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**REDACTED - PUBLIC VERSION**

UP/SP-384

**BEFORE THE  
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 32760 (Sub-No. 21)

**UNION PACIFIC CORPORATION, UNION PACIFIC RAILROAD COMPANY  
AND MISSOURI PACIFIC RAILROAD COMPANY  
-- CONTROL AND MERGER --**

**SOUTHERN PACIFIC RAIL CORPORATION, SOUTHERN PACIFIC  
TRANSPORTATION COMPANY, ST. LOUIS SOUTHWESTERN RAILWAY  
COMPANY, SPCSL CORP. AND THE DENVER AND  
RIO GRANDE WESTERN RAILROAD COMPANY -- OVERSIGHT**

**UNION PACIFIC'S FIFTH ANNUAL OVERSIGHT REPORT**

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**UNION PACIFIC'S FIFTH OVERSIGHT REPORT**

This is the fifth and final oversight report on the UP/SP merger.<sup>1</sup>

The Board may safely allow this oversight proceeding to close as scheduled.

Despite an infamous start, the UP/SP merger achieved all of the types of public benefits UP and SP had predicted. Foremost among these benefits was rescuing SP, which before the merger was providing the nation's worst rail service and nearing a financial crisis. The merger also enhanced competition in dozens of markets while harming competition in none.

The Board correctly held last year that the only remaining inquiry in this proceeding is whether its conditions preserved competition.<sup>2</sup> In Decision No. 16 the Board

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<sup>1</sup> The Board stated that its 2001 review "is scheduled to be the final round of this formal process." Decision No. 16, served Dec. 15, 2000, p. 13.

<sup>2</sup> UPC, UPRR, and SPR submit this report pursuant to Decision No. 44 in the UP/SP proceeding and Decision No. 16 in this sub-docket. We employ the acronyms in Appendix B to Decision No. 44. The following applicants have merged with UPRR: MPRR (on January 1, 1997); DRGW and SPCSL (on June 30, 1997); SSW (on September 30, 1997); and SPT

(continued...)

announced that the purpose of this proceeding is "to examine whether the conditions we imposed have effectively addressed the competitive issues they were intended to remedy." Decision No. 16, p. 13.

Under that standard, the Board has no reason to take any action other than to close the proceeding. In every relevant market, UP rates, adjusted for inflation, declined or were unchanged during the oversight period. With BNSF, TexMex, and URC competing effectively against UP, the Board's primary concern should no longer be with competition in the West but with ensuring that railroads earn adequate revenues to support existing and expanded service.<sup>3</sup>

Section I focuses on the most important benefit of the UP/SP merger: At a cost of billions of dollars, the merger saved the SP system. Before the merger, SP offered notoriously poor service and hemorrhaged red ink. SP's unsecured credit had "junk bond" status, it had accumulated negative cash-flow from operations in excess of \$1.5 billion in 12 years, and in 1994 was losing cash at a rate of nearly \$500,000 a day. For every dollar of revenue, it spent 16 to 18 cents more than its competitors. The SP system would not have survived intact. Thanks to the merger, the entire SP network today offers quality service.

In Section II, we summarize the many other benefits of this merger. These include shorter routes, expanded single-line service, reduced costs, improved service, enhanced

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(on February 1, 1998). As SPT no longer exists, we refer to the combined UP/SP rail system as "UP." We refer to SPR, SPT, and their rail affiliates collectively as "SP."

<sup>3</sup> We will show what happens to railroads that do not earn adequate revenues. See pp. 18-28, below.

safety, and increased investment. We also report on the UP/SP merger's ultimate success in the Houston/Gulf Coast area.

Section III describes how the Board's conditions enhanced and preserved rail competition in the West. UP continues to comply fully with those conditions, and our competitors continue to supply effective competition. We systematically analyze competitive benefits for shippers of every major commodity, including coal, Gulf Coast chemicals, and plastics; in every type of market, including "2-to-1" and "3-to-2" shippers; and in every corridor, including the Central Corridor.<sup>4</sup>

Our Confidential Appendix contains rate and other information for the fifth oversight year and the entire five-year oversight period. In real dollars, freight rates over the five-year oversight period did not increase for any traffic group potentially affected by the merger.<sup>5</sup> See Confidential Appendix E.

As in prior years, the evidence shows that the Board preserved rail competition in the West and that the UP/SP merger enhanced it. The Board should conclude for the fifth time that intramodal competition remains vibrant in the West. Accordingly, UP asks the Board to terminate this oversight proceeding.

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<sup>4</sup> In five years of oversight proceedings, no party has presented concrete evidence of competitive harm. We note that a transportation consultant is soliciting clients to fund a study of the merger. Before conducting the study, the consultant has already concluded that it will show competitive harm. See Exhibit No. 1.

<sup>5</sup> We understand that the Government Accounting Office will issue a report on July 6, 2001, in which it will study the effects of the merger on freight rates in Utah and Nevada. We will comment on the report when it is released.



I. THE UP/SP MERGER PRESERVED THE SP SYSTEM

The merger conferred no greater benefit than this: It saved the SP. SP was approaching a financial crisis. Shippers tried to avoid its erratic and slow service. Because of high costs and low revenues, SP could not afford essential capital investments and was losing the ability to compete. Had the merger not occurred, SP would have withdrawn from markets where it competed with BNSF and UP, increased rates for solely served shippers, and eventually collapsed.

We present here for the first time a detailed account of SP's pre-merger predicament from inside SP's management. The Verified Statement of John T. Gray, SP's Vice President-Network and Corporate Development before the merger, describes in detail SP's increasingly daunting circumstances.

Part A of this section describes SP's approaching financial crisis. Part B recalls SP's inadequate service. Part C discusses SP's inability to make investments essential for adequate service. Part D predicts SP's likely fate without the merger. Part E discusses UP's enormous investment to resurrect SP.

A. SP Was Approaching a Financial Crisis

In 1982, Forbes Magazine issued a somber warning: SP was "Doomed."<sup>6</sup> By 1995, SP was spiraling toward collapse, just as Forbes had predicted. Independent observers concluded that SP could not survive.

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<sup>6</sup> See James Cook, "On the Fast Track To Trouble," Forbes (Aug. 16, 1982), pp. 57-60 (Exhibit No. 2).

When UP and SP proposed to merge, the California Attorney General asked a team of economists to study SP. They, too, concluded that SP was doomed:

In our opinion, SPR will continue to generate a negative net cash flow from operating activities for the foreseeable future. . . . We believe that it is unlikely that SPR will be able to obtain the cash required from asset sales, or from the capital markets in the amount required, when required, and on acceptable terms. Therefore, we do not expect that SPR on a stand-alone basis will remain a viable major western railroad.

JurEcon, Inc., An Analysis of Southern Pacific Rail Corp., April 24, 1996, p. 12, CA-AG-2.

Major customers such as Exxon Chemical and Bayer reached the same conclusion:

After many discussions with SP and assessments by our advisors, we do not believe the SP would survive as an independent railroad if this merger were not to occur. Its financial strength and level of service have been on the decline and we are concerned that this trend will continue.

Townsend V.S., Exxon Chemical Americas, UP/SP-25, Pt. 1, p. 164.

Southern Pacific is so financially weak that we believe that they cannot solve our service problems or effectively compete over the long run with Union Pacific or the newly-merged BN/Santa Fe.

Phalin V.S., Bayer Corp., UP/SP-25, Pt. 1, p. 57.

SP's management was well aware of the company's predicament. It recognized during the 1970s that SP earned inadequate revenues. SP responded by diversifying into other businesses, including telecommunications, trucking, and insurance. For example, SP transformed its railroad microwave system into the predecessor of SPRINT, the well-known communications company. By the end of the 1970s, SP also owned Ticor Insurance Company. SP began to exploit its urban real estate, transit corridors, and land-grant tracts.



Diversification did not save SP. Indeed, it may have doomed the company, as Forbes concluded in 1982. According to Forbes, SP had broken a cardinal business principle: "A capital-intensive company with an inadequate cash flow [the railroad] should never, repeat *never*, diversify into another capital-intensive business."<sup>7</sup> SP had fallen into this trap by diversifying into the capital-intensive business of telecommunications.<sup>8</sup> "The result [was] that [SP had] the worst of two worlds, and some analysts [were] privately speaking of it as 'a potential Penn Central.'"<sup>9</sup> Forbes observed that, "[l]ike the Penn Central before it, the Southern Pacific has been slowly starving for lack of business," and "SP's slide may be irreversible."<sup>10</sup>

SP's financial predicament deepened during the 1980s and 1990s. As John Gray explains, SP did not earn enough to invest, could not invest enough to provide quality service, and therefore could not improve its earnings. After surviving for years on the proceeds of asset sales, SP had run out of resources. It was caught in a vicious circle.

For over a decade, SP generated negative net-operating cash flows. Gray V.S., p. 28. Between 1983 and 1994, SP posted a staggering operating cash-flow deficit of over \$1.5 billion. Id.; see also, Yarberry V.S., UP/SP-22, p. 281. In 1995, the company hemorrhaged cash at a rate of half a million dollars a day. In contrast, UP, BN, and Santa Fe collectively

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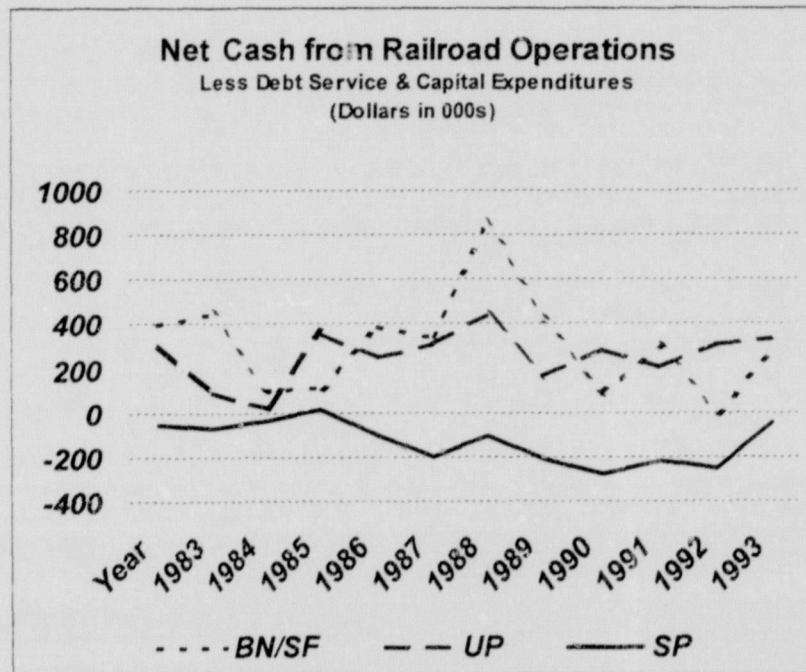
<sup>7</sup> Exhibit No. 2, p. 57.

<sup>8</sup> In 1980, Southern Pacific Communications absorbed 11 percent of SP's capital expenditures, 26 percent in 1981, and 40 percent by 1982.

<sup>9</sup> Id.

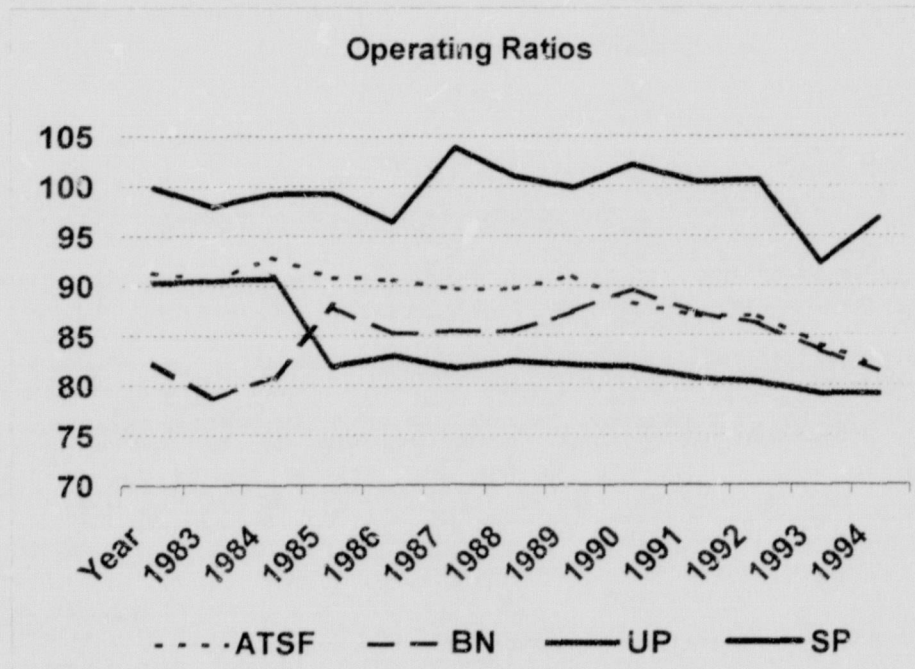
<sup>10</sup> Id. at 57, 60.

generated \$6.8 billion in operating cash flow over the same period. Id. The graph below depicts SP's relative disability.



See Yarberry V.S., UP/SP-22, Table 4, p. 281.

Another key measure of railroad health, the ratio of operating revenues to operating costs (operating ratio), similarly depicts a dramatic difference between SP and its competitors, BN, UP, and Santa Fe. SP operated far less efficiently than the others. Its operating ratio hovered near 100, while its competitors' operating ratios declined toward 80 or below. SP's efficiency deficit crippled it in competing with other western railroads and other transportation modes.



See Yarberry V.S., UP/SP-22, Table 3, p. 277.

Throughout the 1980s, SP faced intensifying competition, yet its cash flow failed to cover operating expenses and the investments essential for competition. To cover this gap, SP had two choices: borrow heavily in the capital markets or sell non-rail assets. SP tried both. It increased its debt-to-equity ratios by borrowing and sold assets to subsidize maintenance expenditures and fund a few capital improvement projects. SP sold SPRINT in 1983 for \$750 million in cash and \$300 million in assumed debt. It sold Ticor in 1984 for \$271 million. See Gray V.S., p. 30. Between 1989 and 1994, SP also sold approximately \$2 billion in real estate and transit corridors. Yarberry V.S., UP/SP-22, p. 284.

SP spent those funds to remain afloat. During the same six-year period, 1989 through 1994, SP's capital expenditures totaled \$2.1 billion, or roughly \$350 million a year. *Id.* As these numbers show, SP funded capital improvements before the UP/SP merger by selling



assets. But as the operating ratios demonstrate (and as shippers would later testify in the UP/SP merger proceeding), these minimal capital expenditures were inadequate to allow SP to compete.

By 1995, SP was running out of assets to sell. The subsidiaries, urban parcels, and transit corridors were gone. SP's alternative -- turning to the capital markets -- was either impossible or prohibitively expensive. Gray V.S., p 32. In 1995, the company's debt-to-capital ratio rose to 63 percent, notwithstanding SP's attempt to lower its debt by an equity offering in 1993. Yarberry V.S., UP/SP-22, p. 285. Watching SP's financial situation, the market realized that SP was failing behind its competitors and that the future looked grim. In 1995 Standard and Poors stated "[SPR's] financial performance has deteriorated in recent quarters, while competing railroads are posting improved results."<sup>11</sup> Just as SP could no longer rely on non-rail assets to subsidize capital improvements, the company could no longer call on the capital markets.

SP's inability to finance improvements clashed with the evolving needs of its customers. Many customers were adopting "just-in-time" inventory management. Gray V.S., p. 18. By keeping inventory levels low, companies could realize remarkable savings. But shippers required reliable transportation service to prevent shortages of parts and raw materials. According to Peter Murley of Distribution Services of America, SP's customers were "all striving to operate more efficiently by cutting back inventories and relying on 'Just In Time' deliveries. There is no room for inconsistent transit time and late deliveries within this atmosphere."<sup>12</sup> Unfortunately, SP led the industry in inconsistent transit time and late deliveries.

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<sup>11</sup> See Yarberry V.S., UP/SP-22, p. 286.

<sup>12</sup> Murley V.S., Distribution Services of America, UP/SP-25, Pt. 1, p. 155.

B. SP Offered Inferior Service

SP's service problems were notorious. Owens-Illinois, Inc. summarized the situation: "SP has had a reputation for the poorest service in the railroad business."<sup>13</sup> Cavenham Forest Industries declared SP "a nonentity in the rail marketplace" and "had refused to use them for shipments to Phoenix."<sup>14</sup> Literally hundreds of shippers savaged SP's service in the UP/SP merger proceeding.<sup>15</sup>

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<sup>13</sup> Krause V.S., Owens-Illinois, Inc., UP/SP-25, Pt. 1, p. 341.

<sup>14</sup> Reyneke V.S., Cavenham Forest Industries, UP/SP-25, Pt. 3, p. 96.

<sup>15</sup> Many SP shippers chronicled SP's service problems. These customers included: Chemicals Products Corp., Consolidated Oil & Transportation Co., Golden Peanut, Co., Hannibal Industries, Inc., Kavanagh Associates, Keystone Terminals, Inc., Long Island Intermodal Sales, MACSTEEL, MBT Fertilizers, Inc., Pacific Coast Producers, Piggyback Plus, Inc., Pioneer Chloa Alkali Co., Premier Juices, Red Star Yeast & Products, Rexene Corp., Riss Intermodal Corp., Springfield Group, Terminal Consolidation Co., USA Industries, Inc., Western Intermodal Forest Products, Inc., ABL-TRANS Co., Alex Trading Inc., All-Coast Forest Products, Inc., Alliance Steel Service and Brokerage Co., Asset Based Intermodal Co., Barton Beers, Ltd., Basin Fertilizer & Chemical Co., Bay State Milling Co., Bonus Crop Fertilizer, Inc., Builder Marts of America, Inc., Calumite Co., Coffey & Camp Lumber, Compass Consolidators, Inc. (Cincinnati), Dairyman's Cooperative Creamery Association, El Dorado Chemical Co., G.S. Roofing Co., Galaxy Transport, Inc., General Mills, Inc. Georgia Pacific Corp., Glidden Co., Hoechst Celanese Chemical Group, Home Lumber Co., Honeyeard Products Co., Interamerican Logistics, Inc., Intermountain Orient, RFL Division, ITG Transportation Services, Inc., J.H. Baxter & Co., JTS Enterprises, Inc., Navajo Western Asphalt Co., Pacific Chemical Distribution Corp., Pozzolan International, Raven Logistics, Inc., Reddy Raw, Inc., Rhone-Poulenc North American Chemicals, Santiam Midwest Lumber Co., Abilene AG Services Supply, Inc., Arizona Grain, Inc., Banks Lumber Co., Boer Commodities, Inc., Buckingham Branch R.R., Comtrak, Inc., Continental Paper Grading Co., Cook Flour Co., Crete Carrier Corp., Duro Bag Manufacturing Co., Eastern America, ERO/Goodrich Forest Products, Inc., Fort Vancouver Plywood, Co., General Intermodal Service, Inc., Hamilton Materials, Inc., Imperial Grain Growers, Inc., Industrial Logistics, Inc., Jacob Hartz Seed Co., Lesbro Co., LMS International, Mazzei-Franconi Co., Mid-South Transload Co., Newport Steel Corp., Pinole Point Steel Co., Rockwell Intermodal, Inc., S.E. Rykoff & Co., Smith Seed Services, Target Transportation, Texas, Gonzales & Northern Ry., Tricon Timber, Inc., and United Refrigerated Services, Inc. For other examples of service problems experienced by SP customers, see the support statements of Continental General Tire (noting SP's failure to meet marketing commitments, promised improvements, or follow through on marketing programs), Hills Brothers Chemical Co. (same), and Paradise Tomato Kitchens, Inc. (same).



1. SP could not compete on service

In the mid-1990s, SP provided the worst rail service in the West. Its transit times were much longer and much less reliable than those of its competitors. As John Gray notes, SP's shortest transit times often exceeded its competitors' longest transit times. Gray V.S., p. 4. For example, BN moved lumber from the Pacific Northwest to Chicago in six to seven days. SP's transit times ranged from nine to eighteen days. See id. In BN's worst periods, when it experienced the worst congestion and delays, its cars still arrived two days ahead of shipments on SP.

SP's disappearing produce trains underscored SP's service failures. SP had once operate entire fleets of daily trains from both Southern and Northern California to the Midwest and Northeast. Gray V.S., p. 5. As SP's service declined, customers abandoned the railroad in favor of trucks and competing rail carriers. Sunkist reduced its SP shipments from 40,000 tons in 1990 to 50 carloads in 1995. Id. at 5-6. By then SP consumed up to 18.1 days to move food products from California to the Midwest, a market it had once dominated. Santa Fe took only 4.8 to 6.2 days. See id. at 5. Santa Fe inherited the business that trucks did not win.

SP's equipment was unreliable and inadequate.<sup>16</sup> Its aging locomotives failed at unacceptable rates,<sup>17</sup> and it needed up to 400 more locomotives to power its trains because of its poor service. Only 400 of SP's 1600 refrigerator cars were reliable enough to travel across the

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<sup>16</sup> See Frazier V.S., Red Wing Co., UP/SP-25, F-1, p. 393 ("Southern Pacific has had an inadequate supply of refrigerated equipment for our shipments of frozen foods. It apparently has been unable to make the capital investments necessary to improve their refrigerated fleet equipment levels because of capital constraints.").

<sup>17</sup> In 1995, SP owned fleets of locomotive models that UP had retired 15 years earlier. SP operated the oldest SD-7 locomotive in America. Gray V.S., p. 36.

country. SP lacked the centerbeam cars its forest products customers demanded. Other customers experienced a shortage of coil cars.<sup>18</sup> Still others suffered inordinate delays due to equipment shortages and switching snafus.<sup>19</sup>

SP's shippers suffered. FMC expressed its frustration with SP service levels, complaining that "one car which was destined for Chicago was lost in the St. Louis switching district for 4 days . . . . In addition, El Paso has been choked, slowing movements to the west. These problems have slowed our deliveries significantly and increased the turn time for our equipment."<sup>20</sup> Hoechst Celanese Chemical Group had "experienced serious problems with service on the SP." The company had to increase its tank car fleet because SP could not achieve satisfactory cycle times.<sup>21</sup> MBT Fertilizers, Inc. found that delivery of cars by SP "was so poor that the appearance of a rail car at our facility was always a surprise."<sup>22</sup> Krueger Engineering & Mfg. Co. had witnessed "shipments of steel plate from Chicago area mills that seem to wander aimlessly around the country, sometimes through California, before finally reaching its plant in Houston."<sup>23</sup> BMW automobiles arrived with damage.<sup>24</sup> Clorox shipped hundreds of carloads of chlorine, bleaches, cleaning product, cat litter, salad dressing, and charcoal briquettes via rail

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<sup>18</sup> Bellesen V.S., California Steel Industries, Inc., UP/SP-25, Pt. 3, p. 80.

<sup>19</sup> E.g., McEntee V.S., Cook Flour Co., UP/SP-25, Pt. 4, p. 135. See also Gentz V.S., Long Island Intermodal, UP/SP-25, Pt. 2, p. 387 ("Currently we experience delays on the SP at St. Louis with a shortage of flat cars and at Kansas City due to power shortages.").

<sup>20</sup> Abbott V.S., FMC Corp., UP/SP-25, Vol 4, Pt. 1, p. 174.

<sup>21</sup> Seawright V.S., Hoechst Celanese Chemical Group, UP/SP-25, Pt. 1, p. 226.

<sup>22</sup> Gorda V.S., MBT Fertilizers, Inc., UP/SP-25, Pt. 4, p. 362.

<sup>23</sup> Krueger V.S., Krueger Engineering & Mfg. Co., UP/SP-25, Pt. 1, p. 260.

<sup>24</sup> Swain V.S., BMW, UP/SP-25, Pt. 1, p. 61 ("Past and current vehicle movements by Southern Pacific have resulted in higher than industry accepted damages to automobiles than other railroad companies.").



from its facilities in Georgia, Tennessee, and Ohio to Los Angeles and Stockton. Although SP served those destinations via the Sunset Route through El Paso, "Clorox discontinued intermodal shipments [via] El Paso because of poor service from SP."<sup>25</sup>

SP's service deteriorated throughout its system and across all lines of business. SP's facility at Colton, California, was described as "truly a 'black hole;' cars enter that area and disappear for days."<sup>26</sup> SP's rail yard in San Antonio was "notorious for its congestion."<sup>27</sup> Richard Fetzer of Patterson Frozen Foods testified that "we have been experiencing horrible rail transit times by going through SP's Roseville, California and Kansas City terminals. This is primarily due to terminal facilities which are in dire need of improvements, but SP . . . does not have the resources to make improvements to those terminals."<sup>28</sup>

SP lost traffic to other railroads. Poor service drove Hickson Kerley, Inc. to use SP's competitors: "On a number of routes where the destination is not SP only, we ship via other carriers to avoid having to use the SP. In some cases we even truck to avoid the problems encountered with SP service."<sup>29</sup> Similarly, Interdom Partners shipped approximately 60,000 containers per year on the Class I railroads. Although SP served its markets, Interdom said,

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<sup>25</sup> Childers V.S., Clorox Co., UP/SP-25, Pt. 1, pp. 102-03.

<sup>26</sup> Krause V.S., Owens-Illinois, Inc., UP/SP-25, Pt. 1, p. 341. See also Griffith V.S., Crown Pacific Lumber, L.P., UP/SP-25, Vol. 4, Pt. 4, p. 158 ("We have encountered frequent equipment shortages and major delays at SP facilities, particularly at West Colton in California (often referred as the 'black hole')."); Wueste V.S., Golden Peanut, UP/SP-25, Vol. 4, Pt. 1, p. 195 ("In the past our shipments to the west coast were slow and cars were often lost once they arrived in Colton, Ca. yard.").

<sup>27</sup> Schachter V.S., Golden Aluminum Co., UP/SP-25, Pt. 3, p. 193.

<sup>28</sup> Fetzer V.S., Patterson Frozen Foods, Inc., UP/SP-25, Pt. 4, p. 434.

<sup>29</sup> Quinton V.S., Hickson Kerley, Inc., UP/SP-25, Pt. 1, p. 221.



"We have not utilized [SP] in over five years due to service concerns."<sup>30</sup> Instead, it used UP and BNSF to handle its container business.<sup>31</sup> Coast Energy Group chose not to ship propane on SP to Reno, Bakersfield, and Oroville, California, "due to unreliable rail service."<sup>32</sup> Consolidated Oil & Transportation Co. did "the least amount of business with the SP of all the major western carriers," because SP's service did not meet COTC's needs.<sup>33</sup>

SP lost traffic to trucks. For example, Crown Pacific Lumber had shipped almost half of its forest products by rail, giving SP 5,000 carloads annually. But SP failed so frequently that Crown Pacific stopped using rail service to its SP-served facility in favor of trucks.<sup>34</sup> Similarly, Fought & Co. transloaded about one-third of its inbound steel shipments to its Tigard, Oregon, facility from other railroads to trucks to avoid SP.<sup>35</sup>

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<sup>30</sup> Rudie V.S., Interdom Partners, Ltd., UP/SP-25, Pt. 1, p. 241.

<sup>31</sup> Numerous SP shippers were forced to use other railroads because of SP's service problems or lack of resources. These companies, whose statements appear in UP/SP-25, included: Amvac Chemical Corp., Buckman Laboratories, Inc., Chemical Products Corp., Piggyback Plus, Gilman Paper Co., Grove Lumber, Hickson Kerley, Inc., Landmark Forest Products, LMS International, Midstate Lumber Corp., Navajo Western Asphalt Co., and Sundance Lumber Co.

<sup>32</sup> Hunder V.S., Coast Energy Group, Inc., UP/SP-25, p. 130.

<sup>33</sup> Herbert V.S., Consolidated Oil & Transportation Co., UP/SP-25, Pt. 2, p. 150.

<sup>34</sup> Statement of Maria Griffith, Crown Pacific Lumber, L.P., UP/SP-25, Pt. 4, p. 157-58. In the UP-SP merger proceeding, many shippers established that they were forced to use trucks to haul their business due to SP's poor service problems or inadequate resources. Customer statements addressing this issue appear in UP/SP-25 or UP/SP-36 and, whose statements appear in UP/SP-25, include: Coast Energy Group, Crowman Corp., Fisher-Price Toys, Golden Peanut Co., Hickson Kerley, Inc., Krueger Engineering & Mfg. Co., Maks Wood Products Co., Premier Juices, All-Coast Forest Products, Inc., Golden Aluminum Co., Northwest Container Services, Inc., Northwest Packing Co., Bayer Corp., Intermountain Orient/RFL Division, and Shasta Sweetener.

<sup>35</sup> See Statement of Alan Humbard, Frought & Company, Inc., UP/SP-25, p. 184.

SP's service failures also caused SP customers to lose business. Holman Distribution Center "lost the Tropicana account which we had had for a number of years in Portland to a competitor which was served by the Union Pacific. The reason given was that the service provided by the Southern Pacific was inadequate and did not meet Tropicana's expectations."<sup>36</sup> Cascade Empire, which had shipped approximately 3,300 carloads of lumber annually, declared that "occasionally" [it would] not buy from SP-served mills for fear orders will not ship promptly due to poor equipment availability or poor transit time."<sup>37</sup> MFP of Oregon shipped hundreds of carloads of lumber via rail from the Pacific Northwest to various points throughout the United States. Due to SP's poor service, MFP lost sales:

We depend on having [carload quantities of] traffic moving on railroads that can offer dependable service and competitive rates. With the financial health of the Southern Pacific a constant issue - we have experienced neither. We have customers who, due to the poor service, now refuse to buy wood originated on the "SP."<sup>38</sup>

Similarly, "Roseburg Forest Products has been disadvantaged . . . by non-competitive service provided by SP and has lost customers entirely, because SP rail service has not been comparable with that available to competitors located on the Union Pacific or the Burlington Northern railroads."<sup>39</sup>

SP's customers recognized that SP's financial straits caused these costly service problems. The CEO of Navajo Western Asphalt Co., Leland Brake, had dealt with SP for over 25 years. His company "lost hundreds of thousands of dollars in additional costs as a result of

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<sup>36</sup> Hobbs V.S., Holman Distribution Center, UP/SP-25, Pt. 1, p. 233.

<sup>37</sup> Greene V.S., Cascade Empire Corp., UP/SP-25, Pt. 4, p. 104.

<sup>38</sup> Dawson V.S., MFP of Oregon, Inc., UP/SP-25, Pt. 1, p. 276.

<sup>39</sup> Williams V.S., Rosenberg Forest Products Co., UP/SP, Pt. 1, p. 419.



service problems on the SP railroad in the past three years.”<sup>40</sup> Notwithstanding the losses his company suffered, he did not fault SP employees, but rather SP’s tenuous financial situation:

It has been my experience working with the SP personnel that they are bright, hard working, energetic people who are simply not able to maintain the railroad they operate to the standards they themselves would like to be able to achieve. The frustration I have felt with these poor individuals who are responsible for maintaining this railroad is genuine. I know they would like to fix the problems if they had the equipment and finances available. It is obvious they do not have this because their railroad would not be in the shape it is in presently.

Id.<sup>41</sup>

2. SP could no longer compete on price

Before the UP/SP merger, SP had become a low-price carrier because its product was so poor. It had no choice but to cut its prices in order to hang on to any business that enjoyed a competitive alternative. Gray V.S., p. 20. John Gray explains, for example, that SP had to focus on international intermodal transportation because it could not provide premium service at premium rates. Id. at 12. Even when lower prices made SP a successful bidder, as it did with Geneva Steel, it sometimes could not carry the traffic because it could not supply freight cars. Id. at 7.

SP could not sustain a strategy of charging discount rates, though, because it was the highest-cost railroad in the West. SP’s poor service resulted directly in higher operating costs. A railroad that provides bad service does not lower its operating costs. Gray V.S.,

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<sup>40</sup> Leland S. Brake, CEO Navajo Western Asphalt Co., UP/SP-25, p. 308.

<sup>41</sup> SP’s customer surveys confirmed that its customers preferred to use other rail carriers. As John Gray notes, SP’s surveys rated Santa Fe, BN, and UP twice as high as SP for transit times, service consistency, equipment supply, and equipment condition. Gray V.S., p. 18.

pp. 21-22. Long transit times require extra cars and locomotives.<sup>42</sup> The railroad must pay more car hire because cars spend more time on its lines. Train delays require more crew starts, producing higher labor costs. This helps explain why SP consistently had higher operating ratios than its competitors.

SP was also the highest-cost carrier because of its route structure and traffic densities. SP's routes climbed most of the big mountain ranges of the West. Its Central Corridor route ascended a three percent grade to Tennessee Pass at over 10,000 feet, the highest mainline rail passage in the West. SP had to maintain \$24 million worth of helper locomotives at Minturn, Colorado, to push trains over this mountain. Gray V.S., p. 9, n.4. And the California-to-Midwest manifest trains that used these helpers had previously required helper locomotives to climb the Sierra Nevada. A competing UP manifest train, however, traveled from Oakland to Chicago without a single helper. Id. at 24.

SP's unit costs were higher than Santa Fe's and UP's because SP's traffic densities were lower. On the Central Corridor, UP carried over 120 million gross tons per mile across Wyoming. SP carried only about one-quarter as much freight, and densities were lower than that on much of its route. Except on the Sunset Route between El Paso and Los Angeles, SP carried far lower volumes of traffic than its rail competitors. Id. at 23. Yet because its lines were single-tracked, it incurred extra maintenance costs. Unlike Santa Fe and UP with their double-track lines, SP could not shut down a track for repairs and continue to operate on the other. Id.

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<sup>42</sup> For example, SP's long transit times caused it to incur \$265 more in equipment costs for every carload of lumber from the Pacific Northwest to Chicago. Gray V.S., p. 21. As John Gray notes, BNSF could make money by charging less than SP's costs.



C. SP Was Unable to Make Essential Capital Investments

SP knew that its customers demanded better service and that it had to make capital investments to provide that service. A decade of inadequate cash flows had left SP with a long list of urgent capital improvements. But SP could not afford them. Instead, it often substituted stop-gap measures that increased operating expenses to compensate for the capital it lacked. In 1995, it faced a potent new competitor prepared to spend billions to take away its traffic.

In his verified statement, SP Chairman Philip Anschutz described a number of essential investments. They included combining and upgrading carload and intermodal terminals facilities to reduce delays and to increase bypass capabilities; adding route capacity, particularly on the Sunset Route and the Tucumcari Line, to reduce congestion and to improve transit times, service reliability and consistency; improving train dispatching and other technological systems designed to increase operating efficiencies; increasing tunnel clearances, particularly on the I-5 and Central Corridors, to allow doublestack container traffic; expanding car supply; and building new intermodal terminals and new reload and distribution centers.<sup>43</sup> But as Mr. Anschutz noted, SP lacked the financial resources to fund these projects.

John Gray's verified statement provides the details. Before the UP/SP merger, SP believed that these investments were the bare minimum needed to remain competitive. SP studied its requirements and identified needs far beyond its means. It cut that list down to a mere \$1.3 billion of essential projects, but SP could not afford them either. See Gray V.S., p. 32. Some of the projects SP could not fund were as follows:

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<sup>43</sup> See Verified Statement of Philip F. Anschutz, UP/SP-22, p. 188.

- \$101 million to rehabilitate and expand its existing terminals. More specifically, the company wanted to rehabilitate the terminal at Roseville; create inter-yard connections at Armourdale Yard at Kansas City; extend the yard tracks at Strang, southeast of Houston; construct two additional tracks and extend two other tracks at Herington, Kansas; extend tracks at Dayton, northeast of Houston; reconfigure the yard at Avondale near New Orleans; construct a tail track at Lake Charles; construct a cross-over in Houston; replace the hump retarders at City of Industry, California; rehabilitate the yard at Eugene; construct additional bowl and receiving tracks at West Colton; and expand capacity at Miller Yard in Dallas. See id. at 36-37.
- \$274 million to construct new intermodal, auto, and other facilities. For example, SP needed to expand its intermodal facilities at Kansas City, Avondale, Los Angeles (ICTF), San Antonio, and Oakland. It needed to expand auto facilities at Benecia, Salt Lake City, Chicago, Denver, Galena Park, Phoenix, and Valla. It needed to purchase land and construct new intermodal facilities in Chicago (costing \$60 million), Memphis (\$20 million); and Southern California (\$68 million). It needed to invest \$40 million to construct or improve transload facilities for bulk commodities in Los Angeles, San Francisco, Portland, El Paso, Houston, Kansas City, and Pine Bluff. See id. at 37-38.
- \$500 million for capacity improvements. For example, SP had insufficient funds to finance the following assortment of capacity-improving projects it had collected over the years: rail and bridge work between Topeka and El Paso (costing \$32 million); new and extended sidings and CTC between El Paso and Herington (\$86 million); additional double track between El Paso and Carizozo (\$15 million), between Pomona and Colton (\$38 million), and between Colton and El Paso (\$183 million); track and bridge work and CTC between Tracy and Martinez (\$32 million); bridge upgrade at Victoria (\$3 million); tunnel improvements for automotive and doublestack operations in the Sierras (\$18 million); CTC and extended sidings on the "Rabbit" line northeast of Houston (\$35 million); rail and extended sidings between Pueblo and Kansas City (\$30 million); and a new international bridge at El Paso (\$30 million). See id. at 34-35.
- \$328 million to acquire new grain cars and locomotives. SP also needed to rebuild its aging switcher locomotive fleet. See id. at 35-36.
- \$100 million in technology improvements. SP needed to replace its outdated operating system. See id. at 38.

As John Gray explains, SP's \$1.3 billion estimate for these projects was far too low. SP had underestimated the costs of most of these investments. UP has performed many of the projects on SP's list, and the costs were much higher than SP had assumed. See, e.g., id. at 35.



Moreover, SP's list of investments did not include hundreds of millions of dollars to remedy a growing track maintenance deficit. SP's senior maintenance officer during the first half of the 1990s, Gene Reilly, describes SP's irreversible slide into inadequate track maintenance. See Reilly V.S. As Mr. Reilly explains, SP maintained its mainlines adequately until the 1988 DRGW-SP consolidation. As rail lines deteriorated or suffered major failures, though, SP abandoned them. In Texas alone, SP gave up its direct route from Beaumont toward the north; its alternate mainline on the Sunset Route west of Houston; its direct route between Houston and Corpus Christi; its route between San Antonio to Corpus Christi; its line from Houston to Galveston; and its line into Ft. Worth from the northeast. In every instance, SP gave up capacity that it would later need. Reilly V.S., pp. 2.<sup>44</sup> SP's decisions to shed rail capacity contributed to the 1997-98 service crisis. See Ongerth V.S., UP/SP-358, pp. 11-13.

After 1988, SP cut back on maintenance in two waves. Beginning in 1988, SP reduced the number of ties and miles of rail it installed each year and cut its maintenance budget by 25 to 40 percent. Reilly V.S., p. 3; Gray V.S., p. 38. It focused its remaining resources on the Sunset Route and other lines that carried SP's most valuable traffic. It stopped maintaining yard tracks and branch lines. It also used less expensive rail on its many mountain curves, which required the railroad to replace rail as often as every other year. Reilly V.S., p. 4.

SP slashed its maintenance budget even more dramatically in 1993. It cut its track forces almost in half and lost the equivalent of a full year of rail and tie maintenance over the next two years. Id. at 5. Mr. Reilly had to tear up tracks in Nevada to obtain a few precious

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<sup>44</sup> Tex Mex recently bought part of the former SP line between Houston and Corpus Christi. Tex Mex will recreate the shorter route that SP had abandoned.

miles of desperately needed second mainline on the Sunset Route. He picked up the tracks from the Central Corridor and re-laid them in Arizona. Meanwhile, BNSF was preparing to spend billions on its competing mainline in the same Southern Corridor.

Starved for capital, SP was forced to adopt short-term solutions that curtailed investment costs but that significantly increased operating costs. This strategy was most evident in the way SP served the plastics industry from Bayport, Texas, to Lake Charles, Louisiana. Although the plastics industry enjoys massive economies of scale, many of its customers require only small quantities of product. Plastics producers therefore require railroads to store loaded hopper cars full of plastics until receivers need them. See Gray V.S., p. 15. This process is called Storage-in-Transit (SIT), and no railroad can compete for plastics business without providing it.

UP and BN had built SIT yards for plastics. SP had not. Although SP could not finance a new SIT facility, it had to find places to store thousands of carloads of plastics. It stored plastics anywhere it could find room. SP confiscated space from its operating facilities: the classification bowl at the Beaumont yard, the Lafayette and Avondale switching yards, and the arrival and departure yards at Houston's Englewood Yard.

Loaded plastics cars also filled up to half of SP's sidings between Houston and Lake Charles. SP needed those sidings so that priority trains could pass slower trains and so that oncoming trains could pass one another along stretches of single-line track. But yet the sidings were full of plastics. This was one of the principal reasons that SP was in repetitive service crises in the Gulf Coast region. See id. at 16. Instead of building a modern SIT facility, then, SP sacrificed operating costs by cramming carloads of plastics all over its network in Eastern Texas and Louisiana.



When a customer needed its carload of plastics, SP had to dispatch a local freight train to switch the siding where the car was stored, occupying precious mainline capacity and delaying through trains. This occurred dozens of times daily and increased SP's cycle times, clogged its mainlines and sidings, and increased operating costs. Id. at 16. Cars stored in the switching yards had to be "switched around" on a daily basis, causing yard congestion. This haphazard storage strategy demanded extensive record keeping and inventory management, which increased clerical costs. SP's network was literally overflowing with plastics.

SP eventually solved its SIT problem by increasing its operating costs in another way. Unable to fund its own SIT facilities, SP contracted with a private operator to build and maintain a SIT yard near SP's Dayton Yard. Id. at 17. This reduced track congestion but forced SP to pay storage fees that were sometimes greater than its customers would fund. Plastics traffic was much less attractive for SP than for other carriers.

SP's solution to its lack of modern rail cars provides another example of an expensive short-term fix. SP could not afford new cars, nor could it afford to repair existing equipment. Instead, SP sold its own freight cars to third parties. The third parties rebuilt the cars and leased them back to SP for a high per diem charge. By the time of the merger, almost one-quarter of SP's freight car fleet (10,000 cars) was in these rent-and-lease-back arrangements. See id. at 34. Although these arrangements took a heavy toll on operating costs, they permitted SP to reserve precious capital for critical investments.

The BNSF merger would have deepened SP's capital shortfall. In 1995, BN and Santa Fe announced plans to spend \$3 billion in the two years following their merger. Those investments targeted SP's key routes in the Southern Corridor and would have required SP to respond with comparable investments. Gray V.S., p. 25. SP could not respond.

BNSF actually spent over \$10 billion through 1999 to implement its merger. See BNSF-PR-14, BNSF Quarterly Progress Report, filed Apr. 2, 2001, Chart No. 58, p. 83. BNSF spent almost \$1.6 billion to expand capacity between 1996 and 1999 and more than \$2 billion to acquire 1407 new locomotives and to overhaul another 1850 locomotives. Id. at 83, 86. SP could never have matched those investments.

A flood of customers confirmed what many in the railroad industry knew: "For some years now, SP's financial situation has raised questions about its ability to reinvest in its facilities and ultimately its long term viability."<sup>45</sup> Dozens of shippers told of SP's fragile financial state in 1995:

SP has been unable to invest in certain needed improvements in its system. This failure to address various capital needs has had a significant adverse affect on SP's operations. As a result, SP is falling further and further behind the other major carriers in service quality.

- Rousse V.S., Pacific National Transportation Warehouse Systems Corp., UP/SP-25, Pt. 1, p. 348.

Over the past few years, we have been alarmed by the financial problems that would imminently interfere with the SP providing long term quality service to our facilities.

- Parker V.S., CMC Steel Group, UP/SP-25, Pt. 1, p. 106.

The Southern Pacific has been struggling and hampered by financial problems. We feel that their survival depends on what the UP can offer - the stabilizing support of a better organized and healthier rail system. Already, our customers and suppliers, especially those captive on the Southern Pacific, are looking forward with hope.

- Dawson V.S., MFP of Oregon Inc., UP/SP-25, Pt. 1, p. 276.

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<sup>45</sup> See Seawright V.S., Hoechst Celanese Chemical Group, UP/SP-25, Pt. 1, p. 227.



If the merger is not approved, we will most likely experience in the West the same inevitable decay of Southern Pacific that destroyed many Eastern railroads in the 1960's and 1970's. The merger of Southern Pacific with Union Pacific is essential to assure continued, quality rail service in the long term, by a financially viable system that is capable of competing with Burlington Northern-Santa Fe.

- Smith V.S., TransWood, Inc., UP/SP-25, Pt. 4, p. 510.

During the merger proceeding, SP predicted a capital investment shortfall of at least \$1 billion in the next three to four years without a major change in business strategy. Yarberry V.S., UP/SP-22, p. 260.

D. SP Would Have Retrenched Without the Merger

SP's business strategy was untenable. The report prepared for the California Attorney General concluded that SP did not have the cash reserves, asset sales, or access to new debt and equity to remain in business. It determined that SP could not rely on asset sales to offset its capital deficit. It recognized that SP was already highly leveraged and had credit ratings that "were below investment grade and [were] considered clearly risky."<sup>46</sup> As noted above, The study concluded that SP could not survive.

SP knew it would have had to change strategies and focus only on the rail traffic that would yield the quickest and highest returns without requiring additional capital investments. See Gray V.S., p. 40. The new goal would have been to maximize short-term returns on SP's assets by extracting value from the system.

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<sup>46</sup> JurEcon, Inc., An Analysis of Southern Pacific Rail Corp., p. 41 (Apr. 24, 1996), CA-AG-2.

To extract value from the system, SP might have considered implementing the following strategies. See Gray V.S., pp. 40-44. SP would have focused its commercial strategy on extracting as much revenue as possible from its least competitive traffic. In other words, it would have raised rates for "captive" traffic. See id. at 44. This would have been a short-term fix, because solely served shippers would eventually have paid other railroads to build in to their facilities. See Gray V.S., p. 44. Prospective shippers, deciding where to build new facilities, would build their facilities near other railroads. Id. In the meantime, however, SP would have enjoyed the added benefits of lowering traffic volume, reducing maintenance needs, and saving operating costs.

SP might also have withdrawn from less profitable traffic and reduced the size of its system, avoiding unnecessary capital and operating costs. (The entire railroad industry will be compelled to follow such a strategy if regulation prevents railroads from earning adequate revenues.) As Mr. Gray explains, SP might have curtailed its intermodal service in the I-5 and Central Corridor and closed several intermodal facilities, including terminals in Chicago and Los Angeles. Gray V.S., p. 41. SP probably would have been forced to discontinue its through manifest service over the Central Corridor. Mr. Gray predicts that SP would have sold portions of this route to short line railroads. Id. at 42. It would have slashed line improvements and terminal enhancements to the bare minimum. SP would have cut employment as well. Even using these desperate measures, SP would eventually have become completely uncompetitive and non-viable. See id. at 44.

Many observers assumed that SP would have sold itself in parts. Mr. Gray describes this assumption as unrealistic. Gray V.S., p. 40. Purchasers were willing to buy some SP segments, but no combination of sales preserved a viable core or provided as much value to



SP shareholders as the strategy Mr. Gray describes. As he explains, no core SP system could have been an effective competitor against BNSF and UP over the long term. Id.

Events that occurred after 1995 could have pushed SP over the edge. Even before the UP/SP merger was approved, BNSF took substantial amounts of business from SP. See Gray Rebuttal Verified Statement, UP/SP-231, pp. 23-25. For example, SP lost bulk sugar traffic from California to Kansas City. Id. It lost chemical traffic moving between California and Colorado. SP lost 200 carloads a year of petroleum products moving from North Dakota to Kansas. Id. It also lost over \$1 million of ferrous metal traffic from Eagle Pass and El Paso to Vancouver, British Columbia. Id. With five additional years of hindsight, we need only look at BNSF's huge capital investments to confirm that SP could not have survived.

Loss of auto traffic might have dealt a "death blow" to the profitability of the Central Corridor. See Gray V.S., p. 7. Approximately one third of the carload traffic on the Central Corridor consisted of Ford automobiles moving from Midwestern production plants to points in Northern California, Utah, and Colorado. By 1997, Ford adopted a "mixing center" approach to vehicle distribution that placed a high premium on single-carrier service and responsibility. Only one carrier in the west, BNSF, could have met the Ford's requirements. Neither SP nor UP alone had the geographic scope necessary to give Ford single-line access to Western markets.

As Mr. Gray, who was SP's Vice President-Network and Corporate Development, explains, losing this Ford business would have destroyed SP's last remaining significant niche in the automotive market. The immediate impact would have been to eliminate three percent of SP's most profitable revenue and to erode the foundation for manifest service in the Central Corridor. Without the auto traffic, the remaining manifest business probably could not have

supported continued operations across the western half of the corridor in Utah and Nevada. See id. at 8. At minimum, the loss would have driven up the unit costs of operating over the Central Corridor and reduced the profits on the shrinking base of remaining traffic. See id.

Lost traffic would have pummeled SP's operations in the Central Corridor, but the Great Salt Lake would almost certainly have provided the knockout blow. A year ago, a section of SP's causeway across the Great Salt Lake began to sink into the lake at rates almost up to four feet per day. See Gray V.S., p. 42. SP had previously abandoned at least three line segments elsewhere on its system because it could not afford to repair bridges that had been destroyed or damaged. UP spent more than \$13.5 million to stabilize the sinking causeway. It is doubtful SP would or could have spent its precious capital to save the causeway. Instead, SP likely would have rerouted any remaining through traffic over the Sunset Route, sought trackage rights on UP for the remaining local traffic, and ultimately abandoned the Overland Route as a through line. See id.

SP would have lost a significant part, if not all, of its Chicago-Los Angeles intermodal traffic to the newly combined BNSF. BNSF began to integrate BN and Santa Fe facilities at Chicago and Kansas City after the UP/SP merger. BNSF rationalized its intermodal facilities, which created efficiencies unavailable to SP, and began to build new intermodal facilities and to lay hundreds of miles of double-track. In contrast, SP's poor track conditions made SP service unreliable,<sup>47</sup> and SP lacked the resources to invest the facilities needed to handle premium business. With BNSF pouring hundreds of millions of dollars into its

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<sup>47</sup> As John Gray explains, lack of CTC on SP's route required crews to walk their trains in an "intricate, slow ballet" in order to meet other trains. This caused lengthy delays. Gray V.S., p. 12.



intermodal facilities to attract this business, SP could attract only non-premium international containers on this route. See id. at 12-13.

SP would also have lost its copper traffic because of a significant drop in copper prices. This drop caused UP's shipments of copper-related goods to decline precipitously at El Paso. SP had relied heavily on copper-related traffic to support its Sunset Route; the traffic accounted for \$100 million in revenue for SP.

There are numerous other examples. Recent steel-related traffic losses at Pueblo, Colorado would have battered SP's fragile carload traffic base. SP handled almost no export grain traffic, reducing the number of export wheat shipments SP would have received from Kansas. Customers in the Houston area recently turned to China for barites that SP had previously moved from Nevada, this would have cost SP \$5 million of revenues.

Having suffered negative net-cash flow since 1986, SP could not have survived for long with even less revenues due to the competitive losses it would unquestionably have faced these past five years. SP was, indeed, "doomed."

E. The UP/SP Merger Rescued the SP System

No railroad ever committed more resources to restoring another railroad than UP committed to SP. UP invested over \$5 billion to acquire SP and assume its debts and spent several billion dollars more to cope with SP's deteriorating physical condition and implement the merger. The 1997-98 service crisis, directly attributable to SP's poor infrastructure,<sup>48</sup> cost UP billions of dollars. Over a five-year span, UP is spending well over \$1.5 billion just to replace

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<sup>48</sup> Houston/Gulf Oversight, Decision No. 10 served Dec. 21, 1998, pp. 7-8.

rail, ties, and ballast on SP track segments and to add capacity to SP lines.<sup>49</sup> Viewed differently, UP is spending almost as much each year on SP track maintenance and improvements as SP spent on its entire capital budget, which encompassed locomotives, freight cars, computers, facilities, yards, communications, and all other capital expenditures. UP continues to make up for SP's maintenance deficit and continues to add capacity, such as adding second main track on SP's Sunset Route between El Paso and Southern California.

