -- including products in the same market where it would be possible for a hypothetical monopolist to raise price by 5 percent for a significant period of time.

Q I have just described it as a concept.

A Okay.

Q On page 16, you are talking about situations where rail modal share tends to be high.

A Yes.

Q I realize this is a range, but what do you mean by high share?

A Well, we are really talking about an inverse relationship here, so perhaps to clarify the point, it would be better put elasticity of demand tends to be

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lower where the rail modal share tends to be higher so that -- I didn't have specific numbers in mind, specific ranges. If you look at the empirical evidence, that is to say, the econometric studies, the sort of thing that emerges from both my own work on transportation demand and that of Winston and Friedlaender & Spady and Oum and others, is that demand tends to be -- demand elasticity tends in fact to be below one in most instances where the rail modal share is above 50 percent, but that is by no means a hard and fast relationship.

Q In cases where a rail share, not the elasticity but the rail share may be low, does that mean that the rail elasticity demand for many shippers will always be low as well?

A No, it is the other way around. You said if the rail share is low --

Q No, I meant to ask the question the way I asked it. Let me rephrase it, though.

Is it correct that even though rail share may be low, there may be many shippers that still have a rail elasticity demand which is rather high?

A You just stated the question the reverse of the way you stated it before.

Q Is it impossible for you to answer the question I have just asked you?

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A No. I think I can answer it.

It is indeed possible if the rail market share is low for the elasticity of demand for rail for many shippers to be high, yes.

Q Is it also possible that the rail elasticity of demand for many shippers in that circumstance could be low?

A It could be, yes, although the systematic tendency would be the reverse.

Q I think we have covered both sides of that now.

On page 23 you discuss using a two-digit STCC level.

A Yes.

Q Are there aggregation problems associated even at the two-digit STCC level?

A Sure. In using these data, basically derived from the waybill tapes, there is always a tradeoff between the aggregation problem that is entailed by lumping together rather diverse commodities within the same two-digit class and on the other side the consideration that estimated market shares are much more imprecise when you use a more disaggregated level of analysis.

So, for example, the standard errors as

associated with market shares at the five-digit level can be pretty high.

Q The standard errors depend on how many observations you have?

A That's right. So in five-digit commodity groups with a lot of traffic, the market share estimates would be much more precise.

Q I think you partially explained it, but for the record, what is the advantage of using the more disaggregated five-digit, for example, method?

A Well, when it is possible and when there are a large number of underlying waybills, obviously it is useful to go to a more disaggregated level because the commodity characteristics can differ within a two-digit class. Some commodities, take as an example STCC 29, which is petroleum products. We have products like gasoline and ordinary home heating oil that tend to go in very high volumes and it is susceptible to transportation by pipeline, for example, and also can go by water, tankers. For much lower volume products and more viscous products, so residual fuel oil and lubricating oils and things of this sort, they tend to neither work technically in pipelines nor do they move in large enough volume to go in tankers. So they tend to go really quite predominantly by rail.

So you do mask some important distinctions.

Q On page 5, you are talking about the conditions that are generally necessary for source competition to be effective, and one of them is the last one when the share of transport costs and the delivered price of the product is high.

Do you see that?

A Yes.

Q Why is that a factor in considering the effectiveness of source competition?

A It is a factor in the following sense, and maybe an example would help to clarify it.

Suppose everything else specified here is satisfied, that is to say, there are a number of sources of supply and we have a homogeneous product, and relatively equal transportation costs from alternative sources and so forth. Now, consider the situation where the transportation cost is just 1 percent of the value of the delivered product. Well, then, one of the transport alternatives could double its rates and it would have only a 1 percent increase in the final delivered price.

If you think of a product where the transportation costs are 30 percent of delivered value, as is sometimes the case with coal and products like

that, if the transportation supplier doubled its price, it would have a 30 percent impact on the delivered price, or something in that neighborhood. So in that sense the availability of alternatives from other sources provides much more discipline in the case of coal where the price is high. To get that 1 percent increase in delivered price, you can only raise your rail rates by 3 percent. In the other case, you could double them and it would only raise the price, delivered price, by 1 percent.

So that is the sense in which the share of transport cost matters.

Q I think I understand you, but there is one point I am still confused on which is in the small number case, the 1 percent case, why hasn't that, if it is possible that that could occur, why hasn't that price doubling already occurred?

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A Because competitive conditions might prevent it from occurring, competitive intramodal or intermodal competition.

MR. RATNER: That is all I have, Your Honor. Thank you very much.

JUDGE HOPKINS: Thank you.

Ms. Reed?

MS. REED: I have no questions, Your Honor.

JUDGE HOPKINS: Thank you.

MR. BAKER: A short amount of redirect, please.

JUDGE HOPKINS: Mr. Martin, I think you had something.

MR. MARTIN: I just wonder if I might be allowed a couple of questions, and if so, whether I should come before or after any redirect.

JUDGE HOPKINS: Are you talking about as a result of --

MR. MARTIN: I want to follow up on one of Mr. Ratner's questions, if I might.

JUDGE HOPKINS: Do you have some objection? We have had this situation before with the Justice Department involved, and now --

MR. BAKER: All right, Your Honor, we won't object, but I think it is best that it happen now.

MR. MARTIN: That is why I raised it now.

BY MR. MARTIN:

Q You were asked a question by Mr. Ratner about the composition for the IRMA, and how it would differ from rate regulation, and your answer, if I understood it correctly, was, it wouldn't differ in terms of the textbook economic principles, but it would differ from traditional ICC rate regulation pre-Staggers Act.

Is that essentially your answer?

A Yes.

Q All right. Now, you understand that in terms of those traditional rate principles pre-Staggers Act the Commission has been implementing some changed principles, and that it has proposed new standards in a docket called Ex Parte 347, which I am sure you are at least generally familiar with.

Those involve Ramsey principles, which we talked about this morning, avoiding cross-subsidy, use of current cost, and things of that sort. My question is this. If you focus not on the traditional ICC rate maximum standards, but on those that have been proposed in Ex Parte 347, would there be any significant difference between the principles that ought to govern the compensation for an IRMA and the principles that ought to govern the compensation for maximum rates -- or

the maximum rates? Excuse me.

A Subject to the qualification that certain finer nuances about Ramsey pricing principles, some of which I averted to this morning, have not been fully discussed in Ex Parte 347, or at least to my satisfaction fully discussed in Ex Parte 347.

Subject to that qualification, I would agree with you.

MR. MARTIN: Thank you. No further questions.

JUDGE HOPKINS: Mr. Baker.

REDIRECT EXAMINATION

BY MR. BAKER:

Q Professor Levin, with regard to this morning's cross examination by you of Mr. Martin, do you recall what his last -- Mr. Martin's question of you this morning, do you recall what that last question was?

A I believe so.

Q What is your recollection of that question?

A He referred me to the first sentence on Page 35.

Q This is KCS-14?

A KCS-14. And he asked me whether in reaching the conclusion stated in this sentence I relied on comparative cost evidence.

Q And what was your answer to that question?

A My answer was yes.

Q And what did you have in mind in terms of saying yes, you relied on comparative cost evidence?

A Well, there are at least three different pieces of comparative cost evidence discussed in the preceding section of my testimony, and I really have all of those in mind. One piece of comparative cost evidence is the literature on comparative costs which I cite, actually not in the preceding section, but two sections earlier, on Page 10, so I had that sort of comparative cost evidence in mind.

And I also had in mind the comparative cost evidence adopted by the Association for American Railroads that was relied upon by Professor MacAvoy and referred to in his testimony, and also discussed in my testimony.

And then finally I had a third source of comparative cost evidence, which was the calculations done by Dr. Roberts.

Q Now, do you recall that there were several questions posed to you this morning by Mr. Martin which used the term "market power?"

A Yes, I do.

Q And in your answers to those questions,

where, you used the term "market power," did you intend that term to have the same meaning or the same sense in which that term is used in the Department of Justice's merger guidelines?

