

Docket No. F.D. 30400 et al. - 10/4/84 - Pgs. 738 - 796

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 :

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Hearing Room A
12th & Constitution, N.W.
Washington, D.C.
Thursday October 4, 1984

The hearing in the above-entitled matter was convened,
pursuant to notice, at 9:30 a.m.

BEFORE:

JAMES E. HICKINS,
Administrative Law Judge

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C O N T E N T S

2	<u>WITNESS</u>	<u>DIRECT</u>	<u>CROSS</u>	<u>REDIRECT</u>	<u>RE CROSS</u>
3	Bruce G. McPhee				
4	By Mr. Mayo (resumed)		748		
5	By Ms. Mahon		778		
6	By Mr. Birney		783		
7	By Mr. Stepenson			791	
8	By Mr. Mayo				802
9					
10	Thomas J. Fitzgerald				
11	By Mr. Wilson	821			
12	By Mr. Kharasch		823		

E X H I B I T S

15	<u>Exhibit No.</u>	<u>IDENTIFIED</u>	<u>RECEIVED</u>
16	DRGW-C-6	766	778
17	DRGW-C-4 and 5		778
18	SFSP-C-1	795	819
19	SFSP-C-2	821	
20			
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R E C E E P T S

1
2 JUDGE HOPKINS: Let's get back on the record.
3 Are there any preliminary matters?

4 MR. MURRAY: Your Honor, my name is Steve
5 Murray, and I would like to enter an appearance on
6 behalf of my self and Roland P. Wattle, Jr., for the
7 International Brotherhood of Teamsters, pending the
8 action on our motion to intervene which has been
9 previously filed.

10 JUDGE HOPKINS: Thank you.

11 Are you ready to proceed, Mr. Mayo?

12 MR. MAYO: Yes, Your Honor.

13 Whereupon,

14 BRUCE G. MCPHEE,

15 the witness on the stand at the time of recess, having
16 been previously duly sworn, resumed the stand, and was
17 examined and testified further as follows:

CROSS EXAMINATION - RESUMED

18 BY MR. MAYO:

19 Q Good morning, Mr. McPhee.

20 A Good morning, Mr. Mayo.

21 Q Let's return to the topic that we had been
22 discussing yesterday, specifically, the traffic of the
23 Southern Pacific.
24

25 You mention at Page 13 of your verified

1 statement that in 1982, General Motors permanently
2 closed two of the three major auto assembly plants
3 located on SPT lines, and the third plant was reduced to
4 one shift, and you go on to say that while General
5 Motors' Fremont plant may be reopened eventually, the
6 current effect of reduced production in California has
7 caused SPT to lose traffic formerly occurring as auto
8 part shipments into the plants and shipments assembled
9 as cutbound.

10 Now, isn't it true, Mr. McPhee, that as
11 explained in the 1982 Southern Pacific annual report,
12 Page 17, the loss of this traffic was partly offset to
13 increase shipments of finished automobiles, trucks from
14 midwestern plants to western states, and that imported
15 autos from west coast ports partially offset the effects
16 of these closings, and further, that imported auto parts
17 going to assembly plants in Tennessee and Ohio somewhat
18 offset the effects of these closings?

19 A It is somewhat offset, but it was nowhere near
20 the volume that we had enjoyed beforehand from General
21 Motors.

22 Q Did you read the Washington Post this morning,
23 Mr. McPhee?

24 A No, sir, I did not.

25 Q Did you read the Wall Street Journal?

1 A Scanned it.

2 Q I take it you didn't note in the Washington
3 Post therefore that auto makers are now reporting the
4 best sales they have had in five years. Are you aware
5 that sales are at that level?

6 A I knew that sales had substantially
7 recovered.

8 Q Assuming that I am accurately reporting the
9 level of auto sales, is that good news for the Southern
10 Pacific?

11 A That is good news, but at the same time you
12 must realize that there are a very high level of imports
13 sold in the state of California and in our operating
14 area.

15 Q What is the current status of the GM Fremont
16 plant?

17 A Currently GM has an agreement with Toyota to
18 combine and reopen the Fremont plant some time late '84
19 or '85 for a joint venture which will produce a new
20 car. On that, though, I would like to point out that GM
21 and Toyota also have as part of the agreement that half
22 the parts for the new automobiles will be imported from
23 Japan, and therefore we would not participate to any
24 great extent for transportation for those parts.

25 Q But you would participate in transportation

1 for the automobiles produced by the plant. Is that
2 correct?

3 A We would hope so.

4 Q And you would also participate in the
5 transportation of the 50 percent of the parts that are
6 produced domestically. Is that right?

7 A We would hope so.

8 Q Now, Mr. McPhee, I notice that in reviewing
9 your statement you make no mention of intermodal
10 traffic. Is that right?

11 A That's correct.

12 Q Now, isn't it true, as pointed out by Mr.
13 Biaggini at Page 2 of the Southern Pacific 1982 annual
14 report that intermodal traffic volume was up 24 percent
15 in 1982, and that this was more than three times the
16 industry average, despite the effects of the recession
17 and the general decline in rail traffic?

18 A This is true, but that is only one commodity,
19 and intermodal traffic is also highly competitive, and
20 the margins are narrow.

21 Q Isn't it also true that as pointed out at Page
22 8 of Santa Fe Southern Pacific's 1983 annual report,
23 that in 1983 there was again a 24 percent increase in
24 intermodal shipments, and that such shipments in 1983
25 represented 18 percent of Southern Pacific's freight

1 revenues?

2 A I am sure that is true if you are reading that
3 from the annual report.

4 Q Mr. McPhee, you say at Page 2 of your
5 statement, "Southern Pacific is experiencing increasing
6 difficulty in raising new capital at reasonable rates
7 because of declining earnings and an inadequate rate of
8 return."

9 What type of difficulty are you referring to
10 there?

11 A Well, our financial ratios are such that we
12 feel it would be difficult to raise debt in the public
13 markets, and this year almost all of our capital
14 programs, with the exception of the bank financing which
15 had been committed to previously, almost all of our
16 capital programs are financed by lease, and we have had
17 some difficulty in negotiating those leases.

18 Q Have you had any financing proposal
19 specifically rejected by a lender?

20 A No, but we have had some financing proposals
21 made in the name of SP Transportation Company that had
22 to be guaranteed by the St. Louis South Western, which
23 has better financial ratios.

24 Q At Page 3 of your testimony, you say that a
25 number of investors have become discouraged by the

1 financial problems of railroads. You go on to say that
2 these investors have shifted funds to more tranquil
3 investment opportunities offered by other industries.

4 There you are not talking specifically about
5 the Southern Pacific, but instead talking about the
6 railroad industry generally. Is that correct?

7 A That's correct.

8 Q Do you have any specific evidence of shifting
9 funds, shifting investors away from the Southern Pacific
10 itself?

11 A There was one time earlier on when we were
12 doing financing for SP Communications Company that an
13 insurance company that had pledged to execute and had
14 agreed on a rate for the communications company suddenly
15 decided to withdraw, and the reason for withdrawing was
16 the decline and the bankruptcies in the railroad
17 industry, and we very narrowly put that financing back
18 together again. It almost fell apart.

19 Q What was the date of that?

20 A I think it was in about 1975, '76.
21 Seventy-five, I would say.

22 Q And at that time Southern Pacific -- well,
23 strike that question.

24 Now, you say on Page 12 of your testimony that
25 the decline in SP's rate of return has progressed almost

1 steadily for more than a decade, and is now at such a
2 low level as to discourage outside investors from
3 lending funds to SPT for capital improvements.

4 Now, despite your statement, isn't it true, as
5 we talked about briefly yesterday, that in June, 1983,
6 regardless of SPT's low rate of return as reported by
7 the ICC, SPT was able to arrange to issue \$135 million
8 of notes under a credit agreement with a group of eight
9 banks, and that the proceeds of the notes were to be
10 used specifically to finance capital improvements, in
11 this case the three-year rail program?

12 A That is true. We had our fingers crossed. We
13 feel that the bankers were looking at the history
14 wherein Southern Pacific Company had always been
15 standing behind Southern Pacific Transportation Company,
16 and had indeed in the past advanced moneys to Southern
17 Pacific Transportation Company during periods of
18 recession or financial need, and also the fact that in
19 June of '83, Southern Pacific Company had just sold
20 Southern Pacific Communications Company to GTE, and had
21 just received a net of about \$726 million in cash.

22 Q I take it the Southern Pacific Company in no
23 way provided a guarantee to the lenders in this
24 instance. Is that right?

25 A No, but the lenders requested such a

1 guarantee.

2 Q And it was not provided?

3 A It was not provided. That's correct.

4 Q Isn't it true that in the voting trust
5 litigation that Southern Pacific took the position that
6 the credit of Southern Pacific Company was unimportant
7 to the ability of Southern Pacific Transportation to
8 obtain financing?

9 A You are saying in the voting trust
10 proceeding?

11 Q That's correct.

12 A They may have taken that position, but I don't
13 personally agree with that.

14 Q Well, let the record speak for itself in that
15 respect, because I think those affidavits are part of
16 the record.

17 Now, with respect to this bank financing for
18 the three-year rail program, isn't it true that as of
19 September 30, 1983, \$45 million of these notes had been
20 issued with the remaining two-thirds to be drawn down in
21 1984 and 1985?

22 A That is correct.

23 Q Have any notes been issued in 1984?

24 A I am sure there have been. I would expect the
25 \$45 million for '84 has been issued.

1 Q Now, isn't it true that under the terms of
2 this credit agreement, the interest rates of SPT's notes
3 are initially based on SPT's choice of three separate
4 rates, first, the prime rate, or second, the certificate
5 of deposit rate plus three-quarters percent plus
6 associated banking expenses, or third, the London
7 Interbank offering rate plus five-eighths percent?

8 A That is correct.

9 Q Now, would you agree with the statement made
10 at Paragraph 12 of Mr. Smith's December 8th affidavit
11 that "These interest rates are attractive and comparable
12 to rates charged other major corporations by commercial
13 banks?"

14 A They are comparable. They are comparable for
15 the kind of credit that SP Transportation Company is.
16 They are comparable with other short-term rates.

17 Q Are you saying that if in your view Southern
18 Pacific had a stronger credit rating, it could have
19 gotten money at a rate better than the prime rate?

20 A Not better than the prime rate, but the
21 spreads over the CD rate and the London Interbank
22 offering rate were debated, and we attempted to get a
23 lower rate, and could not, a lower spread.

24 Q Right, but you still have the option of paying
25 the prime rate. Isn't that right?

1 A That's correct, but the CD rate is usually
2 substantially below the prime rate.

3 Q Tell me again what your point is with respect
4 to the CD rate.

5 A The CD rate usually is below the prime rate,
6 so the spread over the CD rate is important to us.

7 Q And it is your testimony that you believe you
8 could have gotten a better spread had you been a
9 stronger credit?

10 A We were aware of other companies. I don't
11 recall which one. I think it -- in fact, in our
12 discussions with GTE, it was GTE that was obtaining a
13 lower spread over the CD rate and the London Interbank
14 offering rate than we could obtain.

15 Q You are not aware of any railroads that were
16 obtaining short-term financing at rates better than the
17 rates obtained in this particular financing?

18 A I am not aware of other railroads obtaining
19 short-term funds.

20 Q Would you further agree with Mr. Smith's
21 statement at Paragraph 12 of his affidavit that "This
22 financing is a recent example of SPT's ability on its
23 own credit to fund projects on reasonable terms through
24 external sources?"

25 A Let me find Mr. Smith's statement. May I have

1 that reference again, please?

2 Q Paragraph 12.

3 A Excuse me. Would you repeat the essence of
4 your question, please?

5 Q Let me find the specific reference. The
6 specific reference is the last sentence.

7 A "This financing is a recent example of SPT's
8 ability on its own credit to fund projects on reasonable
9 terms through external sources."

10 Q That's correct. Would you agree with that
11 statement?

12 A I would agree with that statement, but we were
13 quite concerned about the ability to close this
14 transaction, but I would agree basically with this
15 statement.

16 Q Now, you state on Page 19 of your testimony
17 that SPT's financial strength has weakened to the point
18 where it may soon be excluded from capital markets.

19 Now, isn't it true, Mr. McPhee, that SPT has
20 confirmed credit lines of \$180 million from six major
21 commercial banks?

22 A I think those credit lines have been reduced
23 to \$80 million.

24 Q Is it \$80 million now?

25 A Yes.

1 Q Is that the \$80 million that was obtained
2 after the creation of the voting trust?

3 A Yes. Correction. I'm not sure exactly when
4 it was obtained, but I could look that up and let you
5 know. I am not sure I can find it immediately.

6 Q Can you explain to me what circumstances
7 prompted the reduction of the credit lines?

8 A I don't know why they were reduced.

9 Q Do you know whether they were reduced upon the
10 decision of Southern Pacific that they did not require
11 the credit lines?

12 A That is a possibility.

13 Q With respect to the \$80 million credit line
14 that Southern Pacific has, what is the term of that
15 credit line?

16 In other words, when does it expire? When
17 does it have to be renewed?

18 A I am not certain on that particular \$80
19 million. However, normally credit lines are renewable
20 annually.

21 Q What sort of security is provided to the
22 lender when the lender extends a line of credit?

23 A It may be unsecured. It may have certain
24 restrictive covenants, that is, that certain ratios woul
25 be maintained in order to maintain the credit line.

1 Q Do you know what sort of security was provided
2 in connection with the \$80 million line of credit that
3 is currently outstanding?

4 A If you will give me a moment, please.

5 (Pause.)

6 A You are asking me if I know what kind of
7 conditions or terms exist on the credit line? I don't
8 see any specific conditions. I am not aware of any
9 covenants.