UP also invested heavily to upgrade SP's locomotive fleet and relieve its desperate shortage of working locomotives. To reduce SP train delays, UP transferred 180 locomotives to SP within a month after the merger. Since the merger, UP's investments in locomotives have dwarfed SP's. During the five years before the merger, SP could acquire only about 440 locomotives, and it had difficulty maintaining those. Since the merger, UP has flooded the SP system with new, high-powered locomotives. It spent more than \$2 billion on new power. UP also scrapped SP's antique locomotives, rebuilt SP's more modern units, and rehabilitated SP's yard switchers. The new locomotives are larger and can carry much more freight, so UP has much more power than the two separate railroads.

UP has acquired freight cars that SP could not afford. Since 1996, UP has spent \$827 million on new freight cars, including centerbeam flat cars for lumber shipments and covered hoppers for grain shipments. As John Gray explains in his verified statement, SP was

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<sup>49</sup> Although UP is spending well over \$1.5 billion on SP lines, UP does not consider this entire amount to be a cost of implementing the merger. UP considers part of that investment to be normal maintenance unrelated to the merger. Through March of this year, UP classified slightly over \$1 billion in maintenance and capacity investments as merger-related investments.



unable to purchase new freight cars. It instead used expensive financing arrangements to sell and lease back its own cars.

UP has implemented modern traffic control systems on SP lines, greatly increasing their capacity. For example, UP installed hundreds of miles of CTC on SP's Tucumcari Line between El Paso and Herington, Kansas. Between 1996 and 2000, UP added almost 2,000 miles of CTC systemwide, most of it on former SP lines.

UP has invested in terminals and facilities that SP could only dream of funding. For example, SP estimated that it needed to spend some \$38 million to rehabilitate its Roseville Yard in Northern California. Gray V.S., p. 36. UP completely rebuilt the yard at a cost of about \$140 million.<sup>50</sup> UP also rebuilt part of SP's West Oakland Yard and added new tracks at Dolores Yard in Los Angeles, where the railroad assembles container trains from the Ports of Los Angeles and Long Beach. UP constructed a \$53 million intermodal terminal for the Memphis area at Marion, Arkansas. And UP rebuilt parts of Englewood Yard and most of Strang Yard, both in Houston. SP could not have afforded those investments.

UP also spent over \$100 million on new computer systems for SP. SP could not afford to purchase new computer systems and relied on making patches to its outdated TOPS system. Gray V.S., p. 38. SP's computer system was frequently unavailable, far short of the 99.9-plus percent standard that U.S. industry expects.

Thanks to these and other investments, UP gives SP shippers the quality service SP could not provide. For example, SP's best service from California to Chicago in 1995 was

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<sup>50</sup> During the process, UP discovered and removed several dozen unexploded bombs that had been buried under SP's trains and employees since the Vietnam War.

10.4 days, and its average was much worse. UP's average transit time today for perishable shipments is 5.4 days, about half of SP's service on its best days. Gray V.S., p. 5 n.2. UP fires intermodal trains across the Central Corridor in slightly over 55 hours, barely two days. Similarly, SP lumber shippers in Oregon could expect their shipments to require an average of 12 days to reach Chicago. UP has cut that transit time to 7.6 days on average. Id. at 4 n.1. SP shippers could not have expected to see this kind of service without the merger.

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The central benefit of the UP/SP merger was saving the SP network. SP's service had been embarrassing for many years. SP could not have overcome these service problems without massive capital investments, investments it could not afford. SP did not have the bankroll to remain competitive with the newly merged BNSF powerhouse.

Without the UP/SP merger, SP would have had no choice but painfully to begin to cut services and raise rates. SP would have retreated from intermodal markets, withdrawn from its Central Corridor business, shrunk its equipment fleet, dropped planned capital projects, laid off employees, and raised rates on non-competitive business. But even so, SP would eventually have failed.

UP stepped in, however, and with \$1.4 billion in capital investments transformed a SP network that was starved for capital into part of a competitive system. Not only did UP make an extraordinary commitment to salvage the SP network, it spent vast sums to recover from the service crisis caused primarily by SP's condition. Its efforts included borrowing \$1.5 billion to address the crisis.

The Board recognized that when a carrier is "in such poor financial shape that a commitment by a financially sound carrier to invest in maintaining and upgrading deteriorating

rail infrastructure is needed," this "constitutes a significant public benefit in its own right, as was the case in UP/SP." STB Ex Parte No. 582 (Sub-No. 1), Major Rail Consolidation Procedures, p. 21, Decision served June 11, 2001. The UP/SP merger provided the ultimate public benefit.

## II. THE UP/SP MERGER DELIVERED ALL EXPECTED PUBLIC BENEFITS

In addition to preserving the SP system, the UP/SP merger provided all of the types of benefits that applicants had predicted during the merger proceedings. The merger improved safety on SP. It expanded single-line service on two comprehensive western networks. It created shorter routes for large flows of traffic. It improved rail service, especially on SP. It generated efficiencies. And it restored capital investment on SP lines.

### A. The Merger Provides the Benefits Forecast in the Application

Five years after the Board authorized the UP/SP merger, the two carriers are one. Unified management oversees the railroad. All labor agreements are in place. UP presents a single marketing face to its customers. Technology integration is complete. UP has achieved the full measure of merger-related efficiencies predicted in the UP/SP application, saving almost \$700 million annually. UP weathered the service crisis of 1997-98 and now provides competitive, quality rail service throughout the western two-thirds of the country. It invested heavily to implement the merger.

#### 1. Safety

Year after year, UP is a safer place to work. Working for UP today is safer than working for SP before the merger. SP had reported substantially higher rates of reportable injuries than UP. After the merger, UP successfully brought SP's higher accident rate down to UP levels, as we reported in our 1998 and 1999 oversight reports.



UP continues to improve its safety record. The most common measure of rail safety is reportable employee injuries per 200,000 man-hours. UP's rate of reportable injuries declined by 12.25 percent from 1999 to 2000. It declined by an additional 3.75 percent during the first five months of 2001, compared to the same period last year. The consolidated UP/SP injury rate was 230 percent higher in 1993 than in 2001.

Data on lost work-day cases exhibit a similar pattern. Incidents that cause an employee to lose time at work declined by 7.73 percent from 1999 to 2000 and declined by an additional 7.49 percent during the first five months of 2001.

UP also reduced collisions between vehicles and trains at grade crossings, saving lives and reducing injuries. It accomplished this even though the numbers of trains and vehicles grew. UP reduced the number of grade crossing accidents by six percent from 1999 to 2000 and by an additional six percent in the first five months of 2001. UP has slashed grade-crossing accidents by more than a third since the merger. The number of injuries attributable to these accidents fell even more sharply. UP reported 17 percent fewer injuries in 2000 compared to 1999 and 22 percent fewer injuries so far in 2001 compared to the same months last year.

## 2. Expanded Single-Line Service and a Comprehensive Western Network

The UP/SP merger created a rail system that matches BNSF in geographic coverage and is able to meet its customers' logistics requirements. Single-line service eliminates interchanges and associated delays, simplifies rate negotiations, reduces billing errors, yields better service, and allows shippers to penetrate new markets. The applicants calculated in 1995 that more than 350,000 units of rail traffic would gain UP/SP single-line service each year as a result of the merger. Every customer on the former UP system that did not also have SP service

now has single-line service to every SP point. Every customer on the former SP system that did not also have UP service now has single-line service to every UP point.

New UP/SP single-line service includes the following examples, among many others:

- Lumber from UP origins in Washington and Idaho to SP points throughout California, Arizona, New Mexico, and West Texas.
- Grains from UP origins in Iowa, Nebraska, and Minnesota to Arizona and the San Joaquin and Imperial Valleys of California.
- Coal from SP origins in Colorado and Utah to export via the LAXT terminal in Los Angeles and to power plants with the Upper Midwest.
- Mexican imports via the UP Laredo Gateway to SP points throughout the Southwest.

In addition, the merger created many new single-line routes on BNSF. BNSF gained single-line routes for intermodal traffic between New Orleans and California, and it uses them heavily. It obtained single-line routes from its Southern Corridor to points between Houston and New Orleans. It gained a new single-line route along the West Coast, a route on which it carries six or more trains per day. BNSF also gained a new single-line route from all points on its system into northeastern Mexico via Brownsville.

### 3. Shorter and More Efficient Routes

The UP/SP merger filled critical gaps on both systems. Indeed, the two carriers' routes appeared designed to complement each other. Peterson V.S., UP/SP-23, pp. 21-54. The southern half of the UP system ended at El Paso; SP's Sunset Route extended it to Southern California. UP's western fingers to Portland, Oakland, and Los Angeles were unconnected; SP's I-5 Corridor route connected them. UP's routes from the Pacific Northwest to the Midwest are much shorter than SP's wandering route via Roseville, California, and Pueblo, Colorado.



Combining UP and SP routes between Memphis and El Paso produced a shorter route than either carrier could offer before the merger. UP rerouted Memphis-Los Angeles traffic off its Central Corridor and saved 600 miles on every car. UP's Texas & Pacific Route from Dallas to El Paso cut off a 200-mile deviation on SP via San Antonio.

Together, UP and SP forged better routes than either could offer separately. Notably, UP recreated the historic transcontinental rail route through the Central Corridor, combining UP east of Ogden with SP west of Ogden. That route saves 200 to 400 miles compared to either railroad's separate route between the Midwest and Oakland. Most importantly, the two railroads paired UP and SP lines from St. Louis and Memphis to the Rio Grande into highly efficient directional railroads, saving hundreds of millions in investments and speeding shipments.

#### 4. Improved Service

UP continues to add new services made possible by the merger. For example, using the UP/SP Central Corridor route, UP and its partners, CSX and several short line railroads, are expanding "Express Lane" service for perishables and canned goods from California and the Pacific Northwest to points throughout the Midwest, East, and South. This service continues to draw truck traffic from the highways. The service established a record last month with 61 cars on one train. Although we did not predict this service in the application, it exists only because of the efficient UP/SP Central Corridor route and SP's gathering network in California.

UP matches the fastest intermodal service between Chicago and Northern California. As Mr. Peterson explains in his statement, BNSF continues to be more successful



commercially on this route because it leverages its superior service to Southern California, but UP's product is more than competitive.

UP also continues to expand its premium intermodal service in the Memphis-California corridor. UP's initial premium service operated from Memphis to Los Angeles and then to Lathrop in Northern California. Interrupted during the service crisis, this service returned and was so successful that shippers such as UPS overwhelmed the train. UP added a second premium train between Memphis and Los Angeles last July. Both trains operate via a combination of UP and SP line segments that shortened the route by 200 miles. The trains use UP and SP directionally between Memphis and Big Sandy, Texas; UP between Big Sandy and El Paso; and SP between El Paso and Los Angeles.

UP and TFM recently began a run-through intermodal train between Mexico City and Chicago that improved service by more than one day in each direction. The train is pre-cleared for the border crossing and provides faster service in this important NAFTA corridor.

UP implemented a new program called "Autoparts Transload" between the Midwest and Mexico City in conjunction with TFM. Truckers bring truckloads of autoparts to a UP transloading facility near St. Louis. Typically, a rail car can accommodate the contents of three highway trailers. The cars then ride UP-TFM train service to Mexico, saving several days over prior rail service. In fact, the service is two days faster than motor carrier service on this route, reducing transit time from eight to six days.

UP participates in a similar transload program in the I-5 Corridor called "Speed Link." This new carload service operates from Portland to Los Angeles on an expedited schedule of only 45 hours. Truckers deliver their loads to a shortline railroads' reload center in

Beaverton, Oregon. UP transports the train to UP facilities in Southern California. Virtually every shipment on these trains comes off the highways.

Using UP and SP segments, UP joined CP to operate a new train from Edmonton, Alberta, to Roseville, California. This train bypasses interchange delays at the international border and cuts transit time from 14 days to 7 days.

Through a combination of the UP/SP and Conrail transactions, UP offers improved service via central gateways throughout the East. UP and NS have developed five-day coast-to-coast intermodal service for UPS via Memphis. The railroads are now in their eleventh month of operating this service without missing a single UPS sorting deadline.<sup>51</sup> UP also provides more detailed blocking and run-through service with CSX and NS via Chicago. Through trains operate from North Platte, Nebraska, to Selkirk, New York; Toledo, Ohio; Willard, Ohio; Elkhart, Indiana; and Pittsburgh, Pennsylvania.

UP continues to move western coal effectively. In recent months, UP originated an average of 11 to 12.4 trains of Colorado and Utah coal daily. UP could have launched more trains, but mines on the North Fork Branch reduced production due to problems with methane gas. UP set an all-time record in March 2001 for loadings from the Powder River Basin. UP loaded a record 1,056 trains that month, or more than 34 trains per day. Now that UP's annual maintenance blitz on its coal line is over, UP hopes to achieve more records.<sup>52</sup>

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<sup>51</sup> They delivered two boxes late one time during that period on a special weekly train that crosses the country in only four days.

<sup>52</sup> Each year UP shuts down its coal routes for approximately a week each year to perform extensive maintenance.



5. Lower Costs

UP achieved the efficiencies it predicted during the merger proceeding. UP estimates its annual savings from the merger at more than \$690 million annually. The savings reflect substantial reductions in administrative personnel and more efficient deployment of agreement employees. More efficient routes, including directional running, reduce operating costs. Car hire and other equipment costs fell as transit times improved and interchange delays disappeared. Combined shops repair locomotives and cars more efficiently.

UP also was able to realize enormous savings by reducing SP's costs of acquiring supplies and equipment. SP lacked UP's sophisticated contract monitoring systems. It also paid higher prices because it could not secure the volume discounts that UP obtained. Combined, UP and SP reduced supply costs even further.

UP's profitability has not increased markedly and its rates have not increased over the five-year oversight period. The Board should therefore conclude that most of these savings were passed along to customers in the form of reduced rates.

6. Capital Investments<sup>53</sup>

By the end of 2001, UP expects to have invested \$1.586 billion to implement the UP/SP merger. UP's investment will exceed the \$1.441 billion we predicted in the merger application by approximately \$140 million. This total excludes more than \$1.5 billion in costs associated with the service crisis of 1997-98. It also does not include most of the costs of acquiring billions of dollars worth of locomotives and freight cars, even though those assets are used on former SP lines.

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<sup>53</sup> We discuss Houston/Gulf Coast area investments separately at pp. 47-49, below.



UP expects to spend \$119 million this year on merger-related capacity projects. It has already spent \$12.7 million to add second main track on three segments of the Sunset Route in Southern California. Farther east on the Sunset Route, UP is spending \$17.3 million this year to construct a second main track from Dragoon to Cochise, Arizona. UP is also spending \$15.4 million on second main track between Razo and Luzena, Arizona. These investments are part of an ongoing project to add 140 miles of second main track on the Sunset Route. UP plans to invest more than \$200 million on these projects. Gray V.S., p. 35.

UP will continue to expand Centralized Traffic Control and siding capacity on the Tucumcari Line between El Paso and Herington, Kansas. Projects include new sidings at Galva and Bucklin, Kansas, and at Tecolote, New Mexico. UP has spent \$197 million on the Tucumcari Line thus far, and it plans to continue to expand capacity on this important route for expedited trains. Gray V.S., p. 35.

UP will complete an \$11 million project to construct a new through route between UP and SP at Ogden, Utah. UP is adding CTC and a new siding on the Kenton Line east of Portland, Oregon, as predicted in the merger application. See UP/SP-24.

UP continues to invest heavily in the KP Line between Denver and Topeka, Kansas, to handle more Colorado and Utah coal. To date, UP has invested over \$250 million to upgrade the capacity of this line. UP is adding \$33 million of investments during 2001, including new or extended sidings at Hackberry, Collyer, Tera Cotta, and Buick in Eastern Colorado and Western Kansas. UP is also beginning work this year on an important connection in Denver, Colorado, between the KP Line and the DRGW line. This \$20 million connection will allow coal trains to traverse Denver without crossing the BNSF mainline at grade. In all,

UP expects to spend some \$312 million on the KP Line -- about as much as SP spent on its entire capital budget for a year.<sup>54</sup>

UP invested additional amounts on lines west of Denver to handle Colorado and Utah coal. As John Gray notes, "the Moffat mainline and the Colorado branches have seen almost \$50 million of work." Gray V.S., p. 10, n.5. This allowed the former DRGW Moffat route to carry the highest amount of traffic in its history last year. Id.

UP is investing in several merger-related facilities this year. Many of these projects were not included in the UP/SP merger application. For example, UP is spending \$7.7 million to improve former SP facilities in Phoenix, Arizona. It is rearranging and expanding the former SP intermodal facility at Oakland at a cost of \$6.3 million. It is expanding intermodal facilities in Los Angeles, Portland, and Seattle. In the Chicago area, UP is beginning to spend more tens of millions of dollars on new and expanded intermodal facilities, partly to handle more traffic on former SP routes.

UP generally followed the UP/SP Operating Plan as it implemented the merger, but it changed course when customers' needs changed or it found a better alternative. The KP Line investment illustrates one such response to the marketplace. UP had expected to spend only \$86.6 million on the KP Line, rather than the \$312 million that it will spend before this project is complete. Colorado and Utah coal needed more capacity, though. UP also spent more than four times as much as it had planned to upgrade Roseville Yard in Northern California. Shippers

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<sup>54</sup> John Gray explains that SP considered using the KP Line in the early 1990s, but SP could not fund the costs of preparing the line for coal service. Gray V.S., p. 10.

benefit from that investment through new services such as the Express Lane service for food products.

UP's investment of more than \$10 million in Ogden, Utah, provides another illustration. Even though UP and SP formed the original transcontinental rail route across the West, the two railroads' tracks in Ogden were poorly configured for through train operations before the merger. UP rebuilt those tracks to create a new mainline through Ogden that eliminated delays for through trains. This project was not included in the merger application but will improve service for most Central Corridor shippers.

The OKT Line exemplifies UP's decisions not to make certain investments that we proposed in the application because it found a better alternative. UP had planned to spend \$91.5 million to upgrade the OKT Line from Herington, Kansas, to Ft. Worth. As we stated in the UP/SP Operating Plan, UP expected to use this route for coal trains between Wyoming and Texas. UP/SP-24, pp. 54-56. UP later concluded, however, that it could acquire greater capacity at lower cost by upgrading its route through Kansas City instead. If UP upgrades the OKT in the future, it will be for a different purpose, such as rerouting grain traffic.

Although UP already has spent more on the UP/SP merger than it had planned (much more if we allocate a full share of locomotive and freight car investments to the SP merger) some merger-related investments will continue. Most significantly, UP is in the midst of adding double track to the Sunset Route. After the City of Reno's plans for a depressed trainway are clearer, UP still expects to increase clearances in the Sierra Nevada to allow full-size doublestack service over Donner Pass. UP plans a similar investment to improve clearances in the Cascade Mountains in Oregon.



B. UP Successfully Implemented the Merger in the Houston/Gulf Coast Area

1. Service Measurements

UP's service in the Houston/Gulf Coast area is better than ever. Until Tropical Storm Allison flooded Houston with up to 36 inches of rain and disrupted all transportation modes earlier this month,<sup>55</sup> UP's Houston yards were operating more efficiently than at any time in the memory of today's operating officials. Switching service for local customers at industries is much more reliable. UP's service has been so prompt that many customers do not have enough room to store all the empty cars returning for loads.

While the service crisis was a difficult and disappointing period for UP and its customers, the railroad fully recovered from the crisis by the spring of 1998 and continued to improve service. Performance measurements reflect this improvement. For example, average dwell times at the Houston yards have dropped again. In May 2001, average dwell time at Settegast Yard was 32.3 hours, a 46 percent improvement since January 1999 and a vast improvement over 1997-98. At Englewood Yard, average dwell time was only 30.8 hours in May 2001, a 21 percent improvement since January 1999. During some periods, average dwell times at Englewood have been less than 24 hours.

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<sup>55</sup> Tropical Storm Allison closed Interstate 45 and other highways, grounded more than 30 Continental jets with hail damage, caused almost \$5 billion in property losses, destroyed 3,400 homes, and killed 22 people. See Houston Chronicle, June 19 and June 24, 2001. Allison took its toll on UP, causing track damage and delays on most routes to and from Houston. Maintenance-of-way forces worked around the clock to repair numerous wash-outs so that train operations could resume. All track was back in service within two days, except the Baytown Subdivision. Damage to a railroad bridge required a temporary change to the transportation plan for customers on that branch.

Locomotive terminal dwell time in Houston dropped to 12 hours, an improvement of 1.5 hours since last year. Recrew rates have also improved tremendously since the service crisis. In February 1998, the recrew rate in the Houston area was a dismal 49.4 percent. Since that time, the recrew rate has steadily fallen, down to only 12.3 percent in May 2001.

UP is achieving these results despite record numbers of SIT cars in storage in the Houston/Gulf Coast area. In May UP stored more than 9,300 SIT cars, 2,300 carloads above what we consider a normal level.

UP's switching at industry facilities is excellent. During the service crisis, UP was lucky to switch a customer on the right day. Now it targets a window of a few hours and hits most of the windows. Outbound cars from customers on the Baytown Branch average just 16.2 hours from arrival at Dayton Yard to departure. During the service crisis, cars remained on the branch from 40 to 60 hours.

## 2. Management and Process Changes

In order to provide better service, UP has implemented a number of process changes in the Houston/Gulf Coast area. For example, UP changed its management structure in Houston. A Senior Director now oversees both the Settegast and Englewood yards, ensuring that the two yards operate in tandem. The Managers of Terminal Operations also oversee both yards 24 hours per day. By integrating management of the two yards -- only one mile apart -- both operate more effectively.

UP recently implemented an advanced version of ATCS in Houston. ATCS allows conductors to enter data about car movements as they occur and allows the UP National Customer Service Center ("NCSC") to transmit information in real time about cars that are ready to move. Previously, switch crews did not learn about cars released after the switch engine

left its origin terminal. The new system enables UP to provide more timely service by moving cars as soon as they are ready to move.

Houston is the pilot location for this advanced technology. All 65 industry switch jobs and 130 locomotives are equipped with ATCS. Each engine has an on-board computer linked by satellite to UP's central computers. UP trained 600 people to use this equipment.

UP established additional direct contacts between local operating personnel and customers. The Operating Department surveys its customers monthly in order to evaluate service and address customer problems more quickly. In order to enhance service in the Houston terminal, UP also hired a "black belt" expert in the Six Sigma Process to develop additional process changes.

UP is working with chemical shippers to obtain weekend billing instructions for their weekend shipments. Without the billing information, UP must hold loaded cars because it does not know where the cars are going. This delays the shipments, causes congestion on weekends, and extends transit times. Several customers are now improving their own service by providing weekend billing.

### 3. Joint Dispatching

Joint UP-BNSF dispatching continues to be an extraordinary success at the Houston Control Center in Spring, Texas. Prior to joint dispatching, the SP dispatched Houston area trains from Denver, while BNSF dispatched Houston-area trains from Ft. Worth. UP dispatched its lines from Omaha, while HBT dispatched the Houston terminal from an office in Houston. Without centralized dispatching, dispatchers on one railroad did not know trains were coming until they arrived. When problems arose, the railroads spent hours arranging a solution.



All dispatchers who control Houston rail lines now work in one room. Dispatchers whose territories connect generally can make visual contact. Face-to-face conversations solve problems that once required multiple long distance phone calls.

Joint dispatching played a significant role in ending the service crisis and continues to smooth the flow of trains through the Houston/Gulf Coast area. UP and BNSF jointly control three terminal dispatchers who handle the Houston terminal. In compliance with Board conditions, the joint employees may use any route through Houston for any train in order to avoid unusual congestion.<sup>56</sup> Joint dispatchers also control the jointly-owned line from Houston to Avondale (New Orleans), Louisiana

Encouraged by the success of the Spring Center, UP moved additional dispatching territories into the Center. UP maintains ten dispatching positions, and BNSF maintains three. UP dispatches the following routes from the Spring Center: Houston-New Orleans (former UP route), Iowa Jct.-Alexandria, Houston-Shreveport, Houston-Galveston, Houston-Hearne, Houston-Brownsville, Houston-San Antonio, San Antonio-Alpine/Eagle Pass, Hearne-San Antonio-Laredo, Hearne-Bloomington via Flatonia, and San Antonio-Corpus Christi. UP transferred control of the SP Sunset Route mainline through San Antonio from San Antonio to Spring earlier this year.

The Spring Center inspired additional consolidated dispatching centers throughout the West, all of them successful. BNSF's San Bernardino, California, center houses UP dispatchers who handle UP and BNSF trains throughout Southern California. UP moved the dispatchers who control its Powder River Basin routes to Ft. Worth, where they can work closely

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<sup>56</sup> Houston/Gulf Oversight, Decision No. 10 served Dec. 21, 1998, p. 1.

with BNSF dispatchers who handle the Joint Line in the Basin. Most recently, UP, BNSF, KCT, and other railroads opened a consolidated dispatching center for the Kansas City terminal area.

#### 4. New Services

UP is introducing improved service for customers along the Gulf Coast southwest of Houston. Traffic from southwest of Houston today moves to Settegast Yard in Houston for re-classification. UP's "Freeport Pipeline" trains will originate in Freeport and roll through Houston without stopping for re-classification. This new service will allow UP to run trains directly to CN at Griffith, Indiana, and to CSX via New Orleans, bypassing yards at Houston, North Little Rock, and Livonia. By eliminating switching and re-classification en route, UP will reduce transit times and improve reliability.

In May UP began operating a vinyl chloride unit train from Gregory, Texas, to Freeport. By eliminating time consuming classifications in Freeport, Angleton, Bloomington, and Sinton, these trains reduce transit times significantly. Transit times for loads dropped from an average of five days to one day, and transit times for empties dropped from seven days to one day.

#### 5. Service for South Texas Aggregates

UP's service for South Texas rock and cement customers recovered from the congestion we had reported last year. Extensive trackwork and extreme heat crippled UP's rock operations for several months in 2000. A new problem arose earlier this year when unusually cool, wet weather bloated customer inventories in Houston and prevented customers from unloading rail cars promptly. By May, however, the weather warmed and service recovered.

UP took several steps during the last year to promote quality rock service. It established a "Rock Desk" at the Spring Center to provide continuous, dedicated coordination

of rock operations. UP staffs the Rock Desk 24 hours per day on weekdays and 12 hours per day on weekends. UP also implemented a multi-disciplinary conference each week to identify systemic problems and resolve them quickly. For example, UP conferees recently identified an improved route for Cemex shipments to Corpus Christi, Texas. At substantial cost, UP also hired a contractor to provide 24-hour locomotive fueling and servicing in the rock-loading corridor to improve locomotive availability. UP increased the number of locomotives in South Texas rock service from 82 in April to 102 in June. And UP is rebuilding dozens of cars used in rock service.

UP is working with customers to solve a longstanding problem that has plagued South Texas rock service for many years. Customers preferred not to load and unload shipments on weekends. As a result, empty trains jammed the loading areas over the weekend, causing near-gridlock on Mondays. By Wednesdays, however, a flood of loaded trains jammed receiving areas, leaving the loading areas with inadequate car supplies. Several major rock shippers, including Martin Marietta and TXI, have agreed to load and unload on Saturdays, improving service. Other shippers continue to study the proposal.

#### 6. Infrastructure Improvements

UP continues to improve and expand rail facilities in the Houston/Gulf Coast area. UP plans to invest \$175.6 million on improvements in this area during 2001.

UP's biggest expenditures are for rail and ties. For example, UP is upgrading Houston terminal trackage this year. In addition, the following capacity projects have been completed since our last report or are underway this year:

In Houston, UP recently upgraded Booth Yard. As shown in Photograph No. 1, UP rebuilt tracks at the south end of the yard and created a new connection from the south end



of the yard to the adjacent mainline. UP plans to make additional improvements to Booth Yard next year. UP added new tracks to the locomotive repair facility at Settegast Yard and installed a new hump computer at Englewood Yard. UP also rebuilt hump tracks at Englewood. See Photograph No. 2.

Also in Houston, UP completed a new connection in the southwest quadrant of Tower 30 and installed an interlocking plant at the tower. The new connection links the mainline coming east from T&NO Junction with the mainline heading southeast toward Galveston. UP also completed the new Bayer Chemical SIT facility and contributed to expanding a yard on PTR. On Houston's south side, UP continued to work with BNSF on adding a second mainline between Double Track Junction and T&NO Junction. UP allocated \$2.3 million to this second track in 2000 and plans to spend \$4.6 million in 2001.

Southeast of Houston, UP improved and expanded Strang Yard. UP is replacing rail, ties, and retarders on the bowl tracks. See Photograph No. 3. UP also built three new long tracks to make up trains and a second track leading into the yard that provides double-track access from the west. See Photograph No. 4. UP and the Port of Houston extended double track from Strang to Deer Park. The entire line from the Barbours Cut port facility to Deer Park now has double track.

South of Houston, UP added an additional siding north of Angleton on the line to Brownsville. This new siding adds fluidity to the Angleton area and allows the existing yard to function without continual interruption from mainline train meets, reducing congestion for both UP and BNSF. UP installed new ties and ballast in Angleton Yard this year.

North of Houston, UP continued to expand its SIT facility at Lloyd Yard in Spring. UP added 400 SIT spaces in the last year and plans to expand the yard again over the next few years.

Northeast of Houston, UP continues to invest with BNSF in adding a second main track to the Baytown Branch. Photograph No. 5 shows a BNSF train on the mainline next to BNSF's yard at Dayton. Further east of Houston, UP continues to pursue a 1,300-car, \$23-million SIT yard in the vicinity of Lake Charles. This new "Brimstone" facility will allow UP to store more plastics shipments awaiting sale. UP expected to invest \$10 million in this project this year, but construction remains delayed by local permitting disputes.

UP also made important improvements in San Antonio during the past year. Most significantly, UP rehabilitated 18 miles of the former SP mainline. New rail track allowed UP to increase speed limits from 20 m.p.h. to between 45 and 60 m.p.h., reducing transit times for every train by 30 minutes. UP added two new tracks at SoSan Yard and extended two other tracks. These new tracks allow UP to build trains on a single track and permit trains to meet at SoSan without splitting one of them. UP is upgrading switching tracks at the former SP East Yard.

UP is making significant improvements at Laredo. UP is adding new staging tracks, installing a new cross-over, and adding a new siding at Milo, Texas. UP plans to spend over \$10 million in 2001 to complete those projects.

### III. THE UP/SP MERGER AS CONDITIONED BY THE BOARD PROMOTED RAIL COMPETITION IN THE WEST

In this section, we show that the Board's conditions have addressed effectively the competitive issues they were intended to remedy and that the merger has caused no competitive harm. As the applicants anticipated, the merger, as conditioned by the Board,



pervasively and dramatically intensified competition that has benefitted shippers throughout the western United States.<sup>57</sup>

In their merger application, the applicants explained why the UP/SP merger and the BNSF settlement agreement would greatly intensify transportation competition throughout the West. The applicants explained that UP and SP together would be a much stronger competitor than either railroad standing alone because the merged system would be able to provide shippers with more competitive rail services. They predicted that the merger would spur competition with shorter routes, greatly expanded single-line service, faster schedules, upgraded track, new facilities, lower costs, greater reliability, much improved equipment supply, more efficient terminal operations, and lower reciprocal switch charges.

The applicants also explained that the BNSF agreement would further strengthen competition in two important ways. First, the BNSF agreement would provide stronger competition for all "2-to-1" shippers – shippers that would have lost one of two competitive options. The BNSF agreement guarantees each of these shippers access to two stronger, broader, more efficient rail networks than had served them prior to the merger. Second, the BNSF agreement would provide new or strengthened competition by supplying the few pieces missing from BNSF's nearly comprehensive network in important markets such as the West Coast North-South Corridor, the West Coast-New Orleans Corridor, the Houston-Memphis Corridor, and U.S.-Mexico markets. The BNSF agreement thus ensured that all shippers served by UP and

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<sup>57</sup> We systematically review UP's compliance with the specific merger conditions and provide detailed data on BNSF, Tex Mex, and URC trackage rights volumes in the Compliance Appendix.



BNSF after the merger could choose between two equally matched competitive and comprehensive rail systems.

During the merger proceeding, the competition-enhancing features of the UP/SP merger and the BNSF agreement evolved beyond the already extensive measures described in the application. The applicants entered into a settlement agreement with CMA, which supplemented the rights that BNSF had received in the BNSF agreement. The applicants also entered into a competition-enhancing settlement agreement with URC. The Board imposed the terms of the BNSF, CMA, and URC agreements as conditions to its approval of the merger. The Board further ensured that the merger would promote competition by augmenting certain rights granted to BNSF in those agreements and by partially granting a Tex Mex trackage rights application. The Board also imposed a five-year oversight period as a condition to ensure that the conditions it imposed effectively addressed the competitive issues they were intended to remedy.

In each of the four previous oversight decisions, the Board has concluded that UP/SP merger, as conditioned, caused no loss of competition. Decision No. 10, p. 2 (first oversight proceeding); Decision No. 13, pp. 8-9 (second oversight proceeding); Decision No. 15, p. 5 (third oversight proceeding); Decision No. 16, p. 6 (fourth oversight proceeding). In the final year of oversight, the Board's conditions continue to guarantee and strengthen rail competition.

In this section, we revisit the core competitive issues addressed in the merger application. We use rate studies, shipper case studies, and trackage rights data to show that "2-to-1" shippers, "3-to-2" shippers, and shippers in every rail corridor affected by the merger are now enjoying stronger competition than they had before the UP/SP merger. We also show that customers in the two regions most directly affected by the Board's merger conditions – the

Central Corridor and the Gulf Coast – now enjoy stronger competition. We describe how the merger has strengthened competition for traffic to and from Canada and Mexico as well. We discuss competition for commodities subjected to particular scrutiny in the merger proceedings: Colorado and Utah coal, Gulf Coast chemicals and petroleum products, Houston-area aggregates, soda ash, and grain. We show that competition for each of these commodities is stronger than ever. Finally, we explain how the merger and the conditions that the Board imposed guarantee that competition for western rail traffic will continue to increase long after the Board's oversight concludes.

The evidence after five years of merger oversight is indisputable: the Board's expectation that its conditions would preserve competition has been met and surpassed. UP and BNSF have spent the past five years competing vigorously for business using their well-matched, highly efficient and highly competitive networks. As a result, rates have fallen, service has improved, and the clear winners are shippers. By any measure, the UP/SP merger, as conditioned by the Board, has strengthened rail competition in the West.

A. The UP/SP Merger Was Pro-Competitive

As the applicants explained, the UP/SP merger was precipitated by the merger of BN and Santa Fe. By merging, BN and Santa Fe created the largest and most competitively powerful rail system in the United States. UP and SP saw that, over time, the large, efficient, financially powerful BNSF would better satisfy shippers' needs for fast, low cost, reliable, single-line service. BNSF was a powerful competitor in almost every major corridor, offering shippers a wider system that could reach more markets with a single-line service. SP in particular was falling further and further behind in the competitive race. SP's motivation to

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merge was particularly strong because it knew that without the merger it would not have a viable, long-term future.

UP and SP saw that their route structures could create a system to rival BNSF's. UP and SP routes were parallel in some areas and end-to-end in others. When combined, they produced myriad competitive benefits: route and terminal flexibility that would increase efficiency and capacity for overloaded rail lines and terminals; opportunities to triangulate equipment and reap major gains in car utilization; and shorter routes and new single-line routes that would allow new and improved services.

UP and SP realized that a merged system would offer shippers single-line service in the West Coast North-South Corridor. A merged system could also offer single-line service between UP-served grain origins in the Upper Midwest and SP-served points in the Southwest and to Northwestern Mexico, and between SP-served Utah and Colorado mines and export facilities in Los Angeles and Long Beach. The merged system would create shorter routes across the Central Corridor and the Southern Corridor. It would increase capacity by creating parallel routes and by increasing the number of terminal facilities. The merged system could also afford to invest in and improve SP lines and facilities – something that SP alone could not afford.

UP and SP knew that an expanded single-line network, shorter routes, and capacity improvements would allow the merged system to provide faster, more frequent, and more reliable service. A merged system could take advantage of the best of each railroad's intermodal facilities, auto ramps, SIT yards, rail-owned transloading facilities, and other specialized facilities. UP and SP recognized that all of these benefits could be obtained only by merging and that only a merger of UP and SP could produce a railroad that would be the competitive equal of BNSF.

UP and SP also understood, however, that it was important to propose conditions that would preserve competition for every "2-to-1" shipper. UP and SP accordingly approached other railroads and opened negotiations over such conditions. As a result, UP/SP granted BNSF trackage rights and sold lines necessary to preserve competition for "2-to-1" shippers. The BNSF Settlement Agreement also injected new competition into key markets. The applicants later entered into agreements with CMA, URC, and a number of other parties to ensure that the merger would enhance rail competition.<sup>58</sup>

B. The Merger Conditions Addressed Every Potential Competitive Concern

The Board's decision approving the merger preserved strong competition for every shipper that might have lost a choice between UP and SP service. It also enhanced rail competition throughout the West by imposing, as conditions the terms of the BNSF, CMA, and URC agreements, and by augmenting in several ways the rights that BNSF obtained under those agreements. The Board enhanced competition by granting Tex Mex trackage rights between Robstown and Beaumont, Texas. These conditions, which in several important respects are more extensive than the conditions that have been imposed on any prior or subsequent merger, have been extremely effective in guaranteeing that the merger would produce vigorous competition and improved service in the West.

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<sup>58</sup> In addition to the BNSF, CMA, and URC agreements, the applicants entered into settlement agreements with a host of other parties, including other railroads, shippers and government bodies, where the applicants were able to resolve the parties' concerns in a manner that was consistent with the pro-competitive aims of the merger.



1. BNSF Agreement

The BNSF settlement agreement resulted from the applicants' unprecedented effort to guarantee strong rail competition for every shipper who would otherwise have seen their competitive options reduced from two serving railroads to one as a result of the merger. The basic terms of the BNSF agreement withstood intensive scrutiny throughout the merger proceeding, and their effectiveness has been demonstrated in four previous oversight proceedings.

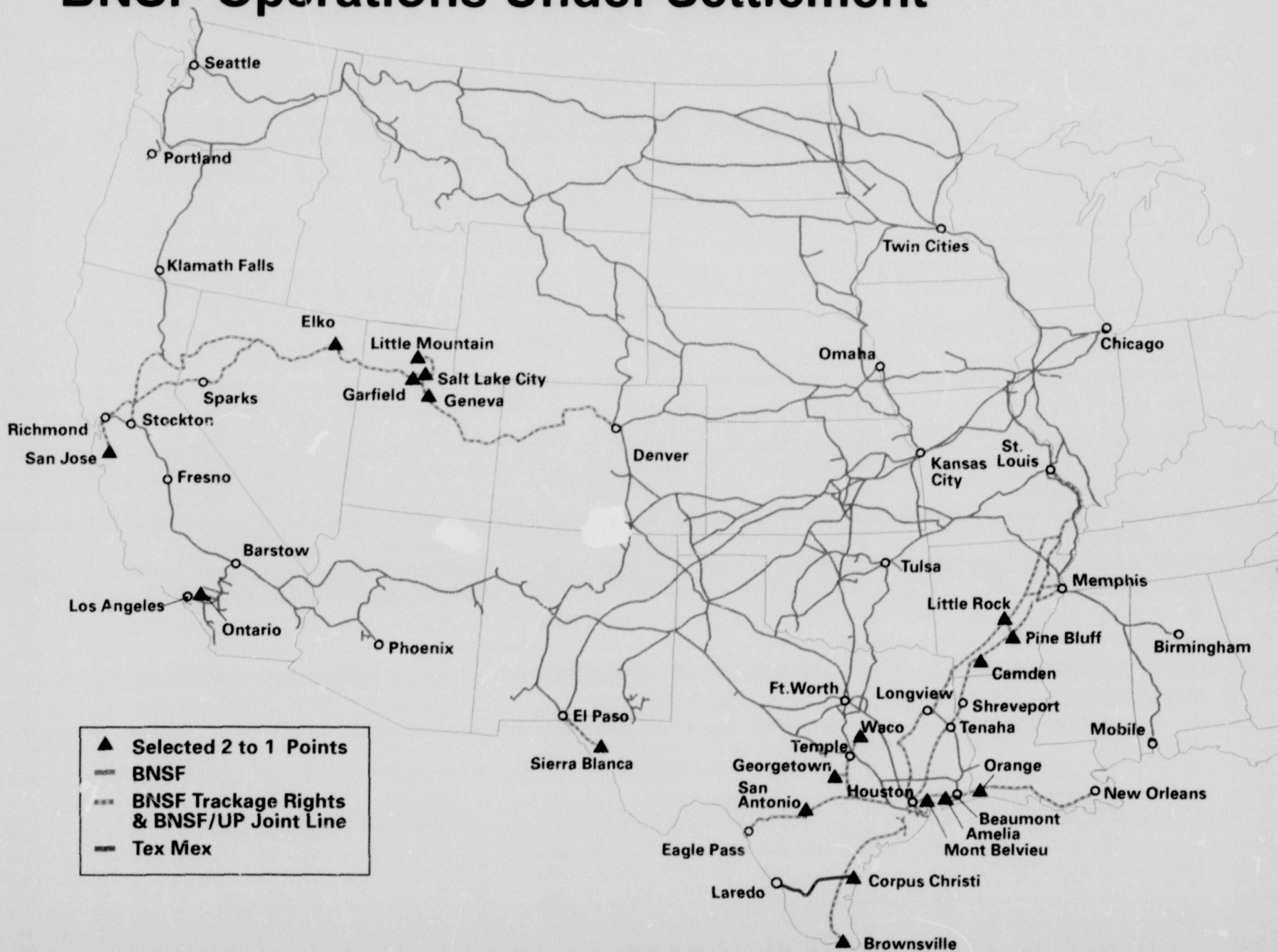
The BNSF agreement granted BNSF trackage rights and line purchases that have allowed it to serve competitively all "2-to-1" traffic. BNSF gained the right to serve all shippers located at "2-to-1" points, to handle intermodal and automotive traffic to and from such points, and to serve new industries and transloading facilities that located at such points after the merger. BNSF also obtained trackage rights in the Houston-New Orleans and Houston-Memphis corridors because UP and SP had the only genuinely competitive rail routes in those two corridors. The trackage rights and lines that BNSF received tied efficiently into the existing BNSF system to ensure that competition would be preserved for every shipper that might have lost two-railroad competition in an unconditioned merger. Map #1 illustrates how well the rights that BNSF gained in the settlement integrate into and complement BNSF's system.

The trackage rights and line purchases in the BNSF agreement were designed to preserve competition at "2-to-1" points by tying these points efficiently into BNSF's network. They also enhanced competition for all shippers that had the ability to use BNSF service. The BNSF agreement filled the few remaining gaps in BNSF's network and thus enabled BNSF to strengthen its existing competitive position at "3-to-2" points and in the many other locations where it was already competing against UP or SP. The BNSF agreement benefitted shippers that were served exclusively by BNSF, because it created new single-line service between those



Map #1

# BNSF Operations Under Settlement



shippers and all "2 to 1" points. Finally, the BNSF agreement enhanced BNSF's competitive position by creating entirely new single-line competition where there were previously none, perhaps most notably in the West Coast North-South Corridor.

The BNSF agreement also contained a variety of other pro-competitive provisions that enhanced competition, such as a grant by UP to BNSF of access to the Oakland Joint Inter-modal Terminal, which the Port of Oakland has just completed; a grant by BNSF to UP of overhead trackage rights between Mojave and Barstow, California; and a grant of trackage rights by BNSF to provide UP with improved access to the MERC dock in Superior, Wisconsin. The BNSF agreement also established a UP capital reserve of \$25 million to fund merger-related projects along BNSF trackage rights lines.

## 2. CMA Agreement

The applicants and BNSF entered into a settlement agreement with CMA that supplemented the rights that BNSF gained in the BNSF agreement. For example, the CMA agreement provided that BNSF could serve new industries that located after the merger on any SP line over which BNSF received trackage rights. The CMA agreement also contained a provision that enabled a CMA member to show that the merger had deprived it of a build-out option and to require UP to provide BNSF with trackage rights necessary to reach a build-out point. The agreement also required UP to provide BNSF equal access to SP's Dayton Yard for storage-in-transit of traffic handled pursuant to the BNSF agreement; it required UP to grant BNSF a few additional trackage rights segments that CMA believed would be relevant to the transportation of its members' products; and it required UP to modify any contracts with shippers at "2-to-1" points in Texas and Louisiana to allow BNSF access to at least 50 percent of the volume.



3. URC Agreement

The applicants entered into a settlement agreement with URC shortly after filing the merger application. The URC agreement provided URC with new rights to serve the Savage truck-rail coal loadout on the CV Spur, near Price, Utah, which SP had served exclusively. The agreement also granted URC trackage rights to Grand Junction, Colorado, to connect with BNSF, and new rights to serve exclusively the Willow Creek mine, which URC had formerly served jointly with SP. By granting URC access to the Savage facility, the applicants created the opportunity for two-railroad competition at all Utah coal mines that they served, except for the Skyline Mine, which SP had served exclusively prior to the merger.

4. Additional Board-Imposed Conditions.

In its August 1996 decision approving the UP/SP merger, the Board imposed the terms of the BNSF, CMA, and URC agreements as conditions. The Board augmented the new industry, transload, and build-out provisions in the BNSF and CMA agreements in several significant respects, and it further enhanced competition by granting Tex Mex trackage rights between Robstown and Beaumont, where it could connect with KCS. The conditions imposed by the Board are in many respects unique. They are more extensive than the conditions the Board imposed in any prior or subsequent merger proceeding and they guarantee that competition for western rail traffic will continue to increase long after the oversight period ends.

The Board expanded the BNSF agreement to allow BNSF to construct new transloading facilities on all of the trackage rights lines it acquired -- not just at "2-to-1" points. The Board extended the CMA agreement's new industry provision to allow BNSF access to new industries located on all of the trackage rights lines, and not just former-SP lines. The Board also extended the CMA agreement's build-out provision to all shippers, removed the time limit for



invoking the provision to which the parties had agreed, and established that a shipper need not demonstrate economic feasibility before UP would be required to provide BNSF with trackage rights to reach a proposed build-out point. Finally, the Board extended the CMA's contract reopener provision to all "2-to-1" shippers to ensure that BNSF had immediate access to a traffic base sufficient to support effective trackage rights operations.

The Board also enhanced competition for Eastern Mexico traffic by granting Tex Mex, which owned a line between Laredo and Robstown, trackage rights between Robstown and Beaumont. Tex Mex connects these with KCS, creating a third competitive rail route into Eastern Mexico.

As documented in UP's prior oversight reports, UP swiftly and effectively implemented the Board's conditions, and there have been only a few disputes in the five years since the merger. UP and BNSF have resolved most issues that have arisen without the need for Board intervention. In fact, both railroads have realized additional benefits from the need to meet to address merger-related issues. For example, the development of new joint dispatching centers covering the Houston, Los Angeles and Powder River Basin areas flowed from the regular senior-level UP-BNSF operating meetings that have been held since UP implemented the merger. In those instances when the Board was asked to clarify the conditions, UP and BNSF were able to use the Board's decisions as guideposts to avoid future disputes.

C. The Merger Has Strengthened Competition at "2-to-1" Points

The BNSF agreement provided BNSF with trackage rights and line purchases, which have allowed it to serve competitively all "2-to-1" shippers (including shortlines). This competition is effective regardless of whether these shippers ever used their rail alternatives or whether they enjoyed such strong truck or source competition that they would have lost little or

no competition as a result of the merger. The applicants also included in the list of shippers to which BNSF would gain immediate access five SP-exclusive Gulf Coast chemical plants (Exxon, Amoco and Chevron in Mont Belvieu/Cedar Bayou, Texas, and Bayer and Borden in Eldon, Texas) to which UP was seeking access through build-outs. BNSF was also granted immediate access to the Lower Colorado River Authority facility at Halsted, Texas – an exclusively served UP point to which SP had a contractual right to gain access some two years in the future.

The applicants engaged in an extensive review of UP and SP traffic data to identify to the best of their ability all rail facilities that were served by UP and SP and no other railroad. Since the merger, UP and BNSF have successfully worked together to implement BNSF access to “2-to-1” shippers and to resolve any questions about the status of any particular shipper in accordance with a protocol the railroads established to govern the listing of “2-to-1” facilities.

The BNSF agreement was designed to yield more intense rail competition for “2-to-1” rail shippers than they had prior to the merger. The settlement has worked as anticipated. Every “2-to-1” shipper gained access to two fiercely competitive rail systems with comprehensive networks that could provide efficient single-line access to far more points than either served before the merger.

1. UP and BNSF Competition for “2-to-1” Traffic Has Been Intense

BNSF service to “2-to-1” shippers has proven to be highly efficient and competitive with UP service. The majority of “2-to-1” shippers are located in Texas, Arkansas, Utah, Nevada, and California. Most “2-to-1” shippers are clustered in larger cities, such as San



Antonio, Little Rock, Salt Lake City, and San Jose, although there are "2-to-1" shippers in many other smaller and more remote locations.

BNSF serves the great majority of "2-to-1" shippers via its trackage rights, which tie those shippers efficiently to the BNSF system. For example, "2-to-1" customers in Utah sit astride BNSF's Central Corridor trackage rights, over which BNSF offers competitive service that links major BNSF terminals at Denver and Stockton, two locations from which BNSF is a much stronger and more effective competitor than was SP. Traffic for "2-to-1" customers in the Gulf Coast similarly flows efficiently to and from BNSF's former network at key BNSF terminals, such as Houston, Memphis, and Temple.

BNSF has initiated direct operations to serve fifty-one "2-to-1" locations. Thirty-two locations continue to be handled via UP haulage. Twenty-one of the haulage locations are "omnibus points" -- isolated "2-to-1" points that are not located along BNSF's trackage rights lines. The remaining haulage operations are in areas in which UP has agreed to provide BNSF with haulage to minimize interference from local train movements and to minimize disruption to customers' facilities by switching both UP and BNSF traffic with the same train.<sup>59</sup> UP haulage in these situations undoubtedly benefits BNSF as well as the affected shippers, as the haulage fees are less costly to BNSF than if it had to mount its own local operations. BNSF retains the right to serve directly all "2-to-1" customers.

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<sup>59</sup> Haulage situations along the trackage rights lines are concentrated in two areas: the paired track in Nevada and UP's mainline east from El Paso. In both of these sparsely populated areas, BNSF has access to every station and customer because of the joint industry access rights both UP and SP enjoyed prior to the merger, but local traffic volumes are relatively small, while through train movements are significant.



(a) Benefits for "2-to-1" Shippers Using BNSF. BNSF competes aggressively in business. BNSF consistently quotes very competitive rates, and it bids on all major traffic. As a result, BNSF has handled hundreds of thousands of carloads of "2-to-1" traffic. BNSF provides access to "2-to-1" points. **REDACTED**

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(b) Benefits for "2-to-1" Shippers Using UP. Just as important to shippers as BNSF's success in capturing "2-to-1" traffic are the rate, service, and equipment improvements that UP has offered to retain traffic in the face of strong BNSF competition. Confidential Appendix C contains some **REDACTED** most of which involve "2-to-1" traffic. These many instances of improved competitive offerings as compared to the pre-merger status quo are further proof that the UP/SP merger and BNSF agreement have increased competition for "2-to-1" traffic.