A No, I think that Mr. Martin and I agreed for purposes of discussion on a definition of market power that I defined as essentially having some power over price, or some influence over the price of the product. And on a definition of monopoly power, that referred to the ability to price above prices that would earn a competitive return on capital.

In fact, in the merger guidelines, many of my colleagues in the economics profession tend to use the term "market power" to refer to precisely that notion defined in -- that notion that I just defined about raising price above competitive levels or prices large enough to earn a competitive return on capital.

That is the way market power is used in the merger guidelines. That is the way many people use it. We were simply trying to clarify a point that influence over price to some degree is one matter, and then the ability to price above the level that would generate a competitive return was another matter, and I used the terms "market power" to refer to the former and "monopoly power" to refer to the latter, but it does

depart from some conventional usages of those terms.

MR. BAKER: No further questions.

JUDGE HOPKINS: Anything further, Mr. Martin?

MR. MARTIN: No.

JUDGE HOPKINS: Anything further, Mr. Ratner?

MR. RATNER: No.

(Witness excused.)

MR. BAKER: Your Honor, we move the admission of Dr. Levin's two verified statements.

JUDGE HOPKINS: Any objection?

MR. MARTIN: Yes. Your Honor, I would object or move to strike, whichever is the appropriate form, with respect to part of K[illegible]14, that is to say, Pages 29 through 34, dealing with comparative cost evidence, and also Tables 12 through 18.

MR. BAKER: Tables 12 through 18 or Pages?

MR. MARTIN: Tables 12 through 18. As I understand it, the original tables submitted, 12 through 18, have been replaced with new tables, revised Tables 12 through 18, and my objection or motion to strike or exclude would be directed to Pages 29 through 34 of the text and those revised Tables 12 through 18, and that is on the assumption that the old Tables 12 through 18 are not being proposed.

JUDGE HOPKINS: You would have no objection if

both were in there?

MR. MARTIN: No, I understand they are not advancing or moving -- either the old or the new 12 through 18 tables and Pages 29 through 34.

JUDGE HOPKINS: You would strike either one?

MR. MARTIN: Either one.

MR. RAKER: I am happy to respond, Your Honor, if I knew what the grounds for the motion was.

JUDGE HOPKINS: Go ahead, Mr. Martin.

MR. MARTIN: Well, Professor Levin has indicated in response to my questions that he is not a cost expert. He didn't do the work with respect to either the rail or the motor costs. Dr. Roberts and his firm did the work, and they sent him the costs, and as to him it is hearsay. He put it in. He did his best to explain what the methodology was.

There are many instances in which he could not explain the methodology. For example, he couldn't explain exactly the way URCS worked. He wasn't sure what the percent variability was or what the cost of capital rate was, what the techniques of accounting were for the rail costs.

He wasn't sure what the method for allocating the fixed costs was. There were similarly other points that he was not sure about, how the truck costs were

calculated, but even, and this is the key point, even where he did his best to explain it, his explanation was based entirely on what he was told by Dr. Roberts, and Dr. Roberts is not here, and he has not testified, and his evidence is not in this record, and his study that underlies these costs is not in the record, and it is hearsay.

MR. BAKER: Your Honor, I think there is a clear exception to the hearsay rule. The expert is entitled, for example, to rely on published articles of other experts. They often do in this situation. Professor Levin went to an accepted authority to seek him to have the comparative rail and truck costs developed.

On the one hand, that authority used the Commission's own URCS methodology for the rail costs. In connection with the truck costs, he used his own model. The applicants have been aware of this since the testimony was filed in November.

At no time have they asked either on discovery for information, either from Professor Levin or to request that Professor Roberts be deposed. If they had requested, we would have produced him either for deposition or we would have produced him here at these proceedings, and we are still prepared to produce

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Professor Roberts if that is what applicant's concern is.

JUDGE HOPKINS: It isn't up to applicants. I am going to deny the motion to strike on the same basis that I denied some others. I have some question as to the testimony that is in here, but Mr. Martin, you have had a good cross examination on this point, and I see no reason therefore to strike it, so I will deny the motion to strike. Let's proceed. Who is the next witness?

MR. RAKER: The next witness, Your Honor, is Paul Richardson.

Whereupon,

PAUL F. RICHARDSON

was called as a witness, and having been first duly sworn, took the stand, and was examined and testified as follows:

DIRECT EXAMINATION

BY MR. RAKER:

Q Would you please state your name and business address?

A Paul F. Richardson, 53 Main Street, Holmdel, New Jersey.

Q And what is your occupation, Mr. Richardson?

A I am an international maritime consultant.

Q With what firm?

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A Paul F. Richardson and Associates.

Q Mr. Richardson, have you submitted a verified statement in this proceeding which is included in KCS-14?

A Yes, I have.

Q And that is a verified statement which indicates that it was verified by you on November 18, 1984?

A Correct.

Q And have you previously submitted corrections to that verified statement which corrections are contained in KCS-16?

A Yes, I have.

Q And have you further submitted corrections which are contained in KCS-18?

A Yes, I have submitted additional errata on 17 seven days ago.

Q Do you have any further corrections or modifications which you wish to make at this time?

A No, I do not.

Q As corrected by the errata which you have previously filed, is your verified statement to the best of your knowledge true and correct?

A Yes, it is.

Q And do you adopt it at this time as your

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testimony in this proceeding?

A Right. Yes, it is.

MR. BAKER: That concludes Mr. Richardson's direct examination.

JUDGE HOPKINS: Mr. Hynes?

MR. HYNES: Good afternoon, Your Honor.

CROSS EXAMINATION

BY MR. HYNES:

Q Good afternoon, Mr. Richardson. My name is Terry Hynes. I am here on behalf of the primary applicants.

Would you turn, please, to Page 3 of your verified statement?

A Yes.

Q I would like to direct your attention to the paragraph immediately below the heading Scope of Testimony, where you set forth the various origin and destination pairs which the primary applicants handled, and you note there, do you not, that the Santa Fe currently offers MLP service to New Orleans and Lake Charles in connection with the Louisiana and Arkansas Railway?

A That's correct.

Q Do you consider the joint Santa Fe-L&A routing to be a viable competitive alternative to the single

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line service which SP offers to New Orleans and Lake Charles today?

A I am of the opinion -- not the opinion, but I am aware that there is considerable cargo moving over Lake Charles, primarly destined to Puerto Rico, and in my testimony I have alluded to this. And obviously two carriers domiciled in Lake Charles, they apparently consider it to be a viable gateway vis-a-vis alternative water service.

Q My question to you, sir, was, in your view, is the joint Santa Fe-L&A routing competitive routing with the SP single line service to New Orleans.

A I haven't checked. I am not going to comment on rail service, one combination of railroads versus direct. I have no reason to be familiar with that. I haven't compared the two.

Q Do you know, based on your view of MLB statistics, whether the joint Santa Fe-L&A routes handle an appreciable amount of MLB cargo between Los Angeles on the one hand and either Lake Charles or New Orleans on the other?

A Yes, they do.

Q And does the existence of this joint Santa Fe and L&A route constrain the ability of SP to raise its MLB rates on movements to New Orleans?

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A I don't think I really understand what you are asking. Try that again, if you would.

Q Does the existence of this joint route today, Santa Fe-L&A alternative for a movement from Los Angeles to, let's say, New Orleans, does the existence of that joint route and the ability of an ocean carrier to route its MLB containers over that route constrain the ability of Southern Pacific to raise its charges for MLB cargoes above a certain level today?

A No, I don't think it necessarily does.

Q So it is your testimony that notwithstanding the existence of this joint route today, that SP can charge an ocean carrier whatever it wants for a movement between Los Angeles and New Orleans?

A No, no, I say it is competitive. No, I misunderstood your question, obviously.

Q My question was, does the existence of this alternative, a Santa Fe-L&A routing, let's say, between Los Angeles and New Orleans, does that constrain the ability --

A Yes. I am sorry. I misunderstood what you were getting at.

Q So the answer to my original question was yes?

A It is yes.