10 Q Do you know whether Southern Pacific has drawn
11 down on that \$80 million line of credit?

12 A I don't believe so.

13 Q Do you know whether if Southern Pacific were
14 to draw down on that \$80 million line of credit, and it
15 would become insolvent and go into bankruptcy, whether
16 the banks extending that line of credit would be
17 subordinate to your bond holders?

18 A Barring specific arrangements to collateralize
19 such lines, they would be subordinate to our equipment
20 obligations and our bond holders.

21 Q Mr. McPhae, what has happened to the \$150
22 million advanced by Southern Pacific to Southern Pacific
23 Transportation Company? Is it being maintained in some
24 sort of separate account, or is it being escrowed in any
25 way?

1 A No.

2 Q Has it been used by the Southern Pacific?

3 A A substantial amount of it has gone to fund
4 capital expenditures to fund the repair of the Salt Lake
5 Fill and for current liabilities.

6 Q Now, in the event of the Southern Pacific's
7 insolvency, assuming the merger is not approved, does
8 that \$150 million become an obligation of the Southern
9 Pacific Transportation Company to the Santa Fe Southern
10 Pacific Corporation?

11 A No, my understanding is that it was a
12 contribution to capital, and it is entirely the property
13 in effect of Southern Pacific Transportation Company.

14 Q Now, you state at Page 14 of your testimony
15 that as a result of declining financial ratios on August
16 5, 1982, Standard and Poor's announced that they were
17 lowering your rate on SPT's unconsolidated equipment
18 trust certificates from AA to A, and its mortgage bonds
19 from A to BBB.

20 Until that downgrading occurred, how long had
21 Southern Pacific maintained its AA/A rating from
22 Standard and Poor's?

23 A For many years.

24 Q Did you have any advance notice from Standard
25 and Poor's that they were going to downgrade your debt?

1 A I think we had one or two days' notice at
2 best.

3 Q Had you had any meetings with them prior to
4 the downgrading?

5 A I believe so. It is our policy to have annual
6 meetings with the rating agencies.

7 Q You make presentations to the rating agencies,
8 don't you?

9 A Yes, sir.

10 Q And each year you provide the rating agencies
11 with data about your performance over the preceding
12 year. Is that correct?

13 A Yes.

14 Q And then based on that presentation plus the
15 rating agency's analysis of publicly available data, the
16 rating agency makes a judgment about how they will rate
17 your debt. Is that correct?

18 A Yes.

19 Q Now, the two major rating agencies for
20 corporate debt are Moody's Investment Service and
21 Standard and Poor's Corporation. Is that right?

22 A Yes.

23 Q And the ratings they assign railroad debt is
24 designed to assess the creditworthiness of that debt.
25 Is that right?

1 A Yes.

2 Q Now, your Moody's ratings on August 5, 1982,
3 that is the date that Standard and Poor's people
4 downgraded your debt, and today for Southern Pacific's
5 equipment trust certificates is AA Sub 3, and on SPT's
6 mortgage bonds is A Sub 3. Is that right?

7 A That's correct.

8 Q How long has Southern Pacific held these
9 Moody's ratings?

10 A It has held those ratings for many years, but
11 at the present time, with our financial ratios, with the
12 status of our rate of return, coverage of fixed charges,
13 and margin of safety, I do not see how we can maintain
14 these ratings much longer.

15 Q When did you last make a presentation to the
16 Moody's people?

17 A I have never made a presentation to the
18 Moody's people. But I believe the company made a
19 presentation to the Moody's and Standard and Poor's
20 people probably in the spring of '83. They must have
21 made something this year. I am not aware of that.

22 Q But you would think that because it is an
23 annual presentation, that they made it some time in
24 1984. Is that right?

25 A Yes, I can speak for Southern Pacific Company,

1 Southern Pacific Transportation Company, but I cannot
2 speak for Santa Fe Southern Pacific Company.

3 Q But Santa Fe Southern Pacific Company would
4 not be making a ratings agency presentation on behalf of
5 Southern Pacific, would they?

6 A No, but they could on behalf of the entire
7 corporation.

8 Q But doesn't Southern Pacific Transportation
9 Company now make its own rating agency presentation
10 under the voting trust?

11 A I am not sure if Southern Pacific
12 Transportation Company has made such a presentation
13 since the initiation of the voting trust.

14 Q Since you are no longer treasurer of the
15 corporation, would you necessarily know if the company
16 had made such a presentation?

17 A I may not.

18 Q Now, the Moody's ratings for your debt are
19 roughly comparable to the ratings which Standard and
20 Poor's assigns your debt prior to August 5, 1982. Is
21 that right?

22 A Yes.

23 Q And Moody's did not downgrade your debt, as
24 did Standard and Poor's?

25 A Not yet.

1 Q So that there is at least currently
2 disagreement between the rating agencies with respect to
3 the creditworthiness of your debt?

4 A They bear different ratings.

5 Q Southern Pacific has what is known in the
6 investment banking community as a split rating. Is that
7 right?

8 A Correct.

9 Q Now, it is common in the railroad industry,
10 isn't it, for equipment debt to carry a rating which is
11 one grade higher than the senior mortgage debt for
12 railroads. Is that right?

13 A That is correct.

14 Q And that is because the equipment debt is
15 specifically secured by the equipment and also has
16 special protection under the bankruptcy laws.

17 A Yes, it is also generally of a shorter
18 maturity.

19 MR. MAYO: Your Honor, I would like to have
20 marked for identification DRGW-C-6. These are copies of
21 the indices contained in the two books in front of me
22 which provide a key to the Moody's corporate bond
23 ratings and a key to the Standard and Poor's corporate
24 bond ratings.

25 JUDGE HOPKINS: It will be marked for

1 identification.

2 (The document referred to
3 was marked for
4 identification as Exhibit
5 Number DRGW-C-6.)

6 BY MR. MAYO: (Resuming)

7 Q Mr. McPhee, you are familiar with the range of
8 ratings shown for both Moody's and Standard and Poor's
9 as set forth on DRGW-C-6, aren't you?

10 A Yes.

11 Q The ratings shown, the rating definitions
12 shown on this exhibit are consistent with your general
13 understanding of what those ratings represent. Isn't
14 that right?

15 A Yes.

16 Q Would you read into the record what Moody's
17 definition is for an AA rating?

18 A "Key to Moody's corporate bond ratings: AA.
19 Bonds which are rated AA are judged to be of a high
20 quality by all standards. Together with the AAA group
21 they comprise what is generally known as high grade
22 bonds.

23 "They are rated lower than the best bonds
24 because margins of protection may not be as large as in
25 AAA securities, or fluctuation of protective elements

1 may be of greater amplitude, or there may be other
2 elements present which make the long-term risks appear
3 somewhat larger than in AAA securities."

4 Q You have just read into the record the
5 description of the rating assigned by Moody's to your
6 equipment debt. Is that right?

7 A To AA rated equipment debt. Our equipment
8 debt.

9 Q Now would you read into the record the Moody's
10 definition of A rated bonds, which is the rate assigned
11 to the mortgage debt?

12 MR. STEPHENSON: Your Honor, is this
13 necessary?

14 JUDGE HOPKINS: Why are we reading it into the
15 record?

16 MR. MAYO: We don't have to read it into the
17 record.

18 JUDGE HOPKINS: Thank you.

19 BY MR. MAYO: (Resuming)

20 Q Now, your debt carries a sub identification 3,
21 which on the page which precedes the index is defined as
22 follows, and tell me if this is consistent with your
23 understanding.

24 "The modifier 1 indicates that the security
25 ranks in the higher end of its generic rating category.

1 The modifier 2 indicates a midrange ranking. And the
2 modifier 3 indicates that the issue ranks on the lower
3 end of its generic rating category."

4 Is that consistent with your understanding of
5 those sub ratings?

6 A Yes, the sub ratings for SF equipment
7 obligations is 3, and its mortgage bonds are 3, which
8 indicates that Moody's considers this in the lower end
9 of the rating range.

10 Q Now, the Cotton Belt carries higher ratings on
11 both its equipment rate and mortgage bond debt. Is that
12 right?

13 A That's correct.

14 Q And the Cotton Belt's equipment debt rating is
15 AAA, and its mortgage debt rating AA2 or rather 3.
16 Correct?

17 A Yes. There is very little Cotton Belt
18 mortgage debt.

19 Q The rating I just described is the Moody's
20 rating. Now, the Standard and Poor's rating for that
21 debt is AAA, AA. Is that right?

22 A That is right. The Cotton Belt, a smaller
23 subsidiary, has somewhat different financial position.

24 Q So the rating agencies are not split with
25 respect to how the debt of the Cotton Belt should be

1 rated.

2 A Generally not.

3 Q Now, would you agree with the statement made
4 by Mr. Smith where he states in paragraph 13 of his
5 December 8 affidavit that, "Based on these credit
6 ratings," and he is talking about the credit ratings of
7 the Southern Pacific and the Cotton Belt, including
8 taking into account the downgrading by Standard and
9 Poor's, that based on these credit ratings, "there is no
10 reason to believe that future equipment debt and
11 mortgage debt could not be obtained externally?"

12 A I strongly disagree with that statement.

13 Q What is the basis for your disagreement?

14 A Because if we were to go to the rating
15 agencies in our current financial posture and our
16 current financial ratios, it is my personal belief that
17 we would not obtain these ratings, that we would be
18 downgraded.

19 Q Do you believe that the rating agencies do not
20 follow your financial performance over the course of a
21 year?

22 A No.

23 Q So you think that they do follow your
24 financial performance?

25 A That is their charge, and that is their

1 business.

2 Q And yet they have not downgraded your debt,
3 have they?

4 A Mr. Mayo, I am giving you my personal opinion
5 based on my financial analysis.

6 Q Now, isn't it true that as stated in Paragraph
7 14 of Mr. Smith's affidavit, SPT has been advised by its
8 investment banker, Morgan Stanley and Company,
9 Incorporated, that while this stock is in a voting trust
10 it could borrow funds in the capital markets at
11 reasonable terms and rates of interest?

12 A That was the advice at that time, and I think
13 since that time things have deteriorated further.

14 Q This is only some ten months ago that this
15 advice was given. Is that right?

16 A That is correct.

17 Q And it is your belief that in the space of ten
18 months, your investment bankers would no longer give you
19 that advice. Is that correct?

20 A It is doubtful in my opinion.

21 Q Now, you note at Page 15 of your statement
22 that the Union Pacific carries a Moody's rating of AAA
23 on equipment debt and AA2 on its mortgage debt. Then on
24 that same page you go on to discuss the relevant
25 strengths of the BN and Missouri Pacific in comparison

1 to the Southern Pacific.

2 A What page are we on, please?

3 Q This is on Page 15 of your statement.

4 A Thank you. Yes.

5 Q Do you know what the Moody's ratings are for
6 both the Burlington Northern and Missouri Pacific debt?

7 A Yes, I do. Burlington Northern debt is AA,
8 and Missouri Pacific, their equipment debt -- well,
9 Burlington Northern, Moody's, AA2, and Standard and
10 Poor's, AA. Missouri Pacific is AA2 on the equipment
11 debt, Moody's, and Standard and Poor's is AA.

12 Q I think that you skipped the mortgage
13 indebtedness. What is the mortgage bond rating?

14 A The mortgage bond rating, Moody's, for
15 Burlington Northern is A2 and Standard and Poor's on
16 Burlington Northern is A, and Missouri Pacific was the
17 other one you requested? Mortgage bonds are A2, and
18 Standard and Poor's is A minus.

19 Q Focusing solely on the Moody's ratings, isn't
20 it true that the Moody's organization rates the Southern
21 Pacific debt as being only slightly less creditworthy
22 than the Burlington Northern and Missouri Pacific debt,
23 that slight difference being the difference between a
24 sub rating of 2 and 3?

25 A That is true.

1 Q Now, would you look at Paragraph 3 of Mr.
2 Smith's December 8th, 1983, statement?

3 This statement, having been made only four
4 months before the filing of your verified statement, and
5 only ten months ago, was that, "SPT, with its stock
6 interests, will be, as it is today, a significant
7 financially viable business. SPT on its own has an asset
8 base and a financial capacity to not merely survive, but
9 to vigorously compete with other large western railroads
10 and motor carriers."

11 Would you agree with that statement?

12 A Yes, but I would like to explain. I think
13 that Mr. Smith made the statement some months ago, say
14 ten months ago, and it was based on financial
15 information that he had through the third quarter of
16 1983, and that the company was beginning to come out of
17 the recession at that time. He had the prospect of a
18 \$150 million -- I guess he had at that time a \$150
19 million capital contribution from the parent company,
20 and did not have the results of 1983.

21 When the 1983 results came in far below our
22 expectations, when the housing market deteriorated
23 because of increasing interest rates, when we had a cash
24 drain because of the Salt Lake Fill, and for other
25 reasons, I suggest that the financial conditions have

1 changed substantially since the time Mr. Smith made that
2 statement.

3 Q Now, you say he didn't have the results for
4 1983. Didn't he have three quarters, three full
5 quarters of results for 1983 when he made that
6 statement?

7 A Yes, and he had the benefit of a certain
8 forecast for '83.

9 Q And did anything truly dramatic happen in the
10 fourth quarter which might have been responsible for his
11 changing his views?

12 A Well, we came in substantially under the
13 forecast.

14 Q For the fourth quarter?

15 A For the year. He was basing his, I believe,
16 on the year, and we came in substantially under the
17 forecast for the year, and part of it was the fourth
18 quarter, and we had a substantial cash runoff in the
19 fourth quarter.

20 Q Wouldn't that trend have been clearly
21 indicated in the three quarters of actual results which
22 were already reported to the FCC and the ICC?