A particularly notable example of a shipper that has received tremendous benefits even though it has kept most of its traffic on UP is the largest "2-to-1" shipper of all - Geneva Steel. **REDACTED**

**REDACTED** Additional details are contained in Confidential Appendix D.

Other examples of "2-to-1" traffic enjoying UP rate, service, and equipment improvements as a result of BNSF competition are more fully described in Appendix C. **REDACTED**

REDACTED

2. "2-to-1" Rates Have Fallen

Further evidence that the UP/SP merger and the BNSF agreement have enhanced competition for "2-to-1" traffic can be found by examining average rates for this traffic over the period covered by the oversight condition.<sup>60</sup> Rates for "2-to-1" traffic have declined during the five-year oversight period as UP and BNSF have aggressively competed for business. During the merger oversight period, rates for traffic from "2-to-1" shippers fell by approximately four percent. Rates for traffic moving in the Houston-New Orleans and Houston-Memphis "2-to-1" corridors fell by more than ten percent over the same period. These same rates remain below pre-merger levels despite the tremendous increase in operating expenses that UP has confronted recently, which resulted in some rate increases over the past year. Confidential Appendix E-1 contains detailed data on "2-to-1" rates during the oversight period. Confidential Appendix E-2 contains data regarding the changes in rates between the period covered by this oversight report and the previous report.<sup>61</sup> In all of the categories of traffic analyzed in UP's rate study, despite

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<sup>60</sup> All average rate figures herein are computed as total revenue (net of allowances) divided by total revenue ton-miles for the particular periods and commodities at issue. The implicit GDP inflator issued by the Bureau of Economic Analysis has been used to account for inflation over the five-year oversight period. Additional details regarding the rate study are contained in Confidential Appendix E-1.

<sup>61</sup> Along with the detailed information on changes in rates over the five year oversight period that is contained in Confidential Appendix E-1, we have included Confidential Appendix E-2, which contains information regarding changes in average rates between the October 1999-March 2000 period and the October 2000-March 2001 period. The data show some increase in average rates for certain categories of traffic between the two recent periods, which largely (continued...)



the tremendous increase in operating expenses that UP has confronted recently which has led some rates to increase in the past year, rates remain at or below pre-merger levels.

D. The Merger Has Strengthened Competition at "3-to-2" Points

The UP/SP merger and the BNSF agreement have also strengthened competition for shippers who went from three serving railroads to two. Contrary to the claims made by merger opponents that the merger would produce a "duopoly," weakening Western rail competition, the evidence from five years of merger oversight shows that "3-to-2" shippers are benefiting from stronger competition as a result of the merger and the BNSF agreement.

In the merger application, the applicants explained that the merger would create stronger competition for "3-to-2" shippers because, as a result of the merger and the BNSF agreement, both UP and BNSF would be stronger competitors than either UP or SP or BNSF had ever been. Both railroads would have a more comprehensive and more efficient route structure than they had prior to the merger, and both would have the resources to compete vigorously by offering improved rates, service, and equipment supply. Moreover, the alternative to the merger was a weak SP that would have fallen further and further behind in the competitive race. As the applicants explained, the shift from three railroads to two would increase competition by

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reflects the tremendous increase in operating expenses – particularly as a result of the doubling in fuel costs that UP and other railroads have faced over the past 18 months. In no case, however, have the recent average rate increases offset the decline in rates during the oversight period. Rates for all of the categories of traffic included in the rate study remain below pre-merger levels.

providing more competitive routes, more diverse geographic competition, and by providing financial stability to the network of a weak carrier.<sup>62</sup>

In the merger application, the applicants reviewed the twenty-six "3-to-2" points at which UP, SP, and another railroad (usually BNSF) were present. We showed that SP was pervasively the weakest carrier and that its service was distinctly inferior to BNSF and UP service. The applicants explained that a large portion of the "3-to-2" traffic was intermodal and automotive traffic, and that SP was a particularly weak competitor or a noncompetitor for much of this service-sensitive traffic. The applicants also explained that SP had attempted to preserve its ever-declining carload traffic base at these points in the face of its poor equipment and service offerings by raising the reciprocal switching charges on the customers it directly switched.

The UP/SP merger and the BNSF agreement have significantly improved competition for "3-to-2" customers. Former SP-switched shippers now have access to the merged company's new route structure and improved services and equipment supply. These shippers can now use BNSF's equally attractive services for a switch charge of merely \$130 per carload (\$75 per carload for grain). Shippers at "3-to-2" points that had used UP or BNSF prior to the merger can now take advantage of either railroad's geographically comprehensive route structure, efficient service, and ability to invest in continually improving its network and facilities.

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<sup>62</sup> Claims that UP and BNSF might collude are effectively rebutted by the rate study presented in Confidential Appendix E-1 and by a comprehensive rate study released by STB staff in December 2000, which shows that rail rates in the West have fallen dramatically over the past fifteen years, despite the sharp reduction over that same time period in the number of railroads serving many shippers. Surface Transportation Board, Office of Economics, Environmental Analysis, and Administration, "Rail Rates Continue Multi-Year Decline," December 2000.

Just as UP and BNSF are competing head-to-head for "2-to-1" customers, they are competing fiercely for business at "3-to-2" points. For example, **REDACTED**

1. The Merger Has Strengthened Competition at Every "3-to-2" Point

Anecdotal evidence helps to paint a picture of the competitive benefits that "3-to-2" shippers are enjoying as a result of the merger, but a more systematic approach demonstrates that the merger has strengthened competition at every "3-to-2" point. In the merger application, the applicants examined five major "3-to-2" points – Portland, Oakland, Los Angeles/Long Beach, Denver and Houston – and the twenty-one other locations in which the number of carriers serving some shippers would go from three to two as a result of the merger. One does not have to pause long to understand that shippers at all of these points are better off today than they were before the merger.

a. Major "3-to-2" Points.

Portland. Portland illustrates how shippers in a major city directly served by UP, SP, and BNSF saw their competitive options increase substantially as a result of the merger and the BNSF agreement. At Portland, prior to the UP/SP merger, SP's only route led south down the West Coast North-South Corridor, while the BN and UP routes led north and east. Only for



traffic moving east of Denver and Fort Worth could the three railroads overcome circuitry and have even a theoretical opportunity to compete.<sup>63</sup>

The merger increased competition for Portland shippers by replacing SP's service in the West Coast North-South Corridor with two single-line routes along the West Coast, each of which offers shippers several new product options. These new options include BNSF's guaranteed service and UP's 5-7-9 schedules and Speedlink carload merchandise trains, which are discussed in more detail in the section below that addresses competition in the West Coast North-South Corridor. In addition, former SP-switched shippers in Portland can now take advantage of UP's excellent service to the East (or BNSF's comparable service, with a \$130 reciprocal switch). Prior to the merger, these shippers would have paid a \$495 per carload switch charge to use the UP or BNSF routes.

Oakland. Bay Area shippers have also seen their competitive options improve dramatically as a result of the merger and the BNSF agreement. At the time of the UP/SP merger, there was little competitive carload traffic to and from the Oakland switching district, and SP directly switched almost all of the industries in Oakland. The Oakland-area "3-to-2" intermodal traffic consisted primarily of traffic moving between Northern California, on the one hand, and the Midwest and Northeast, on the other hand, as other markets, such as Southern California and the Pacific Northwest, were served efficiently by only one or two competitors. BNSF was the predominant carrier to the Midwest and Northeast. SP, which did not have the

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<sup>63</sup> In fact, as explained in the merger application, much of the carload traffic that originates or terminates at "3-to-2" points is not practically open to competition among all three carriers, either because the actual originating or terminating industry is not actually open to all three carriers or because the other end of the movement is exclusively served by only one or two of the three carriers.

resources to establish consistent and competitive intermodal service through the Central Corridor, handled only a tiny amount of Northern California-Midwest/Northeast intermodal traffic. SP's automotive volume had been declining significantly, and as Mr. Gray explains in his verified statement, SP would likely have lost its remaining major customer, Ford Motor Company.

The merger improved competition for former SP-switched shippers in Oakland, who can now take advantage of UP or BNSF service without incurring SP's \$495 per car switching charge. BNSF remains the leader in intermodal traffic, but shippers have benefitted as UP has taken advantage of its merger-shortened Central Corridor route to offer stronger competition for Chicago-Bay Area intermodal traffic. In fact, UP now operates the fastest trains in the market – the new expedited Chicago-Bay Area premium trains. The merger has also resulted in intense competition between UP and BNSF for automotive traffic. BNSF has taken advantage of its route structure and service capability to bid aggressively for traffic from the three major domestic auto producers, as well as foreign producers.

Los Angeles/Long Beach. Los Angeles/Long Beach shippers are enjoying significant competitive benefits as a result of the merger and the BNSF agreement. Los Angeles has little competitive carload traffic. BNSF, with its superb routes to the Midwest and East handled the largest share of the Southern California-Midwest/ Northeast intermodal market – the largest intermodal market in America. BNSF, however, had weak access to the Los Angeles/Long Beach port complex. SP had the best coverage of the ports, including its strategically located ICTF intermodal facility, but poor service performance, and its routes lacked the capacity to support expedited service. SP had also been largely driven out of the



Southern California automotive market because it could not compete with UP and BNSF offerings.

The merger has intensified competition in the Los Angeles/Long Beach area. BNSF has further improved its already strong position through the BNSF agreement, which provided it with new single-line routes to New Orleans and the Southeast, as well as to the Pacific Northwest and Western Canada. The BNSF agreement also provided BNSF with enhanced access to the Los Angeles/Long Beach port complex. UP is now able to offer a Southern Corridor route that improves on SP's route by combining the former-SP Colton-El Paso line with the UP El Paso-Dallas line to compete against BNSF, so both carriers have comprehensive service offerings direct from the ports to all eastern markets. And, as at Oakland, automotive and carload shippers have also benefitted from reduced switch charges, access to broader networks, and intense bidding for traffic.

Denver. Shippers in Denver are also enjoying enhanced competition as a result of the merger and the BNSF agreement. Prior to the merger, SP's competitive position in Denver was precarious. SP's only route to the East was the inefficient DRGW route in which traffic would first operate south to Pueblo and then turn east, and its routes to the Pacific Northwest and Southern California were circuitous. BNSF had a direct high-speed mainline from Denver to Chicago, and multiple routes to the north and the south, but no efficient route to the west.

The merger has intensified competition in Denver by providing former-SP shippers with solid UP service to Chicago via North Platte, to Kansas City and St. Louis via the upgraded KP line for coal and automotive traffic, and to the West Coast via Cheyenne. BNSF shippers now have access to BNSF's strengthened system, with its new Central Corridor route to the west and better service to the east, which has been enhanced by the volumes flowing into



Denver from the west on BNSF's new trackage rights. All Denver shippers now have competitive access to two strong, comprehensive rail systems that go virtually everywhere.

Houston. There may be nowhere that shippers have seen more competitive benefits from the merger and the BNSF agreement than in Houston. Prior to the merger, UP shippers had no Southern Corridor route to the West. BNSF shippers had no route to New Orleans, very limited access to Mexico, and a circuitous route to Memphis and the Midwest. SP shippers faced increasingly frequent service problems as SP's infrastructure decayed, and SP-switched shippers faced \$495 switching charges to avail themselves of UP or BNSF service, which many times could not take them where they wanted to ship.

As a result of the merger and the BNSF agreement, Houston shippers now have competitive access to two strong, comprehensive rail systems that go virtually everywhere, including Mexico, California, the Midwest, and the Southeast via New Orleans and Memphis. In addition, the Board further expanded the competitive opportunities for Houston shippers by granting Tex Mex's request for a trackage rights condition that allows Tex Mex to provide additional competition for Houston-Mexico shippers.

b. Other "3-to-2" Points

Shippers at the twenty-one smaller "3-to-2" points have not suffered any competitive harm as a result of the merger. In fact, they have seen their competitive options grow. **REDACTED**

The merger has strengthened

competition for Sacramento traffic thanks to shorter Central Corridor routes and new West Coast North-South Corridor single-line benefits. At Stockton, BNSF recently opened a large, state-of-the-art intermodal terminal with new daily trains to and from Chicago and other eastern points for LTL carriers, other premium customers, and shippers of perishables and other food products. The merger has strengthened competitive options for Stockton shippers thanks to new West Coast North-South Corridor single-line benefits and BNSF's new access to New Orleans. At Modesto, where SP handled only a tiny portion of the competitive traffic, BNSF continues to dominate the "3-to-2" competitive business, but competition has increased for the same reasons that it has increased at Stockton. **REDACTED**

At El Paso, Texas, volumes have declined along with copper prices. This severe slump would have been devastating for an independent SP, which depended on copper-related traffic for over \$100 million in annual revenue. El Paso shippers have benefitted from UP's and BNSF's efforts to reduce rates to aid the copper producers' competitiveness. SP's carload traffic base would also have been damaged by the loss of steel-related traffic at Pueblo, Colorado, where UP handled little traffic prior to the merger, and by declining wheat traffic from Kansas "3-to-2" points. In both areas, shippers that had been using SP service have benefitted from the financial stability and expanded networks provided by the merger.

2. "3-to-2" Rates Have Fallen

Further evidence of the pro-competitive impact that the UP merger and the BNSF agreement have had on "3-to-2" shippers can be found by examining rates for "3-to-2" traffic. Rates for "3-to-2" traffic have held steady or declined during the merger oversight period as the

closely matched UP and BNSF have aggressively competed for shipper business. During the merger oversight period, rates for "3-to-2" intermodal traffic have held steady. Rates for carload traffic have declined by almost five percent. Rates for automotive traffic fell even further, dropping by more than twenty percent during the same period. Confidential Appendix E-1 contains detailed data regarding "3-to-2" rates.

E. Competition Has Been Strengthened in Every Rail Corridor

In the UP/SP merger application, the applicants examined the major corridors in which UP, SP, or both operated and concluded that, following the merger, competition would be strengthened in all of those corridors. The applicants' analysis revealed that in the large majority of rail corridors throughout the West, the UP/SP merger would combine the railroads that were number two and number three – often a weak number three – and create a more formidable and equal competitor to the number one railroad, BNSF (or in a few north-south corridors in the central United States, KCS or IC).

In the five years since the merger, it has become increasingly clear that the applicants' analysis was correct. The merged UP has taken advantage of shorter routes, improved equipment supply, and the availability of investment capital to expand its service offerings and improve its performance in the major corridors in which UP and SP operated prior to the merger; BNSF has taken advantage of the trackage rights it gained through the BNSF agreement to improve its own offerings and performance; and UP and BNSF and other railroads operating in these corridors have all responded to each other's improved competitive offerings by instituting new and better services of their own. As a result, competition in all of the major corridors in which UP, SP, or both operated has been strengthened, and shippers have benefitted.



1. West Coast-Midwest/Northeast

The UP/SP merger and the BNSF agreement have strengthened competition in the three major West Coast-Midwest/Northeast corridors. The West Coast-Midwest/Northeast corridors link the Pacific Northwest, Northern California, and Southern California, on the one hand, with the Midwest gateways of Chicago, Kansas City, and St. Louis and the regions served via those gateways, on the other hand. In discussing these corridors, we shall focus separately on each western region.

a. Pacific Northwest-Midwest/Northeast

The UP/SP merger has strengthened competition in the Pacific Northwest-Midwest/Northeast Corridor. Map #2 shows the pre-merger routes of UP, SP, BNSF, CN, and CP in this corridor, along with UP's post-merger route between the Pacific Northwest and Chicago, which is the primary gateway to the Northeast.

Prior to the merger, BNSF was the dominant carrier between the Pacific Northwest and the Midwest gateways and regions served over those gateways (the Northeast and the Midwest). BNSF dominance was the result of its extensive shipper coverage in the Pacific Northwest and its excellent routes from Seattle/Tacoma and Portland to the Midwest. BNSF also benefitted from serving Vancouver, British Columbia, and many other points in Washington that neither UP nor SP could serve directly. SP was a minor player in this corridor because its lines did not reach Washington, and its route via Roseville from Oregon to the Midwest was circuitous. UP was hampered in these regional flows because it had more limited shipper access in Washington than BNSF, and it had no shippers in southern Oregon.

Five years after the merger, BNSF remains the dominant carrier in this corridor, but competition has improved. CN and CP are both focusing on increasing their competitive

# Pacific Northwest - Chicago Routes



presence in this corridor – CN's pending acquisition of Wisconsin Central would provide it with a direct link into Chicago. UP's ability to compete in this corridor has been enhanced, and SP customers in particular have enjoyed vast improvements in service.

For example, prior to the merger, SP struggled to move declining volumes of Oregon lumber to the East via its circuitous Central Corridor route. The merger has significantly improved rail competition for this Oregon lumber traffic. Following the merger, UP placed into service a new lumber train from Eugene, Oregon, direct to UP's Proviso Yard in Chicago for connection with eastern carriers. This train operates via Hinkle, Oregon, which saves over 750 miles between Portland and Chicago as compared with SP's former route via Roseville. This new service, coupled with highly competitive UP pricing in this corridor and the improved equipment supply that UP has been able to offer to these shippers, has resulted in new and expanding markets in the Northeast for former-SP Oregon lumber producers.<sup>64</sup> The volume of this Oregon lumber moving on the UP system to the Midwest and Northeast has increased by more than seventy percent since the merger. As one would expect, BNSF has countered with its own rate reductions, which have further benefitted lumber producers.

b. Northern California-Midwest/Northeast

The UP/SP merger has strengthened competition in the Northern California-Midwest/Northeast Corridor. Map #3 shows the pre-merger routes of UP, SP, and BNSF in this corridor, along with UP's post-merger route between Northern California and the Chicago gateway.

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<sup>64</sup> Rates for this Oregon lumber traffic to the Northeast have fallen by more than twenty percent during the merger oversight period. For details, see Confidential Appendix E-3.



Northern California had traditionally been a center of strength for SP. However, in the years prior to the UP/SP merger, BNSF had capitalized on its excellent route from the Bay Area to Kansas City and Chicago and superlative intermodal and carload service to become the traffic leader. SP lagged far behind, hampered by a slower route from Oakland to Chicago. Clearance restrictions forced high-cube intermodal traffic over the longer Tucumcari route, and service problems on both its Central Corridor and Tucumcari routes often led shippers to select UP or BNSF when a rail alternative was available, or to truck when there was no rail alternative. UP had limited shipper coverage north of the Bay Area and in the important San Joaquin Valley, where BNSF and SP were the main competitors. Also, unlike BNSF and SP, UP had no efficient route that it could use efficiently to reposition equipment between Northern and Southern California.

Five years after the merger, it is clear that Northern California shippers have benefitted tremendously from the merger, especially with regard to transcontinental flows to the Midwest and Northeast. As anticipated in the merger application, UP has combined its high-speed main line between Chicago and Ogden with the former-SP high-speed main line west of Ogden to restore the traditional Overland Route and assemble routes to Midwest gateways that are much shorter than either UP's or SP's pre-merger routes. The merger reduced UP's mileage between Oakland and Chicago by 189 miles and SP's by 388 miles. UP is using the restored Overland Route to offer expedited intermodal service between Chicago and the Bay Area. This service, which UP initially implemented in 1997 and then redesigned in 2000, now operates on a 51-hour schedule, which is even faster than BNSF's high-speed service. As UP began to acquire BNSF premium intermodal customers, BNSF responded competitively by redoubling its efforts to improve on-time performance and shipment availability and by providing additional

# Northern California - Chicago Routes



incentives for customers who also use its premium Southern California service. BNSF's competitive response has allowed it to recapture a substantial portion of this traffic, but UP has now gained a foothold, and it is steadily developing new traffic for its premier Overland Route intermodal service.

Another merger-related development that has dramatically benefitted shippers in this corridor has been UP's nearly \$150 million investment to completely dismantle SP's large, dilapidated Roseville Yard and construct on its site a new, state-of-the-art hump yard – an investment that SP could not have afforded. The new yard has provided tremendous benefits to shippers in the Northern California-Midwest/Northeast Corridor.

For example, UP has taken advantage of the new yard's capabilities by initiating its new Express Lane service, which moves perishables and other food products from Northern California to Northeastern markets on CSX. This service provides eighth-morning availability at New York markets and now operates with over ninety percent reliability. UP and CSX back this service with a guarantee that imposes monetary penalties for late shipments, but most customers do not pay for the guarantee because performance has been so reliable. This service would not have been possible without Roseville Yard, which serves as the gathering point for food products traffic from dozens of former-SP Northern California origins (and especially the San Joaquin Valley) and assembles the Express Lane train.<sup>65</sup> The expedited schedule would also not have been possible without use of UP's shorter route from Ogden to Chicago and UP's investments in

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<sup>65</sup> The two major California shortlines, San Joaquin Valley and California Northern, operate key parts of the former-SP branch line network in Northern California. They originate over one-third of the food products traffic on the train, and their gathering service is essential to the success of Express Lane. Other short lines, including MET, STE, and Yolo Short Line are also important food products originators for the service.



upgrading former-SP lines west of Ogden following merger. The Express Lane service has improved shippers' competitive options and returned to rail carload service fresh vegetables, citrus, and wine, which had largely been lost to truck.

Many of the merger-related benefits that Pacific Northwest and Northern California shippers are enjoying were made possible because UP has been able to make investments in tracks and facilities that SP could not have afforded. UP has invested approximately \$900 million in the Central Corridor to improve competition and services to shippers. This includes not only the complete rebuilding of the former-SP Roseville Yard for nearly \$150 million, but also nearly \$300 million to upgrade former-SP track west of Ogden, over \$300 million for a new triple-track UP main line in Nebraska, and over \$100 million in other improvements, such as new double track in Iowa and streamlining the Ogden terminal, which were not documented in the merger application.

BNSF has not stood still during all of this. BNSF has increased its Northern California business to the point where last year it constructed a new intermodal facility near Stockton, California. Much of the traffic that uses this facility moves to and from the Midwest and Northeast in direct competition with UP's strengthened service. BNSF continues to compete in this corridor using its high-speed and efficient Southern Corridor route, and it has spent hundreds of millions of dollars to expand capacity on this route to accommodate its continued strong growth in its intermodal traffic in this market. BNSF has repeatedly proven that its Southern Corridor route is highly competitive with UP's Central Corridor route for Northern California traffic. **REDACTED**

## REDACTED

In addition to its pre-merger Southern Corridor route, BNSF now also has a Central Corridor route that is available to handle a variety of traffic in this corridor. Thus far, BNSF has elected to invest in the capacity required to move most of its Northern California-Midwest business via its high-speed Southern Corridor route, but it has regularly used its Central Corridor rights for a portion of its Northern California-Midwest traffic.

### c. Southern California-Midwest/Northeast

The UP/SP merger has strengthened competition in the Southern California-Midwest/Northeast Corridor. Map #4 shows the pre-merger routes of UP, SP, and BNSF in this corridor, along with UP's post-merger route between Southern California and Chicago.

The most competitively significant body of traffic in this corridor is intermodal traffic. Prior to the merger, BNSF dominated the intermodal business in this corridor, with the fastest and most reliable service, due in large part to a mileage advantage over UP and a service advantage over SP. In addition to its mileage handicap, UP suffered from capacity constraints in its routes to key gateways, poor coverage of shipper facilities in Southern California compared with both SP and BNSF, and its inability to reposition equipment between Northern and Southern California. SP provided only unreliable, fourth-day intermodal service to Chicago, which meant that its traffic consisted primarily of non-premium, international container business moving at rate levels that did not provide enough contribution for SP to upgrade its lines.

Five years after the merger, BNSF remains the dominant carrier in this corridor, but UP is increasing its competitiveness and shippers' options. The Chicago-Southern California market is the largest transportation lane in the country, and BNSF has targeted this lane as a

# Southern California - Chicago Routes





major contributor to its growth. As the applicants observed in the merger application, at the time of the UP/SP merger, BNSF was capitalizing on its own merger by integrating BN's facilities in Chicago, Galesburg, and Kansas City, including BN's large Chicago intermodal facility, with Santa Fe's collection of facilities in both Chicago and the Los Angeles Basin. BNSF has continued to invest heavily in this corridor with new or expanded intermodal facilities in Southern California, Chicago, and Kansas City; double-tracking hundreds of miles of former single track; installing reverse-signalized CTC across hundreds of miles of former directionally-signalized double track main line in Arizona and California; and announcing a major new intermodal terminal near Joliet, Illinois, southwest of Chicago.

Without the merger, SP would have surely failed to keep up with the BNSF onslaught. However, in the merger application, UP indicated that it, too, would target the Chicago-Southern California market and increase its competitiveness with BNSF. The first step has been to invest in the improvements necessary to bring former-SP lines up to their full potential from a scheduling and capacity standpoint. UP has invested nearly \$200 million to upgrade track, build new sidings, and install CTC on the Tucumcari line between Topeka and El Paso. UP has thus far spent nearly \$275 million on track improvements and doubletracking of SP's Sunset Route between El Paso and Los Angeles. And UP is continuing to make substantial investments to improve this route. By the end of 2001, UP will have rebuilt the former-SP line entering the Los Angeles Basin via Beaumont Pass by upgrading track and signals on the western slope of the pass, and doubletracking the eastern slope.

UP has also invested heavily in its Central Corridor route, which is only slightly longer than the former-SP route between Chicago and Los Angeles. UP's investment in triple tracking across Nebraska has provided the additional capacity needed to efficiently handle

transcontinental intermodal traffic along with Powder River Basin coal and manifest traffic. In addition, current economic conditions suggest that Utah coal destined to Los Angeles/Long Beach for export may not grow to the extent envisioned earlier, which would mean that UP will have an even greater opportunity to use its Salt Lake City-Los Angeles route together with its Central Corridor route as an alternative to the former-SP route in this corridor. The ability to use two independent routes has already benefitted UP customers by minimizing maintenance-caused delays, and it will provide even greater benefits in the future. These benefits will arise not only from providing an alternate route when track work, disruptions, weather, and other factors affect the traffic flow on one routing, but also by allowing for increased flexibility to schedule through trains to pick up and set out traffic at the growing intermediate markets, such as Salt Lake City, Las Vegas, Kansas City, and El Paso.

One sign of UP's commitment to providing shippers with the competitive rates and service necessary to build traffic in this corridor is UP's plans to construct a new \$200 million intermodal facility at Rochelle, Illinois, west of Chicago. This facility will ensure adequate terminal capacity to compete with BNSF and secure a larger share of this growing market.

UP and BNSF have taken advantage of all of their investments in this corridor to engage in head-to-head competition for shipper business. **REDACTED**

Shippers have been the clear beneficiaries of the investments UP has made in this corridor and the intensified competition that has resulted.

2. West Coast-South Central/Southeast

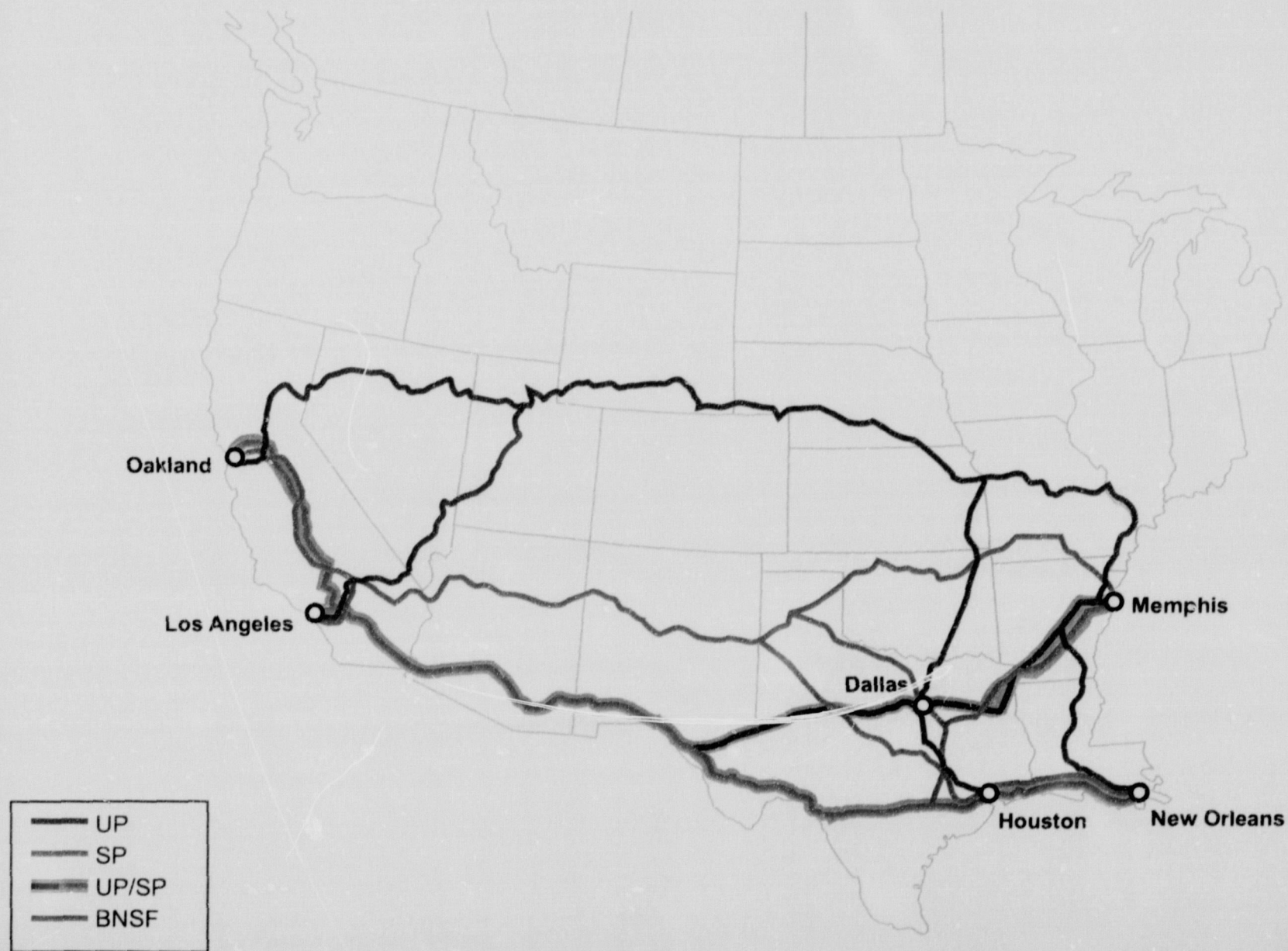
The UP/SP merger and the BNSF agreement have strengthened competition in the West Coast-South Central/Southeast Corridor. The West Coast-South Central/Southeast Corridor links the Pacific Northwest, Northern California, and Southern California, on the one hand, with Texas, New Orleans, Memphis, and the Southeast region that is served via New Orleans and Memphis, on the other hand. Map #5 shows the pre-merger routes of UP, SP, and BNSF in this corridor, along with UP's and BNSF's post-merger routes between California, on the one hand, and Dallas, Houston, Memphis, and New Orleans, on the other hand.

Rail volumes in this corridor, while substantial, are less than half of those in the West Coast-Midwest/Northeast Corridor. These volumes should continue to grow, however, as the population grows in the Sunbelt states, such as California, Arizona, Texas, and Florida.

The largest flows in the West Coast-South Central/Southeast Corridor are between California, on the one hand, and Texas and the Southeast, on the other hand. This is a market where, prior to the merger, UP's route via the Central Corridor was less competitive for some important traffic flows than the alternatives, and consequently, UP carried only a small share of the traffic. SP's Sunset Route was historically the only single-line route in the corridor, but the BNSF merger and SP's declining financial situation resulted in BNSF's becoming a much stronger competitor in these markets. The BNSF merger created a new, highly efficient single line between both Northern California and Southern California, on the one hand, and Memphis and Birmingham, Alabama, on the other hand. The BNSF merger also gave BNSF greater customer access and improved route and terminal flexibility. As BNSF's service improved and as SP's weakened, BNSF captured a number of important intermodal contracts



# West Coast - South Central/Southeast Routes



from SP, including the United Parcel Service traffic between Memphis and Los Angeles, and SP's traffic became more and more dominated by non-premium, low-rated steamship traffic.

Now, as a result of the UP/SP merger, shippers are benefiting as two strong competitors battle each other for business in the Southern Corridor. By combining the former-SP Colton-El Paso line with the UP El Paso-Dallas line, the merged system's route between Los Angeles and Dallas is now 233 miles shorter than the former-SP route and 999 miles shorter than the former-UP route, and the merged system's route between Los Angeles and Memphis is now 283 miles shorter than the former-SP route and 580 miles shorter than the former-UP route. Similar savings have been realized between Oakland and Dallas and between Oakland and Memphis.

Moreover, before the merger, SP had the only direct single-line route between California and New Orleans. As a result of the BNSF agreement, however, BNSF obtained a new, excellent, single-line route between California and New Orleans.

UP has invested heavily to bring the former-SP Southern Corridor route up to near parity with BNSF. UP has upgraded the former-SP route between Los Angeles and El Paso, as mentioned previously; it is completely rebuilding the UP line between El Paso and Fort Worth, which provides a new route between Memphis, Dallas, and Los Angeles that is second to none; and it has implemented directional running between Memphis and Texas and made numerous other improvements to its Gulf-area lines and facilities in order to improve scheduling and reliability.

Shippers have benefitted as UP has placed new train services into the market, including the ZMELT, which handles premium business from Memphis and Dallas to California and has been successful in capturing the United Parcel Service business from BNSF. This

service has been so successful that a second premium service in each direction between Memphis and California has been added.

BNSF has moved aggressively to incorporate its newly gained rights to New Orleans into its network and to exploit its New Orleans access. BNSF is using its rights to New Orleans not only for traffic terminating in New Orleans, but also to connect at New Orleans with NS, CSX, and CN, which BNSF could not do before the UP/SP merger. The ability to access the New Orleans gateway also provides BNSF with a significant advantage when competing for transcontinental traffic, especially steamship traffic from California, because it is now able to provide competitive bids for all eastern gateways. **REDACTED**

BNSF's new route to New Orleans has been critical in all of these competitive situations, and shippers have clearly benefitted from this new competition.

3. Midwest-South Central City Pairs

The UP/SP merger and the BNSF agreement have also strengthened competition between Midwest and South Central city pairs that, prior to the merger, were served by UP or SP or both.

In the UP/SP merger application, the applicants analyzed the impact of the merger and the BNSF agreement on a long list of relatively short-haul city pairs in the Midwest-South Central area. The applicants explained that more railroads usually served these city pairs than the transcontinental corridors discussed above. The applicants also explained that in most of the



Midwest-South Central city pairs, railroads other than UP or SP were the primary rail carrier, that trucks and barges were often extremely competitive in these markets, and that the merger would benefit shippers by making UP a stronger competitor.

It is clear that the merger has preserved and enhanced competition in the Midwest-South Central city pairs that were examined in the merger application. Where UP and SP were the primary carriers, BNSF's trackage rights have preserved and enhanced competition. As discussed later in the Gulf Coast competition section, this is the case between Houston and New Orleans and between Houston and Memphis.

In other city pairs, railroads other than UP or SP dominated the business before the merger, and they continue to dominate after the merger as well, although the UP/SP merger has increased the level of competition.

For example, CN (formerly IC) is the dominant carrier between St. Louis and Memphis; St. Louis and New Orleans; Chicago and Memphis; Chicago and New Orleans; and Memphis and New Orleans. BNSF is a strong, if not the strongest, competitor carrier between Dallas and Houston; St. Louis and Dallas; Kansas City and Houston; Chicago and Dallas; Chicago and Houston; Kansas City and Memphis; and Kansas City and Dallas. KCS has excellent routes between Kansas City and New Orleans; Dallas and New Orleans; and Dallas and the Southeast. Furthermore, a host of railroads have competitive routes between Chicago and St. Louis; St. Louis and Kansas City; and Chicago and Kansas City.

Former-SP and UP customers with traffic moving between any of these city pairs are clearly much better off today with the merged system's improved competitiveness against these other carriers, as well as against truck and barge options.

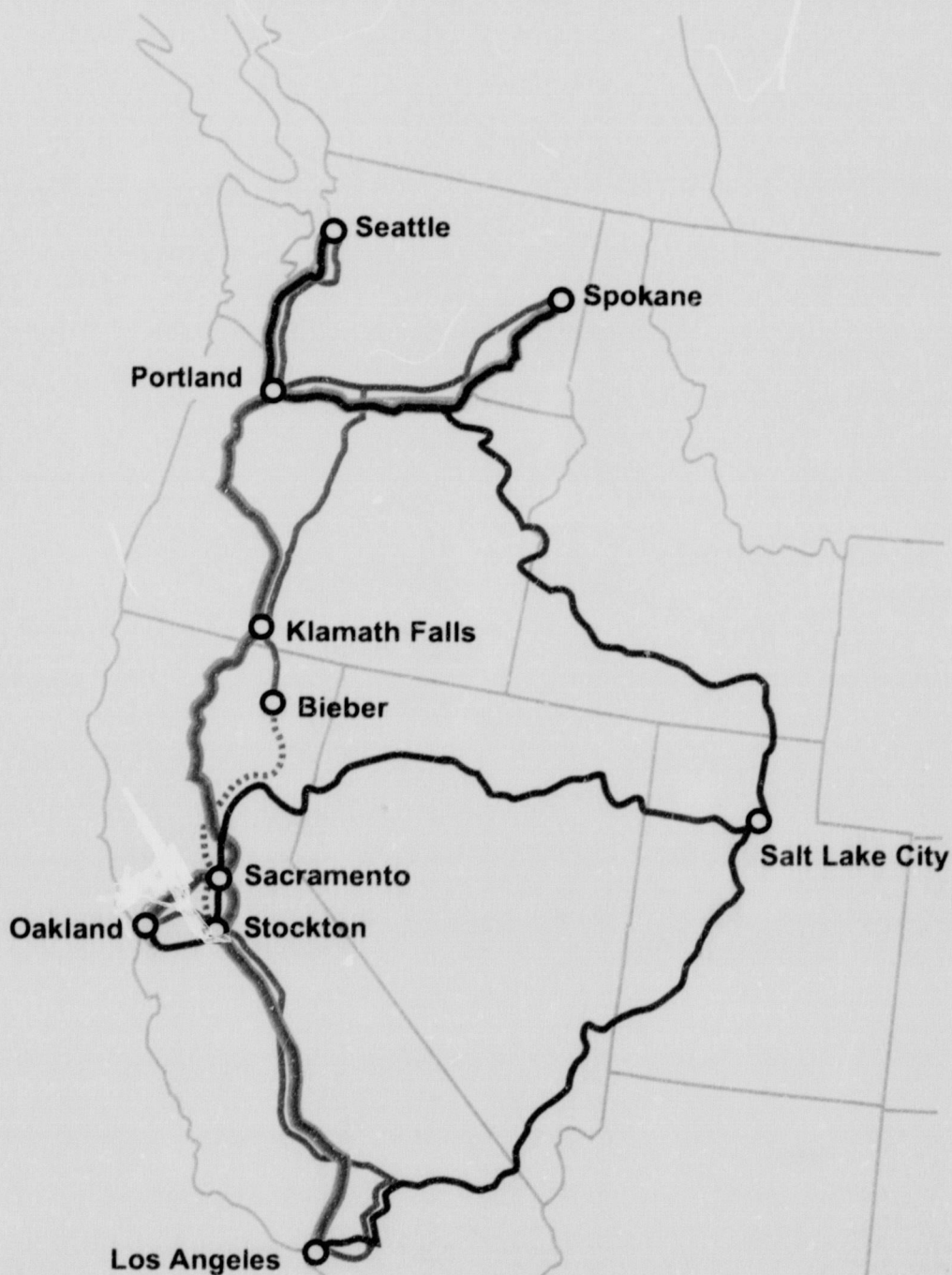
4. West Coast North-South

The UP/SP merger and BNSF agreement have created entirely new and highly intense competition in the West Coast North-South Corridor. The West Coast North-South Corridor links together the major West Coast cities from Seattle, in the north, to Los Angeles, in the south, and all of the points in between. Map #6 shows the pre- and post-merger routes of UP, SP, and BNSF in this corridor.

Prior to the UP/SP merger and the BNSF agreement, no railroad could provide competitive single-line service between Los Angeles and Seattle or between the Bay Area and Seattle. UP had a line between Seattle and Portland, but it had no route between Portland and the Bay Area or between the Bay Area and Los Angeles, except for extremely circuitous routes via Salt Lake City. SP had a route from Los Angeles to the Bay Area to Portland, but no route to Seattle. BNSF had a route between Los Angeles and the Bay Area and between Portland and Seattle, but no route that connected the Bay Area to Portland. Truck tonnage and water movements in this corridor far exceeded rail volumes.

Now, as the result of the UP/SP merger and the BNSF agreement, shippers are benefiting from intense, two-railroad competition up and down the West Coast. The UP/SP merger and BNSF agreement created two new single-line routes in the West Coast North-South Corridor. The merger combined UP's Seattle-Portland route with the former-SP Portland-Bay Area-Los Angeles route to create new UP single-line service along the West Coast from Seattle to Los Angeles. The BNSF agreement provided BNSF with the rights necessary to complete its own north-south route along the West Coast, one that stretches from Vancouver, British Columbia, to Mexico. The BNSF route was not needed to address any loss of competition

# West Coast North-South Routes



- UP
- - - SP
- UP/SP
- BNSF
- ..... BNSF Line Purchase  
& Trackage Rights



caused by the UP/SP merger; rather, it was a bargained-for provision that immeasurably added to the competitive options available to West Coast shippers.

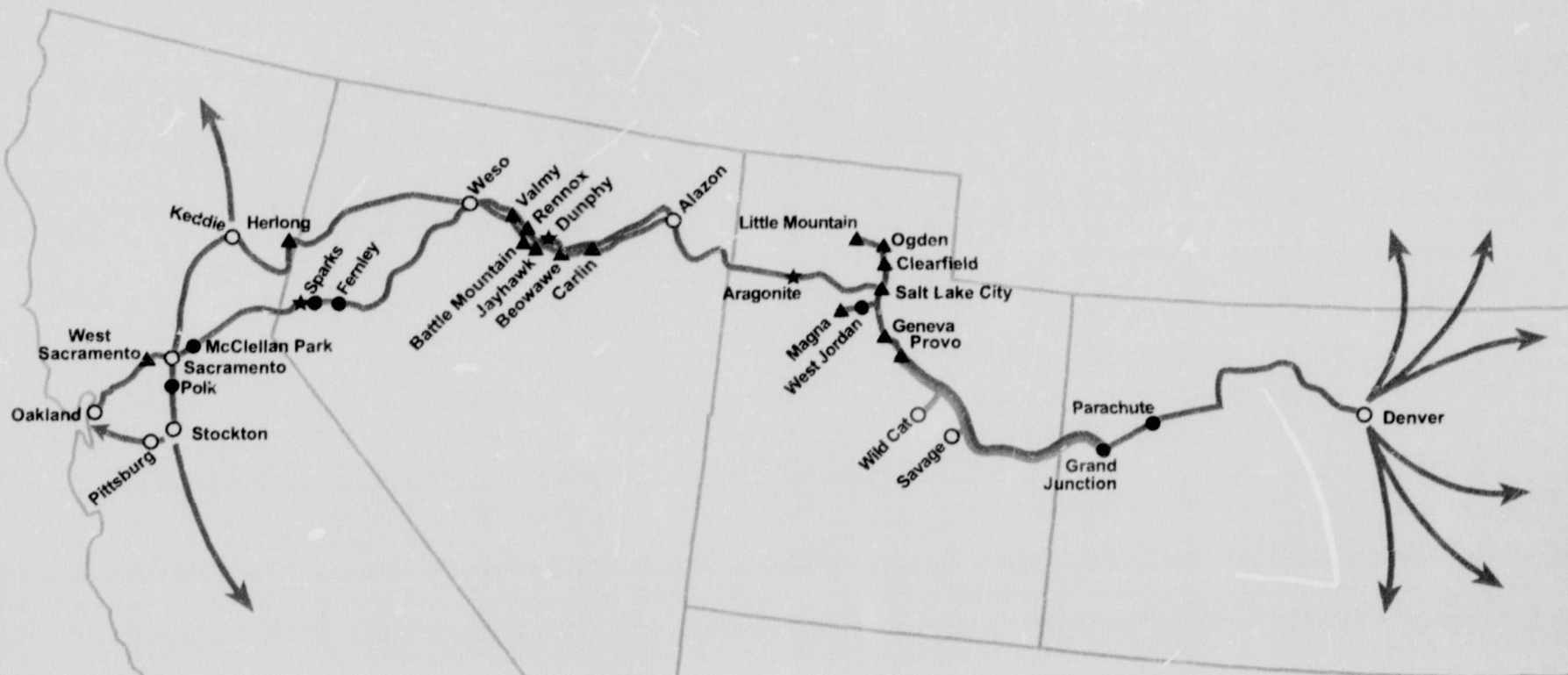
In the merger application, the applicants briefly addressed the anticipated new UP single-line service utilizing SP's route south of Portland. They also discussed the new BNSF single-line route between Vancouver, British Columbia, and points as far south as Los Angeles, San Diego, and Phoenix. However, no one could have anticipated the dramatic upturn in rail competition that has resulted from the creation of these two new West Coast routes.<sup>66</sup>

During the past five years, BNSF has increased the volume on its former "Inside Gateway Route" through Bieber, California, from a handful of cars per day to more than three trains per day in each direction. BNSF's extensive coverage of shippers in Washington, northern Idaho, Montana, and the Dakotas, plus BNSF's direct connections with BC Rail, CN, CP, and Southern Railway of British Columbia ("SRY") at Vancouver, B.C., have provided trainloads of forest products, grain products, metals, chemicals, and other traffic moving to the growing population centers in the Southwest, primarily in Southern California and Arizona. BNSF has invested heavily in lumber reload centers in Southern California and Arizona to serve receivers not on rail or served exclusively by UP. BNSF volumes via Bieber have grown to over 200 trains per month, or approximately three to four trains in each direction per day. **REDACTED**

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<sup>66</sup> In the application, the applicants also discussed BNSF's agreement to provide UP with proportional rates for movement of traffic via Portland in BNSF-UP joint-line service, which would give UP a greater ability to compete with BNSF for traffic moving between BN stations and Canadian gateways in Washington, Idaho and Western Montana, on the one hand, and UP stations and gateways in Oregon, California, Nevada, Utah, Colorado, Arizona, New Mexico and West Texas, and all UP Mexican gateways between the West Coast and El Paso, on the other hand. UP has used the proportional rate agreement to provide some service in competition with BNSF's offerings, but for a variety of reasons, the proportional rate agreement has not worked as well as UP had anticipated.

# BNSF Central Corridor Route



- ★ New Transload
- New Industry
- ▲ Major 2 to 1 Points
- BNSF Trackage Rights on UP
- ➔ Major BNSF Routes
- Utah Railway (including trackage rights on UP)



enhance competition for BNSF customers located near the endpoints of the corridor who, prior to the merger, had no efficient BNSF single-line route for their traffic, but who can now replace their pre-merger joint line service with efficient single-line routes, or even reach new markets. Finally, the Central Corridor rights have enhanced competition by providing BNSF with a viable alternative to its Southern Corridor route from California to Chicago.

a. Competition at Central Corridor "2-to-1" Points

The merger and the BNSF agreement have strengthened competition for "2-to-1" traffic in the Central Corridor, as UP and BNSF have offered shippers throughout Utah and Nevada lower rates and better service than were available before the merger in order to capture and maintain their business.<sup>69</sup>

Utah. BNSF has generated many thousands of annual carloads from shippers to and from such "2-to-1" points in Utah as Salt Lake City, Little Mountain, Ogden, Clearfield, and Provo.

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<sup>69</sup> There are no "2-to-1" points in Colorado. BNSF gained access to several "2-to-1" points in Northern California. The only California point that lies along the Central Corridor trackage rights is the Sierra Army Depot at Herlong, which receives only sporadic shipments by rail. BNSF has used its Central Corridor rights and "2-to-1" access to compete for traffic to and from the Depot.

BNSF also gained access to several other "2-to-1" points in Northern California. The most prominent are West Sacramento and a group of stations in the area south of Oakland, including Warm Springs, Fremont, San Jose, Livermore, Pleasanton, and Trevarno. The remaining few Northern California stations are in the area south of Stockton and account for little traffic. BNSF has been successful in gaining significant amounts of traffic from Northern California "2-to-1" points. BNSF has utilized its new single-line routes to the Pacific Northwest and through the Central Corridor to secure these movements. Equally important, though, has been BNSF's pre-existing high-speed mainline via the Southern Corridor, which handles traffic to and from all of the major East-West gateways, as well as intermediate areas such as Southern California and Arizona.



not only the daily carload trains between Vancouver, B.C., and Pasco, Washington, on the one hand, and Southern California, on the other hand, but **REDACTED**

UP has responded with its own sustained effort to take advantage of the new opportunities to provide service in the West Coast North-South Corridor. Shortly after the merger was approved, UP inaugurated intermodal service between Seattle and Los Angeles, and it is planning to increase the clearances in this corridor so that it can handle doublestack container trains. In addition, in conjunction with CP, UP recently inaugurated a new through train between Edmonton, Alberta and Roseville, California.

UP has also implemented new carload services that take advantage of its investment in the former-SP Roseville Yard to provide service from Pacific Northwest origins with arrival at customers' facilities reliably within five days to Northern California, seven days to Southern California, and nine days to Arizona and Nevada. BNSF countered with a service that guarantees scheduled arrivals in this corridor. And UP raised the bar even higher by working in partnership with a shortline railroad in the Portland area to institute Speedlink, a new carload merchandise train between Portland and Los Angeles, which operates on a 44-hour schedule that was formerly available only to intermodal customers. Traffic has shifted between the carriers as each new service was rolled out, and customers have enjoyed substantial rate and service benefits.

Confidential Appendix J contains some 47 specific examples of the intense competition between BNSF and UP in this corridor.

F. Competition Has Been Strengthened for Central Corridor customers

The UP/SP merger and the BNSF and CMA agreements, as augmented by the Board, along with the URC agreement, have resulted in strengthened competition for Central Corridor customers. This competition has increased steadily since the merger, and the Board's conditions ensure that competition will continue to intensify and shippers will continue to benefit long after the oversight period has concluded.

In order to understand the merger's impact on Central Corridor competition, it is important to understand the nature of rail competition in this territory prior to the UP/SP merger.

The Central Corridor is bracketed on the eastern end by Denver, a significant "3-to-2" location, and on the western end by several "3-to-2" locations in the Bay Area: Oakland, Stockton, Sacramento, Modesto, Pittsburg, and Port Chicago. In between these endpoints lie vast reaches of territory in which service was historically provided by only one railroad.

In western Colorado and eastern Utah, SP was the only major railroad in the general vicinity.<sup>67</sup> In western Utah, northeastern Nevada, northwestern Nevada, and eastern California, UP and SP each had its own lines, but across long stretches of this territory their lines were so far apart that they did not serve any common shippers and thus did not provide direct rail competition.

The only pockets of two-railroad competition along the Central Corridor were found in north central Utah, near Salt Lake City, and along the "paired track" in north central Nevada, between Alazon and Weso. In these areas, former-SP lines served customers jointly

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<sup>67</sup> Many railroads served Colorado during the mining booms of the late nineteenth century, but most were abandoned in the early twentieth century. DRGW (which purchased SP in 1988) included much of the surviving Colorado mileage west of Denver and Pueblo.



with UP lines. Outside of these two areas were many hundreds of miles without direct rail competition, and frequently without any significant population or rail traffic.

1. The BNSF Agreement in the Central Corridor

UP's settlement agreement with BNSF granted BNSF overhead trackage rights through the Central Corridor from Denver to Northern California. As shown on Map #7, these rights first extend BNSF's Chicago-Omaha-Denver line from Denver to Salt Lake City using the former-SP main line west of Denver. BNSF's rights then reach west from Salt Lake City to Alazon, Nevada on the UP main line, and then on both the former-SP and UP lines (the "paired track") to Weso in northern Nevada. From Weso, BNSF's rights follow the UP line between Weso and Stockton via Keddle. BNSF's trackage rights between Keddle and Stockton are an important link in both BNSF's new West Coast North-South Corridor route, as well as its new Central Corridor route. The BNSF trackage rights connect to BNSF's main lines at both Keddle and Stockton.<sup>68</sup> BNSF also has trackage rights between Weso and Oakland on the former-SP main line via Reno. Finally, BNSF has rights that extend north from Salt Lake City to Little Mountain, Utah, via Clearfield and Ogden, Utah, to serve "2-to-1" shippers between Salt Lake City and Little Mountain.