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Q Would you turn to Page 4, please?

Now, on Page 4, I would like to direct your attention to a number of assumptions which you set forth at the outset of your testimony. The first assumption, stated at the top of Page 4, starting in the first line, you state, "I was instructed by counsel for Kansas City Southern to assume that railroad service between Los Angeles-Long Beach and the enumerated Gulf coast ports via the Central Corridor route for transcontinental traffic would be too circuitous and costly to offer effective intramodal competition."

My question to you, sir, was, were your instructions concerning this assumption transmitted to you in writing or were they transmitted orally?

A They were transmitted orally.

Q By whom?

A Counsel for Kansas City Southern.

Q And when were they transmitted to you?

A At the time in which we were retained to develop this particular testimony.

Q And can you tell me, sir, more specifically what it was that you were told to assume?

A While the statement was made that we were to assume that the alternative routes, alternative ports were considered to be circuitous, nonetheless we have

treated this -- and not in my testimony, this is treated in Exhibit 22, and we have arrived at our own findings in this particular case.

Q In response to my question, you said you were told to assume not only alternative routes, but you said also alternative ports?

A No.

Q I believe a moment ago in responding you mentioned both alternative routes and ports.

A That was incorrect. I should have said alternative routes.

Q So this assumption was simply that routing for a cargo landed at Los Angeles-Long Beach to a point in the Gulf could not be effectively routed over the Central Corridor because of circuity and cost?

In other words, the scope of this assumption is limited to Los Angeles-Long Beach, and not to the other ports along the west coast. Am I correctly interpreting the --

A No, I have analyzed all of the alternative ports as well.

Q My question was not what you analyzed, sir. My question was what you were told to assume starting out. Do you understand my question, sir?

A I understand your question. I understood the

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statute that other railroads other than Santa Fe or Southern Pacific with connections were not a purview within the parameters of this testimony.

Q You said you understood a statute?

A Well, a statute -- yes.

Q What statute are you referring to?

A The outline of this testimony was indicated not to treat alternative rail routes, but to concentrate on the existing rail routes of the Santa Fe and the Southern Pacific.

Q Is it your testimony, sir, that in analyzing the potential competitive impacts of the Santa Fe-Southern Pacific merger, that it is not within the purview of proper analysis to consider other rail routes? Is that what you have told me?

A We did consider other alternative ports which would necessitate other rail routes. That was considered from alternative ports, was within the scope of this testimony.

Q But other rail routes were not considered by you?

A Well, obviously, if you are coming out of Seattle to New Orleans, you were using another rail route, so you would -- to that extent, you would have to analyze other rail routes.

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Q Just to clarify this with respect to the first assumption stated on Page 4, am I correct that that assumption goes only to movements of MIB cargo which are landed at Los Angeles and Long Beach and does not constitute any assumption that you started out with with respect to movements of cargo landed either at Oakland-San Francisco, or at Seattle-Tacoma?

A We did analyze cargo --

Q I understand that you analyzed it. I am asking you about the scope of the assumption.

A No, I interpreted that we should have analyzed to analyze the TBS testimony, which did include alternative ports, and we did analyze those alternative ports, and whatever routes they entailed, whatever economics they entailed, let us put it that way.

Q Did counsel instruct you to assume, however, that routings via these other ports were either too circuitous or too costly to be effective?

A No, I did not interpret it that way. No. I am sorry if I misled you.

Q Now, you state in the next sentence that this assumption is consistent with your understanding that substantially all traffic in the subject markets moves over the primary applicant's Southern Corridor routes.

The first question with respect to that

sentence, sir, is, when you refer to subject markets, am I correct that you were referring to the Far East-Gulf market and to the Europe to west cost market? Are they the subject markets you have in mind there?

A Yes, that's correct.

Q And by substantially all traffic, how much of the traffic do you mean?

A Well, we referred to TBS's verified statement, Exhibit 1 and 2, in which he estimates the percentage moving minilandbridge, and his table showed from Europe to the west coast 73.7 minilandbridge via the Gulf and shows Asia-Gulf 91.5 percent minilandbridge via Los Angeles-Long Beach versus other gateways. We agreed with that portion of TBS's testimony.

Q Now, your reading of the TBS testimony tells you, sir, that substantially all MLB cargo moving from the Far East to the Gulf moves via Los Angeles-Long Beach?

A Yes. That's correct.

Q When you say substantially all, do you mean 90 percent or more?

A Actually, I think our numbers come higher than 90 percent as we get into our exhibits. I think we are higher than 90 percent.

Q So it is your testimony here today that --

A From Asia --

Q From the Far East to the Gulf.

A To the Gulf, right.

Q Your testimony is that better than 90 percent of all of the UIB cargo moving between Far East and the Gulf moves via Los Angeles-Long Beach?

A I think I have so testified in my statement.

Q Did you or your staff conduct any independent circuity analysis at the Central Corridor rail routing to determine whether or not it was too circuitous, or did you just on the assumption that you were given?

A We analyzed rail rates, talked to operators in the trade, and analyzed the total practicality in cost of alternative methods, particularly with regard to what effect they might have on restricting or capping market power in a merged Southern Pacific-Santa Fe.

Q Well, aside from the cost analysis which is set forth in your study, and we will get to that later, my question is, did you or your staff conduct any independent circuity analysis of the other available rail routes?

A No, no, the answer to that is no.

Q The answer to that question is no, and I would take it that is also true as far as the relative circuity of rail routes from other ports, ports other

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than Los Angeles-Long Beach?

A We analyzed the costs.

Q But you did not conduct any independent circuity analysis?

A No, we analyzed the cost.

Q I would like to direct your attention to the bottom of the page, where the second assumption embodied in your testimony is laid out. Starting five lines up from the bottom, you state that, "I was instructed by counsel for Kansas City Southern to assume that following the merger of Santa Fe and Southern Pacific, any remaining joint line service with KCS to/from New Orleans would not offer an effective constraint on the merged company's rail rates in this market."

Again I ask you was this instruction concerning this assumption transmitted to you orally rather than in writing?

A Orally as far as I recall.

Q And when you speak of the KCS joint line service, is that the service that we spoke about at the beginning of your cross examination?

A Yes, it is.

Q The Santa Fe-L&A service?

A Right.

Q You refer here to any remaining joint line

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service. Am I correct that you were instructed to assume that the existing service, the Santa Fe-I&A service would be eliminated following the consummation of the merger?

A No, we did not assume that.

Q Well, what specifically did you assume when you say any remaining service? Did you assume a downgrading of that service?

A We assumed that there would be a single operator, Santa Fe-Southern Pacific, offering rates within that service. There would be one line offering service, exercising market power in that trade rather than two lines, two major lines with connections.

Q What did you assume concerning the continued existence of a Santa Fe-I&A routing? Did you assume that there would be a joint route and joint rates published for that route?

A We did not make an assumption. We assumed that it would be one single line, Santa Fe-Southern Pacific.

Q Well, you state here that you assumed that any remaining joint line service involving the KCS would not offer an effective constraint. Did you assume that there would be any remaining service or not?

A We assumed there would be no viable service

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offered by that route.

Q When you say there would be no viable service left, what do you mean specifically?

A We assumed that all the traffic would be routed over the Santa Fe-Southern Pacific new southern route.

Q It would be routed over Santa Fe-Southern Pacific because Santa Fe-Southern Pacific closed the joint route involving the KCS?

A It would be a single line. It would be the most direct line between these two points.

Q That is, the merged companies' line?

A That's right.

Q And you assumed then since they had a direct line between those two points that they would close --

A That's the way it was assumed. That was the way it would go.

Q That is what I am trying to get to. You assumed there would be obviously a merged carrier single line service.

A Yes.

Q Just like the SP has today between Los Angeles and New Orleans.

A Okay.

Q My question was, did you also assume that the

existing joint service which involves the KCS's subsidiary, L&A, would exist or would not exist after the merger?

A If it did exist, we do not think it would move any particular traffic. We thought the traffic would move over the new Santa Fe-Southern Pacific merged line direct.