23 A Yes, results for the three quarters were
24 reported.

25 Q And Mr. Smith had that data available to him

1 wher he made the statement, didn't he?

2 A Yes, I think the statement was somewhat
3 optimistic, considering the history.

4 Q Do you think the statement was skewed by the
5 result that Southern Pacific wanted to achieve in the
6 voting trust litigation?

7 A No. As I said, I think Mr. Smith was basing
8 his statement on the ability of Southern Pacific
9 Transportation Company to survive during the period of
10 the voting trust. It was not made solely on railroad
11 operating income. It was made also in light of his
12 statement in here of the nonoperating properties and the
13 prospect of property sales and the cash that would
14 result from that.

15 Q Mr. McPhee, I have one final question for you,
16 and it is not entirely facetious. Do you think that if
17 this merger is not approved, that Southern Pacific bond
18 holders would be advised to either sail out of windows
19 or start their winter fires with Southern Pacific
20 bonds?

21 MR. STEPHENSON: Your Honor, the question is a
22 little bit argumentative.

23 JUDGE HOPKINS: He is willing to answer. I
24 will let him answer.

25 THE WITNESS: Mr. Mayc, you are putting me in

1 a very difficult position, because we have relations
2 with our financial investors as well. I point to the
3 facts, and I point to my testimony of the declining
4 ratios. Those ratios have further deteriorated since
5 the date of my testimony. When we include the 1983
6 figures, it further has deteriorated.

7 I meant very sincerely and I feel somewhat
8 apprehensive in making my comments on ratings in
9 Moody's, but I personally believe that very strongly. I
10 believe that if we do not have the benefit of some
11 merger, and the savings from the merger, that there will
12 be further deterioration and the ultimate restructuring,
13 whatever it may be, of Southern Pacific Transportation
14 Company will be to the detriment of the bond holders
15 definitely, because I think that the collateral, the
16 security will be in question.

17 So, I don't contemplate, suggest, or support a
18 fire sale, but I am very, very worried about the
19 financial future of Southern Pacific Transportation
20 Company even in the short term.

21 Q Isn't it true that literally thousands of
22 investors are making their decisions based at least in
23 part on the ratings assigned to Southern Pacific's
24 debt?

25 A Yes.

1 Q Don't the rating agencies take very seriously
2 their responsibilities in conjunction with their ratings
3 of corporations' debt?

4 A Yes, I would think so, and I would think that
5 our posture is precarious. I have a relationship with
6 Trailer Train, and Trailer Train has an agreement with
7 the rating agencies that as long as they maintain a
8 coverage of fixed charges in excess of 1.5 to 1, that
9 they will retain their A ratings on their securities.

10 Now, Southern Pacific Transportation Company
11 is far below this level of coverage of fixed charges
12 right now, yet Moody's has not even removed its AAB
13 rating. Now, I think that Moody's and the rating
14 agencies may go with you for a period of time expecting
15 recovery, but when that recovery is not forthcoming,
16 even in a period of relative economic resurgence and
17 health, that our ratings are in danger.

18 Q Isn't it true that you are only beginning to
19 see the resurgence in your health?

20 A The resurgence in our health is not
21 commensurate with the growth of GNP. The first half of
22 this year on assets, you know, even net assets in excess
23 of \$4 billion, our operating income was \$35 million.
24 That is before interest charges. That is before payment
25 of principal on debt, and that is an inadequate rate of

1 return, and I don't know how long this can continue and
2 the railroad remain financially viable.

3 Q Don't you agree with Mr. Smith that the
4 railroad industry lags the growth in the economy?

5 A Yes, it lags the growth in the economy, but we
6 know how hard during the recession that smokestack
7 America, the steel industry and other industries, were
8 hit. We know the volume of imports this country is
9 taking in, and we know that the housing industry
10 recovery has been blended by higher interest rates, and
11 the steel industry has not fully recovered, and is still
12 in trouble.

13 In our southern territory in the southwest,
14 the copper industry is hard hit, and we have lost not
15 only the copper ore to the smelters, but the copper
16 anodes out of the smelters. The heavy industry has not
17 recovered to the extent of the general economy.

18 Q And it is lagging the general economy, just
19 like the railroads. Isn't that right?

20 A Yes, it is lagging, but there is some doubt in
21 the current changed economic environment whether the
22 steel and the copper and the auto industry really
23 compared to the imports -- maybe not so much the autos,
24 but the housing industry will recover fully.

25 MR. MAYO: Thank you, Mr. McPhee. I have no

1 further questions.

2 Your Honor, I would like to move into the
3 record, if this is an appropriate time, Exhibits
4 DRGW-C-4 through 6.

5 JUDGE HOPKINS: Do you have any objection
6 now?

7 MR. STEPHENSON: No objection.

8 JUDGE HOPKINS: Those will be received in
9 evidence.

10 (The documents referred to,
11 previously marked for
12 identification as Exhibits
13 Number DRGW-C-4 through 6,
14 were received in evidence.)

15 JUDGE HOPKINS: Who is going to be next?

16 MS. MAHON: I am, Your Honor.

17 BY MS. MAHON:

18 Q Kathleen Mahon, for Missouri-Kansas-Texas
19 Railroad.

20 Do you know what amount of cash or equivalent
21 was transferred by Southern Pacific Company to Santa Fe
22 Southern Pacific Corporation, the existing merged
23 parent, at the time of the merger?

24 MR. STEPHENSON: Your Honor, I object to that
25 question. I don't understand the relevance of the

1 transfer of funds from SPCo. to the parent. It has no
2 bearing on any of the issues in this merger.

3 JUDGE HOPKINS: What is the relationship to
4 the merger?

5 MS. MAHON: Well, the same as the relationship
6 since Southern Pacific Company is the parent of the
7 Southern Pacific Transportation Company, there is a
8 financial relationship between those two companies.

9 MR. STEPHENSON: That may be, but it is not an
10 issue in this case, Your Honor. The parents are merged
11 already. That is an established fact. Whatever has
12 happened, whatever transfer has occurred as a result of
13 that merger are not being litigated before the ICC.

14 MS. MAHON: The financial status of the
15 Southern Pacific Transportation Company is an issue in
16 this case.

17 MR. STEPHENSON: It certainly is, but the
18 question is, what is the relevance of the transfer from
19 SP Company to SFSP on the financial viability or
20 anything of Southern Pacific Transportation? It has no
21 bearing.

22 MS. MAHON: Southern Pacific Transportation
23 Company did contribute \$150 million in capital.

24 JUDGE HOPKINS: It has a relationship as to
25 the financial status at the present time of the Southern

1 Pacific Transportation Company. I will allow it.

2 THE WITNESS: I am not aware of the precise
3 figure. I am aware that Southern Pacific Company sold
4 Southern Pacific Communications Company in June of '83,
5 and received a large amount of cash and cash balance,
6 cash balances way above what has historically been the
7 corporate cash balances, and that those balances were
8 merged with the resultant Santa Fe Pacific Company, and
9 the amount I don't know, but it was hundreds of millions
10 of dollars.

11 BY MS. MAHON: (Resuming)

12 Q What was the value of other assets transferred
13 to the Santa Fe Southern Pacific Corporation by Southern
14 Pacific Company?

15 MR. STEPHENSON: Same objection, Your Honor.
16 I want to have a standing objection.

17 JUDGE HOPKINS: You can. I will allow it.

18 THE WITNESS: I would have to look at the 1982
19 balance sheet consolidated of Southern Pacific Company
20 and pick out a total asset figure and say that those
21 assets on a book basis were merged with Santa Fe
22 Industries to form Santa Fe Southern Pacific Company.

23 Now, I can find that figure for you if you
24 would like.

25 JUDGE HOPKINS: Go ahead.

1 (Pause.)

2 THE WITNESS: The total assets same as the
3 total liabilities of Southern Pacific Company that were
4 merged with Santa Fe Industries is \$5.5 billion at
5 December 31, 1982.

6 BY MS. MAHON: (Resuming)

7 Q Mr. McPhee, in your statement you examine the
8 financial health of the Southern Pacific Santa Fe, the
9 BN, and the UP System. Have you looked at the financial
10 health of other railroads?

11 A Not really. I was primarily concerned with
12 our major competitors and the large merged railroads
13 that compete with us.

14 Q You did not look at the financial health of
15 the MKT, for example?

16 A No, ma'am, I did not.

17 Q Did you give any facts or figures about the
18 effect of the proposed Santa Fe-Southern Pacific merger
19 on the MKT to anyone who made a verified statement in
20 this proceeding?

21 A No, I did not.

22 Q Did you give any facts or figures to anyone
23 about how much traffic loss the MKT would withstand?

24 A No, I am not aware of the MKT's traffic
25 posture.

1 Q Have you ever read the document marked KSC-C-1
2 in this proceeding?

3 A Is that the document that was presented to the
4 Santa Fe Industries board of directors concerning the
5 merger?

6 Q Yes, it is.

7 A No, I have never seen that document.

8 Q When Mr. Mayo was cross examining you, you
9 indicated some disagreement with a couple of points in
10 Mr. Smith's affidavit.

11 A That's correct.

12 Q May we conclude that had you been asked to
13 present an affidavit identical to that submitted by Mr.
14 Smith to the Court in December of '83, you would not
15 have done so?

16 A That is correct.

17 MS. MAHON: That is all I have.
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1 JUDGE HOPKINS: Who is next?

2 MR. BIRNEY: For the record, Your Honor, my
3 name is Bill Birney. I represent BLEA.

4 BY MR. BIRNEY:

5 Q Good morning. As I've indicated, my name is
6 Bill Birney. I'm appearing for the first time in these
7 proceedings. I represent the BLEA.

8 My cross-examination will be brief, given the
9 nature of your prior testimony. I intend to ask you
10 some questions regarding the labor impact costs arising
11 out of the consolidation.

12 First, I'd like to invite your attention to
13 your verified statement. At page 4 of your statement,
14 you state, and I quote: "Inflation has dramatically
15 increased the cost of railroad operations through higher
16 wages and material prices."

17 On the next page, page 5, you state that,
18 based on the index prepared by the Association of
19 American Railroads, that: "In the past ten years
20 railroads have experienced more than a 171 percent
21 increase in material prices and wage rates."

22 Did you verify the accuracy of those figures
23 in the index prepared by the Association?

24 A I didn't verify the figures independently of
25 those prepared by the Association of American

1 Railroads. I have confidence in the Economic and
2 Finance Department. I have worked with them before and
3 I have used their figures before, and I felt that I
4 could rely upon them.

5 Q You found them to be reliable in the past?

6 A Yes. I've never had them questioned before.

7 Q They've never been questioned in any way.

8 A Not in my testimony. I'm not aware of other
9 proceedings.

10 Q Do you know what wage rates -- wage rate
11 increases each of the Applicant railroads in these
12 proceedings experienced during that same ten-year
13 period?

14 A No. I would imagine that the other railroads
15 had similar wage increases because I believe that labor
16 contracts are negotiated nationally.

17 Q On what is that opinion based?

18 A Because there have been national meetings
19 between railroad management and railway labor for many
20 years to negotiate new contracts.

21 Q Do you know what wage rate increases the SPT
22 has experienced during that ten-year period?

23 A Not precisely.

24 Q Directing your attention further down on page
25 5, you state: "Because of SPT's low rate of return,

1 it's internal resources have not been sufficient to
2 support its capital programs and the increasing cost of
3 maintenance."

4 A That's correct.

5 Q Could you please identify the components of
6 those maintenance costs?

7 A Maintenance cost components? You mean like
8 maintenance of way charges for the track structure and
9 maintenance of equipment?

10 Q My question is what you meant in your
11 statement when you refer to maintenance costs, whether
12 or not they include maintenance of way costs or any
13 other costs.

14 A Well, I think I cite examples here about
15 freight car wheels and the increase experienced about
16 sections of carbon rail cost \$167 -- let me say this. A
17 39-foot section of 136-pound carbon steel rail cost \$167
18 in 1973, whereas in 1982 the same rail costs \$462, up
19 177 percent.

20 I have cited examples of steel wheels, carbon
21 steel rail, railroad cross ties, et cetera,
22 locomotives.

23 Q In reading your verified statement, I didn't
24 see any reference whatsoever to wage rates or wage costs
25 as included in your definition of maintenance costs. Is

1 that incorrect, or is it simply an omission from the
2 statement?

3 A I used as an index of inflation or an index of
4 increased expense the AAR index that I cite here on page
5 5 of my testimony.

6 Q But that does reverse the wage costs. My
7 question is to is at page 5, I think you are discussing
8 the capability of the internal resources of the company
9 to meet these increasing costs of maintenance, whether
10 or not those costs include wage rates and wage costs.

11 A Yes. These indexes -- evidently, material
12 prices, wage rates and supplements for Class I
13 railroads. So wages are a component.

14 Q So, although your statement doesn't discuss
15 wage costs --

16 A It's a component of this index, yes.

17 Q It is a component.

18 Has there been a plan formulated to reduce
19 these maintenance costs?

20 A To reduce maintenance costs?

21 Q Yes.

22 MR. STEPHENSON: As part of the merger?

23 MR. BIRNEY: Yes.

24 BY MR. BIRNEY: (Resuming)

25 Q As part of the consolidation or at any time

1 following the consolidation, has there been a plan
2 formulated to reduce maintenance costs for the
3 consolidated railroads?

4 A I'm aware that the merger contemplates
5 internal savings of some \$220 million from various
6 sources and avoidance of certain capital expenditures.
7 I'm not familiar with the specific maintenance programs
8 contemplated.