The UP/SP merger and the BNSF agreement have enhanced competition in this vast territory by filling the Denver-Bay Area gap in BNSF's western network. The merger and the BNSF agreement provide "2-to-1" customers in the Central Corridor with a choice between two stronger competitors than existed before the merger. The Central Corridor rights also

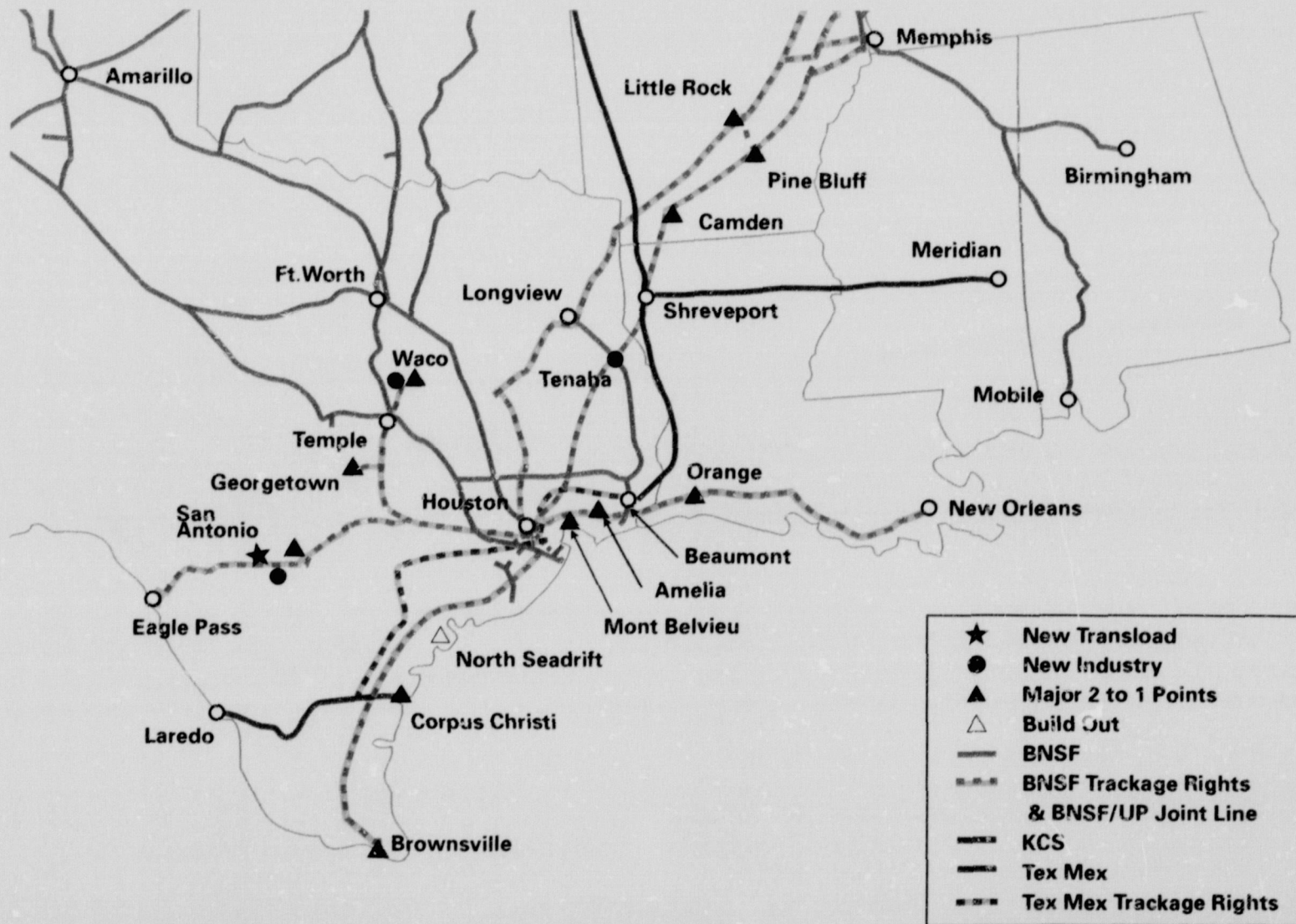
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<sup>68</sup> The BNSF agreement provided BNSF with trackage rights between Keddle and Stockton and required UP to sell BNSF its Keddle-Bieber line to complete BNSF's single-line West Coast North-South route.



Map #8

# BNSF & KCS/Tex Mex Gulf Coast Routes



In Salt Lake City, the second largest source of "2-to-1" traffic in the Central Corridor, BNSF has captured substantial amounts of business by offering shippers reduced rates and improved service. BNSF has been especially successful in competing for petroleum traffic to and from Salt Lake City refineries. BNSF has captured heavy traffic flows to and from areas of strong BNSF coverage, such as Montana and Oklahoma. BNSF has also established doublestack domestic container service between Salt Lake City and eastern points by connecting with BNSF's existing intermodal network at Denver.

Confidential Appendix B contains a wide range of examples of Salt Lake City "2-to-1" traffic that BNSF has captured. The examples include movements of **REDACTED**

Confidential Appendix C includes examples of Salt Lake City traffic that UP was able to retain or recapture by offering its own rate reductions and service improvements.

In Little Mountain, Ogden, Clearfield, and Provo, as well as in Salt Lake City, UP agreed to allow BNSF to use URC as its agent to provide local service to customers. BNSF has used this arrangement to its advantage to capture business, and UP has responded with its own efforts to retain this traffic. Confidential Appendices B and C include significant examples of competition between BNSF and UP to serve shippers at these other northern Utah locations.

BNSF's presence in Utah has been especially important for the largest source of "2-to-1" traffic in the Central Corridor - Geneva Steel. **REDACTED**

The intense competition

between UP and BNSF to serve Geneva Steel and the benefits that Geneva has received from that competition are discussed above, and Confidential Appendix D provides additional details.

Nevada. BNSF has also proven to be a strong alternative to the former SP in providing competition to UP along the paired track in northern Nevada. Confidential Appendix B includes many examples of northern Nevada "2-to-1" traffic that BNSF has captured by offering reduced rates and improved service. These examples include: **REDACTED**

Confidential Appendix C contains examples of traffic that UP was able to retain or recapture by improving its own rates and service to "2-to-1" shippers in northern Nevada.

b. Additional Enhancements to Central Corridor Competition

The BNSF agreement has also benefitted BNSF-served customers located near the Central Corridor endpoints who, prior to the merger, had used joint-line routes through the Central Corridor. For example, in the Denver area, BNSF has successfully utilized its Central Corridor trackage rights to provide new single-line service for a number of important rail customers. **REDACTED**

This traffic formerly moved mostly via BNSF-SP routings through the Central Corridor. BNSF has also used its Central Corridor rights to replace joint-line service or to offer new competitive rates and service for products moving from the Midwest to Northern California, including flour moving between Minnesota and Lodi, and grain and corn syrup moving from Iowa and Nebraska origins to Stockton.



Finally, the BNSF agreement has also benefitted BNSF and its customers by providing BNSF with an alternative to its Southern Corridor route, particularly for Bay Area traffic. BNSF has chosen to continue to route most of this through traffic over its Southern Corridor route, but it frequently uses its Central Corridor rights to move unit trains of coil steel and other commodities. BNSF also uses its Central Corridor route to move traffic that usually flows via the Southern Corridor when there are difficulties on the Southern Corridor line and to reposition empty equipment, thus enhancing efficiency and service reliability for all of its customers.

2. The CMA Agreement and Board-Imposed Conditions in the Central Corridor

In addition to the UP/SP merger and the BNSF agreement, the CMA agreement and the Board's decision augmenting the terms of the BNSF and CMA agreements have played a significant role in strengthening Central Corridor competition, and they promise to take on an even more significant roll in the future.

a. New Industries in the Central Corridor

The BNSF agreement permitted BNSF to serve new industries at "2-to-1" points. The CMA agreement extended this right to SP-owned BNSF trackage rights lines. The Board's merger approval decision further expanded the new industry provision and gives BNSF the right to serve new industries on all BNSF trackage rights lines.

The new industry condition has already had, and will continue to have, a powerful competition-adding effect in the Central Corridor. As is explained above, UP and SP both had lines through the Central Corridor before the merger, but their lines were so far apart in most places that most of the territory was served by only one carrier. Had there been no merger, new industries locating along what became the BNSF Central Corridor trackage rights lines could

have expected service from only one railroad, unless they located in the Salt Lake City area or on the paired track in Nevada. As a result of the Board's decision, however, all new industries that locate along the trackage rights lines may obtain two-railroad competition.

The impact of the new industry condition will grow over time. As time marches forward, a corridor largely populated by solely served shippers will give way to one in which more and more shippers have two-railroad competition. BNSF's competitiveness in the Central Corridor will continually grow, not only for the new customers that take advantage of the new industry condition, but also for existing "2-to-1" customers, who will benefit as BNSF enhances its operations to provide service to the new industries.

The new industry condition has already had an impact. BNSF operates a new local train in the Sparks, Nevada, area to handle traffic to several new industries that have already located on the former-SP line in Nevada, including a BNSF/QDC distribution center at Sparks serving R.R. Donnelly, and Quebecor and Paramount Petroleum at Fernley, Nevada. BNSF has also established a new local train that serves new Conoco and Total Petroleum facilities at Grand Junction, Colorado, on the former-SP main line. Before the merger, only SP could have handled this traffic. When these new facilities were built along the trackage rights lines, however, they were open to BNSF. **REDACTED**

The most recent example of the impact that the new industry condition is having in the Central Corridor is BNSF's acquiring most of the outbound soda ash traffic from American Soda's new facility at Parachute, Colorado - another point along the former-SP main line. Had this facility opened prior to the merger, only SP could have provided service. **REDACTED**

**REDACTED**

The inevitable development of new industries in the Central Corridor will further enhance BNSF's traffic base.

b. Transload Facilities in the Central Corridor

The BNSF agreement permitted BNSF to serve existing and new transloading facilities at "2-to-1" points. The Board's merger approval decision expanded the transload provision and gives BNSF the right to serve new transload facilities on all BNSF trackage rights lines.

As with the new industry condition, BNSF has already used the transload condition to add competition in the Central Corridor. BNSF is constructing a new rail-truck transload facility at Aragonite, a point in western Utah near Clive, Utah, where UP had exclusively served two major waste receivers, Envirocare and Safety Kleen, since their establishment well before the merger. The new transload will allow BNSF to compete for UP's hazardous waste traffic to Clive by building a nearby transload not on a nearby former-SP line but on UP's own line. BNSF will undoubtedly use additional transload facilities in the future to compete for Central Corridor traffic.

3. The URC Agreement

UP's agreement with URC gave URC access to the Savage coal loadout on the CV Spur, a loadout that had been served exclusively by SP prior to the merger; new rights to serve exclusively the Willow Creek mine, which URC had formerly served jointly with SP; and trackage rights from existing URC trackage near Helper, Utah, to Grand Junction, Colorado, for interchange with BNSF.

URC and BNSF have regularly used the Grand Junction interchange to bid on traffic, and they have used the interchange to move unit trains of coal to Missouri and Arizona.



URC had steadily built its Savage volume to 50 trains in 2000, including traffic interchanged with UP at Provo, and it is on a pace to exceed that level this year. URC also increased its operations in the Central Corridor when, in 1997, UP concurred in an arrangement that allowed URC to provide BNSF with local switching service in the Provo, Salt Lake City and Ogden areas.

In a recent letter to the Board, URC reports that it is satisfied with the conditions it received. URC indicates that it "has a good working relationship with both UP and BNSF," and that both "BNSF and UP have competed for certain segments of business in the coal fields served by" URC. URC concludes that the merger conditions "have worked to preserve competition."<sup>70</sup>

#### 4. Central Corridor Trackage Rights Volumes

BNSF's train frequencies and volumes demonstrate that BNSF has achieved the critical mass required to support competitive daily service to the wide variety of Central Corridor customers that it serves. When one considers BNSF's trackage rights volume in the Central Corridor, it is important to remember that most of the traffic traversing the former-SP and UP lines across this hostile territory was overhead traffic moving between the West Coast and points in the Midwest and Northeast. BNSF has elected to use its outstanding Southern Corridor route for most Northern California-Midwest business. BNSF's Central Corridor volumes thus reflect only modest volumes of overhead traffic. It is also important to remember that most shippers located in the Central Corridor did not have competitive service prior to the merger, and they are

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<sup>70</sup> See Letter from John E. West, III, Executive Vice President of URC, to Hon. Vernon A. Williams, dated June 29, 2001 (attached hereto as Exhibit No. 4).

still served exclusively by one railroad today, although this picture will change over time as a result of the new industry and transload conditions. That said, BNSF is clearly providing competitive service to Central Corridor shippers.

One way of measuring BNSF traffic volumes is to examine average monthly data from the five periods that UP has used to submit traffic data in the Board's oversight proceedings: October 1996-May 1997; June 1997-May 1998; June 1998-May 1999; June 1999-May 2000; and June 2000-May 2001.

In the Central Corridor, average monthly trains grew from 62 in the first period, to 138 in the second, before falling to 122 in the third, as BNSF decreased its use of its Central Corridor trackage rights as an alternative to its Southern Corridor route. In last year's oversight proceeding, UP reported that BNSF's average monthly trains had fallen to 78. UP explained that it had changed its methodology for counting BNSF's Central Corridor trackage rights trains, and further analysis shows that volumes were also affected by BNSF's decision to shift some unit trains back to its Southern Corridor route. In the most recent period of oversight, BNSF averaged 78 trains per month, the same level as in the previous year.

Average monthly total tons, which were not affected by the change in methodology, increased from 92,656 in the first period, to 412,999 in the second, before declining to 373,370 in the third period, and to 362,394 in the fourth. In the most recent period, BNSF's average monthly tons have risen slightly to 373,310.

Another way to understand BNSF's Central Corridor activity is to look at BNSF's gross ton miles in this corridor, which were also unaffected by the change in methodology. BNSF gross ton miles across the Central Corridor grew to over 400 million gross ton miles per month, before falling off slightly due to the recent economic downturn. In the previous oversight

period, BNSF averaged 325 million gross ton miles per month. In this oversight period, BNSF volumes increased to an average of 373 million gross ton miles per month.

The number of gross ton miles in any particular month depends heavily upon the number of unit trains operated that month, and thus on BNSF decisions about whether to route traffic via the Southern Corridor or via the Central Corridor. BNSF operates a daily scheduled train between Denver and Provo or Stockton in each direction. These trains handle the regular manifest business, which averages over 300 million gross ton miles per month. This equates to over 10 million gross ton miles per day, enabling BNSF often to run its manifest trains in the 6,000 to 8,000 gross ton range. This is near the maximum tonnage for much of this territory.

In addition to its substantial manifest trains, BNSF operates numerous other trains through the Central Corridor that handle a wide variety of traffic. These movements can fluctuate significantly from month to month. Some of this fluctuation is in response to market conditions for the commodities being transported. Monthly volumes are also influenced by BNSF's decisions as to whether to route via the Southern Corridor or the Central Corridor, which can depend on relative availability of locomotives, crews, and capacity on the two routes.

In recent months, BNSF appears to have handled numerous unit trains for a variety of Central Corridor shippers. **REDACTED**



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Additional evidence of the competition that BNSF is providing for Central Corridor shippers is contained in a recent letter to the Board from the Utah Central Railway ("UCRy"). UCRy reports that the merger has produced "an increased competitive environment, and a subsequent increase in business moving over UCRy." UCRy explains that the "increase in business has been possible due to the ability of UP to offer single line service to our customers over an increased market base," and "Burlington Northern Santa Fe (BNSF) has further enhanced this through the availability of trackage rights over the UP." UCRy indicates that the "availability of competing service, and access to a market base encompassing the entire western US has also increased rail viability for UCRy customers."<sup>71</sup>

BNSF has also used its Central Corridor rights to the benefit of shippers located outside the corridor. **REDACTED**

**REDACTED** BNSF has also operated unit trains of empty auto racks from the Bay Area to Kansas City via the Central Corridor, and it has

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<sup>71</sup> Letter from William D. Blansett, Vice President of UCRy, to Surface Transportation Board dated June 15, 2001 (attached hereto as Exhibit No. 3).

repositioned trains of empty intermodal equipment from Central California to Chicago. BNSF frequently operates empty grain trains from the Fresno, California area to points in Colorado, Nebraska, and South Dakota, freeing up capacity for other traffic on its Southern Corridor route.

In summary, the trackage rights data demonstrate that the volume of BNSF's Central Corridor manifest traffic has grown to levels that are more than adequate to support efficient daily manifest service in both directions. BNSF can also look forward to significant future traffic growth as new industries and transloads develop and expand. The data further reflect BNSF's use of its Central Corridor rights to move a variety of overhead traffic. BNSF has proven that it can provide efficient, competitive service for "2-to-1" shippers located in the Central Corridor, and it has used its Central Corridor trackage rights as an important complement to its own Southern Corridor service. The Central Corridor has clearly become an integral part of BNSF's system that will grow in importance over time.

#### 5. Central Corridor Rates

Detailed information on the rates paid by Geneva Steel, the largest "2-to-1" shipper in the Central Corridor, is contained in Confidential Appendix E-1. Detailed information on rates paid by Colorado and Utah coal shippers are also contained in Confidential Appendix E-1.

#### G. Competition Has Been Strengthened for Gulf Coast Customers

The UP/SP merger and the BNSF and CMA agreements, as augmented by the Board, along with the Board's decision to grant trackage rights to Tex Mex, have dramatically improved competition for Gulf Coast customers.

The effect of the UP/SP merger and the BNSF agreement alone has been to greatly strengthen competition for Gulf Coast customers. Gulf Coast shippers have benefitted



from BNSF's replacing a weak SP at "2-to-1" points and by UP's replacing a declining SP at exclusively served former-SP points. Gulf Coast shippers that prior to the merger had the option of using BNSF service have benefitted from BNSF's gaining a new Houston-New Orleans route and a much-improved Houston-Memphis route, which have made BNSF a true competitive option in those corridors for the first time. Shippers have also benefitted from BNSF's improved access to Eastern Mexico. Shippers on the former-SP line between Iowa Junction and Avondale, Louisiana, who were exclusively served by SP, have benefitted because they now have rail competition where before they had none. Gulf Coast shippers served by UP and SP and other railroads have also benefitted because they now all have access to the two highly competitive, comprehensive rail networks created by the merger and the BNSF agreement.

The additional impact of the CMA agreement and the Board's extension of the BNSF and CMA agreements has been to guarantee that competition will continue to increase in intensity, by expanding customers' abilities to obtain competition by developing transloads, new facilities, and build-outs.

1. The BNSF Agreement in the Gulf Coast

UP's settlement with BNSF granted BNSF substantial trackage rights in the Gulf Coast region. As shown in Map #8, BNSF received trackage rights between Houston and Memphis, which filled a key gap in the BNSF system, strengthening BNSF's competitiveness between Houston and Memphis, St. Louis, and the Northeast, and allowing BNSF efficiently to serve a variety of "2-to-1" shippers en route. BNSF also obtained a new route between Houston and New Orleans, the one mid-continent gateway that it did not serve, through a combination of trackage rights between Houston and Iowa Junction, Louisiana, purchasing the former-SP line from Iowa Junction to Avondale, Louisiana, and then obtaining trackage rights over the final few

miles to New Orleans.<sup>72</sup> Finally, BNSF received extensive trackage rights in south Texas (a) from Houston to Brownsville, with access to Laredo via a connection with the Tex Mex at Corpus Christi; (b) between Houston, San Antonio, and Eagle Pass; (c) between Waco, Temple and Smithville; (d) between Taylor and Kerr; and (e) between El Paso and Sierra Blanca. The south Texas rights not only provided BNSF with efficient access to a variety of "2-to-1" points, but also ensured stronger rail competition at every UP and SP gateway to Eastern Mexico by providing BNSF with new access to Brownsville and Laredo (via Tex Mex), and by converting BNSF's haulage to Eagle Pass to a more competitive trackage rights route.

UP's agreement with BNSF also allowed BNSF to replace SP as the competitive alternative for "2-to-1" shippers along all of the trackage rights lines in Texas, Louisiana, and Arkansas. The BNSF agreement also provided BNSF with immediate access to five chemical plants in the Houston area that were served by SP exclusively, but which UP was planning to serve through build-outs, as well as to LCRA's facility at Halsted, Texas, which was served by UP exclusively, but which SP had a future right to serve. These shippers have all been able to benefit from the availability of single-line access to all UP and BNSF points and the fierce competition between the two railroads.

Gulf Coast shippers have taken advantage of the expanded competitive options that have resulted from the UP/SP merger and the BNSF agreement.

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<sup>72</sup> A February 1998 agreement between UP and BNSF to exchange 50 percent ownership interests in the Iowa Junction-Avondale line and UP's Houston-Iowa Junction line gave BNSF access to shippers on the latter line and associated branches. This access was not the result of a merger condition, but shippers located along this line have been affected by merger-related conditions to the extent that they benefit from BNSF's access to New Orleans or the Houston-Memphis trackage rights.



(a) Houston-Memphis. BNSF has been successful in moving traffic between Texas and Mexico, on the one hand, and the Northeast and Midwest, on the other hand, using its Houston-Memphis rights. Confidential Appendix B contains dozens of specific examples, including: **REDACTED**

BNSF has also been successful in securing business from "2-to-1" points located farther north along the Houston-Memphis Corridor. Confidential Appendix B contains numerous specific examples, including: **REDACTED**

(b) Houston-New Orleans. BNSF has also been very successful in moving traffic between Texas and Mexico, on the one hand, and the Southeast via its new Houston-New Orleans line, on the other hand. Confidential Appendix B contains several specific success stories. These include: **REDACTED**

BNSF has also been successful in securing business from "1-to-2" shippers located along the former-SP Houston-New Orleans line. Except in the Beaumont and Lake



Charles areas, almost all of the shippers along this line were served exclusively by SP. Most of these customers were on the Louisiana and Delta Railroad, which formerly connected only with SP. These shippers now enjoy service from UP and BNSF, and rates for traffic to and from customers on the Louisiana and Delta are now only half of what they were at the time of the merger. Confidential Appendix E-3 contains additional details on rates. Confidential Appendix I contains specific examples of how "1-to-2" shippers have benefitted from the merger.

(c) Other Gulf Coast trackage rights lines and "2-to-1" points. Finally, BNSF has been successful in securing business using its south Texas trackage rights lines and "2-to-1" access to shippers in south Texas. For example, **REDACTED**

2. The CMA Agreement and Board-Imposed Conditions in the Gulf Coast

Competition in the Gulf Coast region was further strengthened by the CMA agreement and the Board's decision augmenting the BNSF and CMA agreements. The additional, competition-enhancing provisions include: allowing BNSF to serve all existing transload facilities and construct new transload facilities at any point along its trackage rights lines; requiring UP to provide BNSF with trackage rights over any former-SP line to connect with build-outs from any shipper served exclusively by UP to that line (and vice-versa); and allowing BNSF to serve all new industries that locate on any of the BNSF trackage rights lines.

Gulf Coast shippers have taken advantage of all of these expanded competitive options. For example, Four Star Sugar has taken advantage of the transload provision by locating on a former-SP line in El Paso, Texas, which is along BNSF's El Paso-Sierra Blanca

trackage rights line. Union Carbide, an exclusively served UP customer in North Seadrift, Texas, is taking advantage of the build-out condition. Union Carbide is building out to a point on the former-SP Port Lavaca Branch, and UP will be required to grant BNSF trackage rights to operate from the build-out point on the branch to Placedo, where it can connect to its overhead trackage rights on UP. Pilgrim's Pride has taken advantage of the new facility condition. BNSF is providing service to this feed mill that Pilgrim's Pride constructed on a former-SP line near Tenaha, Texas, which is along BNSF's Houston-Memphis trackage rights line. NALS, a division of Mars, has also taken advantage of the new facility condition to construct a plant on a UP line in Waco, Texas, which is along BNSF's Temple-Waco trackage rights line.

### 3. The Tex Mex Trackage Rights

Competition in the Gulf Coast region was further increased by the Board's decision to condition the merger on UP's granting Tex Mex trackage rights between Robstown and Beaumont, Texas, which created a third competitive rail route into the Eastern Mexico market. At Beaumont, Tex Mex connects with KCS, which has routes connecting to NS at Meridian, Mississippi, and Kansas City; CSX at St. Louis and via the M&B railroad at Meridian; and CN at Jackson, Mississippi, and St. Louis. The Board's purpose in partially granting Tex Mex's trackage rights request was to address the possible loss of competition at the Laredo gateway into Mexico and to protect the essential services provided by Tex Mex to its shippers. As discussed in the next section, the evidence shows that Tex Mex has carried



substantial volumes of traffic over its trackage rights lines and leaves no room to doubt that competition has remained strong at Laredo and that Tex Mex has remained viable.<sup>73</sup>

#### 4. Gulf Coast Trackage Rights Volumes

BNSF's train frequencies and volumes in the Gulf Coast region underscore BNSF's competitiveness. BNSF has used its Gulf Coast region trackage rights and access to "2-to-1" facilities to move substantial volumes of traffic using its Houston-Memphis and Houston-New Orleans rights.

One way of measuring the continued growth of BNSF traffic volumes is to examine average monthly data from the five periods that UP has used to submit traffic data in the Board's oversight proceedings: October 1996-May 1997; June 1997-May 1998; June 1998-May 1999; June 1999-May 2000; and June 2000 to May 2001.

In the Houston-Memphis Corridor, average monthly trains have grown from 47 in the first period, to 112 in the second, to 120 in the third, to 140 in the fourth, and finally to 164 in the most recent period. Average monthly total tons have increased from 154,475 in the first

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<sup>73</sup> On March 12, 2001, Tex Mex acquired UP's line between Rosenberg, Texas, and Victoria, Texas, to shorten Tex Mex's route between Laredo and Houston. Tex Mex acquired and will rehabilitate the portion of this line between Mileposts 2.5 and 87.8. Tex Mex also received overhead trackage rights over the remaining segments of the line (near Rosenberg and Victoria), which permits Tex Mex to connect to the UP lines over which Tex Mex already has trackage rights. Tex Mex may use its new trackage rights both for traffic having a prior or subsequent movement on Tex Mex's original Laredo-Robstown-Corpus Christi line as well as traffic originating or terminating at shipper facilities located on the portion of the Rosenberg Line that Tex Mex acquired. UP also agreed to modify the terms of Tex Mex's prior traffic rights to permit Tex Mex to handle traffic to and from Rosenberg Line shipper facilities. When Tex Mex begins freight operations over the Rosenberg Line, it will relinquish trackage rights it had obtained over UP's other lines between Rosenberg and Victoria in connection with the merger.



period, to 493,446 in the second, to 674,911 in the third, to 721,355 in the fourth, to 779,869 in the most recent period.

In the Houston-New Orleans Corridor, average monthly trains have grown from 67 in the first period, to 132 in the second, to 167 in the third, to 201 in the fourth, and finally to 234 in the most recent period. Average monthly total tons have increased from 164,116 in the first period, to 551,343 in the second, to 772,231 in the third, to 1.116 million in the fourth, to 1.322 million in the most recent period.

BNSF trackage rights traffic between Houston and Corpus Christi, between Temple and Eagle Pass via San Antonio, and traffic interchanged with the Georgetown Railroad has all grown during the oversight period, which further reflects BNSF's competitive impact in the Gulf Coast.

Tex Mex train frequencies and volumes reflect the significant competitive role that its trackage rights have played during the merger oversight period. In the most recent period, Tex Mex averaged 59 monthly trains carrying 318,019 tons, as compared to 19 trains and 58,580 tons in the first period following the merger. The volume of traffic handled by Tex Mex, working cooperatively with BNSF and KCS to and from Laredo has increased by more than 300 percent since the UP/SP merger.

##### 5. Gulf Coast Rates

Further proof that BNSF has been an effective competitor in the Gulf Coast can be seen in the fact that UP rates in the Houston-Memphis and Houston-New Orleans corridors have decreased by more than ten percent during the merger oversight period. UP rates for Gulf Coast plastics traffic have decreased by more than sixteen percent, and rates for other Gulf Coast chemicals traffic have decreased by more than nineteen percent during the same period. UP rates

for traffic moving over Eastern Mexico gateways have held steady during the oversight period. Details are contained in Confidential Appendix E-1.

H. Competition Has Been Strengthened for Traffic to and from Canada and Mexico

The UP/SP merger and the BNSF agreement have greatly strengthened competition for traffic to and from both Canada and Mexico, thereby benefiting a wide range of shippers and furthering the goal of North American economic integration embodied in the NAFTA agreement.

1. Canada

The UP/SP merger and the BNSF agreement have strengthened competition for traffic to and from Canada.

(a) Western Canada. Prior to the merger, most rail traffic to and from Western Canada from Western U.S. markets was handled through joint-line routes. BNSF connected with CN, CP, BC Rail, and SRY at Vancouver, British Columbia, but it did not have efficient single-line service to California, the Southwest, and gateways to Western Mexico. SP's access to Western Canada was provided through a connection with BNSF at Portland, creating a three-carrier route to SP points. UP accessed BC Rail at Vancouver via barge from Seattle, and it connected with CP at Eastport, Idaho, but like BNSF, it had no efficient single-line route to California and Southwestern markets or to Western Mexico gateways. Truck and water had high shares of Western Canada-Western U.S. traffic.

As a result of UP's and BNSF's exchange of rights in the West Coast North-South Corridor, two vigorous competitors now vie for western Canadian traffic. UP has a single-line route from Eastport to Oregon, California, the Southwest, and the Western Mexico gateways. In addition, the proportional rate arrangement, although it is not operating as well as UP had

anticipated, allows UP to compete via Portland for traffic to and from BNSF's Western Canada gateways. BNSF has a new single-line route from the Vancouver gateway to California, the Southwest, and the San Diego and El Paso gateways to Mexico.

BNSF is operating a sizeable daily priority manifest train from Vancouver to its modern classification facility at Barstow, via its new Keddie-Bieber line and Keddie-Stockton trackage rights, with traffic destined to Southern California and Arizona markets. UP is using a combination of Vancouver-Seattle barge and the proportional rate agreement to access Canadian carriers at Vancouver, in conjunction with the former-SP line south of Portland, to compete with BNSF for this traffic. UP has also been successful in developing significant amounts of new traffic for its new Edmonton, Alberta-Roseville, California run through train with CP via Eastport and Portland.

Confidential Appendix J provides numerous specific examples of how shippers have benefitted from the competition between UP and BNSF for Western Canada-Western U.S. traffic.

(b) Eastern Canada. UP and BNSF shippers of traffic to and from Eastern Canada have also benefitted from the merger. Before the merger, SP had no direct connection with either CN or CP in the Upper Midwest. Former-SP shippers are benefiting from new services that UP has instituted for traffic to and from CN at Duluth/Superior and CP at the Twin Cities.

The merger has also allowed UP to create better service to and from Eastern Canada via the Chicago gateway. UP now funnels former-SP traffic from western points through North Platte, where, combined with UP volumes, it helps UP to provide greater service frequency.



Finally, the merger has resulted in improved service for traffic between the Southwest and Eastern Canada. UP's directional running operations have resulted in much more reliable service, and BNSF is exploiting its new post-merger capabilities, including direct run through service with CN via BNSF's trackage rights to Memphis.

2. Mexico

The UP/SP merger and the BNSF agreement have strengthened competition for traffic to and from every UP and SP gateway to Mexico. UP and BNSF are able to provide more extensive single-line service than existed before the merger, and a third rail competitor, KCS-Tex Mex, now competes in this truck-dominated market.

(a) Eastern Mexico. At the time of the merger, UP and SP handled almost all of the traffic to and from Eastern Mexico. BNSF handled only small volumes via Eagle Pass haulage rights that it had obtained from SP in the BN/Santa Fe merger. As a result of the BNSF agreement, BNSF has more than replaced the competition that SP provided to UP via Eastern Mexico gateways. The Board further increased competition by granting Tex Mex trackage rights between Robstown and Beaumont to connect with KCS, thereby creating a new, third competitive alternative for traffic moving to Eastern Mexico gateways.

BNSF has many advantages over SP, including greater system reach and single-line service, better physical plant and locomotive and car fleets, and greater financial resources. It is thus not surprising that BNSF and Tex Mex are already handling Eastern Mexico volumes approaching, and in some cases exceeding, SP's pre-merger levels, and they are poised for future growth. At Laredo, Tex Mex (now working cooperatively with BNSF and KCS rather than SP) has increased its volume to over three times that of 1995, and its share of traffic as compared to UP's share has almost doubled. At Brownsville, where UP and SP provided pre-merger

competition, and at Eagle Pass, where BNSF competed with SP via haulage, shippers now have single-line access to all points on the UP and BNSF systems.

BNSF and Tex Mex have achieved their gains at Eastern Mexico gateways by offering shippers reduced rates and improved service for a wide variety of traffic. Many of their successes are detailed in Confidential Appendix B. The traffic these carriers have captured includes: **REDACTED**

UP has not sat still while BNSF and Tex Mex have exercised their new rights. UP has responded with rate reductions and service improvements of its own to capture new business and retain existing customers. Examples of UP's successes can be found in Confidential Appendices A and C.

The strong competition at Eastern Mexico gateways is also reflected in the fact that UP's rates for Eastern Mexican traffic have held steady during the five-year merger oversight period. Details can be found in Confidential Appendix E-1.

(b) Western Mexico. The UP/SP merger and the BNSF agreement have also provided benefits to shippers using Western Mexico gateways. Shippers to and from the El Paso gateway have benefitted from UP investments to upgrade all four of its lines entering El Paso: (1) the former-SP line from San Antonio, (2) UP's line from Fort Worth, (3) the former-SP line

from Kansas City, and (4) the former-SP line from Los Angeles. These shippers have also benefitted from access to a more comprehensive BNSF system.

Shippers via the Western Mexico gateways that were solely served by SP have gained single-line access to hundreds of UP points, including Midwest grain origins, Pacific Northwest points and Canadian gateways. Examples of new single-line service to these Western Mexico gateways are contained in Confidential Appendix A.

I. Competition Has Been Strengthened for Key Commodities

In the merger application and throughout the merger proceedings, the applicants responded to a variety of claims that the merger would diminish competition for several specific commodities by explaining why the merger would actually increase competition for the commodities in question. Now, after five years of experience with the merger, it is clear that the merger has not had the detrimental effects that opponents predicted. Indeed, it is clear that the merger has benefitted shippers of Colorado and Utah coal, Gulf Coast chemicals and petroleum products, soda ash, aggregates, and grain.

1. Colorado and Utah Coal

Contrary to the predictions of merger opponents, the UP/SP merger and the settlement agreements entered into by the applicants have enhanced competition for Colorado and Utah coal and provided substantial benefits to producers and customers. UP has invested heavily in providing more efficient service, and rates have remained flat because of the intense competition from other sources of coal at the destination markets and from other railroads. Confidential Appendix E-1 contains additional information on rates for Colorado and Utah Coal.

(a) Colorado Coal. The UP/SP merger has resulted in tremendous benefits to producers and consumers of Colorado coal. During the merger, several parties expressed



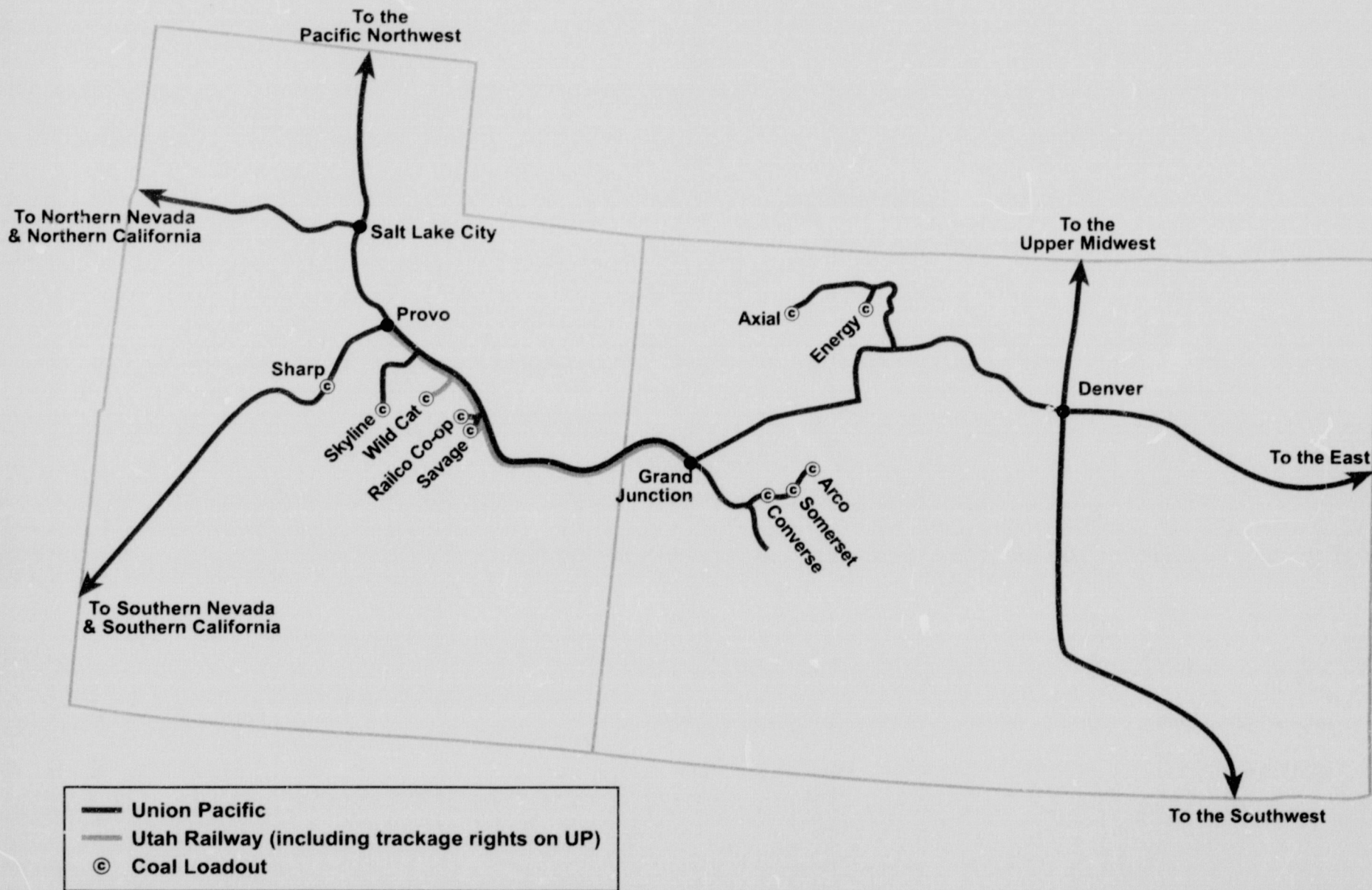
concern that UP would favor the mines it served in the Powder River Basin at the expense of Colorado coal producers formerly served by SP. The applicants explained that this concern made no sense. In the first place, the applicants had every incentive to maximize all profitable opportunities, including opportunities to market Colorado coal. In the second place, high BTU Colorado coal did not really compete with Powder River Basin coal. UP's actions since the merger show that any concerns about UP's incentives were misplaced.

As shown in Map #9, UP exclusively serves five Colorado coal mines. The Colowyo mine at Axial and the Twenty Mile mine at Energy are located on UP's Craig Branch. Colorado utilities consume more than half of the coal from these facilities, and the remainder moves further east. West Elk mine at Arco, Bowie #2 mine at Converse, and Sanborn Creek mine at Somerset are located on UP's North Fork Branch, southeast of Grand Junction. Unlike the Craig Branch, most of this coal moves to markets in the Midwest and Southeast. The coal's low sulfur content and high BTU values allow it to be blended with higher sulfur eastern coals at existing power plants. Prior to the merger, SP exclusively served these five mines.

The merger benefitted producers and receivers of coal from these five mines because UP could do something that SP could not do: make the investments necessary to exploit the full market potential of this coal. All five of these mines lie on branch lines that are expensive to maintain and operate, and SP did not have the resources to make the investments necessary to develop the mines' full potential.

Since the merger, UP has done what SP could not do, and its investments in Colorado coal have been truly impressive. First, UP has spent nearly \$25 million rehabilitating the Craig and North Fork Branches. It placed significant amounts of welded rail, ties, and ballast on these mountainous, long-distance branch lines. These improvements alone demonstrate UP's

# Union Pacific Colorado and Utah Coal Originations



commitment to enhancing Colorado coal traffic. Second, UP is also spending \$25 million in the Denver terminal to improve the connection between the former-SP Colorado main line and UP's KP line, which will allow UP to provide better service for Colorado coal movements. Third, UP has already spent more than \$250 million to totally rebuild its KP line between Denver and Topeka, Kansas, which will allow for better service than SP could have provided on its route via Pueblo, Topeka, and Kansas City, and thus make Colorado coal more competitive in eastern markets. Finally, improvements that UP has made along its Central Corridor route through North Platte have benefitted Colorado traffic moving to Chicago and destinations in the upper Midwest.

The improvements that UP has already made have supported steady growth of Colorado coal movements from these five mines to over six coal trains per day. As described in more detail in Mr. Gray's statement (Gray V.S., p. 10 & n.5) Colorado coal shippers can now look forward to a much more positive future than the uncertain environment that they faced under an independent SP.

(b) Utah Coal. The UP/SP merger and settlement agreements have also benefitted Utah coal producers and customers. Prior to the merger, SP was the dominant coal carrier in Utah, providing exclusive service to a number of facilities. The Utah Railway provided limited competition from the Terror Creek and Willow Creek mines, as did UP from its truck-rail facility at Sharp, Utah.

Utah coal producers and customers have benefitted significantly from the new single-line service created by the UP/SP merger. The merger created a new shorter, single-line route between former-SP served Utah coal producers and domestic coal users in southern Nevada and Southern California, as well as the Ports of Los Angeles and Long Beach for export



to Pacific Rim. In addition, UP has been able to shift some of the traffic that had moved on its Salt Lake City-Los Angeles route to take advantage of shorter, more efficient SP routes and to free up capacity and improve velocity on UP lines in the Central Corridor.

The merger and settlement agreements also strengthened competition for Utah coal by providing URC with greater access to Utah coal. UP's agreement with URC provided URC with access to the Savage truck-rail loadout on CV Spur near Price, Utah, which SP had served exclusively prior to the merger. URC also gained exclusive access to the Willow Creek mine, which it had formerly served jointly with SP. As a result of the URC agreement, only one active coal mine in Utah – the Skyline mine – is served by UP exclusively. All of the other mines are either jointly served, utilize truck-rail facilities, or are served exclusively by URC.

Since the merger, URC has been very aggressive, sometimes outbidding UP to transport coal from central Utah to an interchange with UP at Provo for destinations in the Pacific Northwest served by UP.

The BNSF agreement has also increased competition for producers and customers of Utah coal. Prior to the UP/SP merger, URC connected with both UP and SP at Provo, Utah. BNSF gained a connection to URC when it replaced SP at Provo, and Utah coal producers and customers have benefitted from the increased competition provided by BNSF. For example, Sierra Pacific has benefitted from competition between UP and BNSF for coal traffic to its Valmy power plant on the paired track in northern Nevada. BNSF has handled some Utah coal in connection with URC, but even where it has not won the business, BNSF has been a significant competitive factor because its aggressive bids on numerous coal contracts have forced UP to reduce its rates to retain the business. The URC agreement also expanded BNSF's access to Utah coal by providing URC with trackage rights to connect with BNSF at Grand Junction.

2. Gulf Coast Chemicals and Petroleum Products

Contrary to the predictions of merger opponents, the UP/SP merger, as conditioned by the Board, has produced significant competitive benefits for producers and consumers of Gulf Coast chemicals and petroleum products. In the application, the applicants explained that the merger would produce significant benefits as a result of expanded UP single-line service and much improved operations in the Houston-Memphis Corridor, as well as the assurance that the merged railroad would have the financial resources to ensure transportation safety. The applicants also explained that the BNSF agreement would add BNSF as a strong competitor at many Gulf Coast chemical plants, allow BNSF to become a strong, single-line competitor to New Orleans and Memphis, and open additional single-line destinations to Gulf Coast producers.

In order to respond to assertions that the merger would enable UP to "monopolize" Gulf Coast chemicals, the applicants engaged in an exhaustive study that proved that UP would not have market power over Gulf Coast chemical and petroleum products after the merger. The study showed that UP's Gulf Coast chemical pricing would be competitively constrained by: (1) BNSF access to "2-to-1" chemical plants; (2) improved BNSF routes to New Orleans and Memphis to handle "3-to-2" as well as "2-to-1" chemical traffic; and (3) strong modal, source, and product competition.

The applicants explained that the merger would be entirely positive for Gulf Coast chemicals shippers from a competitive standpoint: it would replace SP with a stronger BNSF, and it would allow UP to increase its efficiency by consolidating Gulf Coast operations and instituting directional running, which in turn would allow UP to improve service and reduce rates to meet the new competition that BNSF would offer.

As the applicants predicted, shippers of Gulf Coast chemicals and petroleum products have benefitted tremendously from the merger. BNSF has successfully used its new access to Gulf Coast facilities and its Houston-Memphis and Houston-New Orleans rights to capture a wide array of new chemical and petroleum traffic in the Gulf Coast area that was formerly handled by UP or SP.

BNSF's new access to Gulf Coast chemical plants has yielded a significant volume of new traffic. Examples of BNSF successes include: **REDACTED**

**REDACTED** BNSF has also been successful at "3-to-2" points, handling various chemicals from **REDACTED**

<sup>74</sup> Additional examples of BNSF's success can be found throughout Confidential Appendix B. BNSF has also demonstrated its intense interest in developing its Gulf Coast chemical business by invoking the CMA agreement's build-out provision, as augmented by the Board, to gain access to a Union Carbide facility in North Seadrift, Texas, which prior to the merger was served exclusively by UP.

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<sup>74</sup> BNSF presence in the Gulf Coast chemicals and petroleum business increased even further after the merger as a result of the New Orleans line swap, which resulted in BNSF's gaining access to former SP-exclusive chemical plants on the Dayton Branch and the Port Arthur Branch.



Even where BNSF has not won the business, its presence as a competitor has forced UP to reduce rates and improve service in order to retain the traffic. Examples of UP's competitive responses to BNSF are provided in Confidential Appendix C.

Source competition has also been strengthened. Gulf Coast facilities that have access to BNSF service have expanded production since the merger, and the production of plastics and chemicals has grown in regions other than the Gulf Coast. For example, increases in Canadian production – including the production of ethylene and polyethylene in Alberta – have given BNSF even greater access to sources of plastics and other chemicals that compete with Gulf Coast production.

Further proof that the merger has increased competition for Gulf Coast chemicals and petroleum products can be found by examining the rates for these products. Rates for Gulf Coast plastics have declined by more than sixteen percent during the merger oversight period. Rates for Gulf Coast chemicals and petroleum products other than plastics have fallen by more than nineteen percent in the same period. System-wide, rates for chemicals and petroleum products have declined by more than eighteen percent during the five years of merger oversight. Confidential Appendix E-1 contains the details.

### 3. Soda Ash

During the merger proceedings, some parties worried that source competition for soda ash might be impaired when UP – the only railroad with direct rail service at major soda ash origins in the Green River area of Southwestern Wyoming – merged with SP – the only railroad with direct rail service to the other domestic soda ash source in Searles Lake, California. The applicants explained that such concerns were unwarranted. The applicants explained that the economics of soda ash transportation was such that the two sources rarely competed, that the

merger would benefit soda ash producers by allowing UP to improve its Central Corridor operations and creating single-line service to SP receivers. They also explained that BNSF had already captured a significant share of Wyoming and Searles Lake traffic using transload facilities, and that it would be granted access to existing SP transload facilities in Utah as part of the BNSF agreement.

The applicants' analysis has proven correct. Rates for soda ash have fallen by almost eleven percent since the merger. Confidential Appendix E-3 contains additional details. Soda ash rates have continued to drop in part because of efficiencies generated by the merger and in part because of the competitive options that BNSF provides for both Green River and Searles Lake producers. BNSF has a large transload operation at Bonneville, Wyoming, some 180 miles from Green River, and at a former-SP facility in Ogden, Utah, some 160 miles from Green River. BNSF also has a transload facility at Boron, California, some 79 miles from Searles Lake. These facilities have allowed BNSF to gain a significant share of soda ash traffic, and UP has responded by reducing rates and improving service to soda ash producers.<sup>75</sup>

Competition for soda ash will only grow stronger in the future. A major new soda ash producer, American Soda, located along the former-SP line in Parachute, Colorado, has direct rail access to BNSF as a result of the Board's new facility condition. BNSF recently outbid UP for this business, which moves primarily to the Gulf for export but also moves to numerous other destinations throughout the country. BNSF service to this producer will provide

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<sup>75</sup> In Docket No. 420444, FMC Corp. v. Union Pacific R.R., one of the Wyoming soda ash producers challenged soda ash rates to certain points. After the Board reduced several rates, the parties negotiated a transportation service agreement.

an additional incentive for UP to reduce rates and improve service to its Green River and Searles Lake customers.

4. Houston-Area Aggregates

In the merger application, the applicants discussed the merger's impact on competition for Houston-area aggregates because they had been an issue in the UP/MKT merger, where SP had replaced MKT as UP's competitor at Texas Crushed Stone's large facility at Georgetown, Texas. The applicants explained that competition would remain strong after the merger for several reasons. First, BNSF would gain access to Texas Crushed Stone via an interchange with the Georgetown Railroad, the shortline owned by Texas Crushed Stone. Second, Mexican aggregates, delivered by water, had become extremely competitive, and the applicants expected that these shipments would continue to grow.

Competition for Houston-area aggregates has remained strong since the merger. As predicted in the merger application, the amount of Mexican aggregates delivered by water to the Houston area has increased sharply. Also, BNSF has handled substantial volumes of aggregates from Texas Crushed Stone in single-line service to BNSF points in Houston and to competitive points as well. Examples are included in Confidential Appendix B.

Other aggregates producers have also benefitted from the merger. Producers that were served by UP exclusively now have single-line access to the numerous former-SP destinations in the Houston area. Similarly, the one exclusively served former-SP aggregates shipper to the Houston area, Martin Marietta at Beckmann, can now access UP destinations on a single-line basis. Some examples of these benefits are contained in Confidential Appendix A.



The heightened competition and single-line service benefits are reflected in the fact that rates for Houston-area aggregates shipments have fallen by approximately four percent during the oversight period. Confidential Appendix E-3 contains additional details.

5. Grain

In the merger application, the applicants explained that the UP/SP merger was a natural fit for grain shippers. UP was a major originator of wheat, corn, soybeans, barley, and other grains. SP originated very little grain, but it served major end markets for grain in California and the Southwest that UP could not reach on a single-line basis. The merger created new single-line markets for UP producers in California's San Joaquin and Imperial Valleys, Arizona, and other areas of the Southwest, adding new competition to these markets that BNSF, a major grain originator, already served. UP competed directly with SP only for modest volumes of hard red winter wheat from Kansas to the Texas Gulf for export, and BNSF remains the dominant carrier for this traffic.

Competition for grain traffic has remained intense since the merger, and shippers have benefitted from UP's single-line routes. Examples of new UP single line movements are contained in Confidential Appendix A. The continuing intensity of grain competition is reflected in the fact that systemwide rates for grain have fallen by almost six percent during the merger oversight period. Confidential Appendix E-1 contains additional details.

J. Unique Features of the Merger as Conditioned Insure  
the Continuing Enhancement of Western Rail Competition

The UP/SP merger differs in several significant ways from rail mergers that had occurred before and that have occurred since. These differences ensure that the UP/SP merger, perhaps more than any other, will continue far into the future to enhance rail competition in United States.