Q And you were told to assume this by counsel?

A That's correct.

Q Did counsel tell you the reason why this routing, if it continued to exist, would not move any traffic?

A I don't recall.

Q Am I correct, sir, that your assumption that this joint route either would not continue to exist or would not move any traffic is the basis for your conclusion that there would not exist a rail alternative for an ocean carrier deciding to move cargo between Los Angeles and New Orleans?

A We did not consider that it would be a competitive rail alternative. There would be a competitive rail alternative.

Q And was your assumption or consideration that it wouldn't be a competitive alternative? That is the premise for your conclusion that there would not be any

rail alternative for an ocean carrier in the Los Angeles-New Orleans corridor?

A That is correct.

Q Would you turn to Page 7, please?

I direct your attention to the very bottom of the page, the sentence that carries over to Page 8. You discuss other maritime intermodal traffic carried by the primary applicants today, and by other I take it you mean traffic which is not either Far East to the Gulf or Europe to west coast traffic. Is that right?

A (Nods affirmatively.)

Q Now, one of the trades you mentioned is to and from Alaska. Do you know the volume of MIB cargo which the applicants handled via Los Angeles-Long Beach to and from Alaska in 1982?

A It was very minimal.

Q Do you know if they handled any?

A There were -- I believe there was some, very few loads. There was some minimal amount. That is why we put it down.

Q Would your answer be the same for '83?

A I don't know.

Q Isn't it a fact, sir, that the vast majority of cargoes destined to or from Alaska are handled through the port of Seattle?

A That's correct.

Q How about for Hawaii? How much MLB cargo do the primary applicants handle over Los Angeles-Long Beach destined to or from Hawaii?

A I think that is in our testimony. I would have to refer to it.

Q Can you point it out to me, please?

A I am going to guess that if it appears, it probably -- if I can find the exhibit, maybe it is in Exhibit 7.

Q Under Other Trades?

A Under Other Trades.

Q Hawaii to U.S. Gulf. Would you turn to Page 10, please, of your verified statement? Again, I will direct your attention to the sentence that begins at the bottom of the page under the heading and carries over to Page 11.

You state in your testimony that in preparing your verified statement you took the perspective of an MLP carrier which is informed of a substantial increase in rail rates for MLB services in the Southern Corridor.

Were you instructed by counsel to adopt this perspective?

A No.

Q Why did you take this particular perspective?

A In our building blocks, all of these exhibits, introducing what we consider to be the accurate tonnage moving within the corridor, which as you know is far in excess of what TBS had presented, caused us to generate what is basically what we call Exhibit 23, showing that there is a substantial cost difference in moving all water vis-a-vis MLB in this particular corridor.

Q And the development of the data which demonstrated this cost difference led you to take the perspective of an MLB carrier in preparing your testimony and presenting it to the Commission?

A We spent a great deal of time -- I spent a great deal of time working with the ocean liner carriers. I am very familiar with the basic economics that drives their decision to ship European cargo via the Gulf, minilandbridge, also that drives them to ship minilandbridge from the west coast back through the Gulf.

So, I was very familiar with the overall economics and decisions made by primary the American lines in this decision. I hadn't at that time -- I knew from comments with operating people with American Presidents Line and Sea-Land that the cost was considerably higher by the all water route.

We set about in this particular testimony to quantify those particular costs from a conservative standpoint using the TBS model of a 12,200 TEU ship moving in both directions.

Q So I guess what you told me is the reason why you chose the perspective of an ocean carrier is because that is what you are familiar with. That is what you have done over the years?

A That is right.

Q And the primary purpose of your testimony was to demonstrate at least based on the figures that you had that this merger could lead to increase in the cost for ocean carriers. That is what you are trying to show us here?

A We tried to show what the accurate numbers were. We took the numbers and let the numbers fall where they may.

I might have had a preconception from operating experience people, whose judgment I would expect it was considerably higher, but in line with that I did not consider it as high as it actually turned out. It was higher in what we finally found out than what I had presumed going into it, but I did have a presumption that it was higher based on people whose judgments I respect.

Q Okay, and you say that the perspective you take is of an ocean carrier executive who has been advised of a substantial increase in rail rates for MLB traffic. By substantial increases in rail rates, how great an increase do you have in mind?

A Well, I would consider a substantial increase any increase in the corridor of more than 5 percent on an annual basis, not justified by a change in market conditions, either volume or cost.

Q And in developing your cost estimates for MLB or all water after an SP-Santa Fe merger, did you adopt a 5 percent increase in the MLB cost? Is that the figure that --

A No, no, you asked me an opinion, what I thought was --

Q My first question to you was what you thought was substantial, and you said 5 percent.

A I just told you that, yes.

Q My question to you then was, in calculating what the difference in cost would be to the ocean carrier after the merger, did you adopt a 5 percent rate increase?

A No, we did not.

Q What did you compare the all water cost to?

A We compared the all water cost to the existing

minilandbridge cost, the current minilandbridge cost.

Q So your costs are a pre-merger comparison of what the railroad -- the comparison was of the pre-merger costs, what the relative costs are today?

(Whereupon, a discussion was held off the record.)

Q Am I correct that the cost comparison that is set forth in your testimony between MLB and all water service is a comparison of the cost today?

A Yes.

Q Pre-merger?

A Pre-merger.

Q You also state in your testimony that the analysis that an executive would have to make in the ocean industry is well known to you based on your experience at Sea-Land. During your tenure at Sea-Land, did you in fact ever encounter a situation where a rail carrier that was working with you and MLB or landbridge cargo came to you and asked you for a rate increase?

A Yes, I have.

Q So you have been faced before with the situation that you fear may occur after an SP-Santa Fe merger?

A Well, I have also been faced in my water experience in direct competition with rail domestically

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both in the northeast Florida corridor and the intercoastal trades.

Q Returning to the first instance, the situation in which a rail carrier requested more money for handling MLB cargoes, can you tell me specifically when you were faced with that situation?

A We had an interchange on a unit train basis, not really dissimilar to what we are talking about here with the Florida East Coast Railway operating from Jacksonville to Miami and return, which was a precursor, if you will, to what we see as the current unit trains.

This was back in the early sixties. We were constantly debating with the far east coast the danger of those rates being increased inasmuch as they could conceivably price us out of the market. We were finally priced out of the market, not just because of that, but a combination of lower rail rates, higher maritime labor costs as well.

So I am familiar with the similar analogy.

Q And so what you are telling me is, this was movement to the port of Jacksonville and the Florida east coast would have handled the cargo from Jacksonville to Miami?

A We had joint service.

Q And they asked for and got an increase in the

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charge for MLB --

A No, but we discussed several times, we discussed increases. I don't recall whether we gave them increases, but we were partners in the trade. It was a jugular vein decision to us. Had those rates gone up appreciably, we probably would have been out of that service earlier.

A And you said that you abandoned the service. Does that mean that you gave up MLB for the movements from Jacksonville to Miami and switched to something else?

A We discontinued the Florida domestic service, intercoastal service.

Q And after that occurred, how did the cargoes get from -- where were they coming from? Let me ask you that.

A The northeast.

Q How did these cargoes then move?

A All rail.

Q All rail?

A The majority of them all rail on that move.

Q Okay. I would like to explore with you for a minute the way in which minilandbridge service works. Am I correct, if I am a shipper and I have a cargo and I want to move it, say, from Rotterdam to Los Angeles, I

contact the sales representative if he hasn't already contacted me, I contact the sales representative from an ocean carrier. Is that correct?

A That's right. Well, you don't have to contact the sales representative. You can call the ocean carrier's office.

Q And if I tell him I have this cargo to move from Rotterdam to Los Angeles, does the shipper generally select minilandbridge or all water or does he generally simply say to the carrier, I have a cargo I want in Los Angeles on the 19th, get it for me there, and let the ocean carrier --

A The shipper will chose the carrier.

Q The carrier?

A He will chose the ocean carrier.

Q Does he chose the service, minilandbridge or all water?