9 Q What constitutes this internal savings you
10 just referred to?

11 A It is listed in the summary to the
12 application. I have only general figures on it. I
13 noted that traffic diversions contemplated would produce
14 about \$69 million worth of savings, whereas internal
15 savings would be \$218 million. But I refer you to the
16 exhibit in the application that details that \$218
17 million annual savings.

18 Q Could you give me the exhibit number and page
19 for that, please, if you have it handy? If not, that's
20 fine.

21 MR. STEPHENSON. It's Exhibit 1-A or Volume
22 1-A, the Executive Summary of the Application, if that's
23 what you're referring to. It's the last page.

24 THE WITNESS: Yes. That's what it is. Thank
25 you, counsel.

1 BY MR. BIRNEY: (Resuming)

2 Q Do these costs, to the best of your knowledge,
3 include any reduction in wage costs?

4 A I don't know.

5 Q if no specific plan is formulated to reduce
6 these costs, are you aware of whether or not the
7 consolidated railroad will be looking for a way to
8 reduce these costs?

9 A I'm not sure I understand your question.
10 Would you please repeat it?

11 Q My initial question to you was whether or not
12 a plan had been formulated to reduce these costs. And
13 you indicated to me that there was no such plan.

14 My question to you now --

15 A Well, it's not that there's no such -- I mean
16 I'm not aware of the detailed composition of the
17 contemplated savings of the merger.

18 Q Among the factors that are being considered,
19 are the railroads considering a means of reducing the
20 costs in the absence of a formal plan that you may or
21 may not be aware of?

22 A Well, I'm aware of -- as part of the plan
23 there is some transfer and some reduction in employment
24 through consolidation.

25 Q How would you propose to reduce the

1 maintenance costs?

2 A How would I propose?

3 Q Yes.

4 A I'm not proposing to reduce maintenance
5 costs.

6 MR. STEPHENSON: Your Honor, I object.

7 JUDGE HOPKINS: I don't think this gentleman
8 is the man on that particular point anyway.

9 MR. STEPHENSON: We have operating witnesses
10 who will discuss the operating plan, the maintenance,
11 the proposed maintenance plan.

12 JUDGE HOPKINS: I've already decided. We
13 don't need a long dissertation. I understand, Mr.
14 Stephenson. If you want to continue for the record, go
15 right ahead, but I don't see the need for it.

16 MR. BIRNEY: Thank you, Your Honor. I'm at
17 the end of that line of questioning anyway.

18 BY MR. BIRNEY: (Resuming)

19 Q Now, I understand, based on the testimony at
20 this point in time, that you probably do not participate
21 in a calculation of labor impact costs. Is that right?

22 A That is correct.

23 Q Do you know who performed those calculations?

24 A There are two gentlemen, Ken Feifer for the
25 Southern Pacific Company, and I'm not familiar

1 immediately with the name of the representative from the
2 Santa Fe Railway.

3 Q Mr. Frestel?

4 A Could be, yes.

5 Q Did you provide those gentlemen with any
6 information to be used in the calculation of those
7 costs?

8 A No, I did not.

9 Q Did you or anyone else from your staff review
10 the calculations that were submitted by Mr. Peifer or
11 Mr. Frestel?

12 A No, I did not.

13 Q Are you familiar with their verified
14 statements?

15 A No.

16 Q One other matter before I conclude. The HIEA
17 has submitted in these proceedings a set of supplemental
18 labor protective conditions. Are you familiar with that
19 submission?

20 A No, I'm not.

21 MR. BIRNEY: Nothing further, Your Honor.

22 JUDGE HOPKINS: Thank you.

23 Who is next? No other cross-examiner here?
24 If not, we will proceed to the next witness.

25 MR. STEPHENSON: Your Honor, I have a little

1 bit of --

2 JUDGE HOPKINS: Oh, I'm sorry. I forget about
3 you sometimes, Mr. Stephenson. I don't know why I
4 should. Go ahead.

5 I was just surprised that there wasn't anybody
6 else.

7 REDIRECT EXAMINATION

8 BY MR. STEPHENSON:

9 Q Mr. McPhee, do you have D&RG-C-5 in front of
10 you?

11 A Yes.

12 Q Directing your attention to D&RG-C-5, Mr. Mayo
13 yesterday directed your attention to numerous pages
14 concerning Southern Pacific's improved operations and
15 improved physical plant.

16 The question is, isn't there a basic conflict
17 between the improvements that he directed your attention
18 to, and your testimony in this case?

19 A No, not really.

20 Q How do you reconcile that?

21 A There are a number of things in this exhibit
22 which constituted a slide show and talk to the employees
23 that were not developed yesterday.

24 And I would refer to page 4 of that exhibit
25 where management is sharing its concerns with the

1 employees. And on page 4, I believe, in the text, going
2 with the slide, it says: "Let's look at Southern
3 Pacific Transportation Company's financial performance
4 in recent years. In a word, it's been unsatisfactory."

5 It closes with saying: "Notice, even in our
6 better years, the non-rail operations were doing better
7 than we were," meaning the rail, and those bars that go
8 below the baseline for SP Transportation Company mean we
9 had a loss.

10 That was part of the presentation, as well as
11 certain other things. On page 5, it says: "Here's a
12 different way to look at the same problem. This chart
13 shows the earnings of Southern Pacific rail operations
14 compared with those of other major western railroads.
15 Our profit has been less than that at Santa Fe,
16 Burlington Northern, and Union Pacific," which is what I
17 am saying in my testimony.

18 And it goes on to say: "Profits are important
19 to all of us because profits mean job security. If we
20 don't make profits, ultimately we'll go out of
21 business." They acknowledge that.

22 Look what happened to the Rock Island, for
23 example, or the Milwaukee. They are saying this to the
24 employees. Our poor profit performance in past years
25 means we don't have as much money available for capital

1 improvements, and our limited capital resources mean we
2 are more vulnerable to price competition by other
3 carriers, and also limits our restructuring options.

4 We aren't in any danger now, they say, at this
5 time -- over a year ago -- but we have to improve.

6 Briefly, I would refer to page 18 and 20, and
7 that's all. On page 18, it talks about the trucks. It
8 says: "This slide shows a real problem we face in the
9 next few years in the battle with truckers. Between
10 1982 and 1985, operating costs for trucks will rise a
11 total of only 3 percent due to higher labor costs, but
12 the railroad costs will rise 17 percent under current
13 contracts which run through mid-1984 because of higher
14 wage and fringe benefits built into the current labor
15 agreements.

16 In addition, because of increased size and
17 weight allowances approved by Congress, trucks have an
18 even greater cost advantage. This is going to make it
19 all the harder for railroads to price their services
20 competitively enough to win freight back from the
21 trucks."

22 And, last, what is very significant to me, on
23 page 20 it talks about car loadings: "The best measure
24 of how much business our customers have given us is the
25 carloads. Go back to 1979 to find SP's last peak, about

1 190,000 carloads per month in the first quarter of '79,
2 down to about 120,000 carloads in the first quarter of
3 this year," meaning 1983, "nearly a 40 percent drop.

4 "Part of this cause of concern, of course, is
5 the recession." They go on: "The incrcads made by
6 truckers are important, too,"

7 Those are statements that were also made by
8 management to the employees that shared the concerns
9 about the financial condition and operating performance
10 of Southern Pacific Transportation Company.

11 Q Well, how do you reconcile the financial
12 problems with the improved physical plant?

13 A Well, it's interesting, and I want to make
14 this distinction. Mr. Mayo cited a number of things in
15 this exhibit, which I will not repeat, about how we have
16 shown that we have made operational improvements in
17 reduced claims and reduced -- increased locomotive
18 ability and so on.

19 And the distinction I want to make is that all
20 the money that had been poured into the property and
21 into the equipment and the efforts management have made
22 to improve performance have indeed made -- well, you can
23 have a railroad that is operationally competitive and
24 viable, but at the same time, these monies going into
25 the properties have created a condition where,

1 financially, at the same time and coexistent with this,
2 the financial ratios have continued to deteriorate to
3 dangerous levels.

4 So, on the one hand, we have an operationally
5 competitive railroad that is facing financial disaster.

6 MR. STEPHENSON: Your Honor, at this time, I
7 would like to have marked for identification an exhibit
8 which we have numbered SFSP-C-1.

9 JUDGE HOPKINS: It will be marked for
10 identification.

11 (The document referred to
12 was marked Exhibit SFSP-C-1
13 for identification.)

14 MR. STEPHENSON: Your Honor, a word of
15 explanation is probably in order before I have the
16 witness address the document.

17 The Rio Grande has filed, under seal, certain
18 depositions and related materials from the Morgan
19 Stanley financial analysis. The financial analysis is
20 sensitive in many ways, because it addresses the
21 non-rail assets which we view are not relevant to this
22 proceeding.

23 In addition, it contains certain five-year
24 forecasts that were done both internally and by Morgan
25 Stanley. Because of the SEC problems, disclosure

1 problems that I discussed yesterday, we have excerpted
2 certain portions of the testimony simply to put this
3 forecast material in context, and we have also submitted
4 the forecast from which we have deleted the years '84,
5 '85, '86, and '87.

6 In other words, what we are looking at was at
7 one time a forecast. It is now past history.

8 MR. MAYO: Your Honor, at this point, I think
9 we would like to express an objection. I don't see how
10 this examination relates to cross-examination. I don't
11 think this is appropriate redirect. Maybe I missed
12 something.

13 MR. STEPHENSON: Yes, you missed something.
14 You asked a question about the Anderson forecast.

15 MR. MAYO: Will this go to the Anderson
16 forecast?

17 MR. STEPHENSON: Yes.

18 MR. MAYO: Go ahead. I'm sorry.

19 BY MR. STEPHENSON: (Resuming)

20 Q Mr. McPhee, yesterday, in response to a
21 question by Mr. Mayo concerning the Anderson forecast,
22 you mentioned that he, in fact, did a forecast that was
23 used, among other things, for the Morgan Stanley
24 analysis.

25 Do you recall that testimony?

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1 A Yes.

2 Q Do you know whether Morgan Stanley utilized
3 that forecast in preparing the financial analysis for
4 Southern Pacific Company?

5 A Yes, I believe it was the basis.

6 Q If you will turn to the page, about in the
7 middle of the document, SFSP-C-1, can you tell us what
8 that page depicts?

9 A What page are you --

10 Q It's the page numbered 134.

11 A Yes. All right.

12 Well, it depicts certain figures for 1983,
13 evidently developed by Morgan Stanley, with the name
14 Project Mustang. And I think everybody knows that
15 Mustang represents Southern Pacific Transportation
16 Company.

17 Q All right. Now, there were two forecasts
18 done, alluded to. One was done by Morgan Stanley. Is
19 that correct?

20 A Yes.

21 Q And the other was done by whom?

22 A Mr. Phil Anderson.

23 Q And who was Mr. Phil Anderson?

24 A He's an operating officer, an operations
25 analyst, in the executive department of Southern Pacific

1 Transportation Company.

2 Q Mr. Anderson, you indicated yesterday,
3 performed a forecast for you in connection with the
4 financing and also for Morgan Stanley. Is that
5 correct?

6 A Yes, sir.

7 Q Is that the same forecast that was used for
8 both?

9 A Yes.

10 Q And who is -- if we look at the word
11 "Mustang," that is the Phil Anderson, or is that the
12 Morgan Stanley?

13 A I think Morgan Stanley, from the figures I
14 have seen here, used Mustang to indicate the Phil
15 Anderson forecast.

16 Q All right.

17 Now, based upon actual results in 1983, how
18 did Mr. Anderson's forecast stack up against the actual
19 results?

20 A Well, of course, Mr. Anderson's forecast was
21 made in June of '83, but by the end of the year -- Mr.
22 Anderson forecast certain levels of revenue and
23 operating income. The revenue level forecast was
24 \$2,375,000,000, and the figures I have indicate that the
25 actual results were \$2,430,000,000 of revenues for

1 1983. That's not too far off. It's between 2 and 3
2 percent.

3 But the operating income that Mr. Anderson
4 forecast on a retirement/replacement/betterment basis
5 was a negative operating income of \$69 million. But had
6 the 1983 results been published on an EB or replacement
7 basis, the results for SP Transportation would have been
8 a deficit or a loss in operating income in excess of
9 \$143 million.

10 Q A difference of what?

11 A A further decline of \$74 million over the
12 figure that Mr. Anderson forecast.

13 Q Let me make sure I understand this. Mustang,
14 under the heading Operating Income, the Mustang figure
15 of \$62 million is Mr. Phil Anderson's operating income
16 forecast?

17 A Yes. That's his operating income forecast.
18 But from that, must be deducted down below, where it
19 says "Mustang FBB depreciation," \$131 million. And
20 that 62-plus turns into a 69-minus, which is the way
21 operating income would normally be reported.

22 And so really, the comparable figure for Mr.
23 Anderson's forecast is operating income deficit of \$69
24 million, taking into account depreciation. But the
25 actual results, taking into account depreciation, were a

1 deficit of \$143 million.

2 Q And again, what is a difference of what?

3 A 74 -- in six months, the forecast was
4 substantially off the mark. And that's the first year
5 of the forecast.

6 Q Would you draw any conclusions as to how far
7 afield it would be in the later years?

8 A Well, the thing is that if the forecast is off
9 that much in the first year, and the future years have
10 greater uncertainty, then I would compound my
11 uncertainty in the future years of that forecast.

12 Q Do you know how the Morgan Stanley forecast
13 stacked up against actual results?

14 A Looking at the Morgan Stanley forecast in
15 1983, they had a similar revenue forecast. I mean they
16 had a revenue forecast of \$2,413,000,000 and came in at
17 \$2,430,000,000, substantially correct.