The UP/SP merger, as conditioned by the Board, has improved service and enhanced competition for many of the same reasons that previous rail mergers have accomplished these goals. The merger has provided shippers with shorter routes, expanded single-line service, faster schedules, upgraded track, new facilities, lower costs, greater reliability, much improved equipment supply, more efficient terminal operations, and other similar benefits that one would expect from the combination of two large railroads. The merger has provided shippers that would have lost their only competitive alternative in an unconditioned merger with access to a new, stronger competitor, as one has come to expect in these types of proceedings.

There are, however, five features of the UP/SP merger that make it unique among the many major mergers approved by the Board or its predecessor, the ICC. The five features are the transload, build-out, and new industries provisions of the BNSF and CMA agreements, as augmented by the Board, the general reduction in reciprocal switch charges sparked by the merger, and development of new routing agreements with connecting carriers. Never before and never since have any of these competition-strengthening provisions been part of a major ICC or STB case. These items add a significant amount of new competition in the West, and their impact will steadily increase in the future.

1. Transloads

In no other railroad merger have recipients of overhead trackage rights been given the right to serve all existing transload facilities at "2-to-1" points and construct new transload facilities at any point along the trackage rights lines. The theory behind granting such rights is that in a merger of parallel rail lines, transloading options that might help one carrier access customers located on the other parallel carrier could be lost.



The applicants addressed the potential loss of transload competition in the BNSF agreement by granting BNSF the right to serve any new transloads at "2-to-1" points, which are spread across the trackage rights lines. The applicants later agreed in the CMA agreement to expand the transload provision to allow BNSF to construct new transloads at any point along any former-SP line over which BNSF received trackage rights, under the theory that this was something that SP could have done prior to the merger. The applicants' concession to CMA was unprecedented, but the Board took it a step further.

In its decision approving the merger, the Board expanded the transload provision to apply to all of the BNSF trackage rights lines, thereby extending new transload competition into territories where transload competition would not have been possible because UP and former-SP lines were not in close proximity.

The Board's expansion of the transload provision to provide BNSF with unprecedented access to new transloads will increasingly allow BNSF to compete for exclusively served customers located on the lines over which it has trackage rights, even though these customers experienced no reduction in competition as a result of the merger.

In fact, this is exactly what is happening today. For example, BNSF has developed a new transload facility at Aragonite, Utah, on a UP line just east of UP's exclusively served waste disposal companies at Clive, Utah. BNSF's intent is not to transload business from customers on the former SP main line, which lies far to the north across hostile country. Instead, BNSF will capture existing UP traffic amounting to many millions of dollars in annual revenue from customers that chose to locate at an exclusive UP point before the merger.

Confidential Appendix G contains additional examples of shippers that have taken advantage of the transload condition.



As BNSF pinpoints more of these opportunities in the future, its efforts to acquire exclusively served UP traffic will grow, its trackage rights volumes will grow, and competition for this traffic, which would have been unaffected in any prior or subsequent rail merger, will increase.

2. Build-outs

In no other rail merger have the applicants been required to preserve any and all potential build-out options and stand ready to grant additional trackage rights necessary to serve the build-outs. The applicants considered whether the merger would eliminate any real build-out opportunities, and they agreed to preserve those opportunities in the only two situations in which a build-out appeared to be even a possibility.<sup>76</sup>

The applicants went even further and made an unprecedented agreement with CMA that preserved build-out options for all CMA members by granting them the right to build from any former-UP exclusive point to a former-SP line and vice versa.

In its decision approving the merger, the Board expanded the CMA build-out provision to apply to any and all potential build-out situations across the merged system. In no previous merger proceeding had the Board (or its predecessor, the ICC) ever imposed a condition designed to preserve all potential build-out options. In the BN/Santa Fe merger, the ICC preserved potential build-outs for two specific shippers, but it never attempted to remedy the potential loss of competition from build-outs at locations in Oklahoma, Texas, Illinois, and

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<sup>76</sup> As noted above, the applicants decided to grant BNSF immediate access to five other shipper facilities to which plans for a UP build-out were already underway.

Missouri in which BN and Santa Fe tracks were parallel, or even at "2-to-1" points, such as Galesburg, Illinois, and Ft. Madison, Iowa.

Moreover, in the BN/Santa Fe merger, the Board required the shippers to prove that a build-out might have been feasible for one of the merging carriers before it would preserve such an option. In the UP/SP merger, the Board ruled that the only test of feasibility was whether a build-out actually occurred, and it ruled that UP must stand ready to grant BNSF the necessary trackage rights from its lines to connect to the build-out point if ever a build-out were constructed.

The Board's expansion of the CMA build-out provision gives shippers located anywhere on the UP system an expanded build-out option. In prior cases, the question was always whether one of the merging carriers would have found it feasible to participate in a build-out. For the UP/SP merger, the test became whether BNSF, which is far stronger and has a far more comprehensive route structure than the pre-merger SP – finds it worthwhile to participate in a build-out. No subsequent transaction (including the more recent Conrail split-up and CN-IC merger) has included this type of build-out condition.

Shippers have used the build-out provision as leverage in their negotiations with UP, and BNSF is using the provision today at North Seadrift, Texas, where Union Carbide will build out to a point on the former-SP Port Lavaca Branch. UP will then grant BNSF new trackage rights to operate from that point on the branch to Placedo, where it can connect to its overhead trackage rights on UP.

Confidential Appendix F contains additional examples of shippers that have taken advantage of the build-out condition.



The comprehensive build-out condition is unique to the UP/SP merger and will continue to result in increased competition far into the future – either because build-outs will be constructed or because shippers will continue to use the provision to negotiate rate concessions.

### 3. New Industries

In no other rail merger have the applicants been required to allow recipients of overhead rights to serve new industries that locate on those lines after the merger. The theory behind granting such rights is that shippers might lose the opportunity to negotiate with the two carriers to obtain the best possible deal before deciding where to site an exclusive facility.

The applicants believed that this type of siting competition would not be lost in the UP/SP merger because even after UP and SP merged, BNSF would still provide shippers with the opportunity to site new facilities anywhere along its extensive network. (The applicants dealt with a separate aspect of plant siting competition – siting at “2-to-1” locations to obtain competitive service – by granting BNSF the right to serve new industries locating at “2-to-1” points.)

Nonetheless, UP made an unprecedented concession to CMA that allowed BNSF to serve any new industries that located on the overhead portions of all former-SP lines where BNSF received trackage rights. As a result, shippers that would have willingly located on a line served by only one carrier could obtain two-railroad competition.

The Board also took this concession and extended it even further. In its decision approving the merger, the Board expanded the new industries provision to apply to all of the BNSF trackage rights lines, thereby providing shippers a tremendous range of sites from which they will be able to enjoy two-railroad competition. This is a pure windfall for shippers. Research by UP's industrial development staff indicates that in siting new industries, a wide



range of factors, including access to raw material, power supply, taxes, proximity to markets, labor costs, and a range of other factors usually strongly outweigh any concern for obtaining rail competition. In fact, over eighty percent of new UP-served industries in the past three years decided to locate at exclusively served points.

The result of this condition has been to bring two-railroad competition to new industries that, in all likelihood, would have located at the same site and received service from only one railroad had the merger not occurred. A prime example is American Soda's new soda ash facility at Parachute, Colorado. The facility has been under development for some time, and utilizes infrastructure (including plant buildings and pipelines) constructed a number of years ago in anticipation of gasification of nearby coal reserves. Prior to the merger, there was no railroad other than SP within hundreds of miles of Parachute. As a result of the merger, however, the customer was able to entertain bids from UP and BNSF, and BNSF was able to capture this business.

Confidential Appendix H contains additional examples of shippers that have taken advantage of the new industry condition.

As more and more shippers locate new facilities along BNSF trackage rights lines – and they certainly will, given the extent of the BNSF trackage rights – competition for this traffic, which would have been unaffected in any prior or subsequent rail merger, will increase, and BNSF trackage rights volumes will continue to grow.

#### 4. Reciprocal Switching Charges

The UP/SP merger has also had a unique effect on reciprocal switching charges. In 1988, SP almost doubled the reciprocal switch charges that it required other railroads to pay when SP switches an open industry to \$450 per car. By the time of the UP/SP merger, the

charges had escalated to \$495 per car. Other western railroads had responded by similarly increasing their switch charges vis-à-vis SP (but not vis-à-vis each other).

SP apparently increased its fee in an attempt to retain its direct switched customers despite its poor service. The marketplace had tried to find ways around SP's increased switch charges, and a number of reload centers sprouted up with business trucked between SP-served customers and UP or BNSF, but the switch charges continued to pose a barrier for many customers who would have preferred service from another carrier.

The applicants indicated in the application that UP intended to reduce the SP switch charges after implementing the merger, and made this commitment part of the CMA agreement, where they specifically promised to lower all reciprocal switching charges for former-SP customers to no more than \$150 per carload.

The reduction in the former-SP charge and the aggregation of individual UP and SP industries into common terminals provided the impetus for reaching a new system-wide reciprocal switching agreement with BNSF that took account of UP's and BNSF's recent mergers. After the merger, UP and BNSF quickly hammered out a new comprehensive, system-wide reciprocal switching agreement that covers virtually all customers, whether formerly located on UP, SP, CNW, BN, or Santa Fe. The agreement specifies rates of only \$75 per carload for grain traffic and \$130 per carload for other traffic. The agreement has worked smoothly and efficiently, reducing marketing response time to customers and streamlining administrative costs. Disputes have been very rare, and customers have benefitted with greatly enhanced competition throughout the West.

Encouraged by the success of its system-wide agreement with BNSF, UP subsequently entered into similar agreements with CSX, NS, and CP. This brings under a



standardized agreement eighty percent of the 275,000 annual carloads of reciprocal switching that UP provides. The standardized and reduced charges have benefitted customers of all of the railroads involved, and they will continue to benefit these customers.

#### 5. Interline Routing Agreements

The UP/SP merger also resulted in groundbreaking efforts to rationalize traffic at key UP and SP gateways and to enter into routing agreements with connecting carriers in order to provide shippers with more efficient and faster routes to destinations in the East and in Canada.

Prior to merger, UP and SP each served the major East-West gateways of Chicago, St. Louis, Memphis, and New Orleans. As UP planned for, and then began implementing the UP/SP merger, it recognized that the two railroads had not been using these gateways in a consistent manner. For example, between a certain area in the Gulf Coast and a certain area in the Southeast, former-SP and UP traffic might flow predominantly via either the Memphis or New Orleans gateways. For transcontinental traffic between the West and the Northeast, UP's service was generally oriented toward the Chicago gateway, while SP handled a greater proportion of its traffic via the St. Louis gateway. In the first years following merger, the multiplicity of routings contributed significantly to UP's post-merger service problems.

UP recognized the potential to improve service by combining former-SP and UP traffic and assembling run-through trains to bypass the major East-West gateways and operate deep into the Southeast and Northeast. UP's strategically-located hump yards at North Platte, Chicago (Proviso), East St. Louis, North Little Rock/Pine Bluff, and Livonia were poised to assemble volumes from former-SP and UP shippers into a number of solid run-through trains for NS, CSX, and other major carriers.



UP understood, however, that these service enhancements could not be fully realized unless traffic was consistently routed via the most efficient gateways. Thus, once UP had determined to rationalize its gateway traffic, it entered into new routing agreements with CSX and NS to implement its plan to offer improved run-through service. As existing transportation service contracts expired and were renewed, UP was able to change the routings so that more and more of its traffic conformed to the CSX and NS routing agreements.

UP's traffic rationalization efforts and routing agreements have enabled UP to provide the improved service it had foreseen. UP run-through trains now operate further into the Northeast and Southeast than ever before. For example, to the Northeast, UP now consolidates traffic at North Platte to make CSX blocks for Selkirk, New York, Willard, Ohio, and Toledo, Ohio, and NS blocks for Conway, Pennsylvania, and Elkhart, Indiana.

UP also entered into a new routing agreement with CP that has made possible dramatically improved service. Prior to merger, SP directly connected with CP at only Kansas City and Chicago. UP connected with CP at Chicago, the Twin Cities, Kansas City, and Eastport, Idaho, as well as at numerous smaller terminals. Under the new routing agreement, CP now builds a train to Roseville, California (a former-SP point), at Edmonton, Alberta, which operates via Eastport (a UP gateway). By combining volumes to former-SP and UP points, UP and CP have been able to develop a new service from Alberta and other western Canadian provinces to the Gulf Coast via the Twin Cities that is two days faster than previous schedules. SP, which could not connect with CP at either Eastport or the Twin Cities had nothing even closely resembling these services for its shippers.

UP's groundbreaking efforts to rationalize its gateways and enter into new routing agreements that take advantage of the combined former-SP and UP traffic have resulted in benefits that will continue to inure to shippers indefinitely.

K. Summary

The Board established a five-year oversight period to ensure that the UP/SP merger, as conditioned, would preserve and enhance competition, as the applicants had promised it would. After five years of oversight, it is clear that the merger has lived up to its promise. The UP/SP merger has not harmed competition – competition has flourished. The past five years have seen shippers enjoying the benefits of reduced rates and improved service, and the merger, as conditioned, will only increase competition in the future.

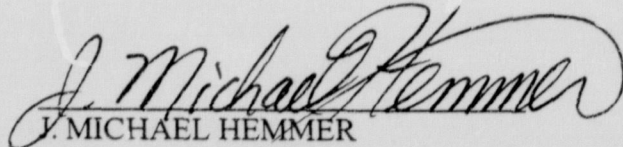
CONCLUSION

The Board should conclude that the conditions it imposed on the UP/SP merger have been effective and that this oversight proceeding should be terminated.

Respectfully submitted,

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*Attorneys for Union Pacific Corporation  
Union Pacific Railroad Company and  
Southern Pacific Rail Corporation*

July 2, 2001



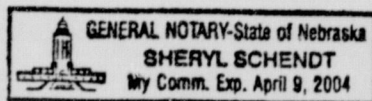
VERIFICATION

STATE OF NEBRASKA     )  
  ) ss:  
COUNTY OF DOUGLAS    )

I, Richard B. Peterson, Senior Director-Interline Marketing, state that I am familiar with the contents of Part III of the Applicants' Fifth Annual Report on Merger and Condition Implementation in STB Finance Docket No. 32760 (Sub-No. 21). To the best of my knowledge and belief, those contents are true as stated.

Richard B. Peterson  
Richard B. Peterson

Subscribed and sworn to before me by  
Richard B. Peterson this 29<sup>th</sup> day of  
June, 2001.

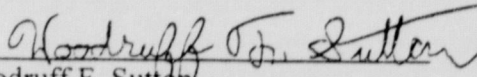


Sheryl Schendt  
Notary Public

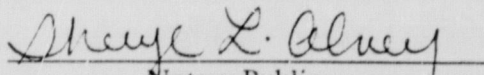
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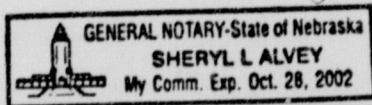
STATE OF NEBRASKA     )  
                                      ) ss:  
COUNTY OF DOUGLAS    )

I, Woodruff F. Sutton, Vice President-Manifest Service of Union Pacific Railroad Company, state that I am familiar with the contents of Part II.A. of the Applicants' Fifth Annual Report on Merger and Condition Implementation in STB Finance Docket No. 32760 (Sub-No. 21). To the best of my knowledge and belief, those contents are true as stated.

  
Woodruff F. Sutton

Subscribed and sworn to before me by  
Woodruff F. Sutton this 29<sup>th</sup> day of  
June, 2001.

  
Notary Public



CERTIFICATE OF SERVICE

I HEREBY CERTIFY that on this 2nd day of July 2001 a copy of the foregoing "Union Pacific's Fifth Annual Oversight Report" was mailed, postage prepaid, to all parties of record.

  
J. Michael Hemmer





**Exhibit No. 1**

Support for Traffic Study to Demonstrate Competitive Harms from UP/SP Merger

In last year's UP/SP merger oversight proceedings, the STB ignored comments submitted by several parties (KCS, EEI, AECC, CPUC) regarding reduced competition on Central Corridor and transcontinental movements, and found that no loss of competition had been demonstrated. In dismissing the competitive concerns as unproven, the Board relied on the fact that no party has submitted a comprehensive traffic study demonstrating the existence of any competitive problems. The Board specifically left open the possibility that a more detailed traffic study could demonstrate the existence of competitive problems that would warrant remedial actions.

Parties who would benefit from the restoration of competition lost in the UP/SP merger are now down to their last opportunity to obtain relief through the oversight process, which ends after the upcoming round this summer. I am asking parties with common interests in this area to sponsor a portion of the traffic study needed to satisfy the evidentiary standard set by the STB, and help ensure that proper relief is obtained before the oversight process expires. The study I plan to perform would encompass the traffic specified by the sponsoring parties, and would be submitted to the STB by August 17, 2001.

Types of rail shipments that could be expected to benefit most from the planned study include:

1. Traffic moving to or from areas that experienced a reduction from 3 to 2 in the effective number of serving railroads, such as southern California, the San Joaquin Valley, the San Francisco Bay Area, Portland, OR and portions of Texas, Louisiana, Arkansas, Missouri, Kansas, Iowa, Oklahoma, Illinois and eastern Colorado;
2. Traffic originating and/or terminating within the Central Corridor (including but not limited to movements of western bituminous coal); and,
3. Any other traffic that relies on the competitive influence provided by the trackage rights originally awarded to BNSF.

The cost of the traffic study is estimated to be \$7,500-\$12,500 for each party, depending upon the number and complexity of flows that the party specifies for inclusion in the study.

Please let me know if you would be interested in joining a group that would sponsor the planned study.

Thanks.

Mike Nelson  
Transportation Consultant

149 Corinth Street  
North Adams, MA 01247  
(413) 663-8078



### Support for Traffic Study to Demonstrate Competitive Harms from UP/SP Merger

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Mike Nelson  
Transportation Consultant

149 Corinth Street  
North Adams, MA 01247  
(413) 663-8078

**Exhibit No. 2**

AUGUST 16, 1982 TWO DOLLARS AND FIFTY CENTS

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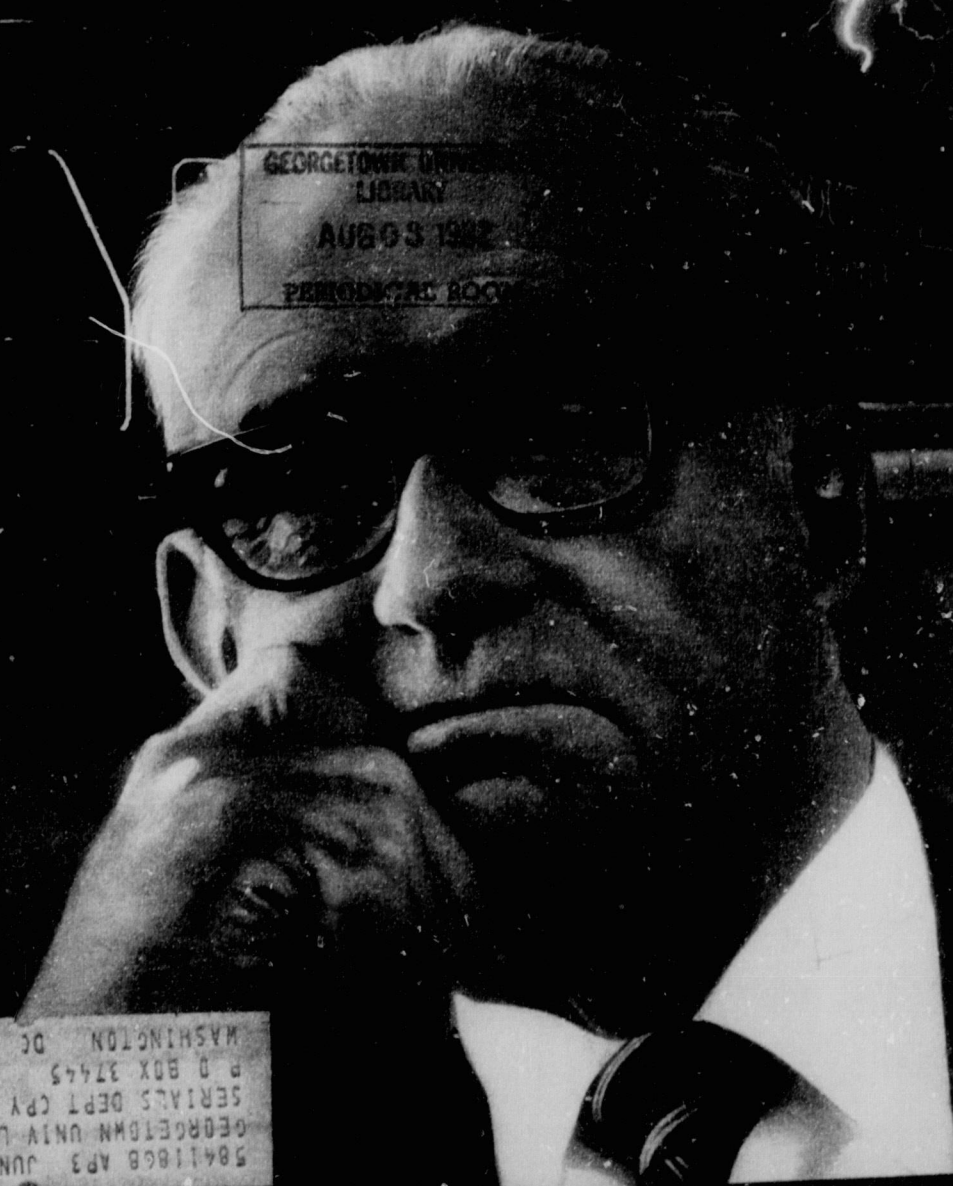
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SP

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*Southern Pacific Co. has vast assets and a strong foothold in a great growth industry. But neither strength may save it. The SP needs capital—and the capital just may not be there.*

## Doomed?

By James Cook

**I**T IS SIMPLE common sense. You don't need a Wharton finance degree to grasp the principle: A capital-intensive company with an inadequate cash flow should never, repeat never, diversify into another capital-intensive business. That will only compound the problem. Short of cash before, you are now twice short. Yet that is precisely the trap management fell into at San Francisco's \$5.5 billion (assets) Southern Pacific Co. The result is that this giant enterprise now has the worst of two worlds, and some analysts are privately speaking of it as "a potential Penn Central." Inconceivable for a company as rich as this one? Here are the facts.

To begin with, SP's 13,740-mile railroad operation lost money in the first quarter—\$16.4 million on a 13% drop in carloadings. Superficially there is nothing much wrong with that. A dozen other marginal carriers also lost money—the Milwaukee, the Illinois Central, the Gulf and Chicago & North Western among them. But Southern Pacific never used to be numbered among the U.S.' marginal railroads. Chairman Benjamin F. Biaggini responded by laying off 1,465 employees and cutting expenses by an estimated \$43 million a year, and though second-quarter carloadings were down nearly 20%, Biaggini succeeded in nudging the railroad's second-quarter net \$1 million back into the black, leaving a first-half

loss of more than \$15 million.

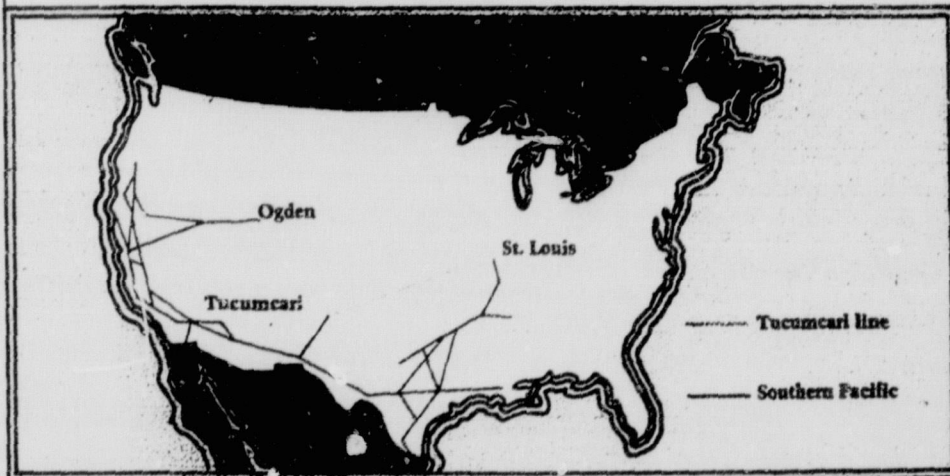
The railroad was only part of it. In the first half of this year, the parent company also lost money in trucking (\$9.4 million) and in title insurance (\$3.7 million). Aided by the \$24 million it got from the sale of some tax credits, SP managed to report a \$26.4 million profit for the first half—a drop of over 60% compared with last year.

ted a mere 0.5% on its return on investment, compared with the industry's average of 4.1%.

"The financial performance of the Southern Pacific railroad during the 1970s concerns us," Biaggini told the Interstate Commerce Commission a while back. "During that decade we experienced little growth in physical volume, and our income declined. At

### Short hauls and long

It costs more to gather traffic than it does to move it, which is why railroads like to distribute those costs over as long a haul as possible. That's why Southern Pacific often moved eastbound traffic the long way over its own lines to St. Louis sooner than turn the traffic over to connections at Ogden or Tucumcari. And why two years ago SP decided to acquire the Rock Island's Tucumcari line to the east.



Like Penn Central before it, the Southern Pacific has been slowly starving for lack of business. In a decade its share of the western railroad market has declined from 20% to less than 13%, its pretax profit margins narrowed sharply. Last year, in fact, the railroad earned \$78 million before taxes (excluding the sale of tax credits), and, as the ICC calculates it, net-

the same time, Union Pacific and Santa Fe, our primary competitors, have had substantial increases" (see chart).

Clearly SP's management knew it had a problem. For generations the company attempted to reduce such problems by diversifying into other businesses related in one way or another to transportation—trucking, pipelines, real estate. In recent years,

however, it has begun to diversify at random, without considering how these other businesses would function within its overall corporate framework. The \$280 million acquisition of Ticor and its title insurance business is the obvious example—an acquisition that only enlarges SP's exposure

in housing, which is the railroad's number one market. Telecommunications is no better. That business is as thirsty for capital as the railroad is—a potentially disastrous situation in a period when the U.S. faces unprecedentedly high interest rates and a continuous shortage of capital.

Not that the prospects in telecommunications aren't intoxicating. They are. Southern Pacific Communications Co. is a long-distance telephone system that competes, like MCI, head-to-head with AT&T. After piling up over \$100 million in pretax losses, it broke decisively into the black last year, with a \$34 million operating profit, and then reported \$37.1 million in the first half, up from \$12.8 million last year. Altogether, SPCC posted only \$235 million in revenues last year. But Biaggini predicts that by the end of the decade SPCC could be producing half of Southern Pacific's revenues—and at last year's levels, that would be over \$3 billion a year.

SP only gradually found out what it wanted to do in telecommunications. It started out in the Sixties with a microwave communications network to replace its old telegraph system and then in 1970 began leasing circuits, as a specialized common carrier, to business customers. That original idea was doomed, but in 1978, when MCI succeeded in prying open AT&T's long-distance telephone business to outside competition, SPCC had the rudiments of a nationwide telecommunications network already in place, saw the opportunity and created Sprint, a low-cost, private long-distance telephone service of its own.

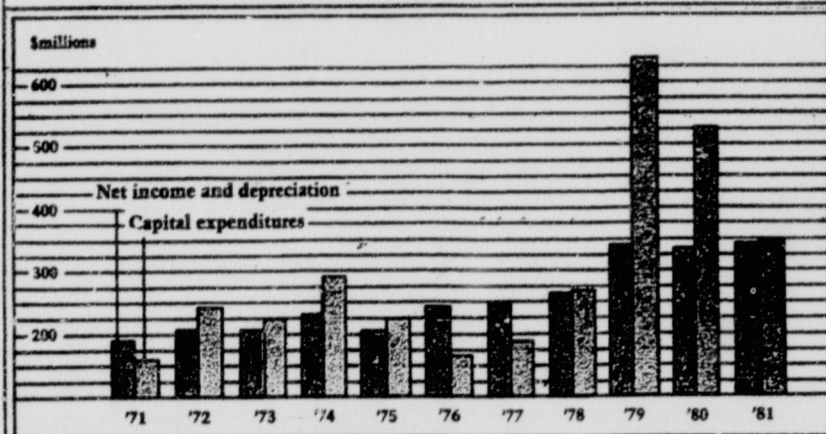
With 250,000 customers, SPCC is about half the size of MCI, but the \$40 billion long-distance telecommunications business is growing at 10% to 15% a year. SPCC is not only catching the basic growth, it is enlarging its market share by aggressively undercutting AT&T's rates.

Unlike MCI, SPCC is moving into the satellite business as well. In 1984, at a cost of \$200 million, it will loft two satellites into space, one designed primarily for cable television, the other for general services—data transmission, teleconferencing, video transmission, facsimile. SPCC will keep 20% of the satellites' capacity for itself—to expand its Sprint capacity nationwide and to open up new opportunities like electronic mail. The rest will go to outsiders—cable television operators, the Catholic Church, Vitalink Communications, the Southern Baptist Convention. By 1984, when the satellites go into orbit, SP could be generating close to \$150 million in satellite revenues, netting maybe \$30 million a year before taxes.

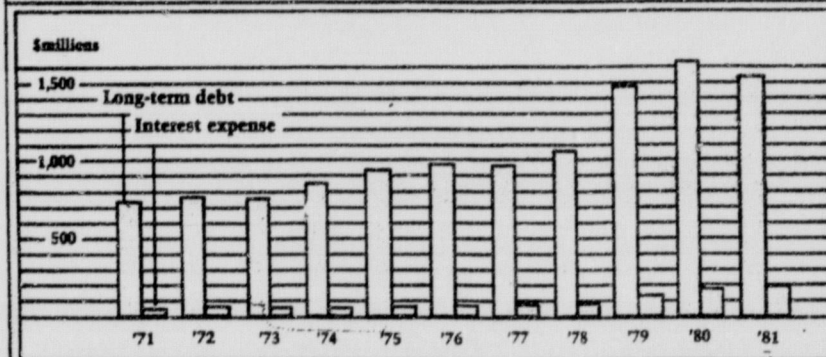
So far so good. But whether Southern Pacific will ever be able to realize this potential is an open question. The problem is money. Telecommunications normally requires \$1 to

## Less from more

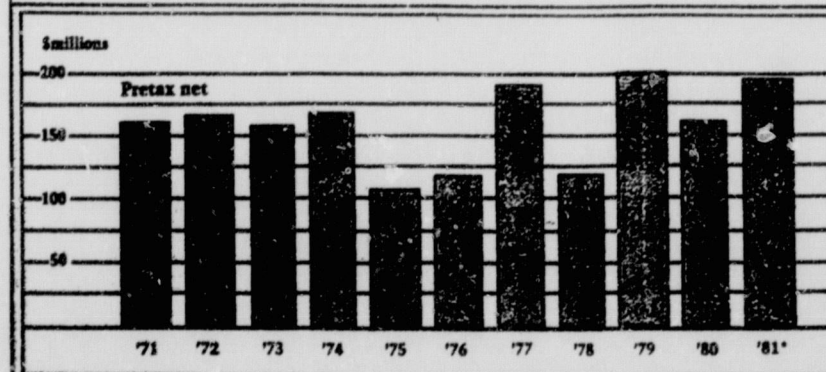
In most years in the Seventies, Southern Pacific failed to generate enough cash flow from earnings and depreciation to finance the heavy capital spending programs required by its diversified operations.



So it borrowed and borrowed and borrowed. Its outstanding debt nearly doubled, while its interest charges nearly quadrupled.



End result: SP's pretax net has stagnated for most of the decade.



\*Excluding sale of tax benefits  
Source: Standard & Poor's



\$2 in capital to generate \$1 in revenues. Thus, to realize its communications ambitions, SP will need to generate considerably more than \$3 billion in capital over the next eight years. From where? Good question. Over the past decade, SP's cash flow (net income plus depreciation) has totaled only \$2.6 billion. Last year it fell over \$75 million short of covering SP's capital and dividend outlays.

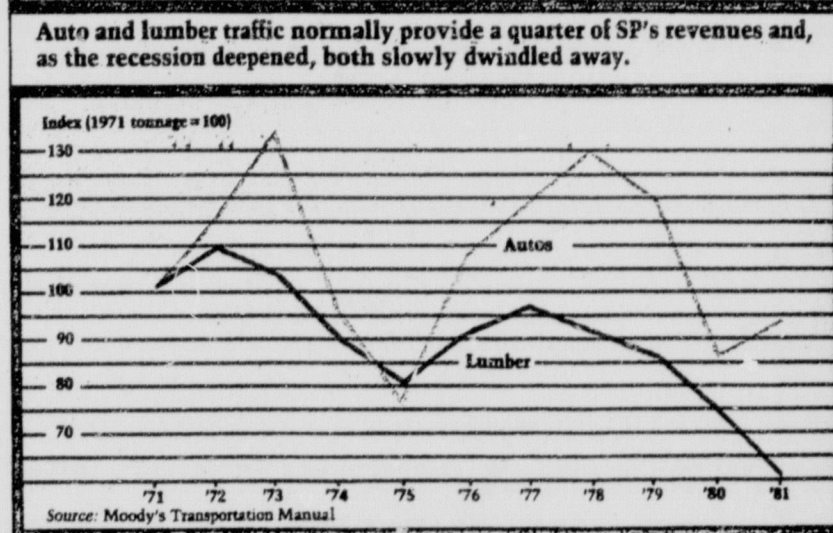
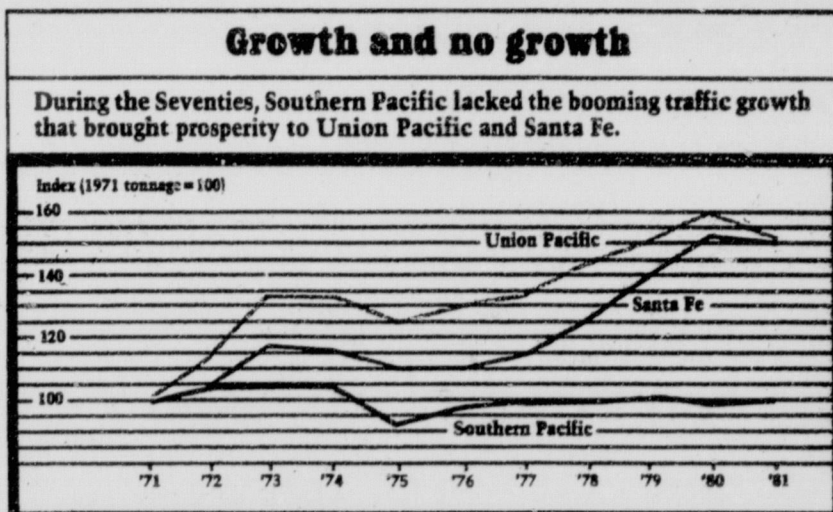
As the Santa Fe reminded the ICC during some recent merger proceedings, "Southern Pacific's already heavy debt load and inadequate net income threaten its bond rating and its ability to raise necessary additional capital." Thus, what capital it can commit to telecommunications can hardly fail to come at the expense of the already faltering railroad, and that's what's happening. SPCC absorbed 11% of SP's capital expenditures in 1980, 26% in 1981, 40% this year. So, in a sense, disinvestment has begun.

Lest it be forgotten, it was lack of investment that helped bankrupt much of the U.S. railroad system in the East and Midwest. What brought the West's proud Southern Pacific Co. to such a pass? Poor management in part, circumstances in part.

For one thing, SP just didn't get the traffic. Union Pacific and Santa Fe cashed in on the Seventies booms in coal and grain traffic, while Southern Pacific, by virtue of its geography, by and large sat out both of them. Meanwhile SP's traditional traffic strengths began to deteriorate. The Rock Island, one of SP's major connections to the East, was slowly sinking into bankruptcy, and, as it did, SP's eastern traffic connections weakened. Then, too, trucks whittled away at SP's higher-profit merchandise traffic and drove SP out of its once basic fresh fruit and vegetable traffic entirely. Canadian spruce and southern pine captured eastern markets formerly held by Oregon and northern California lumber, and the West Coast auto market was the first to be exposed to the effect of Japanese imports.

A more basic problem was SP's California stronghold. In the Seventies California's economy became self-contained and its population growth slackened off. As against 40% in the Fifties and 25% in the Sixties, population growth in the Pacific Coast region slowed to 19% in the Seventies, a prospective 5% in the Eighties.

"In this inflationary economy," says Isabel Benham, president of Princeton, Kane Research and probably the U.S.' most astute railroad consultant, "if you don't have traffic growth, you're going to stand still or go back-



ward. That's what happened to Penn Central. The same thing could happen to Southern Pacific."

Southern Pacific admittedly has tremendous gathering power in California, originating as much as 50% of the state's rail traffic, but in the railroad business these days that isn't enough. You need long-haul traffic to justify the cost of originating traffic, just as Penn Central did to justify its huge terminal costs in the East, and Southern Pacific has been hard put to obtain it. SP had to choose between handing eastbound traffic over to Union Pacific at Ogden, Utah, and to the Rock Island at Tucumcari, N.M. or getting the long haul over its 400-mile longer route to St. Louis (see map, p. 57). Whenever it could, SP chose the latter, routing its eastbound traffic through Corsicana, Tex. onto the lines of its St. Louis Southwestern subsidiary.

Such a strategy may have made sense during the Sixties, when fuel costs were still low, but in the Seventies, when fuel costs mounted ninefold, it was little short of madness to use the longer route. Kidder Peabody's

rail analyst Henry Livingston explains: "SP's route into St. Louis is 400 miles longer. There is no way they could up the freight rate to even approach the kind of money others could make who have the shorter route."

For nearly two decades, Biaggini tried to reduce the problem by extending SP's reach. He tried to buy the southern half of the Rock Island as part of a Union Pacific-Rock Island merger. When that fell through, he tried to acquire the Rock Island's 965-mile Tucumcari line instead. "Gee," SP's former policy strategist John Williams gasped at a private DOT dinner, "if we don't have this [Tucumcari line], we are, you know, we are going to get out of the railroad business, we are not going to make it." Remarkably, both the Justice Department and the Department of Transportation agreed. "The Southern Pacific faces a risky financial future," one DOT study concluded, "and if the proposal is disapproved, it is possible Southern Pacific management will begin to disinvest," and, another DOT study added, "with eventual bankruptcy a possible outcome."



The Tucumcari acquisition was expected to save 9.8 million gallons of fuel oil a year, \$33 million in expenses, and generate between \$33 million and \$140 million in revenues, depending on who made the estimate. It didn't pan out. SP spent \$57 million to acquire the line, another \$97 million upgrading the 545-mile section from Tucumcari to Topeka. But by then the capital shortage had begun to mount. SP deferred spending the additional \$97 million needed to upgrade the presently inoperable section between Kansas City and St. Louis. So the traffic moved over the rival Missouri Pacific instead. The Tucumcari acquisition not only failed to achieve the strategic objective of providing single-line service between Los Angeles and St. Louis, it revealed just how straitened Southern Pacific's financial circumstances had become.

Everywhere Biaggini turns there is clamor for money. Since 1978, for example, SP has spent over \$900 million on roadway and equipment, yet increased its railway operating income a mere \$5 million. Says Isabel Benham: "They've spent this money and they've not gotten a return on it, because the volume isn't there and the territory doesn't provide the volume."

Putting a good face on these ominous trends, Biaggini is counting on a resurgence in traffic to put the railroad and the company back on their feet again. But increasingly that comes to seem like a vain hope. SP never fully recovered from the 1975 recession—the traffic, once lost, didn't come back—and this time the changes in the market look even more radical. U.S. automakers have closed all five of their California assembly plants, permanently, so autos are unlikely to come back completely. Lumber may not come back all the way either. Interest rates remain relatively high and housing starts low, and it's not inconceivable that Americans will start rethinking their expectations in housing just as they have in autos. California's growth prospects are even dimmer in the Eighties than in the Seventies, which may be portentous for all western railroads.

Time is running out on the SP. If Union Pacific succeeds in pulling off its Missouri Pacific-Western Pacific merger—and hardly anyone doubts that it will—Southern Pacific faces an additional threat: the loss of as much as \$100 million in revenues. The UP threatens the SP from one end of the system to the other, but the biggest threat is to SP's central corridor between Ogden and the West Coast. "If the merger is approved," SP says flat-

ly, "it is quite likely that the southern corridor will survive as SP's only viable profit center."

Meanwhile, SP's financial condition continues to deteriorate. Over the decade its long-term debt has nearly doubled, its fixed charges quadrupled and, as its debt ratio swelled from 27% to 34%, the coverage on its long-term debt has narrowed from 4.8 in 1971 to 2.6 last year.

To plug the gap, SP has been liquidating some of its assets. Over the past three years it has stepped up its annual property sales from \$50 million to \$83 million. Last year it tried to sell off 115,000 acres of timber and other lands in northern California but withdrew the offer when the bids proved too low. In May it sold its

**SP's assets may be worth \$500 a share. But those are theoretical values, and it would take a more imaginative management than SP has had to realize them.**

moneylosing Distributed Message Systems to 3M. Now it's planning to sell its Tigor title insurance subsidiary's \$2.8 billion trust operation—for an unspecified amount—to California Federal Savings & Loan.

The railroad has had a working capital deficit for several years. The company overall has been cutting capital spending. Its common stock dividend, currently costing it \$70 million a year, will almost certainly have to be cut. "If they want to be retiring debt instead of refinancing it," says Mary DeSapio, Lehman Brothers Kuhn Loeb's rail analyst, "they should be conserving cash."

Over the next five years SP will have to refinance a large part of its more than \$750 million in maturing debt—close to half the total outstanding—and do so at rates two, three and four times as high as the debt it replaces. Last year, for instance, it retired some old debt at 4.5% interest, and took on new at 8.5% to 21%.

It is true that Southern Pacific has enormous assets—land and resource holdings worth, according to one analyst, as much as \$500 a share—but those are theoretical values, and it would take a more imaginative management than SP has had over the past two decades to realize them. And even if SP had the talent, this is probably not the time to make a big play in oils, minerals or land.

SP's telecommunications business theoretically has other options. With its common selling at 20 times earn-

ings, rival MCI expects to be able to finance its expansion with convertible debentures. But that's a route closed to SP, whose stock normally sells around 5 times earnings. Biaggini could, of course, try to realize more of SP's true value in the market by getting rid of the railroad, as Northwest Industries did a decade ago and as Illinois Central Industries has wanted to do for a decade. But it's one thing to want to sell off your railroad, quite another to find someone to buy.

Biaggini could spin off SPCC, in whole or in part, and create a separate subsidiary, with separate financing, just as the telephone company has. Such a move seems inevitable sometime in the next few years, but it is far from clear that Biaggini could find the will to do it. More likely an outsider will have to come in and do the job for it, as Natomas once considered doing.

All this poses a painful dilemma for Benjamin Biaggini—how to meet the corporation's overall capital needs without stinting on the railroad. He was born and bred in the railroad tradition. His father worked for the Pullman Co., and Biaggini himself went to work for SP back in 1936. He started as a rodman, in the industry's best up-from-the-track-gang tradition. His once reddish hair has gone white, his face is furrowed, but he's still an imperial presence, a towering monolith of a man, with a personality to match—every inch the traditional railroad boss. Since he took over as chief executive in 1968, nobody has doubted who was boss at Southern Pacific, and nobody does now. According to some observers, this imperiousness doomed Biaggini's much-cherished ambition to merge SP first with Seaboard Coast Line and then with Santa Fe Industries.

SPCC does have one ace in the hole: its long-pending antitrust suit against AT&T, which went to trial last May. MCI won a similar suit a couple of years ago, and though most observers expect that to be struck down on appeal, SPCC may have a stronger case—and one that is being tried in a court likely to be sympathetic to the underdog. "You could call it an anti-AT&T court," says Bear, Stearns litigation specialist Calvert Crary. A favorable decision could conceivably yield triple damages of upwards of \$1.2 billion. SPCC and Southern Pacific could go a long way on that. But that's a long shot.

"There are companies that time runs out for," one observer reflects. Given the unwisdom of its diversification decisions, SP's slide may be irreversible. ■

**Exhibit No. 3**





*Service to the East and West via the Overland Route*

15 June 2001

**United States of America**  
Surface Transportation Board  
Office of the Secretary  
1925 K Street NW Suite 810  
Washington D.C. 20423-0001

Re: Support for the end of the oversight process of the combined Union Pacific and Southern Pacific System.

Dear Secretary,

The Utah Central Railway Company (UCRy) respectfully submits the following description of the impact and effects of the merger of the Union Pacific Railroad (UP) and the Southern Pacific Transportation Company.

UCRy initially experienced a downturn in traffic, particularly within our agricultural products group. This downturn of business primarily affected the former Southern Pacific traffic. Service problems during 1997 also affected the ability to maintain a consistent level of service to those customers located at Ogden, Utah. While there were numerous problems in the short term, the longer-term reality has evidenced an increased competitive environment, and a subsequent increase in business moving over UCRy.

This increase in business has been possible due to the ability of UP to offer single line service to our customers over an increased market base. Burlington Northern Santa Fe (BNSF) has further enhanced this through the availability of trackage rights over the UP. The availability of competing service, and access to a market base encompassing the entire western US has also increased rail viability for UCRy customers.

While there are issues that arise from time to time regarding competition, the experience of UCRy has been that such issues are rectified within local channels at both the carriers and local governing agencies. We believe the current arrangement is satisfactory and addresses the needs of our customers.

P.O. Box 10402 • Ogden, Utah 84409 • 801/732-8906 • Fax 801/732-8908

W.D. Blansett / General Superintendent • Beth A. Blansett / Executive General Agent

B.K. Stotler / Division Superintendent • Vicki Pacheco / General Freight Agent

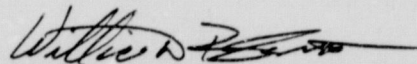


We therefore submit our support for the Surface Transportation Board to end its oversight period of the combined UP/SP system without alteration of existing conditions in Utah.

We further believe in the event any action is required to improve competition or other access for increased efficiencies to our customers, such action can be effectively handled through the appropriate local means. This would include interaction with officials of the railroads involved and local government. Involvement of the Board would only be sought in the event of an impasse.

It is respectfully submitted that the Board consider this letter of support when determining its decision regarding the termination of the oversight period.

Very Truly Yours,

A handwritten signature in dark ink, appearing to read "William D. Blansett", with a long horizontal flourish extending to the right.

William D. Blansett  
Vice-President

**Exhibit No. 4**

# UTAH RAILWAY COMPANY

340 HARDSCRABBLE ROAD  
P.O. BOX 261  
HELPER, UTAH 84526  
Phone (435) 472-3407  
FAX (435) 472-3744

June 29, 2001

The Honorable Vernon A. Williams  
Secretary  
Surface Transportation Board  
1925 K Street, N.W. Room 700  
Washington, D. C. 20423-0001

RE: Finance Docket No. 32760, Union Pacific Corporation, Union Pacific Railroad Company, and Missouri Pacific Railroad Company - Control and Merger - Southern Pacific Rail Company, St. Louis Southwestern Railway Company, SPCSL Corp., and The Denver and Rio Grande Western Railroad Company.

Dear Mr. Williams:

Utah Railway Company ("UTAH") has been asked by Union Pacific Railroad Company ("UP") to submit a letter to the Surface Transportation Board ("STB") describing UTAH's position as to how certain conditions (both imposed by the STB and voluntarily implemented) are working.

During the merger proceedings UTAH and UP negotiated a Settlement Agreement dated January 7, 1996, which became effective with the consummation of the merger. These conditions and the status of each condition are as follows:

## **1 - Trackage Rights:**

*(a) Trackage rights between Utah Railway Junction and Grand Junction, CO for interchange to both UP and The Burlington Northern and Santa Fe Railway Company ("BNSF"), a distance of 176 miles. UTAH has experienced a slight increase in traffic to Grand Junction this year as it has moved 5 trains year-to-date through June 29th. For the year 2000, it moved 5 trains; 1999 - 0; 1998 - 0; 1997 - 3 trains. Trackage rights to Grand Junction was one of the conditions sought by UTAH during the settlement negotiations. Although there has not been significant traffic levels moved over Grand Junction, it remains an important condition of the merger. It is anticipated that traffic will increase via this interchange point.*

*(b) Right-in-common access to the Savage Coal Terminal ("SCT") for loading of unit trains of coal to various customers. Shipments from SCT have increased in the past year. Virtually all of the shipments originated by UTAH at SCT have been interchanged to UP at Provo, UT. YTD through May 2001 UTAH has originated 31*



trains from SCT. During the year 2000, UTAH originated 50 trains; 1999 - 20; 1998 - 15; and 1997 - 0 from SCT.

**2 - Additional Coal Mine Access:** UTAH and UP negotiated UTAH's *exclusive access to the Willow Creek Mine and coal loadout near Castle Gate, UT* with the support of the mine owner. The mine was in development stages during the merger proceedings. In 1999 UTAH moved 60 trains from Willow Creek and in 1998 it moved 151 trains from this origin. This mine was struck by fire on November 25, 1998 and again on July 31, 2000. It has not produced coal since July 31, 2000. UTAH invested \$2.4 million into track structure after gaining access to this loadout and has not yet recovered its investment.

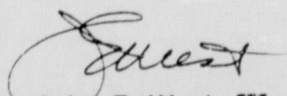
**3 - Other conditions:** In addition to the conditions outlined above, in a letter dated March 4, 1996 to ECDC Environmental L.C., UP agreed to grant *access to transload operations, if any, that may locate on the CV Spur for the purpose of transloading non-hazardous waste*. As of the date of this letter there are no known plans for such transload operations. Another side letter agreement gave *Moroni Feed access to BNSF through UTAH rights to Spanish Fork*. No traffic has moved under this condition.

UTAH has a good working relationship with both UP and BNSF. Both BNSF and UP have competed for certain segments of business in the coal fields served by UTAH but UP continues to move the predominate amount of coal by virtue of the location of the end users.

UP's quarterly reports to the STB have made mention of UTAH's role as the third party switch carrier for BNSF in the state of Utah. This particular arrangement was not a direct condition of the merger and was not a specific condition between UP and UTAH. However, BNSF's settlement agreement provided BNSF with an option to contract with a third party switch carrier to handle its 2:1 customers, which it did with UTAH effective April 1, 1997. This business arrangement has provided UTAH with additional work as it serves over 100 customers along the Wasatch Front of Utah primarily in the Provo, Salt Lake City, and Ogden areas of the Central Corridor. UTAH has made a substantial investment in locomotives, track, structures, and manpower in order to perform this service.

In conclusion, it is UTAH's position that those conditions of the merger that have been exercised (both as imposed by the STB and as negotiated between the railroad parties which affect our operating territory) have worked to preserve competition.

Sincerely,



John E. West, III  
Executive Vice President

Gray

STB

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4 of 5



**VERIFIED STATEMENT**

**OF**

**JOHN T. GRAY**

My name is John T. Gray. I am Vice President and General Manager, Business Development at Union Pacific. In this capacity I am responsible for analysis of strategic issues as and interline relationships with other Class I railroads and shortlines. Previously, I was Vice President and General Manager of UP's Industrial Products Business Unit with responsibilities for a business line with approximately \$2 billion in annual revenue. I came to Union Pacific in 1996 as a result of the UP/SP merger. Prior to the UP/SP merger, I served as SP's Vice President-Network and Corporate Development. In that position I was responsible for SP's Service Design and Planning group, Joint Facilities and Operating Contracts, Strategic Analysis and Capital Planning. During 1995 and 1996 I managed SP's activities associated with the merger of SP and UP.

After earning a Bachelor's degree in Civil Engineering and a Master's degree in Transportation Engineering from Tulane University, I served in the Army as executive officer of a transportation unit. I then took Ph.D. courses in transportation systems analysis and developed railroad cost models as a Research Assistant in the Transportation Center at Northwestern University. As Assistant Professor of Transportation at the University of Alaska, I subsequently taught transportation courses and developed transportation analysis tools.