A Well, he subjectively, if you call Sea-land, what drives you to call Sea-Land may be because you consider that their rates are competitive, and they have a better service. I think -- and many times you will call Sea-Land or APL, well, not APL out of Europe, but Sea-Land out of Europe because they do have this minilandbridge service which is faster, and saves time and money on your product, so the judgment is made for

those reasons.

Q But if I am going to, let's say, contact a carrier such as Evergreen, who offers, and this is the Pacific trade, Evergreen offers both minilandbridge and all water service, does the shipper tell Evergreen, I want my cargo to go minilandbridge, or does he just say, I want my cargo to get there on the 19th, and it is up to Evergreen to get it there on the 19th, whether it be by an all water movement or minilandbridge, whatever they have to offer that will get it there by the 19th?

A Well, Evergreen is no different from anyone else. They publish a schedule. They publish the departures and they publish arrivals. If you book on Evergreen, you don't have to tell them what day to get there. You have already seen what their schedule is, so you have accepted that.

In the case of Evergreen, I am of the opinion that you should know, if you are booking it in Europe, that it is going all water.

Q So what you are telling me then is that the shipper pretty much knows when he looks at the schedule, he can see by looking at it that if he checks this sailing or that sailing, he is going to be choosing MLB or all water?

A Yes, I think the shipper does know.

Q Am I correct that if an MLP routing is involved, the shipper doesn't contact the rail carrier directly, does he?

A No.

Q Who establishes and quotes the rate to the shipper for the joint water-rail movement?

A The ocean carrier.

Q And those rates are set forth in tariffs published by the ocean carrier, is that correct?

A That is correct.

Q And those are published in the form of joint tariffs listing a particular ocean carrier and a particular railroad?

A No. They would be a single factor conference rate published in the ocean carrier's tariff or the conference tariff. It wouldn't name the routing.

Q Could you describe for me or define for me a single factor conference rate?

A A rate between Point A and B, a rate between Europe on the one hand and Los Angeles on the other.

Q So would it be the same tariff, let's say, between Japan and the Gulf, where the same tariff would apply to a movement that was all-water or a movement that was via Los Angeles or a movement that was via San Francisco-Oakland?

A In the case of Far East to the Gulf, there are 26 operators offering service from the Far East to the Gulf. Only two of those carriers of the 26 go via water, and they go via a rather circuitous route up to the east coast and back. So in that particuar instance, the 24 carriers would be all moving minilandbridge.

Q And does the MLB cargo move under a single bill of lading?

A Yes, it does.

Q A separate bill of lading issued at the time --

A A single bill of lading.

Q And am I also correct that the shipper pays the entire tariff rate to the ocean carrier?

A That is correct.

Q It doesn't make any direct payment to the railroad?

A That is correct.

Q And then after the ocean carrier receives payment, that carrier passes a division of that along to the rail carrier?

A He pays him on a per load charge, one charge for 20, another charge for 40, another charge for 20 empty, another charge for 40 empty, by contract with -- between the ocean carrier and the rail carrier.

Q And is it correct, sir, that the rates for an all-water movement are generally equalized with the rates for an MLB movement between any two points?

A That's the current custom, yes.

Q So if I am that customer with a cargo that has got to go from Rotterdam to Los Angeles, I will pay the same amount whether or not my cargo goes all-water to Los Angeles or if it goes via one of the potential minilandbridge routes?

A Yes, generally that is true. There could be an exception to that if you are dealing with non-conference carriers, but for all intents and purposes, yes, that's correct.

Q But generally the conference carriers charge about the same, or the non-conference carriers are somewhat lower but they are in the ballpark with one another as well?

A Yes.

Q Am I also correct that where minilandbridge movements are involved, the ocean carrier rather than the shipper chooses the port of entry?

A The ocean carrier chooses the port of entry, right, based on his economics and his judgment, correct.

Q Let me direct your attention to page 10 of

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your testimony. In the paragraph we just designated Paragraph B, you state that it usually pays from the perspective of the ocean carrier to maximize the water leg of a minilandbridge movement by routing minilandbridge cargoes via the Gulf, and you are talking about the European trade here, because the vessel slot cost per mile is substantially less than the railroad charge per container mile.

MR. BAKER: That isn't what the statement says, Your Honor.

JUDGE HOPKINS: Well, let him read it and ask his question.

BY MR. HYNES: (Resuming)

Q If I mischaracterize what it says, please tell me how I have done that.

A What I have said here, aside from the benefits of balanced, the combined water-rail cost to the ocean carrier of MLB via the Gulf is substantially lower than MLB via an east coast port. The total water-rail mileage is approximately the same for all minilandbridge routes. In such a case, it usually pays -- ands I guess I would highlight usually.

Q There is always an exception to the rule.

A It usually pays to maximize the water leg by routing MLB cargoes via the Gulf because the vessel slot

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cost per mile is substantially less than the railroad charge per container mile, that is correct, and what I am referring to here is the Gulf vis-a-vis New York, okay? So I say the judgment is by the carriers using it that they are better served taking the longer, somewhat longer water miles to the Gulf and the shorter MLB route than the New York route which would be different.

Q And you say the carrier is better served by that, is that correct?

A The ocean carrier.

Q The reason is because on, let's say, a 5000 mile movement from Europe to Los Angeles, that if it can go 4000 miles by water and only 1000 miles by rail --

A No, I would not buy that. I don't believe that's true. I think that our findings here find on that particular example you are using that that's not true.

When you introduce a circuity through the canal, canal costs and around the other thing, our figures, findings in this testimony indicate that that is not true. What was true, and what I am referring to here is that in a choice between port of New York and New Orleans or Houston, that is true.

Q I thought that's what I was speaking of. I wasn't talking about the all-water.

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A Oh, excuse me. I thought you said all the way by water.

Q No, I said 4000 miles. Let's assume --

A Oh, all right. I apologize.

Q We are talking about the New York routing and the Gulf routing, minilandbridge routing, no all-water routing here, and it is your testimony that it pays for the ocean carrier to have that traffic routed via the Gulf because it is cheaper for the ocean carrier to handle it a greater number of miles in water and a smaller number of miles via rail.

Is that what your testimony is?

A There are other factors in that particular decision, but, in other words, there is not -- there is another consideration why they do that, and it is because the European cargo is synergistic with the Far East cargo, and it helps to maintain a balance on minilandbridge cargoes on that 1600 what have you mile run. That isn't true in New York. So that is an added consideration in the minds of Sea-Land Service, for instance, in making their judgment, and it lends to the overall economic benefit of that.

Q And these are all cost considerations from the perspective of the ocean carrier?

A Yes, they are.

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Q Let's look at the same movement from the perspective of transit time.

Isn't it a fact, sir, that the fastest minilandbridge routing from Europe to Los Angeles would be via New York?

A I don't know. We have it in the exhibits. I could check it. But without checking the exhibits, I don't know.

Q I believe the testimony, both TBS's testimony and your own exhibits, show that New York is faster.

A Okay. That would just highlight what I said, the synergism of balance, which is another factor here which is very, very important.

Q Let me direct your attention to Exhibit 12, please. In Exhibit 12 it lays out a list of the principal container shipping lines in Europe to West Coast trade, is that right?

A That is correct.

Q I would like to direct your attention to the entry that is about the seventh or eighth down for Polish Ocean Lines.

Does your exhibit indicate in the third column that Polish Ocean Lines offers an MLB service over Wilmington? Is that Wilmington, North Carolina?

A Yes, it is.

Q And what transit time does it show?

A Twenty-three days.

Q Now look, for example, to the first entry for ABC Line, a minilandbridge movement over New Orleans.

What transit time does that show?

A Thirty days.

Q How about Lykes Lines, minilandbridge over New Orleans? What transit time does that show?

A Twenty-six days.

Q So based on your exhibit, Mr. Richardson, it appears, does it not, that Polish Lines' minilandbridge service over Wilmington is actually faster than minilandbridge over New Orleans, is that correct?

A In this case, transit time, that's correct.