18 Morgan Stanley forecast prior to depreciation
19 an operating income of \$151 million, and then they had
20 depreciation of \$150 million, which is essentially a
21 break-even in operating income, operating income of \$1
22 million. But this compares with actual results of 1983
23 on a betterment basis of this negative, or a deficit of
24 \$143 million.

25 So that forecast in 1983 was off even more

1 than Phil Anderson's forecast.

2 Q What were the basic components of the
3 difference, if you can tell -- or the shortcomings of
4 the forecast?

5 A I don't know what Morgan Stanley's assumptions
6 were in arriving at these total figures. They give
7 figures for operating income, operating margin, other
8 income. They don't detail expense accounts. They give
9 you depreciation and they give you pretax and net
10 income.

11 I'm concerned largely with operating income of
12 the railroad. And other than the results in the
13 operating income sense, I don't know what the individual
14 components of the Morgan Stanley forecast are.

15 Q What can you attribute the shortcoming of the
16 Phil Anderson forecast to?

17 A Well, the revenue forecast was substantially
18 correct, but the expense forecast proved to be
19 incorrect, and the expenses far exceeded those
20 anticipated.

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

22 JUDGE HOPKINS: Mr. Mayo.

23 MR. MAYO: Your Honor, could we have just a
24 couple of moments to collect ourselves here?

25 JUDGE HOPKINS: Sure. We will stay here.

1 We're not going to move.

2 (Pause.)

3 (Discussion off the record.)

4 JUDGE HOPKINS: Let's get back on the record.

5 RECROSS EXAMINATION

6 BY MR. MAYO:

7 Q Mr. McPhee, with respect to Document DRGW-C-5,
8 isn't it true that if the efficiencies discussed in that
9 document --

10 A Which document is this, Mr. Mayo?

11 Q This is the slide presentation.

12 A Okay.

13 Q That the efficiencies discussed in that
14 document, the improvement in those efficiencies, would
15 continue to be realized by the Southern Pacific? Plus,
16 if traffic levels improve on the Southern Pacific, you
17 would expect, over time, that operating income will
18 increase on the Southern Pacific, won't it?

19 A If those efficiencies continue to improve and
20 if traffic improved as well, would operating income go
21 up? I would say yes, I would expect it to go up.

22 Q Now, with respect to the Anderson forecast,
23 has Southern Pacific made any subsequent forecasts of
24 its future operating and financial performance?

25 A No. I know as a matter of practice that they

1 make annual forecasts, but there has been, to my
2 knowledge, no new five-year forecast.

3 Q Now, the figures you read into the record,
4 those were figures that were stated on a betterment
5 basis; is that right?

6 A Yes, sir.

7 Q Would you read into the record the operating
8 income, actual operating income in 1983, on a
9 depreciation basis?

10 A The actual operating income in 1983 on a
11 depreciation basis. The operating income in 1983 on a
12 depreciation basis was a deficit of \$1,890,000.

13 Q Now, would you read the figure from the
14 Anderson forecast for operating income in 1983 on a
15 depreciation basis into the record?

16 A Mr. Anderson forecast operating income as
17 opposed -- Mr. Anderson forecast an operating income,
18 positive, of \$55 million. And that compared with the
19 actual results of a deficit of \$1.9 million.

20 Q Now, would you give me the mid-year 1983
21 actual operating income on a depreciation basis?

22 A 1983, mid-year, on a depreciation basis. I'm
23 going to have to check on this, because I have a 100 for
24 the six months ended June 30, 1983. And I want to make
25 sure I know what basis. It was a on depreciation basis.

1 Okay, a mid-year income from operations for
2 the six months ended June 30, 1983, operating income was
3 deficit of \$5.9 million.

4 Q And on a betterment basis, do you have that?

5 A No, I don't, unless I can obtain it from this
6 10Q of June '83.

7 Q All right. I'd like to have the Anderson 1984
8 depreciation basis.

9 A Have the 1983 I think you mean?

10 Q No, I want '84.

11 A Have Anderson's '84 forecast?

12 Q Right.

13 MR. STEPHENSON: Your Honor, I object. Number
14 one, it's not part of this exhibit.

15 JUDGE HOPKINS: It sounds like we're getting
16 into the problem we were talking about earlier.

17 MR. STEPHENSON: He didn't have a full year
18 forecast anyway.

19 MR. MAYO: It's a mathematical proposition.

20 MR. STEPHENSON: No, it's not. That assumes
21 that all the revenues come in on an equal six-month
22 basis, and that is not, in fact, the way the railroad
23 operates.

24 MR. MAYO: I don't disagree with that. I'd
25 simply like to know what the figure is that you have.

1 MR. STEPHENSON: We don't have it. I don't
2 have it with me, and I don't know if Mr. McPhee has it,
3 but I would object.

4 THE WITNESS: The question is, it is 1984
5 numbers now.

6 MR. STEPHENSON: Yes. If you have the 1984,
7 then you are given the 1984. For the community, they
8 double the half and they know what the forecast is.

9 JUDGE HOPKINS: Mr. Mayo, I thought we weren't
10 getting into the forecast after 1983.

11 MR. MAYO: Maybe I can solve the problem. I
12 will make a proposal to counsel for the other side. I'm
13 not sure of the answer to this question. The reason I
14 want to pursue it is, obviously, Southern Pacific is
15 trying to suggest that the Anderson projections are out
16 of line with historical experience.

17 We know what mid-year 1984 actual operating
18 income was. And I would like to see if I can compare
19 projected '84 to actual mid-year '84 based on the data
20 that we have from Mr. Anderson, to see if the
21 projections are more back into line.

22 Now, I'd be happy to take the answer to my
23 question off the record from the witness, and then,
24 based on that, decide whether we're going to put it into
25 the record under seal.

1 JUDGE HOPKINS: Mr. Stephenson.

2 MR. STEPHENSON: I'm not sure I understand
3 what the proposal is, Your Honor.

4 MR. MAYO: I will take the answer to my
5 question off the record from the witness and then based
6 on his answer make a decision as to whether I want to
7 put it into the record.

8 Alternatively, I would ask --

9 JUDGE HOPKINS: Excuse me. What is the
10 problem if you get the mid-1984, since we are already
11 past the mid-year of 1984, in the same way as we had
12 1983?

13 MR. STEPHENSON: You mean in wanting to know
14 what the forecast is, having the forecast?

15 JUDGE HOPKINS: Right.

16 MR. STEPHENSON: If you double the forecast,
17 Your Honor, you know what the forecast is for 1984.

18 JUDGE HOPKINS: Why can't you just ask what
19 the mid-year forecast was for 1984, for example?

20 MR. MAYO: I can ask him that question. I
21 expect that his answer will be that he doesn't have the
22 data to answer it.

23 JUDGE HOPKINS: Do you have it?

24 THE WITNESS: I have a forecast for the entire
25 year 1984. Now, I can split it up, but I will do what

1 -- I will answer the question that counsel agree upon,
2 but I'm not sure what is agreed here.

3 MR. STEPHENSON: I'm confused. Are we talking
4 about the forecast he has as the Phil Anderson forecast
5 for 1984? Is that what you're talking about?

6 MR. MAYO: Yes.

7 MR. STEPHENSON: That's the whole year.

8 MR. MAYO: That's correct, and I want to know
9 what halving the 1984 forecast of operating income, what
10 that figure would be.

11 JUDGE HOPKINS: Plus his argument is, you give
12 him the full year by --

13 MR. STEPHENSON: You were given the full
14 year.

15 MR. MAYO: I will take the answer under seal.

16 MR. KHARASCH: Your Honor, I really don't
17 understand this long discussion. There is in the record
18 -- that's what Mr. McPhee's statement is -- a forecast
19 of what's going to happen to the SPT.

20 The Applicants have said this is what's going
21 to happen to us. They have forecasted it for years
22 ahead. What's the matter with putting in an
23 inconsistent forecast that they have made internally and
24 see what they've said when they weren't in front of the
25 court?

1 JUDGE HOPKINS: You're talking about -- you
2 see, the problem is --

3 MR. KHARASCH: 1985 or anywhere, they're
4 putting in a forecast with the future. What's the
5 matter with their internal forecast?

6 JUDGE HOPKINS: They're talking about problems
7 with the SEC.

8 MR. KHARASCH: The ICC has plenary and
9 absolute jurisdiction.

10 JUDGE HOPKINS: I know. But I can't order
11 them to submit that now because they're discussing this
12 and they argue the point on the SEC problems. This
13 isn't before me at the present time anyway.

14 MR. STEPHENSON: Your Honor, the 1984 figures,
15 the forecast, are in the record currently. They are
16 part of the record, and Mr. Mayo, at the end of 1985 or
17 early 1986, if he wants to, on brief, compare the actual
18 performance of Southern Pacific Transportation Company,
19 which they will be public figures for '83, '84, and '85,
20 he will be able to do it on brief.

21 There's no reason why he has to do that here
22 today.

23 JUDGE HOPKINS: You're just talking about how
24 he can show the difference. What about the Anderson
25 forecast?

1 MR. STEPHENSON: Well, the Anderson forecast
2 is --

3 JUDGE HOPKINS: You're talking about it's in
4 the confidential. By that time it won't be confidential
5 as to '84 and '85.

6 MR. STEPHENSON: Yes, correct.

7 JUDGE HOPKINS: So we won't have the need for
8 any confidential brief or anything else on '84.

9 MR. STEPHENSON: He can do in brief just what
10 we have done here with the full year '83, '84, and '85.

11 JUDGE HOPKINS: I don't see any problem in
12 doing it that way. I don't see any problem in doing it
13 that way.

14 MR. BAKER: May I make one comment? I have
15 some real doubt as to whether these forecasts ought to
16 be protected.

17 Customarily, the question of forecast is
18 making them public, not making them known only to
19 selected individuals. It seems to me that it would be
20 appropriate to direct the Applicants to the extent that
21 they wish to maintain the confidentiality of these
22 forecasts, to provide to Your Honor some statement as to
23 why legally it cannot be made public.

24 I question whether it cannot be made public.
25 There are times when a company has a public offering

1 underway where it would be inappropriate to make
2 forecasts. There are certain areas and certain times
3 when it would not be appropriate to go public with
4 things of that sort.

5 I don't understand that situation. And it
6 seems to me that their coming in here and saying, "Well,
7 we can't make it public, SEC" is not an accurate
8 statement.

9 JUDGE HOPKINS: Mr. Stephenson.

10 MR. STEPHENSON: I suggest that perhaps we
11 raise it, Your Honor. Our counsel, our corporate
12 counsel have advised us that SEC regulations -- and I
13 can't cite them to you -- do foreclose us from making
14 public internal forecasts. And we have been operating
15 on that assumption throughout, and I can't cite you any
16 case or any regulation at this time.

17 JUDGE HOPKINS: I think it would be wise for
18 you to brief me on that point, since the other parties
19 believe it should be turned over and there's no reason
20 why --

21 MR. KHARASCH: Isn't Mr. McPhee's document a
22 forecast? I don't understand. Mr. McPhee's document
23 and many of the others are forecasts.

24 MR. STEPHENSON: No, it's not. He doesn't go
25 into any detail in terms of operating income.

1 JUDGE HOPKINS: You're talking about he hasn't
2 done any forecasts for 1978, 1987, 1988.

3 MR. KHARASCH: He's told us the company can't
4 operate.

5 JUDGE HOPKINS: I understand. I think it
6 would be wise, Mr. Stephenson, to file a brief on this
7 particular point. How long would it take you to do it?

8 MR. STEPHENSON: I don't know. I suppose we
9 can have it early next week.

10 I might add that we certainly -- I think that
11 counsel for all of these Protestants should keep in mind
12 that their own clients have internal forecasts, and
13 what's good for the good is good for the vander. If
14 they want to produce -- if we are going to be required
15 to produce our internal forecast, then we are certainly
16 going to be asking them for their internal forecast as
17 well.

18 So it cuts both ways.

19 JUDGE HOPKINS: We understand that.

20 MR. BAKER: It's a question of relevancy, Your
21 Honor.

22 JUDGE HOPKINS: Mr. Kharasch.

23 MR. KHARASCH: My only point: may we please
24 have the copies promptly of whatever it is that is
25 supposed to be in the record already by stipulation?

1 JUDGE HOPKINS: Well, the understanding is
2 that the Denver and Rio Grande will provide copies of
3 what they have, what has been agreed on, to Mr.
4 Stephenson. And under a protective order as of now,
5 that will then be handed out to those who request --
6 particularly request it.

7 Is that my understanding, Mr. Stephenson?

8 MR. STEPHENSON: That's correct.

9 JUDGE HOPKINS: And you will prepare a brief
10 on this particular point concerning these forecasts?

11 MR. STEPHENSON: Yes, sir.

12 JUDGE HOPKINS: As to the reason why they
13 can't be put out on the public docket.

14 MR. STEPHENSON: We will.

15 JUDGE HOPKINS: And then the parties on the
16 other side will have time to brief that if they wish.
17 Otherwise, I would make a ruling right on the record.

18 MR. MAYO: Your Honor, with respect to the
19 specific question that prompted this, we will withdraw
20 that question and accept Mr. Stephenson's invitation to
21 address a comparison of actual '84 against forecasts of
22 1984 projections on brief.

23 JUDGE HOPKINS: Thank you.

24 BY MR. MAYO: (Resuming)

25 Q Mr. McPhee, you have stated that based on your

1 analysis, it seems that the expense forecast reflected
2 in Mr. Anderson's projections was out of line with
3 historical, and that is what was driving the difference
4 between forecast 1983 and historical 1983; is that
5 right?