I began my railroading career as Manager-Marketing and Sales for The Alaska Railroad. I later became the Director of Transportation for ARCO Alaska, Inc.

I then spent five years with BN, first as Director-Marketing and Business Analysis and later as Assistant Vice President-Chemicals. I moved to SP in 1992 as Managing Director-Yield Management. I was promoted to Vice President-Network and Corporate Development in 1994.

I offer this verified statement to remind readers of SP's deteriorating condition before the UP/SP merger. SP's rail network would not have survived intact without the merger.

- In Part I, I will review how SP was failing as a competitor. Its inferior service, induced by years of capital starvation, lagged far behind the competition and drove away shippers. Although SP had been forced to reduce prices to compensate for its lackluster service, SP could not sustain a competitive strategy based on price because it was the highest-cost competitor in the West. We expected our competitive position to decline further as a newly merged BNSF made billions of dollars of investments on a network that was far more comprehensive in geographic scope and commercial strength.
- In Part II, I explain why SP could not afford essential investments that would have improved its service and reduced its high costs. Year after year, SP had negative operating cash flow from its rail operations, with operating ratios near or above 100. It had relied for years on selling assets to sustain the railroad, but those assets were depleted. The capital markets were effectively closing to SP because of a decade or more of poor financial performance. As a result, SP

was unable to fund over \$1.3 billion of capital investments it believed necessary to compete effectively. In reality this would turn out to be far less than was actually required to return SP to physical and competitive health.

- In Part III, I will discuss how SP viewed its future without a UP merger. SP expected to reduce service, raise prices, and dismantle parts of its network in order to survive as long as possible.

SP's managers and employees were devoted to their railroad and fought valiantly to save it. They were skilled railroaders, but they lacked the resources to operate a fully competitive rail service. In the mid-1990s they were failing. The SP was a romantic lost cause that, as Forbes Magazine had predicted in 1982, was "Doomed."

#### **I. SP WAS LOSING ITS ABILITY TO COMPETE**

By the mid-1990s, SP was falling further and further behind its railroad and motor carrier competitors. SP had become notorious for slow and erratic service, and shippers avoided SP when they could. SP was forced to reduce prices to reflect its poor service, but that strategy was destined to fail. SP's costs were much higher than BNSF's and UP's. A high-cost competitor cannot compete on price and stay in business. The BNSF merger also posed a major threat to our future.

##### **A. SP's Inferior Service Drove Away Customers**

By the mid-1990s, SP was in permanent service crisis. We could not provide high-quality service in most corridors. Many of our locomotives were elderly and unreliable. Without adequate resources for track maintenance or capacity improvements, we suffered from slow orders and congestion. In describing our pre-merger service, as



throughout this statement, I will draw on and expand my testimony in 1995 and 1996 in the UP/SP merger proceeding. I will also refer to testimony from many of SP's customers.

SP's transit times were much longer than those of its competitors in almost every corridor. In some corridors, SP's shortest transit times were longer than its competitors' longest transit times. For example, BN moved lumber from the Pacific Northwest to Chicago in an average of six and one-half days; its transit times ranged from six to seven days. This narrow range of transit times shows that BNSF's service was predictable and reliable as well as reasonably fast, characteristics shippers value. UP's average transit time was almost exactly one day longer on average, as was its range of transit times -- again, a competitive product.

SP's transit times, by comparison, averaged almost twelve days, and our transit times ranged from nine to eighteen days.<sup>1</sup> Our average transit times were therefore almost twice as long as BN's, our shortest transit times were two days longer than their longest, and our range of delivery times was greater than either of our competitors' maximum transit times. SP shipments might arrive at any time within a nine-day period. We would frequently starve a customer for days, then deliver a week's worth of shipments. One transloader in the Central Corridor, TransWood, Inc., described the situation this way: "...we do not receive rail cars on a steady basis, such as five cars per day. Instead, we receive ten to fifteen empty rail cars every two weeks in one lump delivery." Smith V.S. at 4 (UP/SP-25, pp. 508-11).

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<sup>1</sup> It is interesting to compare SP's 12-day average transit time with service from the same points in Oregon now provided by UP. In June 2001, UP's transit time for this same business was 7.6 days. In short, SP shippers now receive service identical to that UP shippers received prior to the merger and far superior to that offered by pre-merger SP.

Lumber shippers voted against SP's service by shifting their business to other railroads and trucks. For example, Crown Pacific stopped using rail service from its SP-served facility at Gilcrest, Oregon, by shifting all of its business to higher priced trucks. Similarly, Midstate Lumber Corp. stopped shipping on SP in 1995, transferring all of its business to BNSF. It concluded that SP was "incapable of providing the service we require." Midstate Lumber Corp, Bilderback V.S. (UP/SP-25, pp. 157-58). Cascade Empire stopped purchasing lumber from mills on SP because it could not count on SP to supply equipment or move shipments on time.

SP service was equally poor for Central Corridor shippers of other commodities. SP was once the primary originator of food products from California destined to the Midwest and East Coast. We operated fleets of produce trains every day to these markets. SP's transit times slipped to unacceptable levels in the 1990s. Between July 1994 and May 1995, SP's transit times for food products ranged from 10.4 to 18.1 days.<sup>2</sup> Santa Fe's excellent service moved the same type of traffic in only 4.8 to 6.2 days, half as long as SP's service and far more consistent. Santa Fe and truckers captured most of SP's food products traffic in this corridor.

One of SP's larger food shippers, Sunkist, reported moving over 40,000 tons of frozen citrus products over SP from California to Eastern and Midwestern destinations as recently as 1990. Due to SP's service problems, Sunkist almost completely discontinued shipments by rail, shipping only fifty carloads in 1995. By 1996, Sunkist shipped only six

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<sup>2</sup> Once again, the contrast between the service SP provided in this lane and UP service today is striking. SP's best service was 10.4 days. In June 2001 UP's average transit time from former SP California points to interchange in Chicago is only 5.4 days. SP had lost this business to trucks. Today, UP is earning it back.



cars. Sunkist Growers, Inc., Stern V.S., Re: Finance Docket No. 32760. Our transit times for some perishables were so long that claims for damaged product due to long delivery times sometimes exceeded our revenues for providing transportation.<sup>3</sup>

Shippers of perishables rightly complained about SP's inadequate supply of refrigerated cars. SP owned approximately 1600 refrigerator cars, but only about 400 had been rebuilt and were reliable enough to trust for transcontinental movements. We simply could not afford to repair defective cars, and our long transit times so limited utilization and freight car productivity that we could not consider justifying new equipment or even further rehabilitation of the existing fleet. One of our shippers, Red Wing Company, Inc., a manufacturer of food products, correctly concluded that "SP has been unable to make capital investments necessary to improve their refrigerated fleet equipment levels because of capital constraints." Red Wing Company, Inc., Frazier V.S. (UP/SP-25, p. 393).

SP also lost a significant share of Colorado perlite business to trucks or to BNSF transloads. SP's transit times to eastern gateways for these shipments ranged from five to seventeen days, while BN maintained a consistent seven-day service. SP's service was so inconsistent that the variability caused plant shutdowns or slowdowns. Shippers diverted their business to trucks or transloaded product to BNSF, even though rates for either substitute were substantially higher than SP's.

Even when SP was successful in gaining business in the Central Corridor, as it was with Geneva Steel, it was a bittersweet experience. SP captured both the inbound

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<sup>3</sup> I recall an instance reported to me during 1993 concerning carloads of cheese moving from California to the East. The mechanical refrigeration units ran out of their twenty-five day fuel supply prior to reaching interchange. The Midwestern summer then ripened the cheese, producing a particularly odious damage claim.



iron ore business and the outbound finished and semi-finished steel. Because of its network structure, however, SP could only handle the inbound ore via a circuitous route that involved an additional interline carrier. This, plus SP's difficult crossing of the Rocky Mountains, eventually drained the profitability from the movement, even though we were successful in loading coal going back to the Midwest in the ore cars. The outbound business was also a problem. SP was never able to supply enough freight cars to meet Geneva's needs. This forced Geneva to continue to use UP for many shipments, even though SP offered lower rates. Also, since SP did not have UP's direct routes from Utah to Southern California and the Pacific Northwest, our costs were higher (and thus profitability lower) than was UP's for freight to those destinations.

Increasing sophistication in customer logistics strategies might well have dealt a death blow to the profitability of the Central Corridor for SP if the merger had not taken place. Over one third of SP's westbound carload traffic on the corridor was accounted for by Ford automobiles moving from Midwestern production plants to points in Northern California, Utah, and Colorado. By 1997, Ford adopted a "mixing center" approach for distribution of finished vehicles. This placed a high premium on single-carrier service and responsibility and led Ford to select one Eastern and one Western carrier to satisfy its logistics requirements. Only BNSF could have met Ford's requirements in the West. Neither SP nor UP alone had the geographic scope or network connectivity necessary to give Ford single line access to Western markets.

While a failure to gain this business would have been disappointing to UP, its loss would have destroyed SP's last remaining significant niche in the automotive market. It would have eliminated the last remaining basis for expedited service across the

Central Corridor and, in doing so, would have cost SP additional high value business. Losing Ford's business would have immediately eliminated three percent of SP's most profitable revenue and further eroded the basis for manifest service in the Central Corridor. Indeed, it is questionable whether the remaining manifest business could have supported continued through operation across the western half of the corridor in Utah and Nevada. At a minimum, the loss of Ford's business would have driven up the unit costs of operating over the corridor and further constrained profitability on the shrinking base of remaining traffic.

Potential growth opportunities were also constrained by SP's poor service and capital limitations. One of the most exciting growth opportunities for SP in the mid 1990's involved Colorado coal moving to utilities in the Midwest and East. Environmental legislation had made Colorado's low-sulfur, high-BTU coal attractive for blending in plants whose boilers had been designed to use Eastern coals. Although SP was able to begin the process of serving this market, it faced substantial barriers. The coal originated on the west side of the Rockies and required a large number of locomotives to move each train across the mountain grades. Having sufficient locomotives to serve this business represented a continuing problem for SP right up to the UP/SP merger. Trains suffered both delays and cancellations due to shortages of locomotives. Customers could not count on SP service as they took their product to a growing market.

SP's high-cost routes for this business caused even greater strategic concern. Trains originating on the North Fork Branch in far Western Colorado had to traverse Tennessee Pass, the steepest mainline grade in the Western U.S. This operation required



adding two sets of helper locomotives for each coal (and manifest) train for the twenty-mile climb to the summit.<sup>4</sup>

Trains originating on the Craig Branch added 120 unnecessary miles to their journey as they moved through the congestion of the Denver terminal, south along the Front Range mainline shared with BNSF, and through the Pueblo terminal before heading East. The obvious answer to this dilemma, and the one that would have improved service and minimized operating cost, would have been to utilize SP's Moffat mainline to Denver and then Union Pacific's Kansas Pacific (KP) line from Denver to Topeka. Inquiries to UP were positive, and my organization at SP began an analysis to determine whether the alternative was workable. The outcome of this work told volumes about SP's precarious financial and competitive situation.

The results indicated that, indeed, operating costs would be less and cycle times faster via the KP. The reroute would have been particularly effective if we could have diverted not only our coal trains but also our manifest and automotive business. However, although the reroute would have dramatically lowered costs and improved service, SP lacked the resources to make the capital investment necessary to capitalize on this opportunity.

SP could not afford to add additional sidings or lengthen those already on the line to handle unit coal trains or to build a connection in Denver between the Moffat

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<sup>4</sup> Coal trains on the three percent grades of Tennessee Pass required prodigious amounts of power. Even after the arrival of high-horsepower, high-tractive-effort, AC locomotives in early 1996, a 105-car coal train required three locomotives on the front and six helpers. Since two trains were frequently on the hill at the same time, twelve helpers were required at Minturn, CO. This represented a \$24 million investment in helper locomotives.



mainline and the KP. Nor could we afford the up-front costs of relocating labor from the Pueblo-Herington line to the KP. Restoring signals to the west end of the KP to handle all of SP's Central Corridor traffic was so far beyond our financial means as to not even warrant consideration. We also could not afford to add sidings on the Moffat mainline itself to accommodate the higher volumes if the manifest traffic were also diverted. Thus, SP was forced to try to develop a growing market with a more expensive, slower, and less reliable service and route. Had the merger not taken place, SP's higher cost would always have been a liability for the development of Colorado coal markets in the Midwest and East. Since the UP/SP merger, UP has undertaken the investments necessary to help this market grow toward its full potential.<sup>5</sup>

Shipments to and from Southern California and the Southwest suffered from SP's poor service. Some shippers referred to SP's large classification yard at West Colton, California, as the "black hole." Shippers complained that cars disappeared for days in West Colton. California Steel Industries, Inc. expressed its concerns::

"Although SP has tried to meet our needs, we have experienced shortages in the supply of coil cars, particularly due to the poor turnaround times inherent in SP's service. Likewise, congestion at Colton has caused delays on car deliveries to Midwest and Texas customers further contributing to poor turnaround times." Bellesen V.S. (UP/SP-25, p. 80).

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<sup>5</sup> To date, UP has invested over \$250 million in upgrades to the capacity of the KP for handling Colorado coal. Additional investment continues in 2001, and beyond. The Moffat mainline and the Colorado coal branches have seen almost \$50 million work. This would have been far beyond the means of SP. In fact, it is equivalent to the entire amount of SP's mid-1990s annual capital budgets. As a result, the Moffat mainline handled over 40 million gross tons in 2000, the greatest traffic density in its history.

Unable to rely on SP service, livestock feeders shipped grain on other carriers, including more expensive trucks. To avoid SP's poor service, flour mills in Arizona transloaded wheat from Santa Fe into trucks at remote locations, even though SP provided direct rail service to their facilities. One shipper explained how SP's problems had constrained its ability to do business:

"SP's limited resources has resulted in inconsistent service levels for our business over the past several years. With current SP service it will be difficult to remain competitive within our market area. SP's limited origination base for feed grains has restricted Arizona Grain's ability to provide product for the local market. Equipment supply has been a limiting factor in expanding local production of high quality durum wheat for foreign and domestic millers." Arizona Grain, Inc., Skelley V.S. (UP/SP-25, pp. 59-60).

Similarly, copper producers trucked product to BNSF in Phoenix or all the way to Midwestern markets in order to avoid SP service problems. An Oregon lumber producer, Cavenham Forest Industries, summarized the conclusion of many companies when it stated: "Today, SP is plagued with such extensive problems that we consider them to be a nonentity in the rail marketplace, and we have refused to use them for shipments to Phoenix." Reyneke V.S. (UP/SP-25, p. 96)

In 1992, Santa Fe took away SP's lucrative automotive business to Arizona and Southern California because it could invest in rail equipment and automotive facilities that SP could not afford. Santa Fe could make these considerable investments while charging prices that SP could not match, even though SP already had the facilities and equipment in place. Because of its extended equipment cycle times, SP could not even cover its operating costs at the prices necessary to match Santa Fe.

SP's intermodal business was not immune to the service and cost problems that plagued the system. SP's route in the nation's biggest intermodal market, Chicago-Los



Angeles, should have been competitive with that of Santa Fe (BNSF). It was no longer than Santa Fe's line and actually had superior geometric characteristics of curvature and rise-and-fall. However, SP's route was mostly single track, the eastern half of which lacked CTC and power switches and had sidings spaced twenty to thirty miles apart. Particularly at night, it could take a one-and-one-half mile long intermodal train over an hour to get into and out of a siding. A crewman had to walk the length of the train twice in the dark over a rocky, dark surface to throw switches. This hour, or more, delay was in addition to the waiting time while opposing trains covered the long distances between sidings. All of this added to delays, painfully slow transit times, and unreliable service.

SP's operating and service situation stood in stark contrast to Santa Fe's largely CTC-signaled, high-speed, double-tracked line. Trains meeting on Santa Fe usually did not even have to slow down, let alone go through the intricate, slow ballet necessary on SP. As a result SP service was a day longer than Santa Fe's. While Santa Fe advertised, and delivered, fifty-two hour premium service in the Chicago-Los Angeles market, SP's fastest intermodal schedule required seventy-two hours, with actual performance closer to eighty hours. SP could not compete for domestic less-than-truckload and truckload motor carrier shipments, except with customers whose only concern was price. SP concentrated instead on those international container shipments with less demanding schedules, from which it earned lower revenues. Even international shippers sometimes avoided SP. One company that shipped 60,000 containers per year said in 1995 that it had not used SP for five years due to unreliable service. Interdom Partners, Ltd., Rudie V.S. (UP/SP-25, p. 241). The slower service also affected SP's cost structure. The additional day of transit time required an additional train and locomotive set for each daily scheduled service. The



net effect was to reduce dramatically the profitability of this business line versus our competitors, due both to higher costs and the inability to serve the higher priced market.

SP's service for Gulf Coast shippers, particularly the chemical business, exhibited similar service patterns. For chemical traffic moving from the Gulf Coast to Midwestern gateways, SP was late by two days or more on 60 percent of its shipments. This was in a corridor where the over-the-road running time was generally only two days! This required chemical shippers to obtain extra cars to protect themselves against SP's unreliability. Owens-Illinois, Inc. complained about leasing extra tank cars. It said that "SP has had a reputation for the poorest service in the railroad business." Owens-Illinois, Inc., Krause V.S. (UP/SP-25, p. 441). Another Houston-area shipper, Kruger Engineering & Manufacturing, complained that shipments from Chicago to Houston wandered "aimlessly around the country, sometimes through California." Kruger Engineering & Manufacturing Co. (UP/SP-25, p. 260). One shipper, Consolidated Oil & Transportation, summed up the problems many in the chemical industry had with SP when it said:

"Traditionally, it has taken COTC twice as many days to move our tank cars on SP as it has on the UP, BN, or ATSF. Typical transit time from the Midwest to Texas on the SP is two weeks compared to five days on the other railroads. In fact, in 1994 it took three weeks to move loaded cars from McPherson, KS to Houston, TX. By the time cars arrived the market had shifted and COTC lost money on the sale and incurred increased costs due to the transit time. In COTC's opinion, the SP has not been a viable competitor..." Herbert V.S. (UP/SP-25, pp. 149-150)

All shippers in the Gulf suffered due to SP's problems. SP did not have the resources to repair the Beeville Line between San Antonio and Corpus Christi after a derailment destroyed a bridge. This forced all traffic between these two locations to use a much longer route via the Sunset line east to Flatonia, TX, and then south through Victoria

and beyond to Corpus Christi and Brownsville over UP trackage rights. The route was hard to serve, requiring movement on multiple trains in place of what had once been a through service.

A limestone producer in San Antonio, Redland Stone, tried to develop a new market for its product in South Texas. It identified locations where rail unloading could take place and worked with SP operations and marketing personnel to design a service for the new market. Unfortunately, the results were unsatisfactory for both parties. Redland saw cycle times on equipment become so long that they began to lose the ability to serve other, larger markets. SP's increasing costs from long equipment cycles and excessive route miles made the market unsustainable. Eventually, Redland gave up and trucked what product it could into the South Texas market.<sup>6</sup>

SP's capital shortfall and service and cost issues were most evident along the Gulf Coast where it served a vast array of chemical facilities. Here, SP served a long list of plastic plants stretching from Bayport, TX, south of Houston to Lake Charles, LA. As was the norm for this industry, all of these plants required their serving carriers to provide storage for their loaded private hopper cars in order to bridge the gap between their huge in-plant production rates and the consumption rates of their much smaller customers. This process is called Storage-in-Transit (SIT) and is considered a condition of doing business with the plastics industry. UP, BN, and ATSF had built storage yards for this product and were able to efficiently and economically handle the customer requirements as well as

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<sup>6</sup> Fortunately, the UP/SP merger salvaged this market for rail. With UP's direct route Redland's successor, Martin Marietta Materials, has been able to develop the market for stone in the Corpus Christi area. It recently began unit train service using a combination of UP and SP lines to a major fixed construction materials yard located on a former SP branch line that UP has rehabilitated.



charge fees appropriate for the inventory management service they provided. SP was different.

In early 1993, I toured the Gulf area in detail with the operating superintendent of the Houston region. What immediately became evident was that SP had been forced by its lack of a formal, well designed SIT facility to store plastics at every location it could possibly make available. For example, at that time, over half the sidings needed for meeting trains between Houston and Lake Charles were out of service and occupied by loaded plastics cars. At only one location, East Baytown, was a facility exclusively devoted to SIT. This was an abandoned US Steel mill, whose trackage was operated by a contractor, where cars were stuffed into a variety of tracks leading into the hulks of buildings formerly used as part of the mill. Access to, and switching of, the facility were so difficult for SP that it always took two crews (frequently three) to make the 90-mile round trip from Houston.

Upon returning to Houston, I requested a list of all the locations where plastics cars were in storage in that region. Amazingly, there were 56 locations in East Texas and Louisiana. Included in the list were East Baytown; a portion of the bowl at the Beaumont hump yard; most of the Lafayette, LA switching yard; part of the arrival and departure yard at Houston's Englewood Terminal; a portion of the Avondale, LA (New Orleans), switching yard; and stubs of derelict branches and industrial leads. However, by far the most common locations, and the ones that contained the most cars, were controlled sidings as far east as New Orleans and as far north as Dallas and Texarkana. All of these sidings were necessary to keep service fluid, but none were available.

This was one of the most important reasons that SP was in an almost continuous service crisis in the Gulf Coast region during this time. When a producer needed



a particular car, a local freight train would have to be dispatched to the siding where the car was located. It would then retrieve that specific car from among all those occupying the siding (often fifty or more) while using precious mainline capacity and delaying through trains. This occurred dozens of times daily.

Because so many sidings were out of service, through trains ran longer distances to meet each other, incurring the consequential delays. The cars stored in switching yards had to be "switched around" on a daily basis. In addition, the record keeping and inventory management required to keep the system in service demanded clerical support far in excess of that needed by our competitors. In short, what should have been one of SP's most attractive business lines had become marginal due to the high operating costs and service failures brought on by capital starvation.

Without capital, this was clearly not a sustainable situation, particularly in view of the rapid growth of the plastics industry at that time. It was clear from SP's analysis that a minimum of 3500 additional storage spots (1000 near Strang, TX, south of Houston; 1000 near Lake Charles or Beaumont; and 1500 at Dayton, TX, near Baytown), with an anticipated capital cost of at least \$40 million, were essential if we were to become fluid again.

Without capital, SP chose the only road available and selected a contractor to build and operate a new yard near Dayton, TX. When this new facility began operation in late 1995, it immediately began to provide relief to the operation, but at a substantial cash cost. Where SP's competitors could provide and charge for a valuable inventory management service for plastics producers, SP had to pay a third party for this same capability, often paying more than competitive conditions would allow us to charge our

customers. Thus, the only way out of the low-service, high-cost maze was to substitute operating expense for unavailable capital. This further eroded the economic leverage that should have been available from rail technology.<sup>7</sup>

In the I-5 Corridor, where SP enjoyed the only single-line route, SP's service discouraged shippers. SP moved food products from Northern California to Southern California, a distance of under 500 miles, in an average of nine days. Using a longer route via Barstow, California, Santa Fe's average transit time beat SP's by four days with more reliable service. Ninety percent of shipments on Santa Fe arrived within six days, while it took SP twelve days to insure ninety percent availability. A steel producer in the Pacific Northwest complained about inadequate car supply on SP in this corridor: "SP's people do not have the resources available to them that their competitors now have and SP's service suffers as a result."

Literally hundreds of shippers complained in the UP/SP proceeding about SP's inferior service. As one shipper explained, "On a number of routes where the destination is not SP only, we ship via other carriers to avoid having to use the SP. In some cases we even truck to avoid the problems encountered with SP service." Hickson Kerley, Inc., Quinton V.S. (UP/SP-25, p. 221). FMC similarly expressed its "frustration with SP service levels" and complained about lost cars. It noted severe delays in El Paso and congestion in St. Louis. FMC Comments (UP/SP-25, p. 226).

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<sup>7</sup> UP has been able to make substantial progress in dealing with this problem since the merger. UP's SIT yard in Spring, TX, has been further expanded and several new, smaller yards have been added near production facilities. In some places where both SP and UP had switching yards, the consolidation has allowed the conversion of one to SIT use. Finally, UP is in the permitting process to build an entirely new SIT facility near Brimstone, LA.



SP's quarterly surveys of its shippers confirmed their unhappiness with SP service. Our survey in the third quarter of 1995, for example, revealed that approximately 57 percent of Santa Fe, BN, and UP customers were satisfied with those railroads' transit times. SP scored less than half as well; only 24 percent of SP's shippers were satisfied. The disparity was similar when shippers rated our competitor's on consistency of service. SP's competitors also scored more than 20 percentage points better than SP when shippers rated equipment supply and equipment condition.

SP's slow and unreliable service frequently prevented it from meeting the changing transportation needs of its customers. Throughout the 1980s and 1990s, as today, American business faced increasing global pressures to improve efficiency and reduce costs. As a result, they adopted new logistics tools such as "just-in-time" delivery in which components arrive just in time to be incorporated into manufactured goods. JIT and other logistics tools allow companies to reduce inventories and avoid both the investment costs and the storage costs of maintaining supplies of components and raw materials. The savings, when properly managed, can be enormous.

The key to maintaining low inventories lies in having transportation service that is reliable enough to insure that plant production or distribution services are never threatened by material shortages. As Peter Murley of Distribution Services of America explained, "There is no room for inconsistent transit time and late deliveries within this atmosphere." Distribution Services of America, Murley V.S. (UP/SP-25, p. 155). Yet SP was often inconsistent and late. It often could not find enough working locomotives to run trains out of Roseville, Houston, Kansas City, or West Colton. I recall one day in 1994 when Roseville's departure yard contained fourteen trains that had been holding twenty-four



hours, or more, waiting for locomotives or crews. Those trains that were dispatched would all too frequently be delayed by failing locomotives whose rusting paint made them difficult to identify as "Southern Pacific." American business was squeezing out costs and ramping up productivity. SP was simply being squeezed out. Its performance made it less and less relevant to modern production and distribution requirements.

B. SP Could Not Continue to Compete on the Basis of Price

Because of its inferior service, SP often could not command the same prices that other carriers earned for the same or similar traffic. For example, almost one third of SP's revenue came from intermodal business. However, as I mentioned earlier, SP's service consistently prevented it from attracting the higher value business that could support premium prices. SP's slower and less reliable transit times would not allow it to compete for this business. Even on our limited number of high value segments, such as auto parts from Chicago to Mexico, prices had to be low to compensate for service. Our longer route via Eagle Pass simply took more time than UP's route via Laredo. Our route between Chicago and St. Louis, which was crowded with passenger trains and went through the heart of the St. Louis terminal, was just not as reliable. Nor was our intermodal terminal operation in Chicago. It consisted of three small facilities, all of them leased or operated by others with SP as a tenant, all crowded with West Coast international business, and all in need of unavailable capital for expansion, upgrading, replacement.

SP's solution to these problems is symptomatic of the conundrum in which we found ourselves. Illinois Central agreed to permit SP to use its Moyers Intermodal Terminal on the south side of the city. However, as a condition of this use, SP also had to use IC haulage service between Chicago and Memphis for all business that moved through IC's terminal. This solved SP's immediate terminal problem in Chicago and kept a com-

petitive service in this corridor that would allow us to retain the higher value business. However, this solution also increased SP's operating cost and diluted the economies of density on SP's own lines.

SP had to play the role of low-price carrier in many markets because it was the poor-service carrier. Some shippers appreciated the low prices. For other customers, the discount was not worth it. They needed to get their products to market using a reliable transportation company, and SP could not meet their needs. In some cases, they simply stopped marketing their products to or from locations where SP provided the only service. Merritt Lumber's subsidiary, MFP Oregon, Inc., said:

"We have customers, who due to the poor service, now refuse to buy wood originating on the 'SP'. This has pushed our business in other directions, limiting our sphere of purchasing. And with the emphasis on "Just in Time" purchasing-it makes it next to impossible to even consider moving over the Southern Pacific." Dawson V.S. (UP/SP-25, pp. 276-78).

SP's managers knew that SP's low-price approach was not viable in the long run. We knew this because SP had much higher costs than BN, Santa Fe, and UP. For every dollar of revenue SP earned, it spent 16 to 18 cents more in costs than its principal rail competitors. A high-cost enterprise cannot underprice its competitors for long and remain in business. Its competitors can either bid lower and still make a profit or selectively earn higher revenues on the business required to fill out their existing capacity. Eventually, that will allow them to become more efficient, develop additional capacity, and provide ever-better service, which leads to additional erosion of business for the higher-cost, lower-service carrier.

Our costs were high because SP's inferior service was also inherently expensive to provide. Because of its long transit times, SP needed more cars and more



locomotives than its competitors to move the same amount of goods. For example, SP's grain cars averaged 0.64 cycles per month in late 1994 (a cycle is a round trip from origin to destination and back). In other words, SP could not load, unload, and return a covered hopper in a month. By comparison, BN averaged 1.5 cycles per month for its grain cars. This meant that the BN's cars produced revenue at over two times the rate of SP's cars. Obviously, the cost of owning that equipment was no cheaper for SP than for BN even though it was far less productive than BN's.

SP had to pay more in car hire to other carriers because it kept their cars on its lines for longer periods. For example, SP required an average of 10.6 more days than BN to complete a round trip cycle on a lumber shipment from the Pacific Northwest to the Midwest. SP paid approximately \$25 per day for the lumber car, so its equipment expenses for the same, competitive move were \$265 higher than BN's. Thus, BN could price at SP's costs and still make \$265 on a move, while SP would be forced to lose money if it wished to compete for this business. Shippers who supplied their own cars also suffered, because they needed to lease more cars to carry the same volume of commodity. To compete for their business, SP had to discount its prices by the amount necessary to compensate them for the additional time to complete the cycle.

SP also needed many more locomotives than it would have needed had it been able to operate efficiently. This created a vicious circle: SP provided poor service partly because it lacked an adequate supply of functioning locomotives, but SP needed more locomotives because its service was slow. In early 1995, SP's Service Design group completed an analysis of the system's locomotive requirements. This analysis compared the requirements for locomotives based on SP's ability to run to a transportation plan versus the



need to adapt daily to overcoming the poor service and congestion created by our capital starvation. The study indicated that SP required four hundred locomotives more than necessary had the system operated in a fluid manner. SP leased most of this additional power, much of it on short term and at high prices. Much of this leased power was old with high maintenance costs, high failure rates, and low availability. This added a major cost burden that our Western competitors did not bear. We found that this factor alone added about one and one-half points to SP's operating ratio. SP was never able to extricate itself from this dilemma.

SP's poor service also increased its labor costs. SP's trains often did not reach the next terminal before the crew ran out of time under the Hours of Service Law. SP then had to pay additional crews to keep the trains rolling and had to add even more people to make up for crews that were then out of sequence due to service failures. During the decade of the eighties, SP and DRGW had negotiated a number of extended crew districts with the operating unions. All of these should have provided cost savings for a fluid railroad. However, in an environment where congestion made it difficult for trains to complete their runs in scheduled times, these prudent operating measures became simply an additional liability. SP's slower trains could not reliably cover the longer crew districts.

SP was also a higher unit-cost railroad than BN, Santa Fe, and UP because SP had lower traffic densities and less mainline track capacity than its competitors. A railroad's unit costs generally fall as traffic increases, as the high proportion of fixed costs are spread out over increasing volumes. This remains true until traffic volume approaches a rail line's capacity. On its Southern Corridor line, which was primarily single track, SP was near the limits of capacity. It struggled to carry between 60 and 66 million gross tons on the

Western portion of its Sunset Route. Even here, however, SP had to go head-to-head with Santa Fe, which operated its primarily double-track transcontinental mainline line with up to 95 million gross tons annually. Elsewhere, the situation was much more tenuous.

On the eastern segments of the Sunset corridor, SP competed at an increasing disadvantage as traffic densities gradually fell from only about 45 million tons east of El Paso to less than 25 million east of Houston. On the Tucumcari Line between El Paso and Topeka, density was only about 25 million tons annually on the western portion and 20 million on the eastern end.

The situation was similar on the I-5 Corridor. North of Los Angeles, this route generally had densities of only about 20 to 35 million gross tons annually. Only about 15 million gross tons used the line north of Houston. While this grew to about 35 north of Pine Bluff, Arkansas it never came close to matching the levels on the competing UP line at over 90 million gross tons.

Worst of all was the Central Corridor. Here, SP's largely single-track route carried no more than 40 million gross tons, and this for only a short stretch across Western Colorado. Elsewhere, the west end of the route had only 25 million gross tons and the east end 35 million. Compare this to UP's double-track mainline. UP handled up to 120 million gross tons annually across Wyoming on its double-tracked mainline. East of North Platte, Nebraska, UP added over one hundred million tons of Powder River Basin coal, further increasing its relative efficiency. The bottom line was that, except for the western Sunset, SP was a relatively light density railroad, particularly for a western transcontinental system.

SP's route was mostly single-track, much of it in river canyons or climbing over high mountains. Unlike UP, which could run a train from Oakland to Chicago over



modest grades, SP required helper engines on many of its eastbound trains on at least two summits: Donner in California, and Tennessee Pass in Colorado. On the Central Corridor, the tough operating conditions also made train operations slower in many places. This further contributed to lengthened cycle times on locomotives and freight cars, adding to their costs. All of these factors combined to make SP's unit costs of moving a car much higher than UP's or Santa Fe's.

SP's single-track routes raised maintenance costs as well. UP and Santa Fe could close one of their two tracks for regular maintenance without shutting down the railroad. SP did not have that luxury. On our single-track lines, we had to squeeze maintenance work between trains, using our maintenance crews less effectively. Alternatively, we had to close the railroad for a maintenance curfew, delaying trains. This was particularly troublesome on the Sunset Route between El Paso and West Colton, where high traffic volumes only added to the cost of maintenance delays.

Thus, SP was caught in a classic economic squeeze: high costs with low prices. Both arose from poor service, or the necessity to compensate for poor service, which, in turn, was most often created by capital starvation resulting from many years of inadequate earnings. Inadequate earnings came from having high costs and low prices based on service problems. This was a deadly cycle that SP was unlikely to successfully exit simply by "trying harder." Long-term survival of the network required a major capital infusion to break this cycle. This infusion could only come from an external source.

C. The BNSF Merger Further Threatened SP's Ability to Compete

In 1995 SP faced an additional and daunting threat to its franchise. BN and Santa Fe were merging, creating the largest railroad in the West, a railroad that would serve almost every market and would overlay almost all of SP's markets. They had announced



plans to invest an extra \$3 billion in the new BNSF. Much of that investment would help BNSF improve service in direct competition with SP's service. BNSF specifically targeted SP's transcontinental intermodal franchise from Los Angeles to Chicago and the Southeast.

The sheer size of BNSF made it a more effective competitor. BNSF could serve all of the major corridors from the Midwest to the West Coast. It also claimed to be improving its already excellent service between Birmingham and Memphis and West Coast points. This comprehensive route structure allowed BNSF to provide comprehensive service packages to customers. It allowed BNSF to bundle service and price proposals where it competed with us with proposals to serve geographic regions where SP could not provide service. BNSF could provide a single, comprehensive solution to customer logistics problems, while SP could provide only a limited response.

For example, BNSF served all four of the major West Coast intermodal ports, Los Angeles/Long Beach, Oakland, Seattle/Tacoma, and Vancouver, BC. SP served only Los Angeles/Long Beach and Oakland. Most steamship companies make multiple calls on the West Coast, usually at a port in the Pacific Northwest and one in California. When a single rail carrier can bid on both portions of the inland business, it has a significant advantage over carriers that can bid on only a single part. SP saw that a primary area where it had a strategic advantage in this business, its Los Angeles/Long Beach terminal and its route across the Southern Corridor to the Southeast, would be seriously compromised by the BNSF combination.

BNSF also gained the ability to provide more extensive single-line service than SP could hope to match. This allowed BNSF to provide their customers entry into

markets far larger than could SP. As I explained in 1995, BNSF could offer more and better products than we could.

BNSF's heavy capital investments also posed a major threat to SP. The BNSF rail network was already in good condition, unlike SP's. BNSF had announced in its merger application that it planned to spend \$3 billion to implement the merger, much of that amount to expand capacity on Santa Fe's transcontinental mainline, the direct competitor to SP's most important business lane. It expected to provide faster and more reliable service in direct competition with SP, and it expected to reduce its operating costs as well. BNSF indicated that it would spend the capital necessary to make the new combined BN and Santa Fe route between Los Angeles and Memphis/Birmingham an effective competitor in the market between the Southwest and Southeast. This posed a direct threat to SP's fastest growing market segment and one of its primary franchise routes.

Immediately after the merger, BNSF ramped up its investments to even higher levels. As it turned out, BNSF spent almost \$10 billion during the first four years after its merger, seven times SP's annual rate of capital investment. It added hundreds of miles of double track, installed centralized traffic control over additional hundreds of miles of mainline, rebuilt its Kansas City and Lincoln yards, constructed new intermodal terminals and expanded others, bought a shortline and rebuilt it to provide a third route to the Pacific Northwest Coast, rebuilt its line between Tulsa and Avarad, Oklahoma, and re-equipped its locomotive fleet with 1407 new units. Meanwhile, SP was having to take several years to remove a second main track from western Nevada and move the used rail and ties to Arizona to attempt to get a short piece of precious double track on the Sunset Route. BNSF would have inflicted far more damage on SP than our worst fears in 1995.



In 1996 we experienced a taste of what might have happened as we watched BNSF begin to siphon SP's traffic. BNSF captured bulk sugar traffic from Kansas City to California. We lost chemical traffic between California and Colorado and ferrous metal traffic from Eagle Pass and El Paso to Vancouver, BC. Even against more potent UP competition, BNSF captured large segments of intermodal traffic. Without the UP/SP merger, BNSF would have inflicted grievous competitive harm on SP.

## **II. SP COULD NOT AFFORD ESSENTIAL CAPITAL INVESTMENTS**

Unlike BNSF, SP, by the mid-1990s, was unable to make the capital investments in track, locomotives, cars, facilities, and technology that would have improved its service and reduced its costs. SP's rail operations had consistently lost money after 1983, with negative cash flow in all but one year from then until the merger. For years its operating ratio approached or exceeded 100. For six years straight, from 1988 through 1993, it never fell below 99.9 percent. The lowest it reached after 1982 was 92.4 percent in 1994. By the mid-1990s, SP had begun to run out of major assets that it could sell to provide the minimal capital necessary to keep its rail operations going. Its access to the financial marketplace was becoming more limited and increasingly expensive.

In 1994, Mr. Edward Moyers, SP's president, asked me to assemble a list of capital projects necessary to insure the railroad's ability to grow and to provide service levels that were competitive with those of other Western carriers. Upon completion of this work, it was clear that the capital needs far exceeded any hope of capital resources. We then trimmed the list down to those that were deemed critical over the next five years. Based on this list, we thought SP faced a deficit of more than \$1.3 billion in essential investments that it could not afford. As it has turned out, the physical problems we faced were far worse than we estimated at the time. Many of the projects proposed by SP for capacity expansion or



reconstruction of existing lines or terminals were actually undertaken by UP after the merger or are scheduled for implementation. In almost all cases, the actual cost to accomplish what SP needed has far exceeded those early SP estimates, and the work required to make the system safe and competitive is far greater than the band-aids we first proposed in 1994.

A. SP's Rail Operations Consistently Lost Money

For all but three of the eighteen years before the UP/SP merger, SP's rail operations recorded negative operating cash flows after expenses, capital expenditures, and debt service. Between 1983 and 1994, SP's net cash flow deficit totaled a staggering \$1.56 billion. During that entire time period, SP generated positive cash flow in only one year, 1986, and that was only \$14 million. By comparison, BNSF (Santa Fe and BN combined) and UP consistently generated positive cash flows. During this same period BNSF generated \$3.7 billion in operating cash flow. A significantly smaller UP was close behind with over \$3.1 billion in operating cash flow.

As Exhibit JTG-1 illustrates, SP was unable to earn enough revenues from its rail system to cover its operating expenses. On a pre-tax basis, SP generated operating income (not net income) of only \$111 million during the eight years from 1987 through 1994. SP suffered an operating income deficit in five of those eight years. Only in 1994 was there significant positive operating income (\$224 million), with this result achieved only by cutting expenses to the bare minimum. As 1995 was to prove, this strategy was not sustainable. In that year, net operating income fell to only \$77 million and the operating ratio jumped 4.3 points as SP tried to recover from the 1994 cuts. Even in 1994, cash flow was negative (\$46 million) and this trend continued into 1995. Mr. Lawrence Yarberry, SP's Vice President, Finance, reported in his verified statement in November 1995 that "SP

anticipates that it will not have positive cash flow from operations in 1995, nor for the next few years. Currently, SP's cash flow is a negative half-million dollars a day." Yarberry V.S. (UP/SP-25, pp. 280-81).

SP's operating ratio was unacceptably high and far above the operating ratios of its primary competitors. Between 1983 and 1995, SP's operating ratio never fell below 92 percent, as Exhibit JTG-2 shows. In five of those years, SP's operating ratio was 100 percent or greater, reaching 103.9 percent in 1988. It also exceeded 99 percent in four additional years during that period. By comparison, BN's operating ratio never reached above 89.7 percent, and its 1995 operating ratio was 81.3 percent. UP's 1995 operating ratio was 79.2 percent, and Santa Fe's was 81.7 percent, compared to SP's 97.0 percent. Clearly, other sources of income were keeping the railroad going during this period.

B. SP Ran Out of Assets to Sell

In the 1980s and early 1990s, SP remained viable by selling assets. The cash that funded its limited capital programs came from this source, not net income. The company had diversified into other lines of business before 1980, but it sold those businesses in the early 1980s to raise cash. In 1983, for example, SP sold Southern Pacific Communications Inc., better known as "SPRINT," to GTE for \$750 million in cash and assumption of \$300 million in debt. SP sold its insurance subsidiary in 1984 for \$271 million. SP plowed these proceeds back into the railroad.

Between 1989 and 1994 SP realized over \$2 billion in proceeds from real estate sales. Over its long history, SP had acquired many valuable tracts of land and rights-of-way near and through the downtown sections of most western cities. As those cities grew, these urban parcels attracted developers as well as the attention of urban transit planning agencies. In the late 1980s and 1990s, SP scoured its holdings for saleable real



estate. During this six year period from 1989 through 1994, these sales would basically subsidize SP's capital expenditure programs.

SP, in fact, consumed one hundred percent of the proceeds from these sales in keeping the railroad afloat. During the same six years, SP spent \$2.1 billion, or only about \$350 million annually, on capital projects mostly track maintenance. Without the proceeds from real estate and transit corridor sales, SP would not have survived to merge with UP. As Mr. Yarberry indicated, we believed that SP would, from 1996 through 2000, need at least \$1 billion (\$200 million annually) in addition to its planned capital programs of \$350 million annually if it was to be a successful competitor in the west. As I will show, this estimate was to prove optimistic.

By the mid 1990s, SP was starting to run out of major, readily marketable real estate assets that could be liquidated. SP could still find property to sell, but not in the volume or with the frequency necessary to finance the annual capital programs. In fact, SP probably should not have agreed to some of the sales it made out of desperate need. For example, it sold the property under Taylor Yard in Los Angeles, constraining its terminal facilities in growing Southern California.

It sold rail lines to the Southern California Regional Rail Authority (SCRRA), including the south end of the "Coast Line" between Moorpark and Los Angeles and the Saugus Line between Saugus and Burbank Junction. It also sold the Peninsula Line between San Francisco and San Jose. In all cases, SP surrendered dispatching control and became a tenant. In similar deals, BNSF (the Los Angeles-San Bernardino corridor) and UP (the Los Angeles-Riverside corridor) retained dispatching control and granted SCRRA only the right to operate trains after making capital improvements. Presumably, SP obtained a



relatively higher sale price, however, it was at the expense of future control over its freight operations and impairment of the quality of its freight service.

Most importantly, SP sold the Alameda Corridor to the Ports of Los Angeles and Long Beach. Had SP been able to retain sole use of the corridor, it would have had a sustainable advantage for international traffic moving through the ports. Even the emergence of on-dock terminals would not have significantly changed the balance due to the inferior route structure of UP and BNSF into and within the port area. However, SP's desperate need for cash forced it to agree to a program that sacrificed long term competitive advantage in favor of current survival.

By 1995, real estate sales, with the exception of the Alameda Corridor, were tapering off, and that trend continued into 1996. Had the UP/SP merger not been approved, SP would soon have been forced to fund almost all of its capital investments from rail operations. However, as SP's operating results for the prior decade show, the railroad alone could not fund the capital necessary to sustain itself. By the time of the UP/SP merger, SP was approaching a crisis.

C. The Capital Markets Were Closing to SP

With over a decade of negative operating results, SP could no longer turn to the capital markets to finance infrastructure. The markets recognized that SP's financial outlook was poor and that the company labored under too much debt. Notwithstanding a successful recapitalization that reduced debt in 1993 and 1994, SP's debt-to-equity ratio had risen to 63 percent in 1995 largely due to the absolute necessity of bringing additional locomotives onto the system if we were to survive. By comparison, BNSF's debt-to-capital ratio was 44 percent, 19 points lower. SP expected its fixed charges to increase substantially in 1996 due to this urgent purchase of locomotives.

Near the end of 1995, Standard & Poors stated "[SPR's] financial performance has deteriorated in recent quarters, while competing railroads are posting improved results. [SP's] competitive position and market share appear to be weakening in the face of pressure by [BNSF]." Additional financing would have been prohibitively expensive. The Wall Street well was also running dry.

D. SP Could Not Invest to Compete

As I mentioned above, by 1995 SP had amassed a long list of essential improvements to its aging and outdated system. Well before we began negotiations to merge with UP, we had identified almost \$1.3 billion in capital improvements that were considered the bare minimum necessary for SP to remain in competition against BNSF and UP. As events subsequent to the UP/SP merger would prove, we would have needed to have spent more than \$1.5 billion in addition just to rehabilitate our track. Since our project list was prepared before BNSF announced its post-merger plans, it did not take into consideration BNSF's announced \$3 billion investment, much less the full scope of BNSF's eventual investments.

To remain competitive, SP had to improve the efficiency and capacity of its carload and intermodal terminals and acquire additional intermodal and other specialized facilities. We had to increase our route capacity so that congestion would not prevent reliable service and so that service times would be more like those of our competitors. The competitive situation made it imperative for us to improve our information technology to provide customers with up-to-the-minute information, manage SP's service more effectively, improve our transportation analysis and planning capabilities, improve our ability to accurately bill, collect and manage revenue, reduce transaction costs and to manage field operating costs. The company needed to increase tunnel clearances to take



advantage of double stack intermodal economics and to accommodate the new generation of automotive equipment. We urgently needed to modernize the locomotive fleet (including switch and local service engines), build storage-in-transit facilities for our chemical customers, upgrade the Mexican gateways, and provide adequate and specialized rail cars for customers.

Availability of a modern rail car fleet was a particular problem for SP. Since we were unable to fund the acquisition of new equipment, SP had to resort to alternate strategies in order to try to meet customer requirements and remain competitive. SP was forced to sell to outside parties potentially serviceable freight cars that could be rehabilitated. These parties would then rebuild the cars and arrange for SP to use and manage the them in exchange for payment of daily per diem. This relatively expensive approach eventually began to take a heavy toll on operating income. As expensive as it was, SP had no alternative. The resources simply did not exist to buy new equipment or to rebuild existing cars with very scarce capital when there was an alternative available. Even though this strategy provided a high quality car for some customers, it also created an ongoing expense that SP found increasingly difficult to bear. Ultimately, SP was forced to put almost one-fourth of its freight car fleet (almost 10,000 cars) into this type of expensive arrangement because it could not raise the capital necessary to finance more cost effective programs such as long term leases or purchases.

Here are some of the projects SP wanted to undertake, but could not fund:

1. Rail line capacity. We identified half a billion dollars in new mainline capacity improvements SP needed to remain competitive and provide the service customers demanded. SP had insufficient funds to finance the following: rail and bridge



work between Topeka and El Paso (costing \$32 million); new and extended sidings and CTC between El Paso and Herington (\$86 million); double track on short sections of the line between El Paso and Carizozo (\$15 million), double track between Pomona and Colton (\$38 million)<sup>8</sup> and segments between Colton and El Paso (\$183 million); track, bridge work, and CTC between Tracy and Martinez (\$32 million);<sup>9</sup> bridge upgrade at Victoria (\$3 million); tunnel improvements for double stack operations in the Sierras (\$18 million);<sup>10</sup> CTC and extended sidings on the "Rabbit" line northeast of Houston (\$35 million);<sup>11</sup> rail and extended sidings and between Pueblo and Kansas City (\$30 million);<sup>12</sup> and a new international bridge at El Paso (\$30 million).<sup>13</sup>

Even though the merger has made much of this work unnecessary, the projects that have gone forward have been significantly more expensive than SP had expected. For example, the three projects shown above for rehabilitation and capacity upgrade on the Tucumcari line were estimated at \$133 million. To date, UP has spent \$197 million on this line, with significant CTC work still to be done and several new sidings yet to be built. On the Sunset Route between El Paso and West Colton, SP had expected to spend \$183 million on additions of second track segments. To date, UP has spent over

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<sup>8</sup> Unnecessary after merger since parallel UP and SP lines can be operated as double track.

<sup>9</sup> No longer required due to availability of a nearby UP line and changes in traffic flow patterns.

<sup>10</sup> This project is on hold awaiting final approval and funding by the City of Reno for their portion of the rail trench project through downtown Reno.

<sup>11</sup> Unnecessary after merger since this line is now part of "Directional Running" lines in East Texas

<sup>12</sup> KP used for Colorado coal instead. Project not required.

<sup>13</sup> Project no longer required.

\$250 million simply for rehabilitation of the existing track on this line. In 2001, the Sunset double tracking has begun and is now budgeted for at least \$201 million more.<sup>14</sup> These two projects alone, plus the \$142 million rehabilitation and expansion of the Sunset Route's original eastern connection, El Paso to Fort Worth, will consume 55 percent more capital than SP's entire \$510 million line capacity project menu.

2. Equipment. SP needed to invest \$328 million to acquire locomotives, rebuild its aging switcher fleet, and buy new grain cars. Clearly, this amount would not have solved SP's locomotive problems even if the entire sum had been spent on new locomotives. At 1995 prices that amount would only have allowed us to acquire 165 new AC locomotives or 220 new DC units. However, it would have been sufficient to get rid of the fleet of leased power that had become a perpetual, expensive, and unreliable part of SP. The switching and local service fleet was another problem. Many of the locomotives used in this service were elderly GP-9, SD-7, and SD-9 units. By 1996, all of them were over 35 years old and some were approaching 45 (including the first SD locomotive ever produced). They were old and expensive to operate, but in its situation SP could not afford to do without them. To put their age in perspective, most of these locomotive types had been retired from Union Pacific's roster by 1980. The grain cars were a late addition to the capital requirements list that arose when SP obtained trackage rights as part of the BNSF merger. Even though SP expanded its access to shippers as a result of these rights, it needed additional equipment if the new opportunities were to be effectively utilized. This was also

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<sup>14</sup> This amount will add 140 miles of additional second track.



part of the strategy to overcome some of SP's limitations expressed by Arizona Grain in its verified statement.

3. Yards. SP optimistically thought it needed to invest only \$101 million to rehabilitate and expand its carload terminals. Specifically, the company needed to rehabilitate the terminal at Roseville (\$38 million); create inter-yard connections at Armourdale Yard at Kansas City (\$3 million); extend the yard tracks at Strang, southeast of Houston (\$2 million); construct two additional tracks and extend two other tracks at Herington, KS (\$3 million)<sup>15</sup>; extend tracks at Dayton, TX, northeast of Houston (\$2 million); reconfigure the yard at Avondale near New Orleans (\$3 million); construct a tail track at Lake Charles (\$1 million); construct a cross-over in Houston (\$1 million); replace the hump retarders at City of Industry (\$4 million); rehabilitate the yard at Eugene (\$17 million); construct additional bowl and receiving tracks at West Colton (\$25 million); and expand capacity at Miller Yard in Dallas (\$2 million). These terminal upgrades proved to be an area where SP dramatically underestimated the costs that would have been involved.