Q Looking again at the Polish Ocean Lines, the frequency in days is seven.

Am I correct that seven is about the best frequency shown for any of the carriers in the trade?

A That is correct.

Q And am I also correct that schedule frequency is, like transit time and transit time reliability, a very important factor for a shipper in choosing this service?

A That is correct. Of course, there is another factor in the case of Polish Ocean Lines, they are a

non-conference carrier quoting rates considerably lower than conference rates. That is a significant factor in Polish Ocean Lines.

Q Are they offering this service as outlined in your exhibit, though?

A That is correct.

Q So if I am a shipper, I can call up Polish Ocean Lines and there will be a ship there every seven days that will get my cargo to destination in 23 days, assuming that they are on time.

A That is correct.

Q Let's look at the entry on that exhibit for Johnson Scan Star.

Now, that is an all-water movement from Los Angeles to Europe, is that right?

A That's right.

Q What's the transit time on that one?

A Twenty-one days.

Q Okay.

Now, look down at Italian Lines. They have an all-water movement from Los Angeles with a transit time of 20 days, don't they?

A That's right.

Q Am I correct that these are the fastest transit times shown on your exhibit except for the

Sea-Land minilandbridge via Houston?

A That is correct.

Q So Johnson Scan Star can meet or beat transit time of an all-water routing with respect to any minilandbridge operator except Sea-Land, at least based on their published schedules?

A That is correct. That's what this was intended to show.

Q Are these alternate routings for minilandbridge cargoes between Europe and the West Coast being used by shippers today?

A Excuse me, what do you mean by alternate?

Q These different carriers. These carriers are all moving cargo today, aren't they?

A Yes. All these carriers, to a greater or lesser extent, are moving cargo. The most significant ones obviously would be Sea-Land, Johnson Scan Star would be obvious ones, and United States Lines.

Q Can you tell me what percentage of the total European to West Coast -- and when I say that I mean in both directions, minilandbridge cargoes moved to or from the West Coast via ports other than the Gulf ports in 1982?

A The from and to, I think TBS used 73.7. I think we used --

Q I think you misunderstood the question. I am asking what percentage of the minilandbridge cargoes, total minilandbridge cargoes moving between Europe and the West Coast in either direction moved via ports other than the Gulf ports? So I would be talking about East Coast ports or south Atlantic ports.

A To the majority of them, I must have it in here if I can find it, but the majority would be the Gulf ports.

Q Would I be way off base if I suggested a figure of about a third having moved via either north Atlantic or south Atlantic ports?

A I would have to check it out. I wouldn't argue with you. I would have to find out what it is. It is in our exhibits. It is in the testimony.

Q For minilandbridge movements from either north Atlantic or south Atlantic ports, do carriers other than rail carriers, other than the primary applicants, participate in the land leg of those minilandbridge movements?

A I'm sorry, you are going to have to do that again.

Q For a minilandbridge movement from an east coast port, whether it be what they call north Atlantic or south Atlantic region, do rail carriers other than

the primary applicants, Santa Fe and Southern Pacific, participate in the movement of those minilandbridge cargoes to and from the west coast?

A Yes.

Q Let me direct your attention to Exhibit 5 of your testimony.

Am I correct, this is an exhibit that is similar to the one we were just discussing except that it discusses the Asia-Gulf Coast trade?

A Yes. This highlights the container operators serving Louisiana, Texas Gulf from Japan and Korea, not the total.

Q I would like to direct your attention to the fourth column, "Discharge Port." This exhibit shows, does it not, that minilandbridge cargoes to and from the Far East as landed at four different west coast ports.

Is my count correct?

A That's right.

Q Looking at the first two entries for American President's Line, first let me ask you, is API a major participants in the Far East-Gulf trade?

A Yes, they are.

Q One of the largest?

A Yes.

Q Am I correct that these two entries, one for

JK and one for J, are representative of two distinct services?

A They are, yes.

Q One for Japan, Korea, and one for Japan?

A Yes.

Q What ports on the west coast do each of these services call at?

A I'd have to check. Los Angeles is the major inbound port, obviously, and it is their minibridge port.

MR. HYNES: I would like at this time, Your Honor, to have marked SFSP-C-89. It is a group of work papers from Mr. Richardson's work papers. We put them all in one package for the sake of speeding things up.

JUDGE HOPKINS: Thank you.

It will be marked for identification.

(The document referred to was marked Exhibit No. SFSP-C-89 for identification.)

BY MR. HYNES: (Resuming)

Q Mr. Richardson, in the upper right hand corner we have numbered them. There are 21 pages that we have got individual numbers on, and I will try to refer to those numbers.

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I would like to direct your attention, if I could, to the first page of these work papers, and perhaps that will help you answer the question about what ports the APL services call at.

A I just want to check something here.

I have done in Exhibits 19 and 20 in my testimony, the ports carried direct and indirect by APL and all the major carriers on this route, just for the purpose of telling you what standard deployments should be used in a realistic way, is being used by API, and I think it gives you the information, and if I could use this, it tells you that the direct service, what is direct by an API service.

Exhibit 20, first column, it shows that they service southern California direct, the Bay Area direct, direct from Japan, Taiwan, Hong Kong, Korea, and they feed the Philippines.

Now, the purpose of this was to establish what the minimum requirements were for direct service leading up to why the carriers make direct services at Los Angeles or San Francisco.

Q Now, this exhibit, neither Exhibit 20 nor Exhibit 5, though, will tell me for an American President Lines vessel, which according to the schedule which I handed you, the first work paper, calls at

Seattle-Tacoma, neither Exhibit 5 nor Exhibit 20 will tell me, does it, whether or not a minilandbridge cargo ultimately destined for the Gulf is discharged at Seattle or if it continues on board the vessel to San Pedro-L.A. and is loaded on the train at San Pedro-I.A.

A No. But we know from interviews with American President Lines that a minilandbridge cargo destined for the Gulf is loaded on a direct service, first port of all in southern California in Los Angeles as a matter of policy, and it is verified with the management of American President, which we did in this particular case.

Q And isn't your testimony that American President Lines does not offer a minilandbridge service over Seattle?

A Oh, no. I said they certainly do offer a minilandbridge service over Seattle to Chicago and on to the East Coast. Their primary port to the Gulf, however, in the corridor which we are speaking of here, is over Los Angeles.

Q Do they offer an MLB service to the Gulf, to Houston? Let's take a specific point.

A Not to my knowledge, no, not to my knowledge.

MR. HYNES: Your Honor, at this time I would like to have marked for identification purposes

SFSI-C-90.

JUDGE HOPKINS: It will be marked for identification.

(The document referred to was marked Exhibit No. SFSP-C-90 for identification.)

JUDGE HOPKINS: Before you proceed with this, I think iot might be wise to take a recess.

We will take a 15 minute recess.

(A brief recess was taken.)

JUDGE HOPKINS: Let's go back on the record.

Mr. Hynes.

BY MR. HYNES: (Resuming)

Q For the record, I would like to identify the document that was handed out before the recess and designated as SFSP-C-90. It is an excerpt from the December 10, 1984 edition of the "Pacific Shipper" which contains the more recent schedule for American President Lines than that which we were looking at on the first page of SFSP-C-89.

Mr. Richardson, would you agree with that description of what the document is?

A Yes.

Q This is a more recent schedule of API's

services?

A Right, correct.

Q I would like to direct your attention, sir, to the first column on what would be the right hand page. This would be the inbound from the Far East. The first column, the Jefferson Voyage number 109.

A Okay.

Q If you follow the ship's itinerary, it indicates, does it not, that this ship departs Kobe and arrives in Seattle-Tacoma some nine days later?

A Yes.

Q Is it also correct that the ship does not call at San Pedro-L.A. at all?

A I would like to comment why it does not. I think the misconception here that you are getting from this is you are overlooking the fact that American President Lines has a considerable -- has several common ports in the Far East, and by comments with their operating people, what they do with cargo gathered in the Far East, it is transshipped to the ship going directly to San Pedro. So the statement that I made that all of their Gulf corridor, Gulf cargo does go directly to San Pedro is true. It is transshipped. It does not go over Seattle.