6 A Yes.

7 Q Do you know what factors were prompting that
8 expense level that was actually experienced? Isn't it
9 true that in 1983, for example, Southern Pacific
10 experienced storm damage in the amount of approximately
11 \$21 million that was unusual for the Southern Pacific?

12 A I know Southern Pacific experienced storm
13 damage in 1983. I have a figure of \$12 million in mind
14 for the first half. I don't know whether it was
15 subsequently adjusted. If you have something that can
16 assist me, I would appreciate it.

17 Q If you look at page 9 of the Santa Fe/Southern
18 Pacific 1983 Annual Report, you see a reference to a
19 repair bill for storm damage amounting to \$21 million.
20 And it's explained that that was much more than that
21 experienced in a normal year. Is that right?

22 A Page 9?

23 Q I think that's right. Page 9, about the
24 middle of the page, last sentence.

25 A Yes, that's correct. The repair bill for

1 storm damage was \$21 million, much more than that
2 experienced in a normal year.

3 Yes, that's correct. It was \$12 million, I
4 believe, in the first half of the year. When the final
5 figures were in, it must have adjusted to \$21 million.
6 That's correct.

7 Q So the \$21 million is responsible for roughly
8 half the difference between the Anderson projections for
9 1983 and the 1983 actual experience?

10 A Most of the storm damage had occurred and was
11 known prior to mid-year, and should have been known by
12 Mr. Anderson and taken into account in his forecast.

13 Q Do you know whether it was?

14 A I don't know whether it was, but I believe
15 that \$12 million had been written out of the accounts by
16 mid-year.

17 Q When did Mr. Anderson do his forecast?

18 A June of '83.

19 Q I think, if you look at his testimony, he did
20 it in May of '83.

21 MR. STEPHENSON: I think he said May and
22 June. The record will say what he said.

23 THE WITNESS: It may have been late May or
24 early June.

25 BY MR. MAYO: (Resuming)

1 Q Well, let it speak for itself. What else was
2 driving the expenses in 1983?

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1 A I'm not aware of anything other of an unusual
2 nature, other than the storm damage in '83. There may
3 have been some problems with the Salt Lake Fill. There
4 certainly were problems, certainly were major expenses,
5 in '84 with the Salt Lake Fill.

6 Q These are one-time expenses, isn't that
7 right?

8 A Yes.

9 Q So, though they might occur in 1983 and '84,
10 you would not necessarily expect them to occur over
11 time, is that right?

12 A Pardon me. I didn't catch all of that.

13 Q I say, although they have occurred on a
14 one-time basis, you had expenses from storm damage in
15 1983 and you had the Salt Lake Fill in 1984, it's
16 conceivable that in 1985 and 1986 and 1987 you would
17 have none of those expenses, is that right?

18 A None of those expenses?

19 Q None of those specific expenses.

20 A Not specifically. We have, what with the NWP
21 fire, with Salt Lake Fill and the storm damage, we seem
22 to have some unusual non-recurring expense almost every
23 year.

24 Q But at the time that you made these
25 projections, Southern Pacific made these projections,

1 these projections represented Southern Pacific's best
2 estimate of how it was going to perform over the next
3 five years, isn't that right?

4 A That's correct.

5 Q And that was taking into account the
6 expectation of expenses?

7 A Yes.

8 Q But of course, you can't expect the
9 unexpected, is that right?

10 A Yes, sir.

11 Q Mr. McPhee, do you know whether Mr. Smith had
12 access to the Anderson projections when he developed his
13 December 8th --

14 A I believe he did.

15 Q Do you think he reviewed those in preparation
16 of that statement?

17 A I believe so. I don't really know.

18 Q Do you think he relied upon those projections
19 in developing his statement?

20 A As I said yesterday in response to your
21 questioning, I did not participate with Mr. Smith in the
22 development of this statement. In fact, it was entered
23 into the record, it was produced and submitted, before I
24 knew of it.

25 Q To the extent that Mr. Smith relied upon the

1 Anderson projections, he would have had three-quarters
2 of 1983 actual data available to him to compare to the
3 Anderson projections, wouldn't he?

4 MR. STEPHENSON: Your Honor, I object to the
5 question. The witness has said he doesn't know whether
6 Mr. Smith relied on the Anderson projection and so the
7 question is hypothetical as to whether he would have had
8 the first nine months if he had done it. It is purely a
9 theoretical, hypothetical question.

10 MR. MAYO: I think the witness just said that
11 he thinks that Mr. Smith had access to these
12 projections.

13 JUDGE HOPKINS: He did, and I'm going to allow
14 him to answer if he can.

15 THE WITNESS: Now, if you will refresh me.

16 BY MR. MAYO: (Resuming)

17 Q The question was, at the time that Mr. Smith
18 prepared his affidavit wouldn't he have had
19 three-quarters of actual experience with the Southern
20 Pacific available to him?

21 A Yes, he would have had that available to him.

22 MR. MAYO: Your Honor, I have no further
23 questions.

24 JUDGE HOPKINS: Mr. Stephenson?

25 MR. STEPHENSON: No redirect, re-redirect.

1 JUDGE HOPKINS: Thank you.

2 MR. STEPHENSON: Your Honor, I move the
3 admission of Mr. McPhee's verified statement and also
4 SFSP-C-1.

5 JUDGE HOPKINS: Any objection?

6 (No response.)

7 JUDGE HOPKINS: They will be received in
8 evidence.

9 (The document previously
10 marked Exhibit No. SFSP-C-1
11 for identification was
12 received in evidence.)

13 JUDGE HOPKINS: You're excused.

14 (Witness excused.)

15 JUDGE HOPKINS: We normally would have
16 recessed some time ago, but I'm afraid this is the
17 time. Let's take a 15-minute recess.

18 (Recess.)

19 JUDGE HOPKINS: Let's go back on the record.

20 We'd better have a little discussion here.

21 I'm afraid we're going to have to close the hearing at
22 quarter to 1:00. Everybody is going to be thrown out of
23 the building and the building is going to be locked as
24 of 1:00 o'clock. OMB has directed that all Government
25 employees in those agencies where appropriations haven't

1 gone through, that we have got to close down by 1:00
2 o'clock.

3 Now, one of the problems, we are supposed to
4 wait until further notice as to going back to work, and
5 I'd like to discuss it with you people as to whether the
6 situation doesn't look too good if we wait until
7 tomorrow. I'm a little bit reluctant to have everybody
8 sit around and propose you coming back tomorrow morning
9 at 9:30.

10 I am wondering whether it's the best idea to
11 close down until Tuesday. Myself, I think it would be,
12 because I'm not certain that anything is going to be
13 done as of tomorrow morning.

14 Now, I'd like you all to discuss it, because
15 it's a problem with all of the out of town people and
16 everything, and I understand your problems.

17 MR. WILSON: Your Honor, we would like to go
18 ahead tomorrow morning if in fact the building is going
19 to be open.

20 JUDGE HOPKINS: Well, I know that, but we
21 don't know, you see.

22 MR. KHARASCH: May we be off the record?

23 JUDGE HOPKINS: Surely.

24 (Discussion off the record.)

25 MR. WILSON: Your Honor, Applicants call as

1 their next witness Mr. Thomas Fitzgerald, Vice President
2 of Traffic for Santa Fe Railroad.

3 I have distributed at the break to Your Honor
4 and staff and the reporter a copy of Mr. Fitzgerald's
5 verified statement and also a copy of the SP-SF joint
6 route and rate policy, which I would like to have marked
7 at this time as Exhibit SFSP-C-2.

8 JUDGE HOPKINS: It will be so marked.

9 (The document referred to
10 was marked Exhibit No.
11 SFSP-C-2 for
12 identification.)

13 Whereupon,

14 THOMAS J. FITZGERALD

15 was called as a witness by counsel for Applicants and,
16 having been first duly sworn, was examined and testified
17 as follows:

18 DIRECT EXAMINATION

19 BY MR. WILSON:

20 Q Mr. Fitzgerald, you have before you a verified
21 statement. I would like to know whether or not this is
22 your verified statement, signed and verified by you in
23 March of this year.

24 A It is the statement I signed. My copy
25 unfortunately doesn't bear a subscription by a notary

1 public, and I assume that's because it didn't come
2 through on my copy. But it is my statement.

3 Q Okay. Is it, along with the minor errata
4 included in Applicants' errata filing, your testimony,
5 or do you have other modifications you would like to
6 make at this time?

7 A It is my statement, with the errata that were
8 filed, but I do have additional changes.

9 Q Would you please state what those are?

10 A Yes. Page 16, the fifth bullet, which begins
11 "Estimated pre-merger," delete the words "and
12 post-merger." And on page 17, third paragraph, second
13 line, same change.

14 Q With those changes, is your verified statement
15 true and correct to the best of your knowledge and
16 belief?

17 A It is.

18 MR. WILSON: We tender the witness for
19 cross-examination.

20 JUDGE HOPKINS: Thank you.

21 Who's going to start? Mr. Kharasch?

22 MR. KHARASCH: Yes, I am, Your Honor, with a
23 preliminary question: What's SFSP-C-2? This is
24 addressed to counsel. There has been no testimony on
25 it. There is no testimony on it. We have a piece of

1 paper floating around at this time as a counsel exhibit
2 with no testimony.

3 MR. WILSON: All right, Mr. Kharasch, excuse
4 me. I will add one more question, then.

5 BY MR. WILSON: (Resuming)

6 Q Mr. Fitzgerald, does SFSP-C-2 represent the
7 joint route and rate policy of Southern Pacific and
8 Santa Fe Railway as the merged company?

9 A It does.

10 Q Thank you.

11 JUDGE HOPKINS: Mr. Kharasch.

12 CROSS EXAMINATION

13 BY MR. KHARASCH:

14 Q Mr. Fitzgerald, please describe for us the
15 present organization of the Santa Fe traffic and
16 marketing organization which you head.

17 A I have about 660 people in my department. In
18 addition to a small headquarters staff, I have four
19 functional sections: the marketing department,
20 headquartered in Chicago, consisting of about 150 to 160
21 people, largely responsible for pricing activity; a
22 small field marketing section in San Francisco, Los
23 Angeles, and Dallas, Texas.

24 The second group would be the market
25 development and research. It consists of about 25

1 people, headed by Mr. Lawson, who will be a witness in
2 this proceeding. And its role is to conduct
3 longer-range studies, oftentimes commodity specific,
4 with respect to directions that our marketing activity
5 might take.

6 The third group, also consisting of about 25
7 people, involves itself in industrial development. That
8 is to say, locating industrial customers along the right
9 of way of Santa Fe.

10 And the fourth section, by far the largest,
11 consisting of close to 500 people, is our sales staff,
12 which is located in numerous points around the country.

13 Q Would you give us the names of the assistant
14 vice presidents that report to you?

15 A Yes. Mr. John A. Grygiel is assistant vice
16 president, traffic; Mr. J.B. Hardin, assistant vice
17 president of marketing; Mr. J.E. Wourk, assistant vice
18 president of sales.

19 Q And Mr. Grygiel is located where?

20 A All three of them are in Chicago.

21 Q Do you have regular meetings with these
22 people?

23 A Not regular in the sense that they are
24 scheduled, but I see them every day on the job.

25 Q And you are the person, according to your

1 statement, that is responsible for all marketing,
2 traffic, commercial and industrial development policy
3 activities, is that right?

4 A Certainly at my level. Mr. Cena participates
5 in decisions from time to time.

6 Q Are there any major marketing or traffic
7 policies of the Santa Fe that are not brought to your
8 attention for approval?

9 A I would hope not.

10 Q Are you or have you been a director of Santa
11 Fe Industries?

12 A No.

13 Q In 1983, did you participate in a study of
14 Santa Fe's operations in the future which was prepared
15 in order for presentation to the Santa Fe Industries
16 board of directors?

17 A No.

18 Q Do you know who did participate?

19 A Yes.

20 Q Who did participate in that study, sir?

21 A Mr. Booth, as I understand it, was the
22 principal author.

23 Q Please give the full name, if you would.

24 A Terry J. Booth was the principal author, as I
25 understand it. Having sat here through the week, I

1 believe I understood that Mr. Robert Keyes had some part
2 in it, and I'm aware that one of my analysts was on loan
3 to participate in that study and his name is Robert
4 Zdanky. I'm sure there were others.

5 Q In connection with that study, were there
6 interviews with people in the traffic and marketing
7 department that you head?

8 A Not to my knowledge.

9 Q Have you read that study, which appears in
10 this record as KCS-C-1?

11 A No.

12 Q Let me read you a statement and see if you
13 agree or disagree with it: "ATSF's traffic department
14 attributes UP's greater pricing freedom to the
15 following: one, a larger share of revenues from traffic
16 where no rail transportation alternative is available,
17 such as soda ash and coal."

18 Now, that far do you agree?

19 MR. WILSON: Excuse me, counsel. Where does
20 that statement come from?

21 MR. KHARASCH: That comes from page 0020 of
22 KCS-1.

23 JUDGE HOPKINS: Thank you.

24 MR. WILSON: Could you explain for the record
25 what KCS-C-1 is, for the witness also, since you are

1 asking him the question?

2 MR. KHARASCH: KCS-C-1 is a study presented on
3 May 16, 1983, to the board of directors of Santa Fe
4 Industries.

5 BY MR. KHARASCH: (Resuming)

6 Q I read you the statement. Just tell me
7 whether you agree or disagree with that statement.

8 A Soda ash is certainly an important commodity
9 for the Union Pacific. Whether it results in better
10 margins for them, I couldn't say.

11 Q The statement, sir, is: "ATSF's traffic
12 department attributes UP's greater pricing freedom to
13 the following: one, a larger share of revenues for
14 traffic where no rail transportation alternative is
15 available, such as soda ash and coal."