After the merger, UP undertook a number of these projects and considerably exceeded this \$101 million estimate, including: Roseville reconstruction (\$126.5 million), Strang expansion (\$7.3 million), Dayton reconfiguration and expansion (\$4.3 million), Lake Charles yard expansion (\$11.4 million), and West Colton arrival and departure tracks (\$12.5 million). These projects alone total \$162 million. While efficiencies of the merger allowed UP to consolidate operations into adjacent facilities and avoid many of the SP projects, UP's expenses are already 160 percent of what SP estimated for all of the projects.

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<sup>15</sup> Completed by SP prior to the merger at a cost of \$4 million.



4. Terminal Facilities. To respond to customer demands, SP also needed to invest a total of \$274 million to construct new intermodal, auto, and other facilities throughout its network. For example, SP needed to expand its intermodal facilities at Kansas City, Avondale, Los Angeles (ICTF), San Antonio, and Oakland. It needed to expand auto facilities at Benecia, CA, Salt Lake City, Chicago, Denver, Galena Park, Phoenix, and Valla, CA. It needed to purchase land and construct new intermodal facilities in Chicago (costing \$60 million), Memphis (\$20 million); and Southern California (\$68 million). It needed to invest \$58 million to provide Storage-in-Transit (SIT) facilities for our plastics customers and to construct or improve transload facilities for bulk commodities in Los Angeles, San Francisco, Portland, El Paso, Houston, Kansas City, and Pine Bluff. The only intermodal terminal on this list completed since the merger, Memphis (\$59.3 million), suggests that once again the costs for these projects were underestimated. Detailed studies that have been undertaken in Chicago and Southern California now indicate that it is unlikely that those facilities can be built for less than \$100 million and may well cost significantly more. The problems with the SIT facilities have been described elsewhere in this statement. Suffice it to say that UP has spent, or is in the process of spending, over \$40 million to remedy that problem.

5. Technology. SP needed to invest \$100 million in technology improvements. This meant replacing our operations management system (TOPS) with an up-to-date system that could be fully integrated with new operating and customer service processes as well as accounting management processes. TOPS, which had served as the industry standard when built in the 1960's, had become largely obsolete by 1990. Since the early 1980s, it had been kept operating only by patching "fixes" onto the basic system.

6. Rehabilitation. As Mr. Reilly explains in his verified statement, SP's investment in track maintenance before the merger was inadequate. He explains that prior to 1987 SP was able to maintain its mainlines adequately in spite of its negative cash flow. However, starting in 1988 SP reduced track maintenance to only 60-75% of prior levels to conserve precious cash. To stretch maintenance dollars further, SP had to adopt practices that saved money in the short run but would, over time, cause trouble. Among these was the discontinued use of premium rail on curves in mountain territory. Further cutbacks in 1993 only increased the maintenance deficit and the ultimate price of curing that deficit. By the mid 1990s, very little work was done on branch lines and secondary main lines including the west end of the Central Corridor. The money that was available had to be focused on work absolutely essential for safety or where the risk of revenue loss was greater than the cost of maintenance. SP's \$1.3 billion capital list did not include the money necessary to recover from over a decade of maintenance cutbacks. As events after the merger were to prove, this rehabilitation work would be the greatest of SP's immediate needs.<sup>16</sup>

The bottom line for SP is that it had capital requirements that would have been (and are) daunting for a financially healthy carrier such as UP. For SP, they were an impossible cliff to scale. The best SP could realistically hope for was to stay even with the already deteriorated condition of the system. Funds for rehabilitation and growth, both for SP and its customer's rail traffic, could only come from outside. For the second time in the last century, UP would provide that outside capital source.

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<sup>16</sup> Since the merger, UP has spent over \$1.5 billion on rehabilitation of SP lines. Since this work is ongoing, the ultimate total will be much greater. All of this is in addition to the large expenditures for capacity, some of which ultimately served to replace facilities, such as Roseville Yard and the Memphis Intermodal Terminal, which would have required significant maintenance work had SP continued to operate.



### **III. WITHOUT THE MERGER, SP'S NETWORK WOULD HAVE BEEN LOST**

Even without any further problems, such as a downturn in the economy or the loss of significant traffic to BNSF or UP, SP predicted a capital investment shortfall of \$1 billion in the five years after 1995. As we have learned since, this was clearly an optimistic prediction. SP had few significant salable assets left and it was running out of alternatives to finance the future. We predicted that this shortfall would have placed SP in peril of financial and operating collapse. Our service already caused grave concern to our customers and would continue to spiral downward without the resources to make critical investments.

SP management was optimistic in 1995 and 1996 that the merger would be approved, so we did not develop concrete plans for a future without the merger. However, in our verified statements in support of the merger both Jerry Davis, SP's President, and I speculated on possible outcomes if the merger did not take place and SP was forced to "go it alone." Many parties speculated that SP could simply break up the company with the remaining parts surviving as large regional carriers. However, this argument fails to recognize the daunting challenges faced by such carriers, without a strong network, trying to survive in a West dominated by giants BNSF and UP. The bottom line was that SP was worth more to its shippers, its stockholders and to the public as a network than were the individual parts.

Many opponents of the 1996 UP/SP merger naively assumed that an independent SP would simply have continued to do business as usual. However, facing a multibillion-dollar capital shortfall, SP would have been forced without the merger to change its business strategy. SP's somewhat romanticized past was simply not sustainable



in the hard-nosed competitive environment that was emerging for Western railroads. As I testified in 1995, we anticipated adopting a strategy of short-term survival. We expected in 1995 that SP would have to downsize the company and focus only on those specific areas that would yield the quickest and highest returns with minimal capital investments. In general, the objective of this new strategy would have been to maximize the short-term returns on SP's assets by extracting maximum value from the system. To extract value from the system, SP would have considered implementing all or portions of the following strategies:

Withdraw from Less Profitable Traffic. To generate profits, SP would have withdrawn from traffic that contributed little net revenue and scaled back its network. Unless it enjoyed a competitive advantage, SP would have reduced its participation in competitive traffic such as that originating on the Port Terminal Railroad in Houston. SP would probably have focused its attention on exclusively-served traffic in Texas, Arkansas, Louisiana, Arizona, California, Oregon, and Colorado. SP would have retained only the track and equipment needed to exploit these more profitable traffic flows. We would have abandoned or sold off low-density branches and non-essential routes. For example, we would have abandoned or sold the Modoc Line from Klamath Falls, Oregon, to Flanigan, Nevada; the Phoenix line west of Tolleson, Arizona; and the Coast Line between Santa Barbara and Salinas, California.

Revise its Intermodal Service and Close Intermodal Facilities. SP would likely have reduced or eliminated intermodal service between Texas and the eastern gateways, including Chicago; over the Central Corridor; in the I-5 Corridor; and domestic service between Los Angeles and Chicago. SP would have closed terminals at Phoenix and

Tucson and closed Los Angeles Transportation Center (one of SP's three terminals in the Los Angeles Basin). It might also have shut down terminals in Chicago, most likely the Forest Hill terminal. In the Central Corridor, SP would likely have closed Denver, Salt Lake City, and Sparks. In the I-5 Corridor, the Fresno and Portland terminals would have closed. All of this would have reduced the intermodal business to the corridor between Los Angeles and Texas and the Southeast, SP's strongest franchise, with the Chicago and St. Louis gateways having only international service.

Abandon Through Service on the Central Corridor. By downsizing its traffic, SP would have been able to reroute the most profitable manifest traffic from the Central Corridor to the Sunset Route. In this way, SP could consolidate flows from two corridors and achieve density with only limited capital improvements. Local service along the Central Corridor would not have provided sufficient revenues to support continued maintenance of the route. SP might have sold to short-line railroads sections of the route that provided reasonable levels of traffic. Government agencies might have purchased a few segments for passenger service. Or SP might simply have recycled the rail and ties from portions of the Central Corridor to repair its other aging routes. Coal traffic from Colorado and Utah would have been interchanged at Provo or Ogden to Union Pacific for movement to California or Nevada. Whether coal would have moved across the trackage rights on the east end would have depended on whether SP could have extracted more profit from the long haul or by interchanging this business with BNSF or UP at Denver or Pueblo.

The final severing of this line as a through route might well have come during the spring of 2000. Early in that year, a section of the causeway that SP operated across the Great Salt Lake began to settle into the lake, sometimes at a rate of almost four



feet per day. UP maintenance forces and contractors fought this condition for over a year before stabilizing the situation at a cost of over \$13.5 million. SP had, in the past, lost at least three lines when it was unable to afford to repair bridges that had been damaged or destroyed. With only limited business remaining on the Central Corridor, it is likely that SP would have rerouted any remaining through traffic over the Sunset Route, sought trackage rights on UP to operate the remaining local traffic, and would have finally abandoned the Overland Route as a through line. After that, it would only have been a matter of time until the remaining portions of the line in Western Utah, Nevada and Eastern California would have been picked up by UP (the joint track across Central Nevada) or reduced to shortline operation.<sup>17</sup> This would have left the DRGW as an isolated island, without any prospects of through traffic, dependent entirely on local business for survival.

Minimize Line Improvements. With limited financial resources, SP would have had no choice but to limit capacity and track investments. SP would not have spent money to improve the Central Corridor (to the extent SP maintained that corridor at all). It would not have continued its efforts to double track the line from Los Angeles to El Paso. It would not have spent precious resources to improve signaling and capacity on the Tucumcari Line from El Paso to Herington.

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<sup>17</sup> This can be contrasted to the actual outcome under UP management. The causeway has been restored and, additionally, a new double track mainline has been constructed through Ogden restoring the high-capacity, high-speed connection that once existed. This line has been used by UP to gradually restore this route to the premier service status that it enjoyed for the first century of its existence. It is once again the premier route for California perishables going to Eastern markets and for the highest speed service between Chicago and Northern California - all as President Lincoln and E.H. Harriman intended.



Minimize Terminal Improvements. SP would have shrunk its assets to fit the available business. Terminal improvements at Roseville and Chicago would not have occurred, and SP would have abandoned plans to add intermodal capacity in Southern California.

Reduce the Workforce. One obvious way to minimize costs and extract additional value from the SP system would be to reduce substantially the size of SP's workforce. The company would have outsourced administrative functions to reduce management staff. We would have reduced operating personnel in many areas. I predicted at the time of the merger that areas such as the Central Corridor and Texas would have been particularly hard hit.

SP also would have raised prices to extract as much revenue as possible from less-competitive traffic. This works only as a short-term strategy, as that pricing strategy would normally carry serious long-term repercussions. Facing aggressive pricing, solely served shippers would pay other railroads to build-in to their facilities (which might take a few years). Prospective shippers deciding where to build new facilities would build their facilities near other railroad routes to assure that they receive transportation service from someone other than SP. Yet because SP knew its future was limited, it could have engaged in a more aggressive pricing strategy that would have the added benefit of curtailing total shipment volume and reducing the maintenance and operating costs of the railroad. In other words, SP would have begun to act opportunistically, knowing the end-game would limit any adverse repercussions.

But I recognized that in a few years, SP would likely have become non-competitive under this strategy. Clearly, some of the repercussions were already beginning

to happen. UP was in the process of building-in to SP's largest industries on the Baytown Branch. Had SP begun to aggressively increase its prices, it would only have been a matter of time until UP had access to all of the Baytown area, and UP or BNSF would have built-in to the Bayport chemical complex south of Houston. This type of strategy by SP would also have opened up additional business to transloading by both of SP's western competitors.

In summary, the SP that existed in 1995, as well as many of the services that it offered, could not be sustained regardless of its appeal to many in the shipping community. Limited parts, such as DRGW, might ultimately have continued as regional railroads living off their local traffic. Other parts might have been absorbed by competitors or connecting railroads, abandoned, or sold to shortlines. But SP as a network - the network that gave real value to the national rail system and the national and western economy - was doomed.

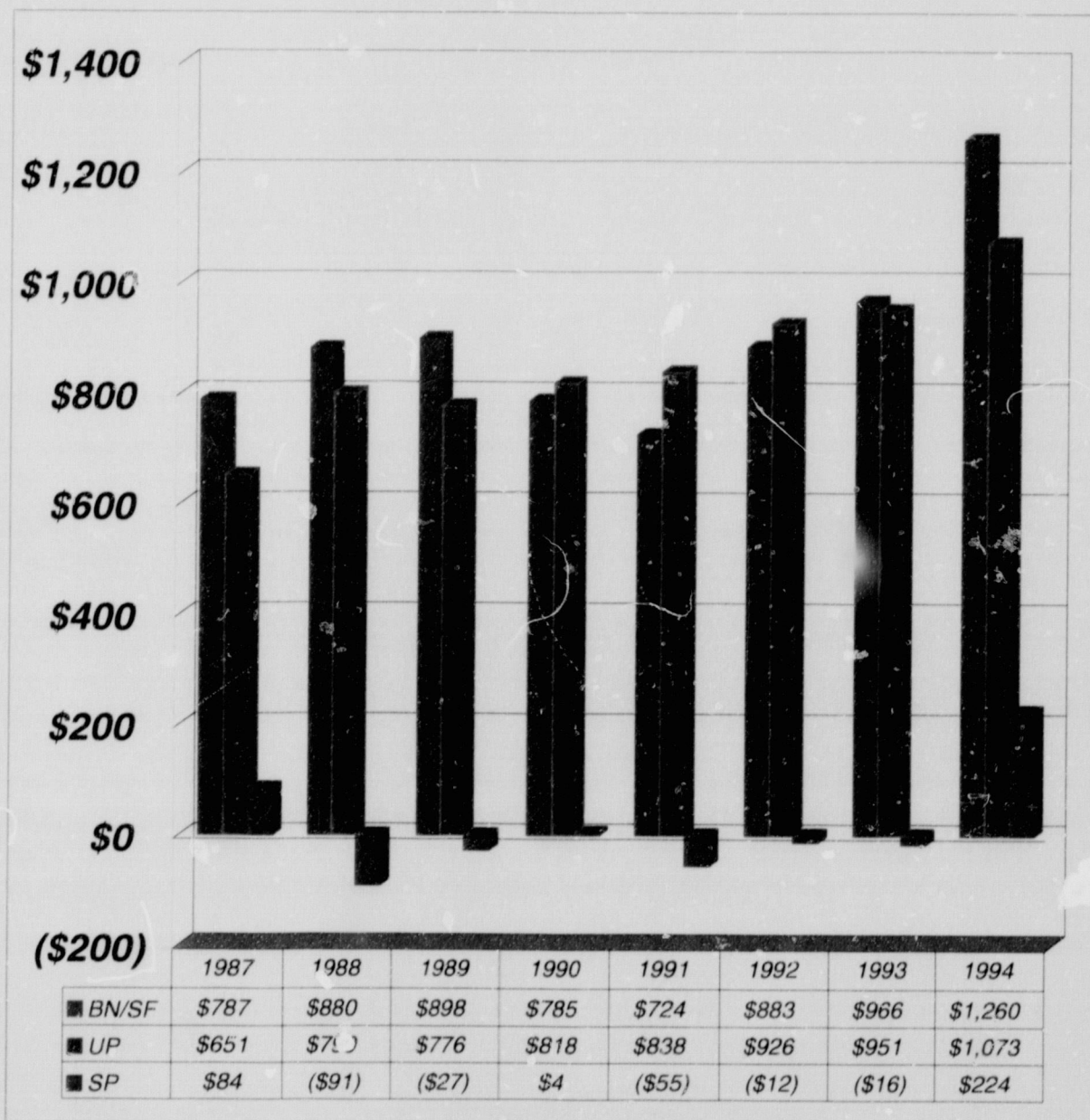
SP tried price cutting to build business even in the face of poor service, it sold assets to finance the minimal capital programs that kept it afloat, it tried recapitalization, and finally, it looked in the cupboard, and the cupboard was bare. Only the necessity for change stared starkly back at SP.

The UP/SP merger provided the change that saved the SP network and kept it as a viable part of the economy and the industry. UP is curing the maintenance shortfall developed by over a decade of capital starvation, pouring capital investment into former SP facilities to revitalize the entire SP network and realize that economic promise locked away for two decades.

This is the lasting and most important benefit of the UP/SP merger.

## Exhibit JTG-1

### Pre-Tax Operating Income: 1987-94\* (in millions)

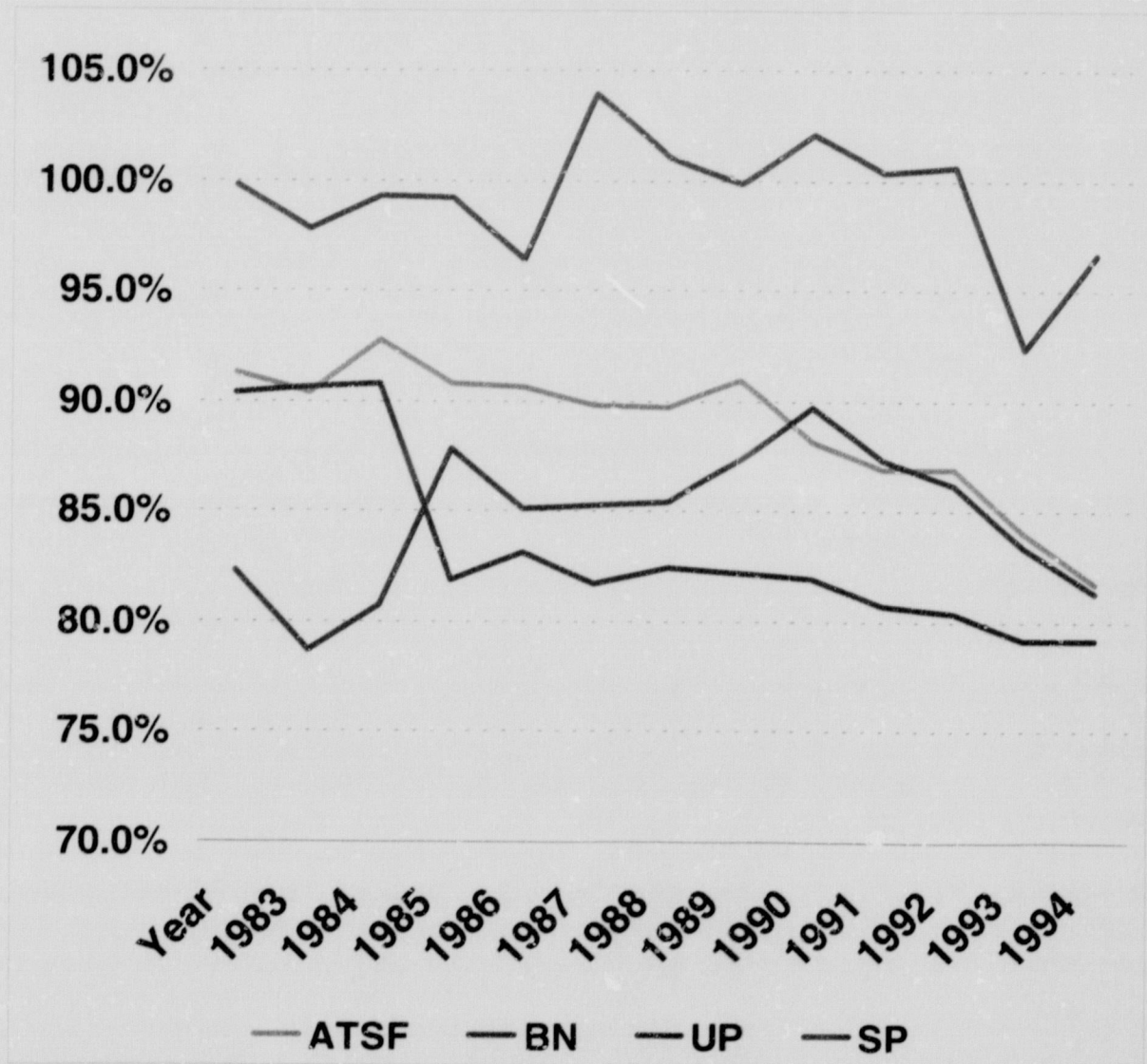


\* Drawn from reports to the ICC on Form R-1. Before special charges. For 1987-1988, SP system figures do not include DRGW. See Yarberry, UP/SP-22, p. 275.



## Exhibit JTG-2

### Operating Ratios: 1983-94\*



\* Drawn from reports to the ICC on Form R-1 and Form RE&I. Excluding special charges. SP system figures include DRGW for years after 1988. 1995 date reflect first nine months only. See Yarberry, UP/SP-22, p. 277.

VERIFICATION

STATE OF NEBRASKA

)

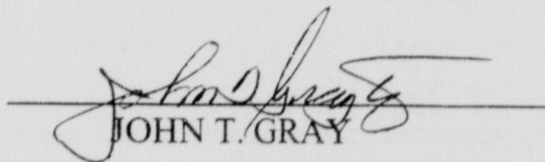
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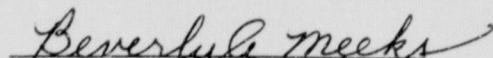
COUNTY OF DOUGLAS

)

JOHN T. GRAY, being duly sworn, deposes and says that he has read the foregoing statement, knows the contents thereof and that the same are true as stated.

  
JOHN T. GRAY

Sworn to and subscribed before  
me this 26 day of June, 2001.

  
Notary Public

My Commission expires \_\_\_\_\_







VERIFIED STATEMENT

OF

GENE P. REILLY

I am Chief Engineer of Maintenance on Union Pacific's Northern Region, which includes all of UP's tracks from Chicago and Kansas City westward to Granger, Wyoming, and Grand Junction, Colorado. This is the most heavily used of UP's three operating regions. From 1988 until UP merged with SP, I oversaw track maintenance on the entire SP system.

In 1980, SP appointed me Regional Engineer based in Tucson. I was responsible for track maintenance on a region stretching from Colton, California, to Del Rio, Texas. From 1981 through 1984, I served as Assistant Engineer-Maintenance for SP's Eastern Lines, which comprised all of SP lines east of El Paso. When SP reconfigured its regions in 1984, I became Assistant General Manager for the Southwestern Region, with responsibility for track maintenance from Fresno, California, to Kansas City, Missouri.

In 1986, SP appointed me Assistant Chief Engineer, based in San Francisco. In that position I became responsible for all track maintenance on the SP system, as well as some engineering functions. SP elevated me to Senior Assistant Chief Engineer in 1988, a position I held until 1993. In 1993, I became SP's Vice President and Chief Engineer, based in Denver. In that position I was responsible for all of SP's track, bridges, signals, communications, and environmental compliance.

After the UP/SP merger, UP named me Chief Engineer-Maintenance of its Central Division. When UP reconfigured its four regions into three at the end of 1998, I became Chief Engineer-Maintenance for the Northern Region.

In this statement, I will describe SP's track maintenance and investments prior to the 1996 merger with UP. I will explain how SP created a track maintenance deficit that would have been difficult or impossible for SP to overcome. I will also discuss the challenges SP would have faced had the Surface Transportation Board rejected the merger.

#### SP Track Maintenance Before the 1988 DRGW Acquisition

Although SP had limited funds before DRGW acquired it in 1988, it managed to maintain most of its rail lines. Between 1983 and 1987, SP installed four to five hundred miles of new and second-hand rail and 1.7 to 2.0 million new ties each year. Our main lines were in good condition, and we maintained most branch lines adequately. Maintaining this level of track maintenance was always a struggle, though, because SP's operating ratio was nearly 100 percent in those years, and the company had a cash flow deficit.

Although SP maintained its main lines in adequate condition, we could not afford to maintain yards and tracks that were not essential. This was particularly true in Texas and Louisiana. For example, SP had rebuilt the Bellaire Branch in 1981 to serve as a second main line west of Houston, but in the 1980s we allowed it to deteriorate to a ten-mile-per-hour branch line. When a derailment destroyed a bridge on the Beeville Line between San Antonio and Corpus Christi, we could not afford to repair it. We lost SP's direct route to the west from Corpus Christi. We also abandoned the Rocklin Branch between Beaumont and Lufkin, which had provided a bypass around Houston for chemical traffic originating in Beaumont and Lake Charles. This sent additional traffic into the already congested Houston Terminal.

We also eliminated substantial amounts of yard capacity in Texas and were unable to add the yard capacity needed to support storage in transit of plastic cars, the fastest

growing business segment in Texas. This inability to adapt our facilities to the needs of our customers forced SP to store plastics cars all over the southern and eastern portion of our system, including in many mainline sidings. This further disrupted our ability to operate efficiently.

When SP's bridge at Seabrook, Texas, became unserviceable, we lacked funds for repair and were forced to obtain trackage rights over UP in order to continue service to Galveston and Texas City. We were unable to maintain our direct line between Rosenberg and Victoria, Texas, in operable condition. We forced the international and chemical business that used this route onto SP's already congested transcontinental mainline between Houston and Flatonia.

Another damaged bridge eliminated SP's direct access to Dallas and Ft. Worth from the east. SP was forced to obtain trackage rights over UP from Big Sandy, Texas, to Dallas and could serve Ft. Worth only from the south or by a slow industrial line from Dallas.

#### SP Track Maintenance Between 1988 and 1993

In 1988, DRGW acquired SP and installed new management. In an effort to reduce debt and return SP to profitability, the new management reduced track investments. In 1988, SP reduced track investment to only 307.7 miles of new and second-hand rail and reduced tie installations to 1.1 million. SP placed fewer than 300 miles of new and second-hand rail in service in each of the years 1990 through 1992, and new tie installations fell below one million in 1991 and 1992. SP began to build up a mainline maintenance deficit.



SP's decision to discontinue use of premium rail on curves in mountainous areas caused extra problems. SP operated over more difficult mountain terrain than any other major railroad. Its mainlines crossed the Cascade Range in Central Oregon, followed the curving Sacramento River Canyon in Northern California, surmounted the Sierra Nevada on the original transcontinental mainline, climbed the Rocky Mountains in Utah and over several mountain grades in Colorado, and crossed the Tehachapi Mountains on a twisting rail route in Southern California. Like most railroads, SP had used premium, "head-hardened" steel to prevent curve tracks from wearing out quickly. The downhill rails wore out under the pressure of heavy loads on mountain curves and had to be replaced as often as every other year. I removed premium rail from our Central Corridor line over the Sierra Nevada to replace worn curve rail on other lines.

#### SP Track Maintenance Between 1993 and the UP/SP Merger

SP made an even more aggressive attempt to return to profitability beginning in 1993, when it hired Edward Moyers as its Chief Executive. Mr. Moyers had cut costs on IC and returned it to profitability. His efforts were not successful at SP.

Because SP did not have the capital to purchase locomotives and support the necessary tie and rail programs, the decision was made to cancel our planned rail and tie replacement programs for the remainder of 1993. During this period, SP started an aggressive locomotive replacement program.

SP immediately cut almost 40 percent of its maintenance-of-way and engineering employees. In May 1993, SP had employed the equivalent of almost 4,600 full-time maintenance and engineering employees. By October, we had reduced that

number to under 2,950. SP's maintenance and engineering head count never again reached 4,000.

In only two years, 1993 and 1994, SP fell another full year further behind its normalized maintenance needs. It made only limited investments in rail and ties. In 1993, for example, SP installed only 147.86 miles of new and second-hand rail. It again cut that investment in half in 1994, installing only 23.35 miles of new rail and 49.16 miles of second-hand rail. The SP tie program dropped to 837,000 ties in 1993 and only 722,000 ties in 1994.

To limit the number of speed restrictions on main lines, we moved rail and ties around the system to critical areas. We focused our efforts on SP's most heavily used mainlines from Los Angeles to El Paso and beyond to Kansas City and San Antonio. We curtailed maintenance on the Central Corridor in Nevada, the Coast Line between Los Angeles and San Francisco, the Sunset Route between Houston and New Orleans, and the Cotton Belt between Flatonia, Texas, and Lewisville, Arkansas, part of our transcontinental mainline to Memphis. We cut back further on yard rehabilitation, and we did little or no work on secondary lines and branches.

SP desperately needed additional capacity to carry more trains on the Sunset Route in Arizona, but we could not afford new track. We removed rail and ties from a second main line on the Central Corridor east of Reno and moved them to Arizona to create a second main line on the Sunset Route.

In late 1994 we developed a transportation plan that would have permitted us to discontinue use of the Modoc line between Klamath Falls, Oregon, and Flanigan, Nevada; limit use of Eugene Yard; and provide service for most traffic to the east and south

by eliminating switching at smaller yards. To put this plan into effect required greater use of Roseville classification yard. Over the years, Roseville's 48-track bowl had deteriorated to the point that by 1994 only 24 tracks remained serviceable. The remainder could be used only to store derelict freight cars awaiting long postponed repairs or scrapping. We were unable to implement the plan, because SP lacked the money to restore to service the 14 tracks necessary to support the additional work required of the yard. Within three months, most of the plan was scrapped because of Roseville's physical frailty and SP's lack of resources to correct the problem.

We knew we were stretching the life of our rail and our ties, so we tested our tracks more often than other railroads to ensure that we could continue to operate safely. SP kept twelve rail test cars in operation on its system. We also conducted an aggressive bridge inspection and rating program, because we could not afford to repair bridges on a regular basis as UP and other major railroads did. As a result, SP has a backlog of bridges needing rehabilitation.

SP was lucky during these years, because we did not have any harsh winters on the West Coast. During most years, SP confronted heavy rains and deep snows in the Cascade Mountains and the Sierra Nevada. Maintenance expenses increased as we battled to keep the tracks open. SP's situation would have been much worse during the Moyers years had we faced typically harsh weather.

SP added personnel and increased its maintenance expenditures somewhat after Jerry Davis came to the railroad as President in 1995. We never returned to the level of normalized maintenance, but we increased the tie program to approximately 1.2 million ties per year. This remained well short of the level we had maintained in the 1980s.



### SP Track Condition Without the UP/SP Merger

SP would have faced daunting challenges had it attempted to operate after 1996 as an independent carrier. As I have already mentioned, we had fallen behind on our rail and tie programs. For example, we needed to replace hundreds of thousands of ties throughout the Gulf Coast area. We also confronted a difficult situation on the Tucumcari Line. SP had rebuilt this between El Paso and Topeka, Kansas, in 1980 and 1981 without replacing the rail. The rails and ties were wearing out. We knew that we would need to replace more than 1,500 ties per mile on the Tucumcari Line in the late 1990s, and much of the rail needed to be replaced as well.

Had the merger not occurred, SP would have confronted severe operating challenges unless it could have found hundreds of millions of dollars for rail, ties, and bridges. We would have been forced to eliminate duplicate routes, such as the Coast Line in California. Mr. Gray's statement describes other steps that SP might have taken had the merger not been approved. SP could not have afforded to return to normalized maintenance.

STB

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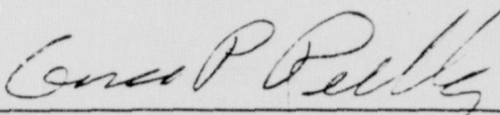
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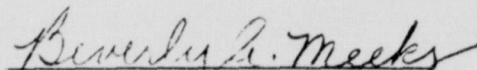
VERIFICATION

STATE OF NEBRASKA                    )  
  )        ss  
COUNTY OF DOUGLAS                )

GENE P. REILLY, being duly sworn, deposes and says that he has read the foregoing statement, knows the contents thereof and that the same are true as stated.

  
\_\_\_\_\_  
GENE P. REILLY

Sworn to and subscribed before  
me this 26 day of June, 2001.

  
\_\_\_\_\_  
Notary Public

My Commission expires \_\_\_\_\_







**This Entire Confidential Appendix Is  
Filed Under Seal**





## COMPLIANCE APPENDIX

### COMPLIANCE WITH CONDITIONS

This appendix reviews UP's compliance with the Board's conditions during the past year and BNSF, Tex Mex, and URC traffic volumes under the conditions. The appendix follows the format used in prior oversight reports.

#### A. BNSF and CMA Agreements

UP has fully complied with the BNSF and CMA agreements.

1. Clarifying Decisions. During the past year, neither UP nor BNSF found it necessary to seek the Board's assistance in resolving disputes. In Decision No. 90, served October 27, 2000, the Board rejected AmerenUE's request to reconsider its decision that the contract reopener condition does not apply to AmerenUE's Labadie, Missouri, power plant.

2. "2-to-1" Protocol. UP and BNSF have continued to abide by the provisions of the protocol they had established to govern the listing of existing "2-to-1" customers. During the past year, UP has responded rapidly, often within hours, to BNSF requests regarding its rights under the merger conditions to access particular customers, including Kronos at West Lake Charles, Louisiana; Pioneer Pipe at Geneva, Utah; Red River Depot and Lone Star Ammunition Plant at Defense, Texas; and Celotex at San Antonio, Texas.

3. Voluntary Agreements. Ever since the merger was approved, UP has voluntarily entered into haulage agreements with BNSF that were not required by the parties' agreement in order to facilitate BNSF's operations pursuant to merger conditions. During the past year, UP has continued to provide BNSF haulage service at a number of "2-to-1" locations where both parties agree that haulage is practical, efficient, and beneficial to customers. UP and BNSF have also entered into a temporary reciprocal switch arrangement for traffic moving to

McClellan Park, California, and UP has offered BNSF interim haulage between St. Louis and Labadie, Missouri, to serve AmerenUE's power plant while BNSF and UP construct a new connection.

URC has continued to serve as BNSF's designated agent for serving customers on BNSF's trackage rights in the Utah Basin. UP consented to this arrangement in 1997 pursuant to its right of consent under the BNSF agreement to allow agents for limited feeder service on trackage rights lines.

4. Implementation. After the merger was approved, UP and BNSF worked hard to establish automated systems that allow the railroads to exchange accurate and up-to-date information regarding each railroad's trackage rights lines. UP and BNSF created a procedure for recording, monitoring, and resolving day-to-day operational issues arising out of the trackage rights, haulage, and reciprocal switching arrangements between the railroads. This procedure continues to work well. Between January 1, 2000 and June 29, 2000, there were only 220 problem log entries, as compared to more than 650 during a similar period in 1999. Between January 1, 2001 and June 29, 2001, the number of log entries fell from 220 to 150, and UP has responded to BNSF within four hours 92 percent of the time. The decline in log entries and UP's rapid responses reflect UP's continuing efforts to ensure that BNSF receives the full benefit of the merger conditions.

5. Dispatching Protocol. The BNSF and UP dispatching protocol has continued to work well. Any disputes regarding dispatching on trackage rights lines are resolved quickly. BNSF continues to maintain a full-time manager at Harriman Dispatching Center, and UP



continues to maintain a full-time manager at BNSF's Fort Worth Dispatching Center to facilitate movement of BNSF trackage rights traffic.<sup>1</sup>

6. Line Sales. The BNSF Agreement provided for the sale to BNSF of three line segments: Dallas-Waxahachie (completed Sept. 20, 1996); Iowa-Junction-Avondale (completed Dec. 15, 1996); and Keddie-Bieber (completed July 15, 1997). In September 2000, UP and BNSF signed the operating agreement and formally completed their exchange of interests in the former-SP Houston-New Orleans.<sup>2</sup>

7. Connections. Connections to facilitate trackage rights operations contemplated in the BNSF agreement were completed several years ago. During the past year, UP and BNSF agreed that BNSF will construct a short connection from BNSF to UP at Pacific, Missouri, to give BNSF a direct route to the AmerenUE plant at Labadie, a "2-to-1" omnibus point.

8. Capital Reserve Fund. Section 9c of the BNSF Settlement Agreement created a \$25 million capital reserve fund to pay for improvements along BNSF trackage rights lines. As

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<sup>1</sup> In addition, UP and BNSF continue to participate successfully in the Houston-area regional dispatching center in Spring, Texas, which has been expanded to include tracks to Mexico and Louisiana. As previously reported, they have also implemented consolidated dispatching in Southern California and the Powder River Basin.

<sup>2</sup> As previously reported, as part of an overall agreement under which BNSF joined in the Spring regional dispatching center, UP and BNSF agreed on February 18, 1998 to exchange undivided half-interests in UP's line between Iowa Junction, Louisiana, and Houston (Dawes), Texas, and BNSF's line between Iowa Junction and Avondale, Louisiana. The agreement also gave UP trackage rights over BNSF's line between Beaumont and Navasota, Texas, allowing trains to bypass Houston, and further clarified limitations on UP's liability for expenditures that have been and may in the future be made to upgrade the Iowa Junction-Avondale line. In addition, the agreement allowed BNSF new access to customers along the former-SP line between Houston and Iowa Junction. The access, which did not require Board action, went into effect immediately. The Board exempted the exchange of ownership interests in Finance Docket No. 33630, Burlington Northern & Santa Fe Ry. & Union Pacific R.R. - Acquisition Exemption - Lines Between Dawes, TX, & Avondale, LA, served Sept. 29, 1998.



reported previously, the funds are exhausted. The fund financed several major projects that facilitate BNSF's operations, including:

<u>Project</u>	<u>UP Cost Estimate</u>
Avondale Connections	6.1 million
Iowa Jct. Siding	5.5 million
CTC, Echo TX to Iowa Jct.	3.4 million
El Pinal Crossing	3.7 million
Stockton Connection	4.0 million
AEI Readers	0.5 million

9. Storage-in-Transit Capacity. As required by the CMA Agreement, UP has continued to make storage-in-transit capacity available to BNSF at Dayton Yard, near Houston, at Beaumont, and at East Baytown, Texas.

10. New Facilities. UP has promptly responded to BNSF requests for confirmation of its ability to access new facilities. During the past year, UP responded to BNSF queries regarding new facilities for customers including PCI at San Antonio, Texas; International Paper Company and Staples at Ontario, California; Unimast, at Baytown, Texas; Green Waste Recovery at San Jose, California; PW Pipe at West, Jordan, Utah; McClellan Park, an industrial park at Planehaven, California; and Paramount Asphalt at Fernley, Nevada.

In addition, UP agreed this past year to lease two tracks to BNSF in Glenwood Springs, Colorado, to facilitate BNSF service to American Soda – a new industry located along the former-SP line at Parachute, Colorado. BNSF will use these tracks while it constructs its own tracks. In November 2000, BNSF began to provide three-day-per-week service to American Soda.

11. Joint Service Committee. The Joint Service Committee provided for in the parties' dispatching protocol has met four times since the last annual report, in June, October, January, and May. A number of informal communications have occurred to follow up on issues

addressed at those sessions. The merger-related issues addressed by the Committee during the past year have included: train performance over trackage rights segments, revisions to directional operations, the status of various capital projects, access to new facilities, development of switching standards, construction of new track, dispatching, and use of storage-in-transit facilities. The Committee also established a joint committee at San Bernadino to review operations on a regular basis. At its most recent meeting, the Committee decided that, in the future, track performance issues would be handled by the railroads' regional vice presidents in meetings to be held on a quarterly basis. The Committee, which will next meet in August, also decided that it will meet three times per year.

12. Segregated Funds. The applicants agreed in Section 6 of the CMA agreement to place trackage rights fees received under the BNSF agreement into two dedicated funds, one with respect to trackage rights lines in Texas, Louisiana, Arkansas, Missouri and Illinois, and one with respect to the trackage rights lines in the Central Corridor and California. The applicants agreed that the money in those funds would be spent on (a) maintenance on those lines, (b) capital improvements on those lines, and (c) costs for accounting necessary to administer the two funds. As UP has shown in prior oversight reports, the expenditures on the trackage rights lines have greatly exceeded the trackage rights revenues. The following table provides information regarding the two funds through March 31, 2001, the latest date for which UP has compiled the data. (In light of the great excess of outlays over fees, UP has not compiled data on capital expenditures on the lines, which have been substantial.)

	Texas, Louisiana, Arkansas, Missouri and Illinois	California and Central Corridor
REVENUE		
Trackage Rights Fees	\$101,504,605	\$83,236,427
Capacity Improvement Fees	<u>0</u>	<u>0</u>
Total	<u>\$101,504,605</u>	<u>\$83,236,427</u>
EXPENSES		
Maintenance	\$165,888,687	\$111,258,302
Depreciation	\$145,236,559	\$110,055,008
Capital Expenditures	(Not reported)	(Not reported)
Accounting Expenses	<u>\$95,136</u>	<u>\$95,136</u>
Total:	<u>\$311,220,382</u>	<u>\$221,408,446</u>

13. Contract Reopener Process. UP continues to comply with the contract reopener condition. As noted above, in October 2000, the Board denied AmerenUE's petition for reconsideration.

14. I-5 Corridor. The proportional rate agreement, the Keddle-Bieber line sale, and UP's trackage rights over BNSF's Bend-Chemult segment went into effect July 15, 1997. Confidential Appendix J contains numerous examples of shippers that have benefited from the creation of two new single-line routes in this corridor and several examples of traffic that UP is handling under the proportional rate agreement.

15. UP Trackage Rights on BNSF and Haulage. UP has exercised the following trackage rights that it received over BNSF lines as part of the BNSF Settlement Agreement: rights at Superior, Wisconsin, to facilitate access to the MERC Dock coal facility; and rights between Mojave and Barstow, California, which UP uses to bypass the Los Angeles Basin for such movements as industrial sand and Utah coal bound to facilities in Southern California. UP also continues to use its rights on the Dallas-Waxahachie line, which was sold to BNSF.



B. Tex Mex Trackage Rights

UP has complied with the Board condition granting Tex Mex trackage rights, and it has participated in several construction projects to facilitate the movement of Tex Mex trains. UP and Tex Mex have constructed new connections at Flatonia and Robstown and have constructed new sidings south of Flatonia at Adel, Texas, and at Robstown.

On March 12, 2001, Tex Mex acquired UP's line between Rosenberg, Texas, and Victoria, Texas, to shorten Tex Mex's route between Laredo and Houston. Tex Mex acquired and will rehabilitate the portion of this line between Mileposts 2.5 and 87.8. Tex Mex also received overhead trackage rights over the remaining segments of the line (near Rosenberg and Victoria), which permits Tex Mex to connect to the UP lines over which Tex Mex already has trackage rights. Tex Mex may use its new trackage rights both for traffic having a prior or subsequent movement on Tex Mex's original Laredo-Robstown-Corpus Christi line as well as traffic originating or terminating at shipper facilities located on the portion of the Rosenberg Line that Tex Mex acquired. UP also agreed to modify the terms of Tex Mex's prior traffic rights to permit Tex Mex to handle traffic to and from Rosenberg Line shipper facilities.<sup>3</sup> When Tex Mex begins freight operations over the Rosenberg Line, it will relinquish trackage rights it had obtained over UP's other lines between Rosenberg and Victoria in connection with the merger.

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<sup>3</sup> Tex Mex agreed that it may not use its prior or new trackage rights to handle traffic originating or terminating at locations on lines connecting to the Rosenberg Line or to/from transload facilities on the line.

C. URC Agreement

The URC trackage rights remained fully operational during the past year, with all necessary support systems in place. URC has provided a letter to the Board in which it concludes that the trackage rights and additional mine access granted to URC have worked well to preserve competition.

II. BNSF, TEX MEX. AND UTAH TRAFFIC VOLUME UNDER THE CONDITIONS

A. BNSF Trackage Rights and Haulage Volumes

BNSF continues to increase the volume of traffic it handles pursuant to its trackage rights.

Since the commencement of operations in October 1996, BNSF has operated a total of 37,482 through freight trains over the trackage rights lines through May 2001. This is shown in Exhibits #1, #2 and #3, which depict, by month, the numbers of BNSF through trackage rights freight trains and the number of cars and gross tons on those trains.

BNSF's traffic volumes on trackage rights through trains have grown, as shown by the average monthly data from the five periods UP has used to submit traffic data to the Board. The five periods are October 1996-May 1997; June 1997-May 1998; June 1998-May 1999; June 1999-May 2000; and June 2000-May 2001. In these five periods, average monthly trains grew from 232 in the first period, to 574 in the second, to 725 in the third, to 793 in the fourth, and to 878 in the most recent period. Average monthly tons increased from 703,922 in the first period, to 2,467,520 in the second, to 3,423,944 in the third, to 4,295,705 in the fourth, and to 4,732,881 in the most recent period. Average monthly cars grew from 8,940 in the first period, to 31,828 in the second, to 43,459 in the third, to 53,768 in the fourth, and to 58,790 in the most recent period. Average monthly tons per train grew from 3,034 in the first period, to



4,299 in the second, to 4,723 in the third, to 5,417 in the fourth, and decreased slightly to 5,391 in the most recent period. Average monthly cars per train grew from 38 in the first period, to 55 in the second, to 60 in the third, to 68 in the fourth, and decreased slightly to 67 in the most recent period.

These figures do not include the many local trains that BNSF has also operated. Much of the business on these local trains connects directly with BNSF's through trains at BNSF's own terminals rather than connecting through trackage rights trains – and thus represents still further traffic secured by BNSF because of the merger conditions. Through May 2001, BNSF operated a total of 2,612 locals between Houston and Iowa Junction; 1,063 locals between Temple and Waco or Elgin, Texas; and 859 locals between Richmond and Warm Springs or Oakland, California.<sup>4</sup> These trains handled 153,672 loaded and empty cars. Since URC commenced as PNSF's agent for local train operations in the Utah Valley on April 1, 1997, it operated some 6,085 local trains and carried a total of 147,581 loaded and empty cars.

BNSF continues to move significant volumes via haulage, though more and more of BNSF's operations have shifted to trackage rights over time. In May 2001, loaded and empty haulage cars totaled nearly 12,138. Much of this traffic related to the AmerenUE plant at Labadie. The remainder was spread among such other locations as Lake Charles, Louisiana; Orange, Texas; the Northern California area; and the "paired track" in Nevada.

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<sup>4</sup> As previously reported, BNSF cancelled its Houston-Dayton local. In an effort to keep cars out of its yard in Houston, BNSF began running a Silsbee-Dayton manifest train in each direction, bypassing Houston. Between Houston and Iowa Junction, BNSF operates a Beaumont-Korf local, a Lafayette (Iowa Jct.)-Lake Charles local, and a Dayton-Sheldon local.



BNSF is providing highly efficient service that is competitive with UP/SP service in every trackage rights corridor. BNSF continues to operate at least daily through train service in all major corridors.

In the Houston-Memphis corridor, BNSF operated an average of 164 trains in the most recent of the five periods that UP has used to submit data in these oversight proceedings, carrying 779,869 gross tons. Average monthly trains have grown from 47 in the first period, to 112 in the second, to 120 in the third, to 140 in the fourth. Average monthly tons have grown from 154,475 in the first period, to 493,446 in the second period, to 674,911 in the third, to 721,355 in the fourth.

In the Houston-New Orleans corridor, BNSF's operated an average of 243 monthly trains in the most recent of the five periods that UP has used to submit data in these oversight proceedings, carrying 1,322,167 gross tons. Average monthly trains have grown from 67 in the first period, to 132 in the second, to 167 in the third, to 201 in the fourth. Average monthly tons have grown from 164,116 in the first period, to 551,343 in the second, to 772,231 in the third, to 1,116,474 in the fourth.

In the Central Corridor, BNSF's operated an average of 78 monthly trains in the most recent of the five periods that UP has used to submit data in these oversight proceedings, carrying 373,310 gross tons. Average monthly trains have grown from 62 in the first period, to 138 in the second, before falling to 122 in the third, as BNSF decreased its use of its Central Corridor trackage rights as an alternative to its Southern Corridor route. In last year's oversight proceeding, UP reported that BNSF's average monthly trains had fallen to 78. UP explained that it had changed its methodology for counting BNSF's Central Corridor trackage rights trains, and further analysis shows that volumes were also affected by BNSF's decision to shift some unit

trains back to its Southern Corridor route. Average monthly tons, which were not affected by the change in methodology, increased from 92,656 in the first period, to 412,999 in the second, before declining to 373,370 in the third period, and to 362,394 in the fourth.

The foregoing corridor figures do not include many other trackage rights trains. BNSF's trains in the I-5 Corridor that use trackage rights over UP between Keddie and Stockton California have grown from no trains in the first period, to an average of 76 in the second, to 124 in the third, to 167 in the fourth, and to 197 in the most recent period. BNSF trackage rights trains between Houston and Corpus Christi have grown from an average of 31 in the first period, to 50 in the second, to 70 in the third, to 73 in the fourth, and to 102 in the most recent period. BNSF's trains between Temple and Eagle Pass via San Antonio have grown from an average of 17 in the first period, to 35 in the second, to 54 in the third, declined slightly to 51 in the fourth, and increased to 52 in the most recent period. BNSF rock trains interchanged with the Georgetown Railroad grew from an average of 13 in the first period, to 17 in the second, and to 30 in the third, before declining slightly to 26 in the fourth, and to 21 in the most recent period, as Texas Crushed Stone has shipped more to fast-growing, nearby markets served by truck. BNSF coal trains to Halsted and Elmendorf have grown from no trains in the first period, to an average of 5 in the second, to 15 in the third, to 30 in the fourth, and have remained steady at 28 in the most recent period. BNSF grain trains to Ontario, California, grew from an average of 6 in the first period, to 11 in the second, to 18 in the third, before falling to 9 in the fourth period, and to 3 in the most recent period.

The continued strength of BNSF's Mexico volumes is also notable. In the most recent period, BNSF operated an average of 162 trackage rights trains to and from Corpus Christi and Robstown, principally for interchange with Tex Mex of Mexico traffic (the trains also



included some Corpus Christi business and perhaps some business interchanged for Tex Mex local points). Those trains handled an average of 8,532 loaded and empty cars and 676,397 gross tons. In the first period, those figures were 31 trains, with 1,579 cars and 206,592 gross tons, and they grew to 50 trains, with 4,161 cars and 363,024 gross tons in the second period, to 70 trains, with 5,224 cars and 414,721 gross tons in the third period, and to 73 trains with, 6,182 cars and 500,091 gross tons in the fourth period. Eagle Pass also remained strong: an average of 52 trains, carrying 4,486 cars and 345,607 tons. In the first period, those figures were 17 trains, with 803 cars and 50,669 gross tons, and they grew to 35 trains, with 2,140 cars and 184,248 gross tons in the second period, to 54 trains, with 4,271 cars and 352,444 gross tons in the third period, before leveling off with 51 trains, with 4,418 cars and 346,523 gross tons in the fourth period.

B. Tex Mex Trackage Rights Volumes

Since the inception of its rights, Tex Mex operated a total of 2,982 through freight trains through May 2001. In the period from June 2000 to through May 2001, Tex Mex averaged 59 through trains per month. Exhibits #4, #5 and #6 depict, by month, Tex Mex's through trackage rights trains and the number of cars and tons on those trains. Exhibits #7, #8 and #9 present the same data, adjusted to exclude the temporary effects of the Board's Service Order No. 1518.<sup>5</sup>

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<sup>5</sup> Tex Mex's trackage rights operations were affected in two significant ways by the Board's Service Order No. 1518. First, between November 10, 1997 and January 29, 1998, BNSF and Tex Mex interchanged considerable volumes of traffic, mostly grain, at Flatonia instead of at Corpus Christi or Robstown pursuant to the Board's emergency order authorizing interchange at that location. As a result, this BNSF-Tex Mex traffic was temporarily included in Tex Mex's trackage rights volumes rather than in BNSF's trackage rights volumes. Second, in February 1998, Tex Mex commenced the operation of new trains between Houston and Tex (continued...)



The Board partially granted the trackage rights conditions sought by Tex Mex in the UP/SP merger proceeding to "address the possible loss of competition at the Laredo gateway into Mexico and to protect the essential services provided by Tex Mex to its shippers." Decision No. 62, p. 6. There is no question that competition remains strong at Laredo and that Tex Mex remains viable subsequent to the merger. The volume of traffic handled by Tex Mex to and from Laredo more than tripled since the UP/SP merger. Exhibit #10 depicts the dramatic increase in Tex Mex's Laredo traffic. Tex Mex's southbound traffic over Laredo – which traditionally made up all of its Laredo business – was 63,178 carloads in the June 2000-May 2001 period – 253 percent of the 24,953 carloads in the same period prior to the merger (June 1995-May 1996). Tex Mex's much smaller northbound volumes increased even more dramatically, from 492 carloads in the June 1995-May 1996 period to 21,017 carloads in the June 2000-May 2001 period.