Q Well, with that in mind, let me ask you again

if the Jefferson Ship 109 calls at San Pedro-L.A.?

A It does not.

Q And is the same true of the other ships listed there which call at Seattle-Tacoma, the Hoover, the Grant, and the Johnson?

A That's correct.

Q Now, what is the total transit time for a minilandbridge cargo on the Jefferson Voyage No. 109 to, let's take Houston?

A I can't determine it from here because, as I said to you, that cargo is transshipped to a direct Los Angeles ship -- it is transshipped in the Far East and goes directly to San Pedro.

Q Are you telling me, sir, that the advertised service which is set forth on this page is not actually available to a shipper?

A That service is available to the shipper.

Q It is available.

A That service is available to the shipper, yes.

Q Now, if I am a shipper at Kobe --

A Correct.

Q And I've got a cargo, I have a box that has got to go to Houston --

A That's right.

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Q Can I have it loaded aboard the Jefferson on Christmas day, the 25th, and have it arrive on the 10th in Houston, the 10th of January?

Isn't that what this schedule shows?

A The 10th of January, correct.

Q And if I ask for this service, API would provide it to me, won't they?

A API will move that cargo to Houston, correct.

I think you are making a misconception that API will guarantee to move it on that ship and not move it over San Pedro. I say that is incorrect, that it is not a practicality, it is not what they are doing. They are transshipping it in the Far East and loading it into San Pedro.

Q Where would a cargo which I tendered to them at Kobe be transloaded?

A Well, Kobe is probably -- well, let's see. Let's find Kobe here and let's find San Pedro.

Here is the Lincoln out of Kobe on 1/9, arriving in San Pedro 1/20.

Q Okay.

A Kobe would be one of the points, incidentally, where they would transship other cargo. It is a major transshipment port for API.

Now, the same can be said for Yokohama. There

again, that would come in directly from Yokohama into San Pedro.

Q Well, let me ask you a question about that, about Yokohama. Let's look at the Lincoln and Johnson voyages.

A The Lincoln and the Johnson, okay.

Q What you are telling me then, sir, is that I have got a cargo at Yokohama on the 14th -- let's take today, the 14th of January, I've got a cargo today at Yokohama, and I want it moved minilandbridge to Houston, that APL will not load it on the Johnson, Voyage No. 102, which departs on Wednesday the 16th and deliver it for me on the 31st at Houston?

A It is my opinion they would not load it on the Johnson because the Johnson does not go to San Pedro.

Q Well, does the entry for the Johnson show an arrival on the 26th at Seattle?

A It does.

Q And it also shows in the same column service on the 31st to Houston, does it not?

A Yes, it shows -- I think that they are mutually independent, the arrival at Houston and the other ship. I contend that they are not, by their own comments to me, they are transshipping all the cargo in the Far East to go to San Pedro.

Q Is Yokohama not the last Asian port of call shown for all of the American President Line ships on this schedule?

A It is.

Q And where would they transship a cargo picked up in Yokohama for ultimate movement to San Pedro?

A Well, the Lincoln, which you mentioned before, does go to San Pedro.

Q A week earlier, six days earlier.

A Well, all right, it would go beyond -- there must be a ship beyond here that -- this just goes out to the 16th of January. I imagine there is a ship the 17th or 18th. I don't know. There is another ship going back in that same cycle to Southern California.

Q So it is your testimony that notwithstanding what the American President Lines published in the "Pacific Shipper" on December 10, that if I had a box at Yokohama on the 16th, I would not be able to get it loaded aboard the Johnson and delivered on the 31st at Houston via minilandbridge move over Seattle?

A My testimony or my comment is that I am of the understanding that if you tender cargo at Yokohama to APL, that they will use the prerogative of putting that on a ship that goes directly to San Pedro.

Q Well, if that is correct, Mr. Richardson, why

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would the schedule for the Johnson show an arrival in Houston on the 31st? There is no arrival on the 31st shown for any voyage going before, and it certainly couldn't arrive on the 31st if it left several days after.

A Well, I think it probably applies to other origins. I don't think that's the intention of the schedule. I am not accountable for what they may put in the schedule, but I have just had this discussion with operating people at APL, and they tell me that they are very strong in their position to move all Gulf cargoes over San Pedro for the simple reason that Los Angeles is a huge consumer market and because it is a huge consumer market, they have a very good opportunity of loading domestic cargo from the Gulf, which is synergistic back to Los Angeles. They went on to say that is the problem, in the discussion they are having -- you know, there is some discussion with them in Seattle. Seattle feels that they should get this cargo and move it to the Gulf. APL as of now tells me they have taken the position that the minibridge transshipment port for the Gulf is Los Angeles because it treats their economics better for the reasons I mentioned.

Q So they have a strong traffic solicitation policy, as it were, to have minilandbridge cargoes

routed via Los Angeles?

A They don't. The customer, generally speaking, and I have spent my life on this, the customer really doesn't care what routing. The customer doesn't care whether you run it over Seattle or you run it over Los Angeles. The customer cares that you give him a competitive service and a reliable service between whatever point in the Far East to the Gulf. The customer doesn't involve himself -- the customer doesn't care. He doesn't really care in most -- obviously doesn't care that it is transshipped.

Q So the choice between Seattle and Los Angeles-Long Beach is strictly for the convenience of API?

A That's correct, and for their economic benefit, which is very common with all of the major carriers.

Q Let's turn to page 12 of your testimony. I would like to direct your attention specifically to the first full paragraph on that page. The sentence begins in the fourth line down, "Since the preponderance of containerizable cargo in the European and Far East trades is characteristic of high value and low density and moves largely in 40 foot containers, 20 foot containers being reserved for high density cargoes" --

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A Wait a minute. I'm sorry. Oh, okay. I have the sentence now. Excuse me. Okay.

Q By low density, am I correct that you mean that the cargo has a relatively low weight per cubic foot?

A Right.

Q And when a low density cargo is loaded into a container, it is very likely to fill up the physical capacity of the container far before it reaches the --

A It cubes out before it weights out, correct.

Q If you consider a 40 foot container, which you have stated is the predominant container in the trades that we are interested in here, in your mind, what is the maximum number of tons of cargo that would be loaded into that container for you to call it a low density cargo?

A I haven't made a differentiation between low and high. You know, you have got to understand that when you talk 40 foot containers today, you are not just talking standard 40 foot container. You are now talking about high cube containers, nine foot, six foot high. In APL's case they now have 45 foot containers. The entire purpose of the nine foot six high high cubes, 45 footers, is to take low density cargoes that were giving a poor weight per load and increase it. The same thing

is being done in Seattle, if you will, to Chicago, just to make an analogy, where Seattle, the port itself, is making available high cube domestic trailers and offering to transship light density cargoes in order to getk the weight up. And so I don't know, I haven't made a differentiation between low desnty -- I haven't done that, and I would be a little afraid to do it because there is an awful lot of variables because there's all kinds of different boxes here. We are not just talking about -- we are talking about trailers, trailers with chassis underneath them, as well as containers. I don't know. I haven't done that.

Q Do you know what the weight capacity of a standad 40 foot box is? Forget about the high cube and the new technology and so forth.

A They are running 60,000 or better on iron and steel products moving by Japan Line from Japan over the bridge or the oil-rigging business.

Q You said 60,000. Is that pounds?

A Sixty thousand pounds, yes.

Q Would you consider a 60,000 pound load to be a low density load?

A No.

Q Would you consider a 30,000 pound load to be a low density load?

A It would be bordering on low density, yes.

Q Bordering.

How about 40,000, are we into high density at that point?

A No. High density would be 60,000.

Q So the border runs between 30,000 and 60,000 pounds?

A I would guess so, yes.

Q The same paragraph or page 12, you state, the very next sentence, that "Temple, Barker & Sloane's use of tonnage data without reference to the container data which was available from the primary Applicants, has caused it to understate the size of the market and the potentially anticompetitive consequences of the proposed merger."