16 Let's break down the question. Do you think
17 that UP has greater pricing freedom than Santa Fe?

18 A I don't have an opinion on that.

19 Q Who in Santa Fe's traffic department would
20 have opinions about whether UP has greater pricing
21 freedom than Santa Fe?

22 A I don't know.

23 Q Do you have an opinion as to whether there is
24 no rail transportation alternative for carriage of
25 commodities such as soda ash?

1 A Yes, I have an opinion on that.

2 Q Please give it.

3 A I think there are alternatives.

4 Q So you disagree with the statement insofar as
5 it states that there is no rail transportation
6 alternative for soda ash?

7 A Yes, I do.

8 Q And here is a statement. How about the
9 statement insofar as it talks about transportation
10 alternatives for coal? Do you think there are
11 transportation alternatives for coal other than rail?

12 A There sure are.

13 Q Let's continue with this statement. It
14 begins: "ATSP's traffic department attributes UP's
15 greater pricing freedom to the following." We read
16 number one.

17 "Two, a lesser degree of rail competition in
18 much of its service territory." That is, UP's service
19 territory.

20 Do you agree that there is a lesser degree of
21 rail competition in UP's service territory?

22 A We're speaking now of rail competition or
23 competition?

24 Q Rail competition.

25 A Yes, I would say that for a considerable

1 amount of their territory they have less rail
2 competition than the Santa Fe does.

3 Q And does that less rail competition than the
4 Santa Fe has give UP greater pricing freedom?

5 A No, I don't think so.

6 Q Let me read you another statement and have you
7 state your agreement or disagreement: "The majority of
8 most railroads' traffic is involved in some sort of
9 interconnection with another carrier."

10 Do you agree?

11 MR. WILSON: Excuse me, Mr. Kharasch. Where
12 are you reading that statement?

13 MR. KHARASCH: 0024, KCS-1.

14 MR. WILSON: Thank you.

15 THE WITNESS: It's becoming progressively less
16 true. If it's true of the Santa Fe right now, it's
17 barely true. And I'm not really aware of what
18 percentage of the other railroads' freight is
19 interline. So to the extent that it goes beyond the
20 Santa Fe, I can't really respond to that.

21 BY MR. KHARASCH: (Resuming)

22 Q All right. Respond for the Santa Fe.

23 A As I said, about 50 percent of ours is local
24 and the rest is interline.

25 Q Keeping in mind the sentence we just heard:

1 "This factor is the key to understanding the
2 consequences of major rail consolidations, as wherever
3 possible the combining carriers can be expected to
4 reroute traffic interchanged with unaffiliated companies
5 to the new combination."

6 Do you agree or disagree?

7 A Well, "wherever possible" I think adequately
8 qualifies that statement. I think it's true.

9 Q "After a rail combination, the combining
10 carriers can be expected to reroute traffic interchanged
11 with unaffiliated companies to the new combination"?

12 A Wherever possible.

13 Q Would that be true of the proposed SPSF
14 consolidation?

15 A Again, wherever possible. But you know, I'm
16 concerned that perhaps you're not reading "wherever
17 possible and I am. "Wherever possible" is, as I am
18 hearing it, taking into account a multitude of factors,
19 starting, for example, with the costs, going through
20 shipper preference in the matter, and perhaps another
21 dozen conditions.

22 But all things being equal, I think that's
23 true, wherever possible.

24 Q At page 29 of KCS-C-1, there appears an
25 estimated Santa Fe trackage loss in millions of 1981

1 dollars to: first, the SP-Tucumcari Line; second,
2 PACRAIL; and third, BN-Frisco. And the total is given
3 as \$238.4 million estimated traffic loss to the Santa
4 Fe.

5 Do you agree or disagree with that estimate?

6 A I had nothing to do with preparing it and I
7 really don't have an opinion as to whether it's true or
8 not. I know that the diversion was substantial.

9 Q By "substantial," was the diversion from these
10 three occurrences over \$100 million?

11 A I certainly think so.

12 Q Was it over \$150 million?

13 A I think if you wait and ask that question of
14 Mr. Reyff, he will be able to tell you.

15 Q I'm asking you, sir, in your opinion.

16 A And I have told you, I don't have an opinion.
17 I know it's substantial. I know it's over \$100
18 million. It was substantial.

19 Q The statement is -- let me read you another
20 statement: "The relative magnitude of the combined
21 projected losses is probably not far from representing
22 ten percent of ATSF's revenues."

23 Do you agree, disagree?

24 MR. WILSON: Counsel, I object to that
25 question. The witness has already stated that he did

1 not participate in the study, and the ten percent figure
2 comes from the \$238 million figure, which the witness
3 has already stated he had no opinion on. I object to the
4 question.

5 MR. KHAKASCH: This man knows everything --

6 JUDGE HOPKINS: He is able to answer, though.
7 I will allow the question.

8 THE WITNESS: I would have to say that ten
9 percent would not be an unreasonable range. That's all
10 I can tell you.

11 BY MR. KHAKASCH: (Resuming)

12 Q Let me continue: "Such a loss affects
13 profitability more severely, due to the high fixed costs
14 associated with railroad operations."

15 Do you agree with that?
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1 A Railroads certainly have high fixed costs. We
2 have had to make some very severe reductions in our
3 expenses in order to offset the kind of traffic loss
4 that you have been referring to.

5 I think under the circumstances we have done a
6 pretty good job.

7 Q That is interesting but not quite my
8 question.

9 Is it true that a loss of traffic affects
10 profitability more severely due to the high fixed costs
11 associated with railroad operations?

12 A I thought I was trying to answer your
13 question. My answer is that if you can't offset your
14 expenses, it is true. We have through a program of
15 major cost reductions offset to a large extent those
16 losses in traffic.

17 Q And therefore, if you have offset those losses
18 in traffic to a large extent, to a large extent these
19 transactions have not caused a loss of profitability.

20 A In the short term, that is I think largely
21 true.

22 Q Do you think it is true of railroads generally
23 that they have high fixed costs?

24 A I testified I did.

25 Q Do you think it is true of railroads generally

1 that if they lose 10 percent of their traffic, they are
2 likely to lose more than 10 percent of their net
3 revenue?

4 A Depending on their ability to -- I'm sorry. I
5 need to have that question again.

6 THE REPORTER: Question: "Do you think it is
7 true of railroads generally that if they lose 10 percent
8 of their traffic, they are likely to lose more than 10
9 percent of their net revenue?"

10 THE WITNESS: The problem I have with your
11 question, Mr. Kharasch, is that I'm not sure I
12 understand your use of the word "revenue." Do you mean
13 net revenue from operations? Do you mean gross
14 revenues?

15 BY MR. KHARASCH: (Resuming)

16 Q Let's talk about gross revenues, that is,
17 revenues from traffic received from shippers.

18 A Gross revenue.

19 Q If you lose 10 percent of your revenue
20 received from shippers, are you likely, carrying it on
21 to the bottom line, to lose more than 10 percent of your
22 net revenue from the railroad business?

23 A It depends on your ability to control your
24 expenses.

25 Q The ability for Santa Fe, you have told us,

1 has been quite good. So you have controlled your
2 ability.

3 A It has been quite, quite painful is what it
4 has been.

5 Q But you have controlled your losses
6 successfully?

7 A In the short term.

8 Q And what do you think of the railroad industry
9 generally? Are they able to do what you did?

10 A I think the railroad industry in general is in
11 big trouble.

12 Q That's not what I'm asking. Is the railroad
13 industry in general, if they lose traffic, able to
14 control their losses by doing the same sort of thing
15 that Santa Fe did?

16 A I'm sure we all can do it to some extent or
17 other. It is certainly not unlimited.

18 Q Have you -- do you in your job pay any
19 attention to the results, financial results of the
20 people who are intervenors in this proceeding such as
21 the MKT and the D&RGW, the KCS and the UP?

22 A I pay at least a passing attention to their
23 stock prices and to their income statements, yes.

24 Q So do you examine their income statements to
25 see how their ratios of gross revenues and net revenues

1 are running?

2 A I don't pay much attention to that particular
3 item.

4 Q In preparation for this proceeding, did you
5 make any study of these intervening railroads'
6 financials and their ratios?

7 A I wouldn't call it a study. I did review some
8 numbers.

9 Q What numbers were those?

10 A I reviewed as to your railroad your
11 profitability and your operating ratio.

12 Q And you did that for all the intervenors, did
13 you?

14 A I'm not sure who all is intervening, but I did
15 look at I guess the principal intervenors.

16 Q And what figures specifically did you look at
17 in making this examination, annual reports, R-1s or
18 what?

19 A Yes.

20 Q Someone on your staff prepare any study for
21 you?

22 A A I tell you, there was no study. I asked to
23 have operating ratios and net income figures.

24 Q Let's return to KCS C-1.

25 I'm on page 0029, Counsel.

1 MR. RAKER: Excuse me. Do you suppose it
2 would be too much for me to have a copy of that so that
3 I can read along with him?

4 MR. WILSON: Would you provide the witness
5 with a copy, counsel?

6 MR. KHARASCH: We only have one.

7 MR. RAKER: I would like it to be clear on the
8 record that he is not, as I understand it, an attorney
9 in this case, and Santa Fe is in agreement that this
10 protected document is being furnished to the witness.

11 JUDGE HOPKINS: I don't think they would
12 object to it.

13 THE WITNESS: I'm only going to look at what I
14 am asked about.

15 I'm sorry, sir, what page?

16 BY MR. KHARASCH: (Resuming)

17 Q The pages are numbered, Mr. Fitzgerald, at the
18 lower right hand corner with a lot of zeroes, and I am
19 at 0029.

20 A Okay.

21 Q Focus on this statement: "Since railroads
22 have the ability to close gateways and routes as a
23 result of deregulation, the transactions may provide the
24 combining roads with additional opportunities to close
25 down important ATSF interchanges."

1 Let's take this in two steps, sir.

2 Do you agree or disagree that railroads have
3 the ability to close gateways and routes as a result of
4 deregulation?

5 A Subject to the authority of this Commission,
6 yes.

7 Q And do you agree with the second half of the
8 statement that the transaction -- and we are speaking of
9 the Tucumcari line, Pac Rail and the BN-Frisco
10 mergers -- these transactions may provide the combining
11 roads with added opportunities to close down important
12 Santa Fe interchanges.

13 A Yes, I do agree with that. In fact, that
14 happened.

15 Q Give some examples.

16 A Well, the Southern Pacific closed a number of
17 gateways in May of 1983. The Burlington Northern
18 followed suit in May of 1983. The Missouri Pacific
19 followed in the fall of 1983. The Union Pacific came
20 into it in June of 1984.

21 Q Describe for the Southern Pacific the
22 principal gateways that were closed and the traffic
23 flows affected.

24 A Well, I don't know quite how to answer your
25 question other than to say that the net effect of the

1 Southern Pacific's action was to require it to have its
2 long haul on traffic in which it participated.

3 Now, I suppose that would involve a number of
4 gateways.

5 Q Well, can you give us the most important Santa
6 Fe haul that was affected by the Southern Pacific
7 action?

8 A It would have involved our participation in
9 transcontinental traffic.

10 Q And the gateway there, sir?

11 A Any number, Stockton, Bakersfield, Los
12 Angeles, Kansas City.

13 Q And the next railroad you mentioned I think
14 was the BN.

15 What did the BN do, and what principal traffic
16 flows of the Santa Fe were affected?

17 A It did a similar thing. I don't know that we
18 were too greatly affected by that one.

19 Q What did the UP do?

20 A The Union Pacific had a similar program, has a
21 similar program.

22 Q And what principal traffic flows of the Santa
23 Fe were affected by the UP action?

24 A Well, it would have affected considerable
25 traffic moving transcontinentally between the east and

1 the southwest. It never became effective as against the
2 Santa Fe because we went to the Union Pacific and
3 negotiated a bilateral agreement with respect to routing
4 and reciprocal switching.

5 Q Tell us about that agreement.

6 A We approached the Union Pacific with respect
7 to restoration of efficient joint line routing. They
8 agreed that it was in the best interests of the railroad
9 industry and both companies to have joint routing, and
10 an agreement was reached, and that was it.

11 Q Did the agreement with the Union Pacific open
12 all previous routes that the Santa Fe had had with
13 them?

14 A I don't think so.

15 Q Did the Union Pacific, if you know, make the
16 same agreement with other carriers?

17 A I don't know that it was the same agreement.
18 I know that they made an agreement with the Southern
19 Pacific for one, and I suspect they did with others, but
20 I don't know.

21 Q Did the Santa Fe make the type of agreement
22 that you are describing with any other carriers and the
23 Union Pacific?

24 A Yes.

25 Q With?

1 A Southern Pacific, with Burlington Northern.
2 We were involved in negotiating one with
3 Missouri-Kansas-Texas.

4 Q Let's continue on page 0030 of KCS-1. The
5 statement says, "The opportunities each transaction
6 provides for expanded, single line ratemaking may impair
7 ATSF's marketing flexibility and adversely affect net
8 revenues, even on traffic retained by the Santa Fe."

9 And do you agree with that statement?

10 A Yes, sir. There is no question but that our
11 railroad is surrounded by the megacarriers.

12 Q But do you agree that the opportunities that
13 the mergers provided for expanded, single-line
14 ratemaking may impair Santa Fe's marketing flexibility
15 and adversely affect --

16 A Yes, as broadly read, I agree with it. From a
17 marketing standpoint, we are limited by what those
18 mergers have done.

19 Q Explain, please, how you are limited in your
20 marketing flexibility.

21 A We are not able to serve the principal
22 Mississippi River gateways as the other systems are, and
23 as businesses continued to shift away from the Chicago
24 gateway, those carriers are able to be in the market to
25 participate in that long haul, transcontinental

1 business, and we are not.