This post-merger growth in Tex Mex's volumes and shares of Laredo traffic occurred because the growth in the volume of traffic that Tex Mex interchanges with BNSF at Corpus Christi/Robstown and handles itself using its new trackage rights between Beaumont and Corpus Christi/Robstown greatly outstripped the decline in the volume of traffic that Tex Mex interchanged with UP and SP. This is most readily seen by focusing on southbound volumes. Exhibit #11 overlays BNSF and Tex Mex trackage rights volumes with SP and UP Tex Mex

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Mex's interchange with KCS at Beaumont that carried traffic moving between Houston and points north, as permitted by the Board's emergency service order. Exhibits #7, #8 and #9 depict, by month, Tex Mex's through trackage rights trains, and the numbers of cars and tons on those trains, excluding estimates of (a) traffic interchanged with BNSF at Flatonia, (b) traffic on BNSF trains that Tex Mex handled for three months between Corpus Christi and Alcoa as BNSF's agent, and (c) traffic carried in Tex Mex's Houston-Shreveport trains.

interchange traffic and graphically demonstrates why Tex Mex's Laredo gateway volumes have increased so significantly.

Tex Mex traffic can be expected to expand even further once Tex Mex begins using its newly purchased line between Rosenberg, Texas, and Victoria, Texas, which will provide it with a more direct route between Laredo and Houston.

C. URC Traffic Volumes

URC, a "2-to-1" shortline, obtained the right to interchange with BNSF as a condition to the merger, thereby preserving competitive options for its on-line shippers. In addition, in consideration for settling issues regarding the use of joint URC-DRGW track, URC received access to the Savage coal transloading facility and the Willow Creek mine, and trackage rights to Grand Junction, Colorado, where it can interchange with both BNSF and UP.

URC reports that it has used its trackage rights to Grand Junction to move five trains through June 29, 2001, as compared to the same number of trains in all of the year 2000. URC reports that it expects traffic to increase at its Grand Junction interchange with BNSF. URC also reports that shipments from the Savage terminal have increased in the past year. URC has originated 31 trains through May, 2001, as compared to 50 trains in all of the year 2000. Before then, shipments had increased from none in 1997, to 15 in 1998, to 20 in 1999.

Most of the coal shipments originated by URC have been interchanged with UP, but BNSF's presence acts as a continuing competitive check on UP.



Exhibit #1

# **BNSF Trackage Rights Number of Through Trains**

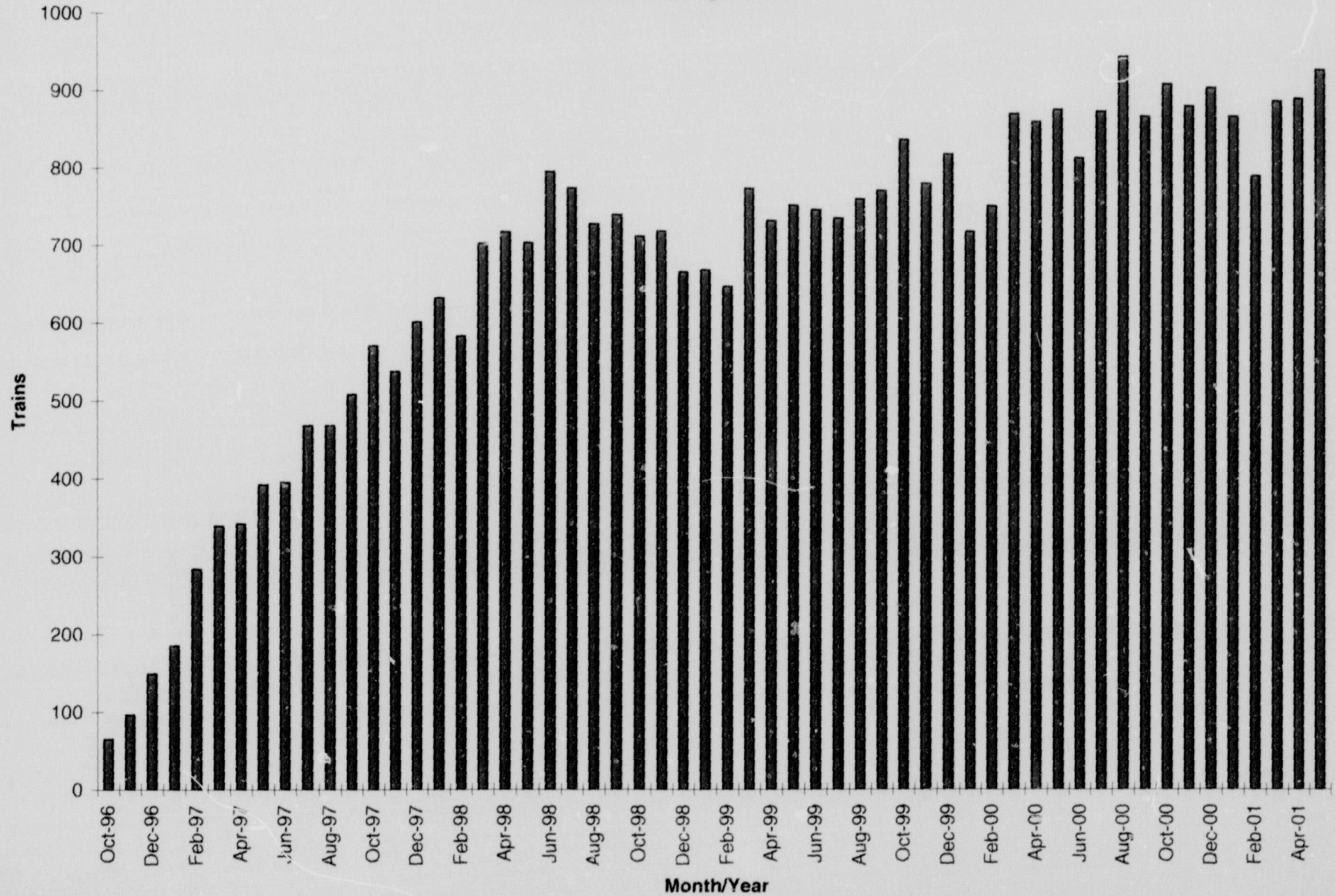




Exhibit #2

# BNSF Trackage Rights Number of Cars (Through Trains)

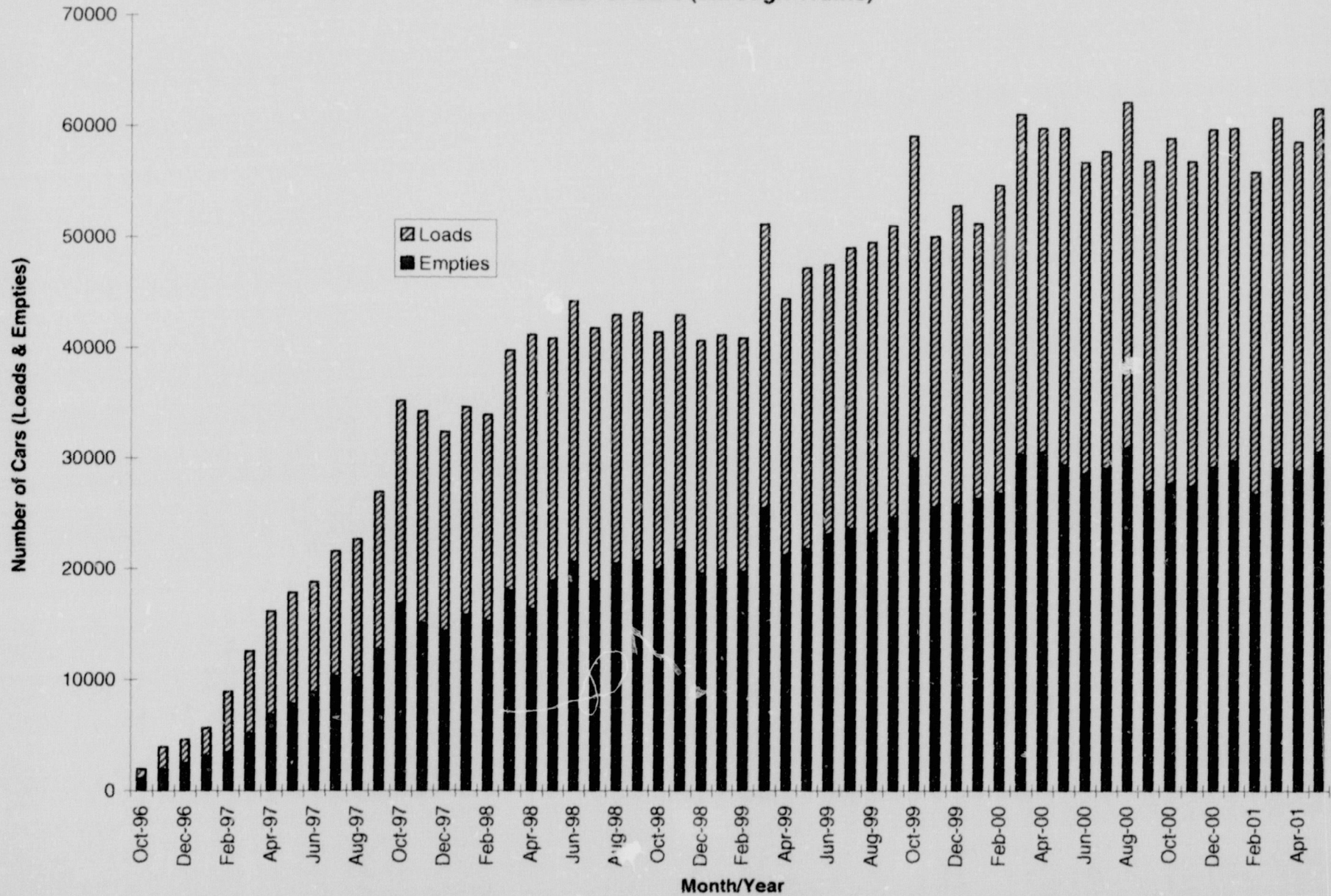


Exhibit #3

**BNSF Trackage Rights  
Gross Tons (Through Trains)**

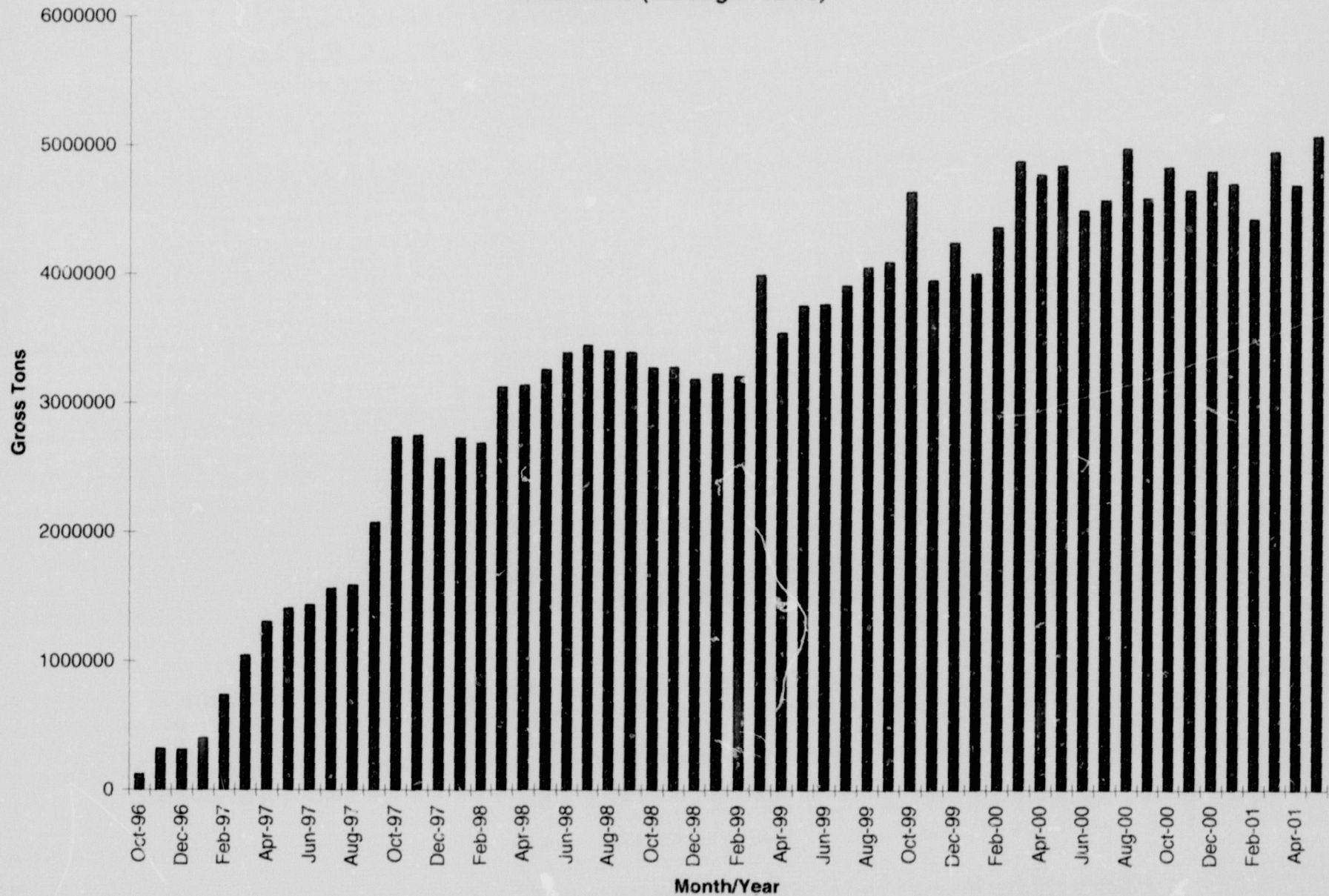


Exhibit #4

**Tex Mex Trackage Rights**  
**Number of Through Trains**  
(All Traffic Included)

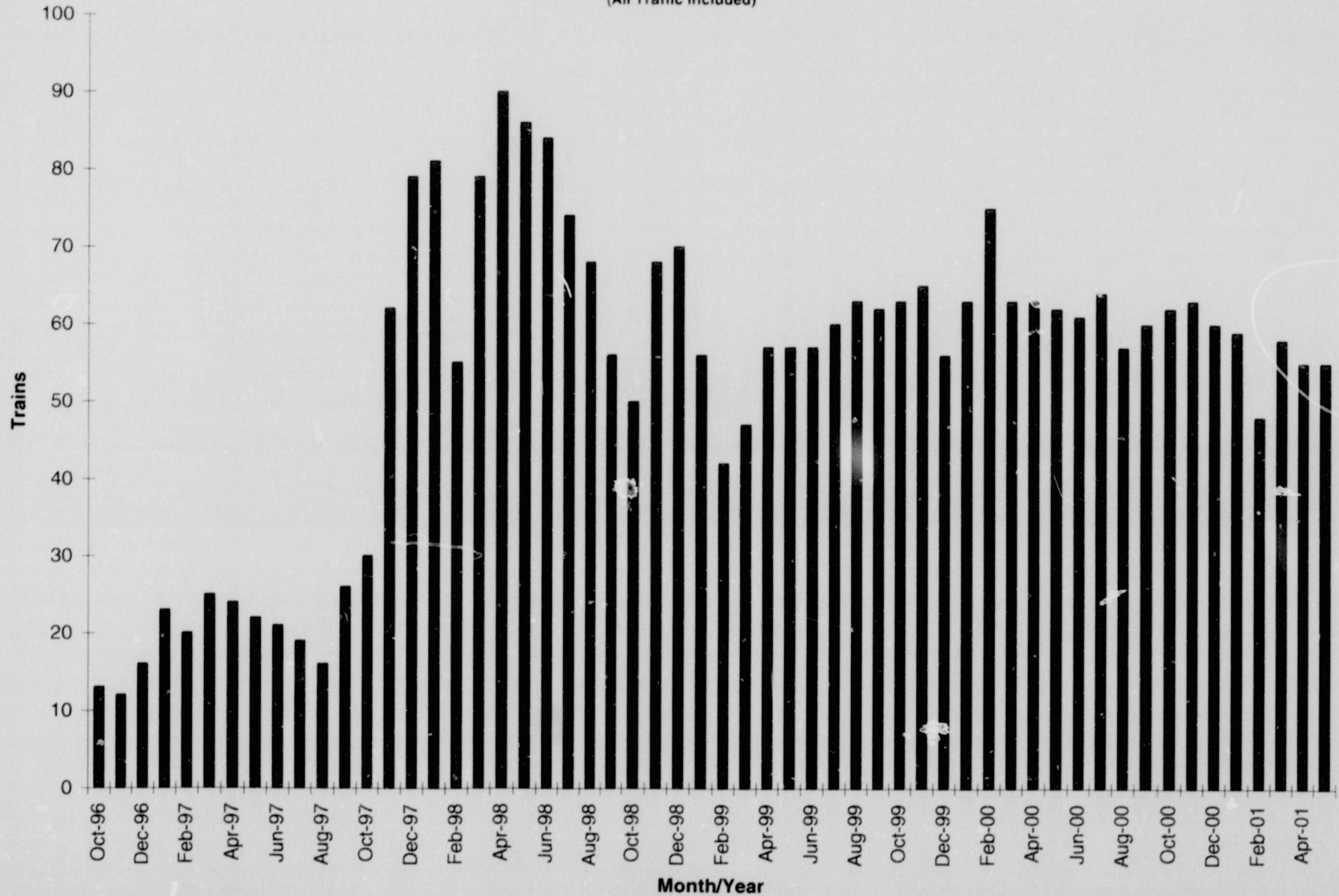




Exhibit #5

**Tex Mex Trackage Rights**  
**Number of Cars (Through Trains)**  
(All Traffic Included)

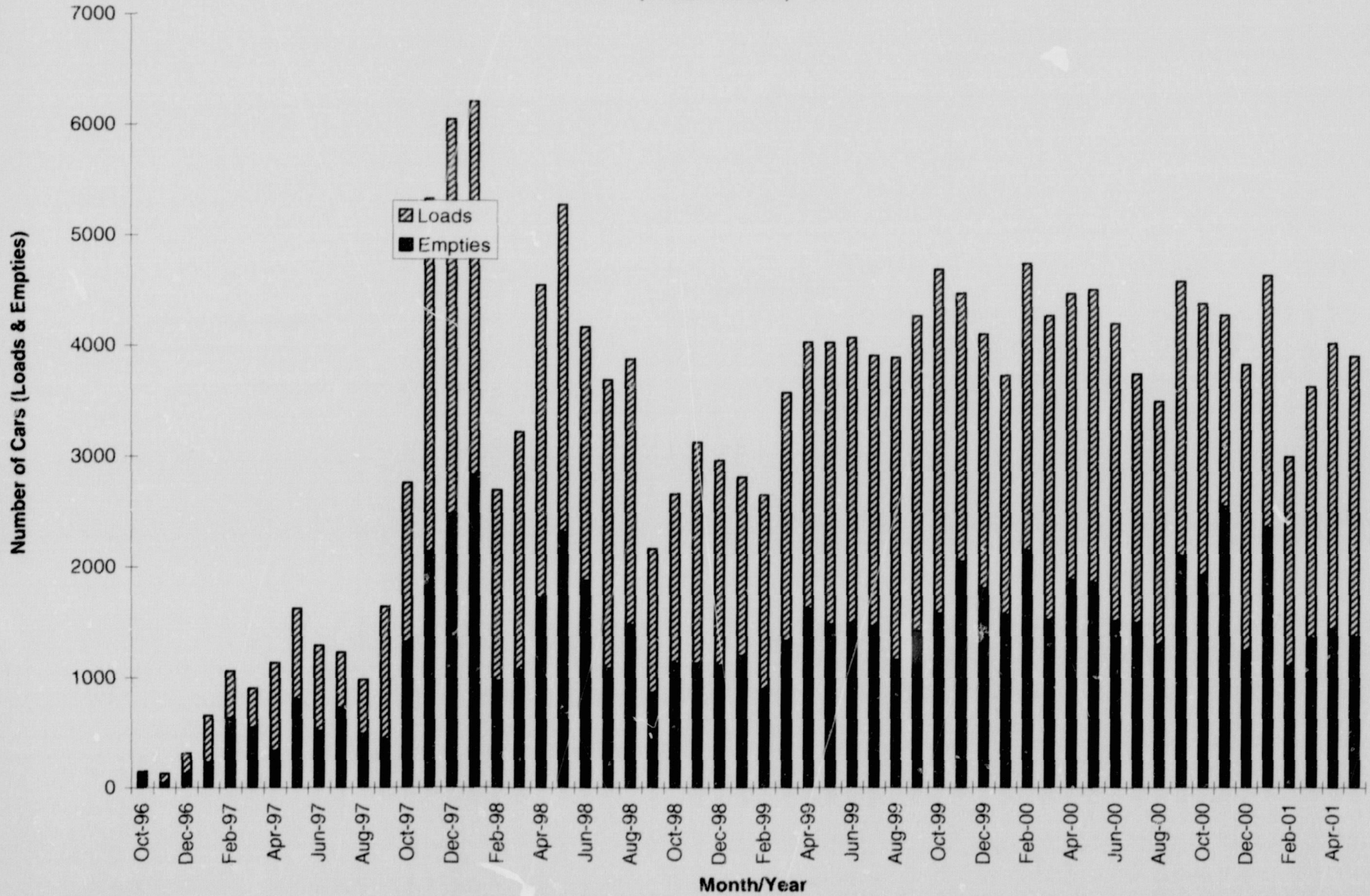


Exhibit #6

**Tex Mex Trackage Rights**  
**Gross Tons (Through Trains)**  
(All Traffic Included)

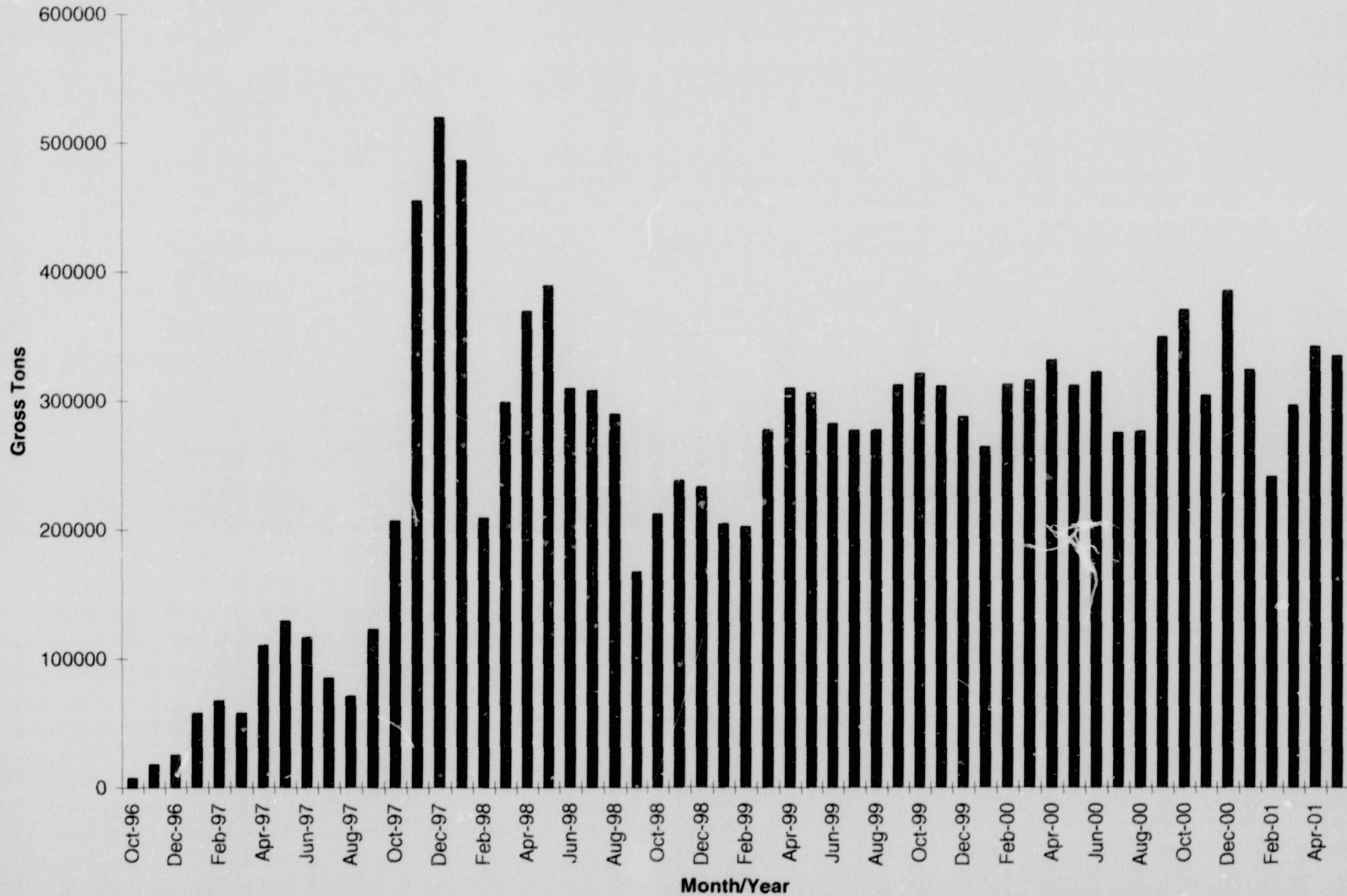


Exhibit #7

**Tex Mex Trackage Rights**  
**Number of Through Trains**  
(Estimated Service-Order-Related Traffic Excluded)

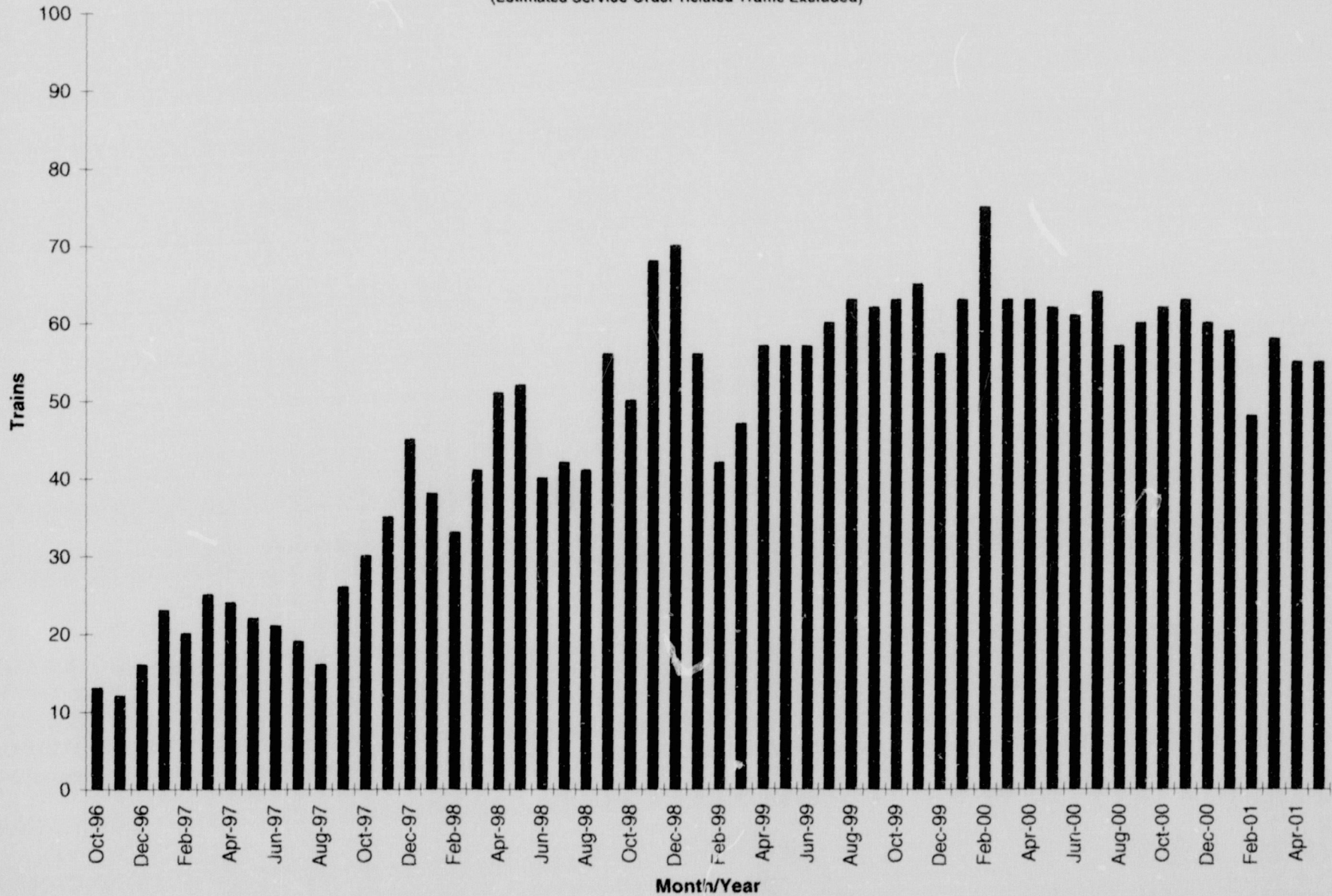




Exhibit #8

# **Tex Mex Trackage Rights** **Number of Cars (Through Trains)**

(Estimated Service Order-Related Traffic Excluded)

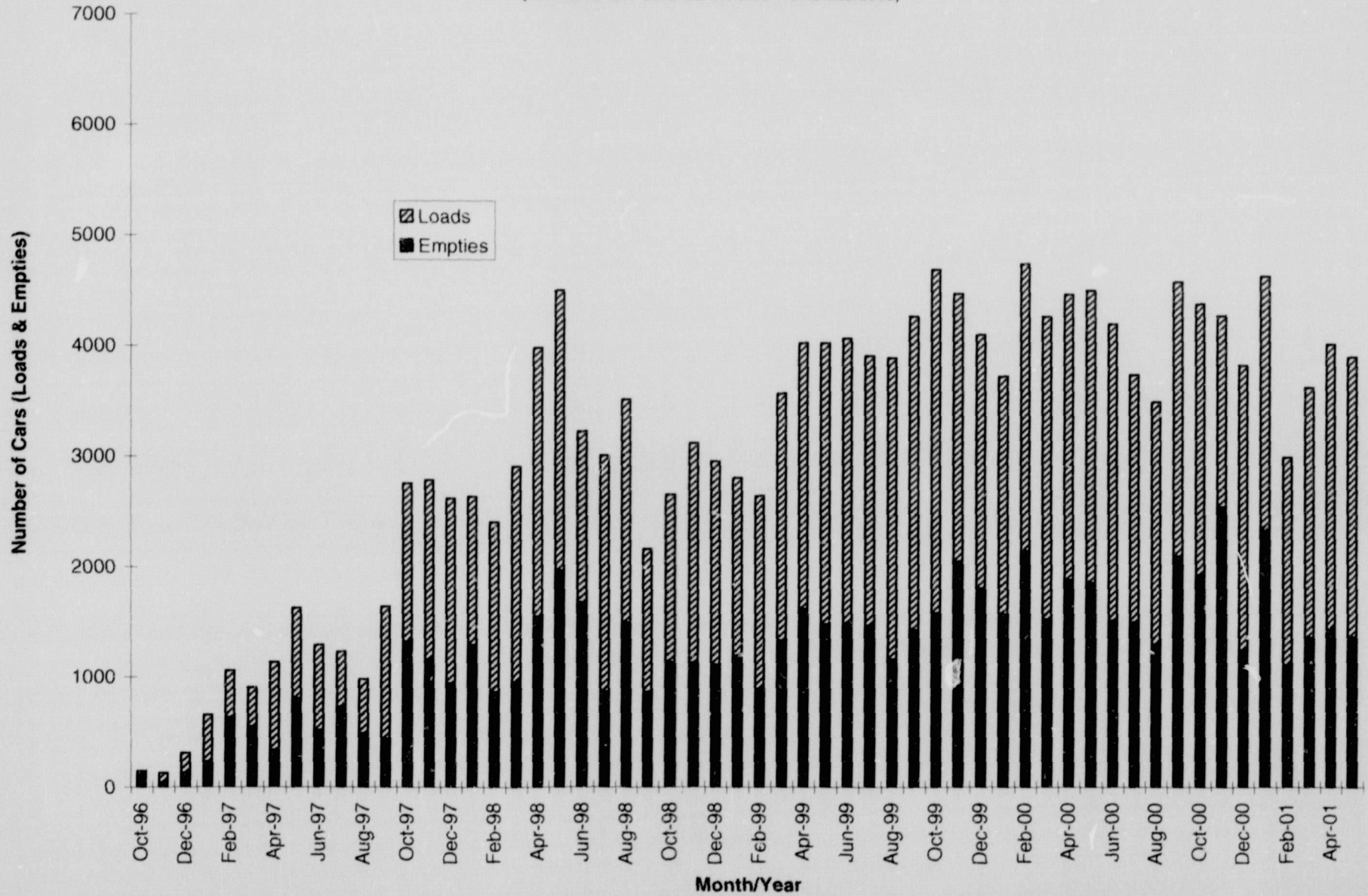


Exhibit #9

**Tex Mex Trackage Rights  
Gross Tons (Through Trains)**

(Estimated Service-Order-Related Traffic Excluded)

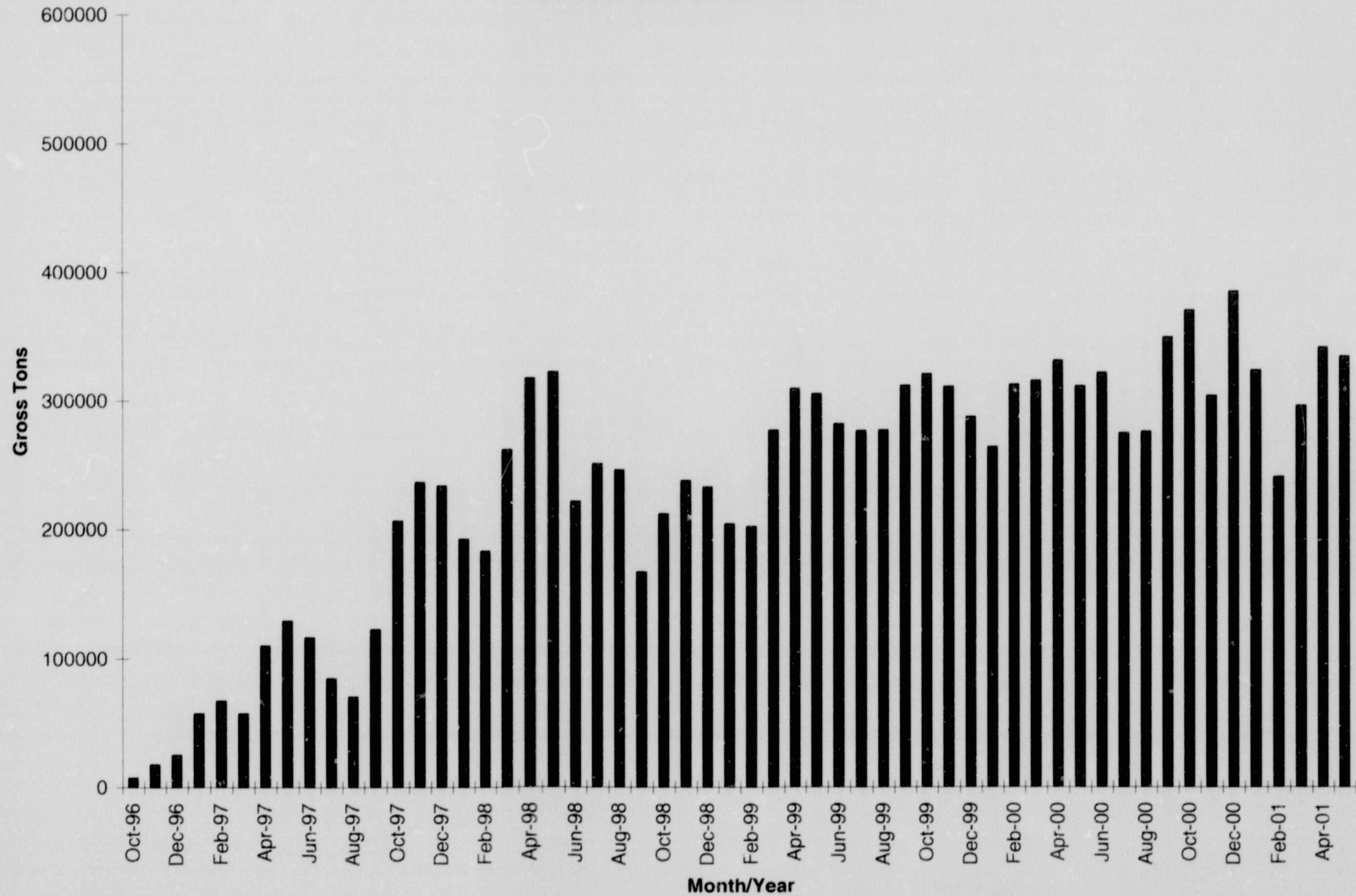


Exhibit #10  
Tex Mex Laredo Traffic  
(Loaded Cars)

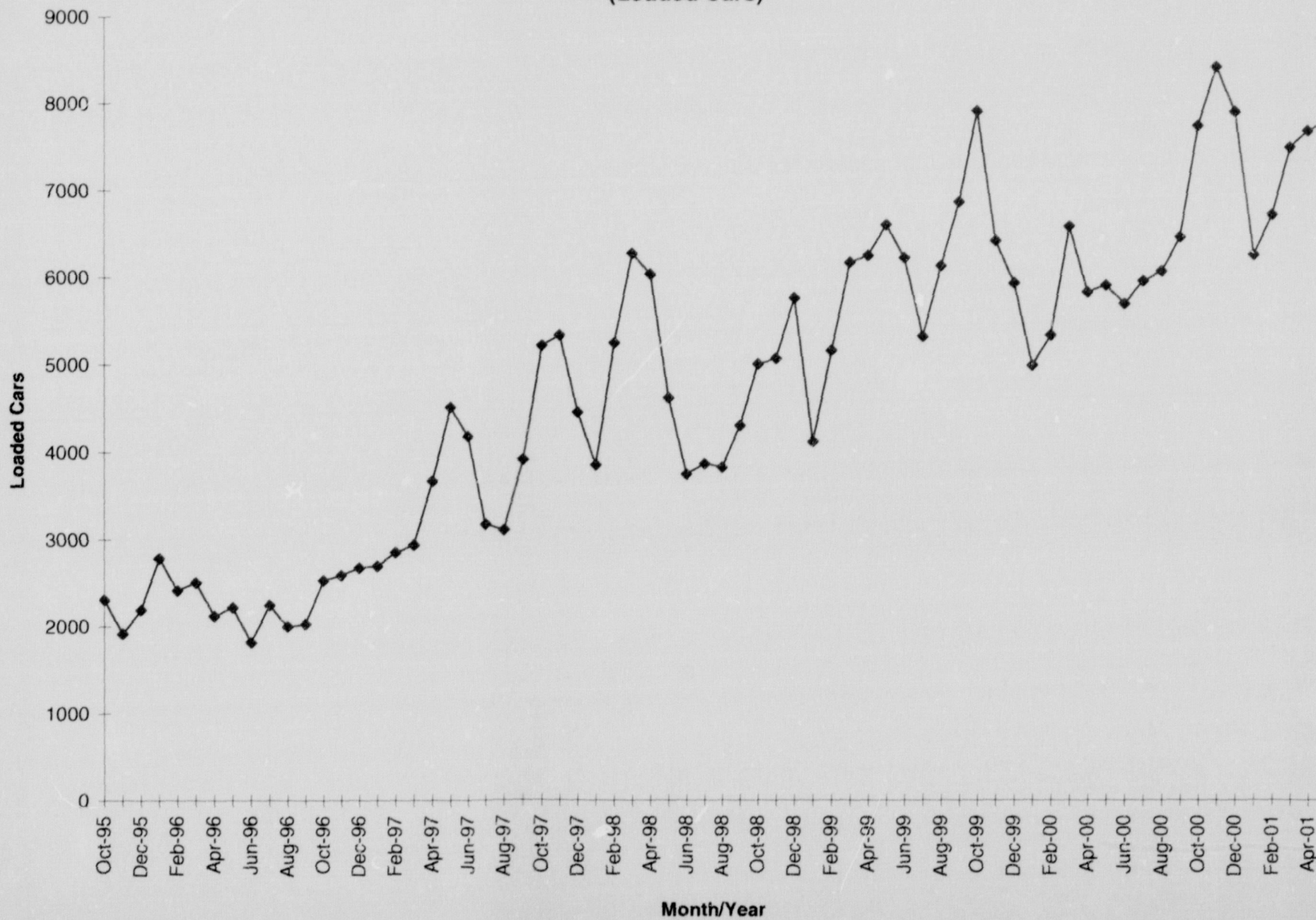
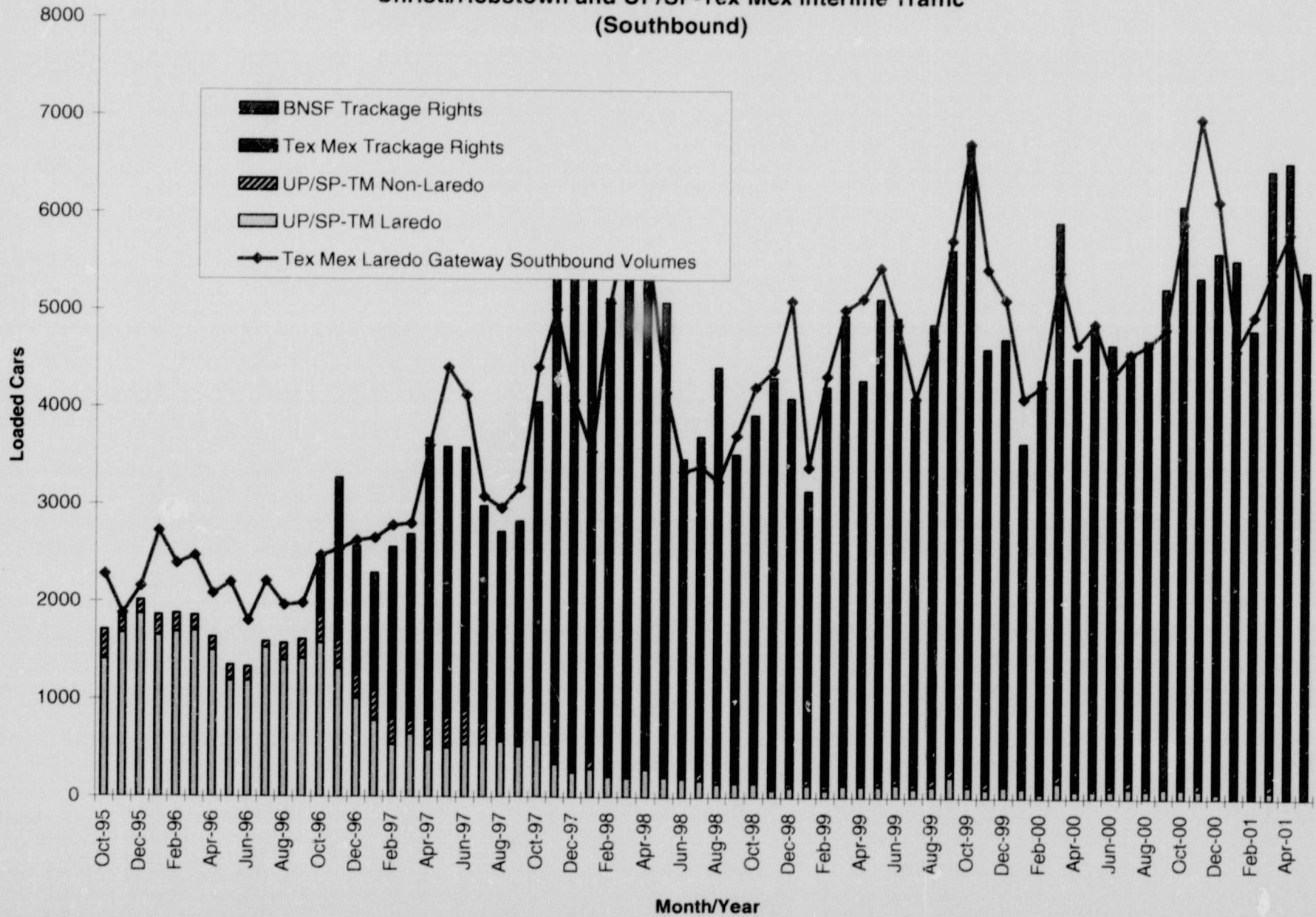




Exhibit # 11

**Tex Mex and BNSF Trackage Rights Traffic to Corpus Christi/Robstown and UP/SP-Tex Mex Interline Traffic (Southbound)**





## ENVIRONMENTAL APPENDIX

### ENVIRONMENTAL MITIGATION CONDITIONS

UP has complied with the Board's environmental mitigation conditions. We address them in the order listed in Appendix G to Decision No. 11:

#### A. System-wide Mitigation

1-7. These conditions have been satisfied as previously reported.

8. Shut Down Locomotives. UP promulgated an official, written policy to comply with this condition. It conducts audits to ensure that locomotives are shut down as required, and it corrects deviations from the policy. UP believes that its train crews comply with the policy on mainlines and at most terminals. UP is aware of several instances in which employees have left locomotives running in terminals or nearby sidings when they mistakenly expected the locomotives to move soon. UP is working to correct these situations. UP sees this as an opportunity not only to reduce air and noise pollution but also to save expensive fuel.

9. This condition has been satisfied as previously reported.

10. Security Forces. As previously reported, UP extended to SP territory its policy of zero tolerance of vagrancy and trespassing on railroad property. UP participates in a nationwide initiative by Operation Lifesaver to reduce trespassing on railroad property.

11-13. These conditions have been satisfied as previously reported.

#### B. Corridor Mitigation

14. EPA Emissions Standards. EPA's national locomotive emissions rule was published in the Federal Register on April 16, 1998. Since no appeals were filed by the June 15, 1998 deadline, the rule is now final. UP is working with locomotive industry suppliers to develop its compliance plan.



UP continues to consult with state and federal officials to identify and address air quality issues. In some cases these consultations resulted in voluntary agreements between regulators and UP, as well as other railroads, to address specific concerns. For instance, in 1998 UP and BNSF entered into a fleet-averaging agreement with the California Air Resources Board to address air quality concerns in the South Coast Air Quality Management District. Under this agreement, the railroads are accelerating placement of new and refurbished locomotives in the South Coast Air Quality Management District to reduce emissions of nitrous oxide. UP and BNSF entered into another voluntary agreement in 2000 with the Texas Natural Resources Conservation Commission to reduce nitrous oxide emissions as a part of the Houston-Area State Implementation Plan under the Clean Air Act.

16. Noise Impacts. UP implemented a noise comment hotline and re-notified each affected county and requested comments in the first part of 1999. UP monitors the noise hotline and compiles and analyzes data to determine if a noise abatement plan is required. Through June 28, 2001, there had been no calls to the noise monitoring hot line in recent months.

17. This condition has been satisfied, as previously reported.

C. Rail Line Segment Mitigation

18. Priority List for Upgrading Grade Crossing Signals. UP provides train density information to states on a regular basis, which they use to prioritize their grade crossing improvements. UP provides the states of Arizona, California, Kansas, Nevada, Oregon, Texas and Colorado with train density data for approximately 500 individual crossing improvements annually.

19. East Bay Regional Park District MOU. The MOU is being implemented in accordance with its specifications. UP is reviewing the Crockett Trail Feasibility Study and is awaiting property descriptions from the District for all trails.

20. Town of Truckee MOU. The MOU is being implemented in accordance with its specifications. UP has completed construction of its portion of the bridge at the I-80 Central Truckee off ramp and is working with the city on roadway approaches.

21. Placer County MOU. The MOU is being implemented in accordance with its specifications. UP continues to meet and work with the City of Roseville. UP has installed train control mechanisms to facilitate passenger operations. Several improvement projects specified in the MOU have been completed while others have been deferred or canceled at the request of the county and/or city involved. UP has conveyed, and is in the process of conveying or leasing other properties as specified in the MOU.

22. City of Reno. The MOU between UP and Reno is being implemented in accordance with its terms. The City is pursuing its plan for a depressed trainway.

23. City of Wichita/Sedgwick County. The MOU between UP and City of Wichita/Sedgwick County is being implemented in accordance with its terms. UP expects to spend \$5.4 million in Wichita this year, even though UP has not yet increased the number of trains operating through Wichita.

D. Rail Yards and Intermodal Facilities

24. Noise Abatement Plans for Rail Yards. Before UP undertakes any rail yard construction at the specified locations, UP will contact appropriate state and local officials and will report to SEA on the results of those consultations. No construction is planned for these facilities at this time.

25. Intermodal Facilities. Before any changes are made at the specified intermodal facilities, UP will contact appropriate state and local air quality officials in the states of California and Illinois and will report to SEA on the results of those consultations. A permit

application for East LA is in progress. No construction or operating changes are planned for the Chicago facilities at this time.

E. Abandonments

26-61. As abandonments are carried out, UP will comply with all conditions. UP has developed a process to ensure that contractors and railroad personnel comply with all general conditions. Progress on specific abandonment conditions is reported below.

40. This work still being enacted. Contractor currently operating on property.

41. This condition has been satisfied, as previously reported.

42. This condition has been satisfied.

43. This condition has been satisfied, as previously reported.

44. This condition has been satisfied, as previously reported.

47. This condition has been satisfied, as previously reported.

48. This condition has been satisfied, as previously reported.

49. This condition has been satisfied, as previously reported.

50. This condition has been satisfied. There is no bridge at this location. The line has been sold to Norfolk Southern.

51. New connection in place at Girard. NHPA work will follow.

52. This condition has been satisfied, as previously reported.

55. This condition has been satisfied, as previously reported.

57. This condition has been satisfied, as previously reported.

58. Suman-Benchley, TX UP has decided to retain this line. The Board vacated the abandonment exemption for the line on June 12, 1998. This condition is no longer applicable.

59. This condition has been satisfied, as previously reported.



60. This condition has been satisfied, as previously reported.

61. This condition has been satisfied, as previously reported.

F. Construction Protects

62-108. As construction projects are carried out, UP will comply with all listed conditions. UP has developed a process to ensure that contractors and railroad personnel comply with all general conditions. Progress on specific construction provisions is reported below.

70. This condition has been satisfied, as previously reported.

78. This condition has been satisfied, as previously reported.

79. This condition has been satisfied, as previously reported.

80. This condition has been satisfied, as previously reported.

81. This condition has been satisfied, as previously reported.

83. This condition has been satisfied, as previously reported.

84. This condition has been satisfied, as previously reported.

88. This condition has been satisfied, as previously reported.

89. This condition has been satisfied, as previously reported.

92. This condition has been satisfied, as previously reported.

97. This condition has been satisfied, as previously reported.

98. This condition has been satisfied, as previously reported.

99. This condition has been satisfied, as previously reported.

100. This condition has been satisfied, as previously reported.

101. This condition has been satisfied, as previously reported.

107. This condition has been satisfied, as previously reported.

108. This condition has been satisfied, as previously reported.



## PHOTOGRAPHIC INDEX

1. Booth Yard
2. Englewood Bowl
3. Strang Yard Bowl
4. Strang Yard Lead Tracks
5. BNSF Train at Dayton





Photograph #1 Booth Yard



Photograph #2 Englewood Bowl



Photograph #3 Strang Yard Bowl





Photograph #4 Strang Yard Lead Tracks



Photograph #5 BNSF Train at Dayton