When you talk about container data which was available from the primary Applicants, specifically what data do you have in mind?

A I refer to work papers, CCI000210, which is the container count for the Southern Pacific-Santa Fe produced by proponents. It is commonly called the Reebie data which was available to Temple, Barker & Sloane and was not used in this case. That is exactly what I refer to in that sentence.

Q Would you turn to page 13, please?

Directing your attention to the first full paragraph, the one that begins in the middle of the page, and to the fifth line, there is a sentence that begins on that line, "On the other hand, the larger container vessels can economically be deployed solely on the major trade routes, commonly referred to as primary routes, where sufficient trade volumes exist to achieve high capacity utilization at a reasonable market share."

Now, when you say larger container vessels, in the context of that sentence, what size vessel do you have in mind?

A I have in mind the 4200 fifth generation container ship vessel referred to by Temple, Barker & Sloane. I have, more specifically, it spelled out quite definitely in the table on page 47 which goes into -- I think it brings this point home pretty graphically.

Q I see on page 47 your table provides a comparison between a 1200 TEU ship and a 4200 TEU ship.

A That's it. That was the comparison suggested in the Temple, Barker & Sloane.

Q How about a container vessel of, say 2700 TEUs, 2400 TEUs? Would that be, in your estimation, a large container vessel in the context of your discussion?

A 2700 TEUs, no, in my estimation it wouldn't be. And why do I say that? Because if you see the announcements by Sea-Land that they are just letting contracts on what they call D-17s, which are huge vessels, not as big -- I think they are 3700 TEU, just slightly smaller than U.S. Lines, Evergreen 2700, Sea-Land is also stretching the D-9s. So this is what I call big ships, the 2700 would be middle, if you have got first generation, maybe third generation, and we are up to fifth generation ships.

Q Can a 2700 TEU middle range ship, as you referred to it, be economically deployed in a trade like the Gulf trade?

A No.

Q Have you done any --

A Yes.

Q -- analysis of that?

A We have done the analysis in the sense that we have made comparisons.

MR. BAKER: Your Honor, Mr. Richardson said no, and then a moment later he said yes, and I am not clear whether he was correcting the -- whether he was changing the no or anticipating the next question.

JUDGE HOPKINS: Let's start with the question and then go on from there.

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Mr. Hynes?

BY MR. HYNES: (Resuming)

Q I believe my question was whether or not a 2700 TEU could be economically deployed in the Gulf trade. To that you said no, I believe.

A I said no, right.

Q I asked you if you have conducted any cost analysis based on a 2700 TEU ship to support your opinion that a 2700 TEU ship could not economically be deployed.

A It could not be economically employed because we have compared. The market is too small. It is a secondary market. It could not support a 2700 ship.

In the hypothetical situation which we presume that Templer, Barker & Sloane offered, we show that it can't effectively handle a 1200 TEU ship.

As you move from 1200 to 2700 to 4200, in this type drill we have done here on this chart, this table on 47 tends to illustrate that, you would see that your utilization falls considerably, and it would be my judgment that this 2700 ship would have inadequate utilization to be cost effective.

Q I notice in your testimony that you also reject the potential option of either feeder service or the option of direct all-water service and say that the

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Gulf trade is too small to support either of those options.

Is that a fair characterization of your testimony?

A We said that it was -- the cost would not justify it, that is correct.

Q Are feeder services used in other secondary markets?

A Feeder services are used worldwide and have been.

Q Would you consider the Bangkok-Singapore market to be a secondary market to the Japan market?

A Yes, I think we have that down as a secondary.

Q And are feeder ships used in that market?

A Yes, they are.

Q Is that market larger or smaller than the Gulf market?

A Oh, I imagine it is larger. I would have to check.

Q How much larger?

A Oh, I don't know. I would have to look. I don't see an analogy between the two. The reason we discounted feeders is, what people don't commonly understand is when you get to Panama you are 1,000 miles east of New York. To feed all the way back to New York is going back in the opposite direction.

You have taken what could be an alternative 1600 mile trip and you've stretched it out to over 5,000 or over 6,000 miles. That's the only reason the feeder won't work. The feeder will work with secondary market, if you're not creating circuity as far as water mileage is concerned.

That's the only point I made there. That's why we rejected the feeder, purely on cost, not on principle. It doesn't cost.

Q Are you aware, sir, of Evergreen's new feeder

service from Jamaica to the Gulf?

A I'm very aware of Evergreen's. I met with Evergreen last week. I'm very familiar with it.

Q And am I correct that that is a feeder service which is going to operate into the Gulf in connection with the around-the-world service?

A That's correct.

Q And is it your opinion, sir, that that is not an economically feasible --

A In my opinion, I don't believe Evergreen is pleased with themselves.

Q But they are going ahead and deploying the service or beginning to provide the service, are they not?

A They are currently in Kingston, that's right, and they are feeding on a triangle service: Houston, New Orleans and Panama.

Q Let's return to page 13 of your testimony. I want to focus on that same sentence, where we were talking about large container vessels. And you speak in that sentence of high capacity utilization. What level of utilization do you have in mind when you speak of high capacity utilization?

A Well, generally speaking -- and this is a generalization of most carriers -- if your utilization

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factor runs below 70 you are in trouble. There may be an exception to this. Some people may argue, with these new huge ships of U.S. Lines, that that factor is lower. That may be.

But generally speaking, what I am talking about is something at 70 percent utilization.

Q But utilization will depend, and there is no magic about it. It will depend on a number of factors, won't it?

A It will depend on volume.

Q In your opinion, is it possible for a vessel operator to break even or show a profit at 50 percent utilization?

A Generally, no. There may be an exception. I would say no.

Q You will give me a firm no to that question?

A Well, I will give you a qualified no, because there are -- the only exception may be on routes running around the world services now, with the 4200 TEU ship of U.S. Lines. I'm inclined to say even there no, but I will hold back because I don't know on that. But on the others, definitely no.

Q Do you know what level of capacity utilization the direct all-water carriers -- let's take Far East trade into the Gulf. Yang Ming I believe is the primary

all-water carrier. Do you know what level of utilization Yang Ming is achieving at this point?

A Yang Ming, what I do know about Yang Ming is -- I don't know what the utilization is, but I know that Yang Ming is handling breakbulk cargoes, normally heavy lift cargoes predominantly, and very little container cargo. So I don't think Yang Ming would be -- in this particular drill is even appropriate. It's not comparing apples with apples.

Yang Ming is a carrier which handles as much breakbulk heavy lift cargo, or more cargo than it does container ship cargo.

Q Is it your opinion, then, that Yang Ming currently has excess container capacity on the ships that visit the Gulf?

A I wouldn't know. I just didn't check it. I wouldn't know. I would suspect they do. I don't know.

Q You stated they're handling breakbulk and other types of traffic.

A But I don't know what their load factors are. I would have no reason to know.

Q I'm going to shift gears a little here. I take it that one of the areas in which you agree with Mr. O'Connell of Temple, Barker & Sloane is that mini-landbridge cargoes are incremental traffic to the

trans-Pacific carrier?

A Yes.

Q And the primary interest of a trans-Pacific carrier, such as Sealand or API, in the mini-landbridge cargo is that that cargo fills up a slot that would otherwise go empty on the trans-Pacific voyage?

A Correct.

Q And these cargoes are attractive, I believe you state in your testimony, because there isn't any real investment in vessels required and there is no cost involved, unless a cargo moves on a particular voyage; is that correct?

A I agree with Mr. O'Connell's statement.

Q Consider for a moment the rail carriers involved in mini-landbridge. Have the rail carriers made capital investments to handle those mini-landbridge cargo?

A Oh, I'm not familiar with the operating or capital structures of the rail carriers. However, obviously you have to have an engine, a locomotive, and flatcars to handle containers. Is that what your question was?

Q In addition -- yes, those are some of the factors that I had in mind. In addition, you would need yard facilities?