2 Q And that's true even if you can serve the
3 origins.

4 Let's take an example of an origin where the
5 Santa Fe serves the shipper, goods are going to these
6 Mississippi gateways that you spoke of. The Santa Fe
7 may serve the origin, but you can't get to the
8 destination.

9 A Not single line, that's right.

10 Q And that impairs your marketing flexibility?

11 A Yes, sir, it sure does.

12 Q And in fact, if the routes are closed, you
13 just can't get in there at all.

14 A Get where?

15 Q To this gateway on the Mississippi that the
16 cargo is going to.

17 A Well, if we serve the origin and we have
18 friendly connections to the Mississippi River gateways,
19 we can get into the Mississippi River gateways. It is
20 not as optimum an option for the shipper. You have to
21 rely on more than one railroad, but to the extent that
22 we are able to market, price and sell our services, we
23 are able to get it there.

24 Q You are able to get it there based on having a
25 friendly connection.

1 Suppose you have an unfriendly connection,
2 then you can't get to that gateway, can you?

3 A Well, my experience has been that at least so
4 far you may not have all the friendly connections in the
5 world, but if you are able to originate traffic in the
6 volume that we are able to originate it because of our
7 position on the west coast, we can normally find someone
8 that is willing to work with us.

9 Q Now, suppose you are dealing at a point where
10 say you and the UP both serve.

11 Are there such points?

12 A Sure.

13 Q All right, you are dealing with traffic that
14 moves from such a point. That traffic has to get, let's
15 say, to a point at the other end that is served only by
16 the UP. If the UP told you that you couldn't connect
17 with them, then you would have no way of getting the
18 traffic to destination.

19 That would be clear, wouldn't it?

20 A The other point is served only by the Union
21 Pacific?

22 Q Yes.

23 A Well, obviously in that hypothetical it speaks
24 for itself.

25 Q Right. It speaks for itself that it couldn't

1 move to an inclusive point served by the UP.

2 A As you pose the question, I think it answers
3 itself.

4 Q Yes, I think so, too, but it's the necessity
5 for you to say something.

6 JUDGE HOPKINS: He would like you to answer.

7 THE WITNESS: It is a tautology, I agree.

8 BY MR. KHARASCH: (Resuming)

9 Q All right.

10 Now, before you made your deal with the UP for
11 traffic moving from a commonly served Santa Fe and UP
12 point, moving to an exclusive UP point, did you have any
13 opportunity to move it until you made your deal with the
14 UP?

15 A Yes.

16 Q How?

17 A We have always had joint routes with the Union
18 Pacific, and as I told you, from the time they cancelled
19 their agreement, there was a 30 day notice, and during
20 that 30 day period we fixed it up. We entered into a
21 bilateral agreement with them which kept the routes
22 open.

23 Q So as far as the UP went, there was no time
24 that those routes were actually closed.

25 A That's right.

1 Q And as far as the BN went?

2 A There was about a month period where they were
3 closed.

4 Q And as far as the SP went?

5 A About a year and several months where they
6 were closed.

7 Q Let's take the SP example.

8 Are you aware that the SP has a line from
9 Houston to Texas City which I will call the Bayport line
10 on which there is a great deal of chemical industry?

11 A No.

12 Q Are you aware of where a great deal of
13 America's chemical industry is?

14 A I think so.

15 Q Please assume with me that there is a line
16 served only by the Southern Pacific between Houston and
17 Texas City along which there is some major chemical
18 industry.

19 A All right, sir.

20 Q Served exclusively by the SP.

21 Now, during the year or more that the SP had
22 cancelled your routes, was there any way for the Santa
23 Fe to move cargo from California or to California points
24 that you serve to the Southern Pacific served points?

25 A Let me take at least one direction at a time.

1 I think it is the same both ways, but can you tell me in
2 your hypothetical whose railroad the receiving industry
3 is on, westbound?

4 Q Let's assume it is at a point served both by
5 the SP and the Santa Fe, say, Los Angeles.

6 A We would not have been able to participate in
7 that traffic.

8 Q And moving the other way?

9 A I think the answer would have been the same.

10 Q Please, if you are --

11 A However, let me just add to that, if the
12 customer at the point of origin came to the Santa Fe and
13 said we want you to participate in that route, I think
14 there might have been an opening for us, but I'm just
15 not sure of that.

16 Q Let's turn to page 31 of KCSC-1, if you are
17 following along, Mr. Fitzgerald.

18 A Yes, sir.

19 Q The statement is made at the top of the page
20 that concurrent with SP's entry into Kansas City, it
21 published TOFC rates west of California and Arizona that
22 "significantly undercut" then existing rates.

23 Do you agree or disagree?

24 A I don't know. I was not in the traffic
25 department at that time.

1 Q On that page, 0032, under the general heading
2 "Consequences of the Staggers Act and Deregulation," and
3 I want to read to you a sentence beginning "Two of the
4 important consequences," that is, of the Staggers Act
5 and deregulation, "are as follows. One, railroads have
6 enhanced opportunity to favor their own single-line
7 routes between origin and destination points."

8 True or false?

9 A True.

10 Q Continuing, "This gives railroads flexibility
11 in citing single line rates, provided two conditions can
12 be met: A, the carrier can handle the movement on the
13 single line basis without any great circuitry; and B, it
14 is the only carrier serving either or both the origin or
15 termination."

16 Agree or disagree?

17 A I agree particularly that that is true in
18 terms of rate reductions. I think it is less true with
19 respect to rate increases. So flexibility on the
20 downward side, certainly.

21 Q Flexibility to you means principally the
22 flexibility to lower rates?

23 A Mr. Kharasch, I didn't write this. I am
24 trying to explain to you what it means to me.

25 Q Yes. That's what I am asking you.

1 A Just because you have single line service and
2 serve only the origin or destination does not mean that
3 here are no competitive factors in the marketplace other
4 than railroads. I am saying that you can reduce your
5 rates, and you have the flexibility to do that. You
6 don't have the unfettered ability to raise your rates
7 because there are other competitive factors in the
8 market.

9 Q Those other competitive factors are people
10 like trucks and so on?

11 A Yes, sir.

12 Q Now, let's say we are talking about two
13 points and the trucks can offer a \$100 price for
14 carrying between the two points. Insofar as getting the
15 railroad rates up, you could come up to \$100 in general,
16 can you not, without losing the cargo to the truck?

17 A I just don't think I could generalize on that
18 without you giving me all sorts of other parameters.
19 What are the service requirements? What is the
20 trucker's flexibility in terms of making corresponding
21 reductions? What volumes is the shipment going to move
22 in? How heavy is it?

23 I have, as I told you, about 150 people that
24 live this day in and day out, and I assure you, it is a
25 pretty complex business.

1 Q And the objective of those people, no doubt,
2 is to obtain a good revenues as they can obtain without
3 losing the business.

4 A That is correct.

5 Q Do you think if two railroads are competing
6 for traffic between two points, and the traffic is open,
7 that that has an effect on raising rates or lowering
8 rates?

9 A I don't know whether it would have any effect
10 at all.

11 What is the traffic, what is the distance, how
12 does it move?

13 Q Well, let's go back and talk about the TCFC
14 rates west of California and Arizona.

15 A All right.

16 Q Assume that it is a fact that concurrent with
17 SP's entry into Kansas City, it published rates that
18 significantly undercut the then existing rates.

19 Would that not have an effect on the competing
20 railroad, requiring the competing railroad to lower its
21 rates, too?

22 A I can't answer that question, and let me tell
23 you why not. There are many times that one railroad
24 will meet the price cuts of another railroad. There
25 are many other times that railroads, for one reason or

1 another, will not meet the price cuts of another
2 railroad. So there is simply no answer to that. That
3 is going to apply in every case.

4 Q Let's go along, since we are at page 32 of
5 KCS-1, and read ourselves a little farther along here.

6 A All right.

7 Q Let's look at the bottom of the page, "It
8 would be difficult to quantify the value of increased
9 pricing flexibility. However, were ATSF able to reach
10 the current Staggers Act permitted revenue/cost ratio
11 level of 170 percent, a revenue increase of roughly 30
12 percent would result based on 1981 freight revenue
13 levels. This would amount to almost \$700 million of
14 allowable but unrealized profit."

15 So far, can we generally agree without
16 focusing on the precision of the figures that that is
17 true?

18 A Or the real world either, I assume.

19 Q The hypothesis is that if you were able to do
20 that, you could get some more money.

21 A That's Mr. Booth for you.

22 Q "Of course, a major portion of this unrealized
23 profit is not attainable due to constraints imposed by
24 competitive railroads and other modes of
25 transportation."

1 Let's stop there.

2 Agree or disagree?

3 A Oh, I agree with that.

4 Q "A significant portion of this unrealized
5 profit is not attainable due to constraints imposed by
6 competitive railroads and other modes of transportation,
7 but," and let's focus on this part, "a significant
8 portion may be available as a result of the pricing
9 freedom granted by the Staggers Act."

10 How do you feel about that?

11 A I think now he is back into theory again.

12 Let me put it this way. I certainly haven't
13 been able to discern that the freedoms that we have
14 gained from the Staggers Act have resulted in anything
15 other than a reduction in rate levels. Theoretically,
16 they can go to 170 percent of variable costs. That has
17 not been the trend on my railroad, I can assure you. We
18 have gone 30 percent in the other direction.

19 Q And that is due to constraints imposed by
20 competitive railroads and other means of transportation.

21 A Yes, sir.

22 Q Have you noticed, Mr. Fitzgerald, in your
23 work, that there are certain commodities moving certain
24 distances that tend nowadays to be carried almost
25 exclusively by railroad?

1 A There are some commodities that tend more than
2 others to be carried by the railroads. That list tends
3 to decrease over time, I have noticed.

4 Q Would you say that coal and grain and ores and
5 heavy chemicals --

6 MR. WILSON: Objection. Let's have -- that's
7 a compound question. Let's go through them one at a
8 time. The answer may be different for each commodity.

9 JUDGE HOPKINS: It might be a good idea, Mr.
10 Kharasch, because he probably will have a different
11 answer as to certain --

12 MR. KHARASCH: Let me pose the question a
13 different way.

14 BY MR. KHARASCH: (Resuming)

15 Q For the moment, getting away from KCS-1, and I
16 am looking at Mr. McNear's statement at page 14, Mr.
17 McNear on page 14 of his statement talks about UP's
18 origination of substantial volumes of coal, chemicals,
19 grain, scda ash and other important rail-dependent
20 minerals.

21 Now, would you agree with Mr. McNear --

22 MR. WILSON: I still object because it is
23 still a compound question and the answer still may be
24 different commodity to commodity. The fact that one
25 witness who is not a traffic expert has said

1 something --

2 JUDGE HOPKINS: That isn't the question. The
3 question is whether he agrees with Mr. McNear.

4 BY MR. KHARASCH: (Resuming)

5 Q That the UP originates substantial volumes of
6 coal, chemicals, grains, soda ash and other important
7 rail-dependent minerals.

8 A I would not agree with his characterization of
9 the word "dependent."

10 Q What do you prefer?

11 A And I guess I prefer your characterization
12 that there are commodities that tend to move on the
13 railroads.

14 Q Commodities that move, rail carriage of
15 commodities depends quite often, does it not, on the
16 length of haul involved?

17 A It is certainly a consideration, yes.

18 Q Let's take something like grain.

19 Does the Santa Fe carry a good bit of grain
20 from the U.S. grain breadbasket to the Gulf of Mexico?

21 A Yes.

22 Q And grain at the origin that grows on the farm
23 goes a short distance ordinarily before it gets to you,
24 does it not?

25 A Well, short or intermediate, I guess.

1 Q But in general grain is not moved from the
2 farm or the origin hundreds of miles, say, 800 miles to
3 destination.

4 A No. But it is certainly not unheard of to
5 have it move from one end of Kansas to the other, and
6 that is 500 or 600 miles.

7 Q Do you know what proportion of grain moves out
8 of elevators in Kansas, since you mentioned Kansas, to
9 the Gulf on rail and what proportion on truck?

10 A No, I don't.

11 Q In any event, in our discussion of grain, are
12 we agreed that the longer the haul, the more it tends to
13 move by rail?

14 A I would say either rail or barge, and less by
15 truck.

16 Q And in speaking of coal, would that be true,
17 too, the longer the haul, the more moves by railroad?

18 A Again, there are options, but obviously that
19 is true. A coal slurry pipeline might be going barge,
20 if that is a viable alternative in a given market, but
21 rail would be a predominant mode of transportation for
22 coal moving long distances. It tends to move by rail,
23 as you said.

24 Q Coal and grain are benefactors of the
25 railroads?

1 A I'm not sure I understand that, sir.

2 Q That's from Mr. McNear, "coal and grain as
3 benefactors of the rail industry," he says. He
4 describes them as staple rail-transported commodities.

5 A I would have to say that they are mutual
6 benefactors.

7 JUDGE HOPKINS: Mr. Kharasch, I am afraid it
8 is about time for us to end for the day.

9 MR. KHARASCH: For the government to close
10 down.

11 JUDGE HOPKINS: Otherwise they will throw us
12 out of this place.

13 We will be in recess, then. If we are open
14 tomorrow, we will be in recess until 9:30 tomorrow
15 morning in Hearing Room A. If not, stand by. As of
16 right now, continue it, other than that, to Tuesday.
17 That would be the next time. We will have to take it on
18 a day by day basis.

19 (Whereupon, at 12:15 p.m., the hearing in the
20 above-entitled matter was recessed, to reconvene at 9:30
21 o'clock a.m., Friday, October 5, 1984, or Tuesday,
22 October 9, 1984.)

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