

STB FD 32760 (Sub 26) 9-18-98 B 191210V2 2/5

same patterns characterize the Houston-Iowa Junction (New Orleans) corridor, as also was shown in Exhibit 3.

Tex Mex confronted similar constraints during the service emergency.

The service problems of late 1997, extending into 1998, were serious and particularly so at Houston. All the carriers were caught up in the snarl, which belies the KCS/Tex Mex claim that if "1-to-1" shippers served by UP could have employed another carrier they would have done so. (KCS-2 at 12, 19-20). This helps explain why so relatively few cars were shifted from UP to other carriers at Houston when they were freed from their contracts by the emergency service order and could do so. On service grounds all the carrier choices were impaired.

The primary reason why UP has been losing share -- at Houston and elsewhere in the Gulf Coast -- is found in the merger conditions that were imposed and these will have lasting effects. The conditions permanently opened up large amounts of UP traffic to BNSF competition and gave BNSF the added routes to sustain what it could divert.

Plastic resins traffic is a good illustration. The merger threatened to give UP exclusive access to 63% of plastics production capacity in the Gulf. With the conditions imposed, however, UP would have exclusive access to only 40% of Gulf area resins production capacity (Decision No. 44 at 126). The result was that BNSF was given the opportunity to compete for 30,000-40,000 annual loads of new plastics traffic.<sup>19/</sup> (BN/SF-54, Rose VS).<sup>20/</sup> All told, BNSF calculated that through the conditions it will be able to compete as a consequence for traffic with a value of \$1.8 billion, including \$699 million in annual revenue potential in the Gulf Coast area (BR/SF-1, Lawrence VS at 3-5).<sup>21/</sup> By early 1997 BNSF overall had realized only about 20% of its competitive revenue potential (BNSF Presentation to Financial

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<sup>19/</sup> Of STC 28211 traffic (mostly consisting of plastics and resins) originated by rail in Texas, BNSF's share has

(There are no complete data for Louisiana since IC, a significant plastics transporter, is excluded from our available 1998 traffic base.) Note that these shares are of rail traffic only and do not indicate the respective carrier shares of plastics production or capacity (see Peterson VS).

<sup>20/</sup> BNSF believes it can obtain half of this newly-competitive traffic (Rose VS, id.). Where it had access to plastic and chemical shippers, and routes to key interchange points (given it through the conditions), BNSF had been able to "develop a 50% share of [the] business." Decision No. 44 at 135.

<sup>21/</sup> This dollar figure for the Gulf area includes access to new traffic in the Houston-New Orleans corridor valued at \$126 million, \$62 million Houston-Memphis, \$88 million Houston-Brownsville, and \$423 million via Tex Mex/Laredo.

Analysts, April 22, 1997). Through rate competition, BNSF has since made further inroads in realizing its big diversion potential but there is still more traffic available for which it can successfully compete. It can and will continue to absorb additional traffic.<sup>22/</sup> How much it will gain -- how the future balance between UP and BNSF will play out -- will be determined on a robustly competitive battlefield.

Tex Mex's recent increases in traffic, with an expanded share of Laredo border crossings, can also be expected to continue over the long-term.

KCS shares Tex Mex's optimistic outlook, particularly for US-Mexico traffic. Hailing itself as the

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<sup>22/</sup> In its Quarterly Progress Report, July 1, 1998, BNSF states that its "traffic volume over the lines to which it received access as a result of the merger continue to grow," and that it "expects that these traffic volumes will continue to increase." Id. at 60.

"NAFTA Railway"<sup>23/</sup> -- comprised of Tex Mex, KCS, and KCS connecting roads (NS, IC/CN) -- KCS sees Tex Mex playing a vital role in handling the growing volumes of traffic for Mexico through its Beaumont interchange. (All of this projected traffic can be handled by Tex Mex under the conditions now in effect.)

In sum, the competitive inroads recently made by BNSF and Tex Mex through diversion from UP are rooted in long-term factors that will persist in the years to come. UP's loss of traffic share is basically the product of competition, not temporary circumstances. It is competition among the three participants -- UP, BNSF, and Tex Mex -- that will determine price and service outcomes in the future. The conditions have laid in place a sturdy foundation for competitive market evolution.

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<sup>23/</sup> KCS Second Quarter 1998 Presentation to Financial Analysts, July 29, 1998, slide 25. It is stenciling its new cars with "NAFTA Railway" lettering. KCS News, Aug. 26, 1998. With Tex Mex an integral part of the KCS family, the company regards itself as "positioned for dramatic growth." Id.

II. THE ADDED CONDITIONS SOUGHT BY KCS/TEX MEX AND BNSF ARE UNWARRANTED, LACKING ANY NEXUS TO THE TRANSACTION AND PROVIDING PRIVATE GAINS THAT DILUTE THE MERGER'S PUBLIC BENEFITS

In approving the UP/SP merger the Board imposed many carefully-tailored conditions that have effectively remedied such competitive and other harms as the transaction might have caused (see Part I). All the merger's potential harmful effects have been previously identified (at Houston and elsewhere in the Gulf Coast Area)<sup>24/</sup> and all of those effects have been dealt with, leaving competition invigorated while preserving the merger's substantial public benefits.

Despite this, KCS/Tex Mex and BNSF now seek to add major new conditions. The KCS/Tex Mex proposals are warmed-over restatements of what has been considered earlier and rejected; and they offer no new evidence that warrants a different disposition. BNSF, having decided that it cannot secure a better revenue division from Tex Mex for the large volumes of traffic it is interchanging with it for border crossings at Laredo, now seeks to "resolve" its dispute with Tex Mex by having the Board give it trackage rights over UP's heavily-used San Antonio-Laredo line.

Although KCS/Tex Mex and BNSF struggle to find some thread of connection to the merger, they fail to do so. What they want is not conditions designed to deal with an adverse

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<sup>24/</sup> At Houston all "2-to-1" and "3-to-2" shippers have competitive service via UP and BNSF. BNSF seeks access to not a single new shipper. BNSF July 8, 1998 submission at 12.

competitive effect of the merger, but new, restructured service opportunities that will yield them sizable private gains. They do not seek to replace competition the Board found that would be diminished, but to establish a new rail service regime that did not exist pre-merger.

Stripped to the essentials, KCS/Tex Mex's proposals would (a) treat "1-to-1" shippers at Houston (those served pre-merger exclusively by SP or UP but not by both) as if they were or had been "2-to-1" shippers, and (b) give Tex Mex access to Houston traffic via a "neutral switching" road and enable it by divestitures and new conditions to become a third line-haul carrier for outbound moves where the Board found that there would be no reduction in competition. In seeking rights over UP's San Antonio-Laredo line, BNSF also aims at reconstituting rail service to its liking, not to replicate the competition that was furnished by SP but to establish an entirely new level of competition.

Although not explicated in the Statements of Purpose included in their July 8 filings, KCS/Tex Mex and BNSF pleas for added conditions would confer on them large benefits. By their own estimates, the KCS/Tex Mex conditions would divert \$155 million from UP (of which \$120 million would be realized by KCS/Tex Mex); and BNSF's would divert \$103 million from UP (in 1999). While these estimates are likely understated, they demonstrate the private gains the proponents would realize through conditions that are needless and intrusive. These

diversion gains, though enriching their proponents, inevitably would reduce the UP/SP merger's public benefits and generate none on their own (neither KCS/Tex Mex nor BNSF claims or offers any evidence to show that their conditions would yield any public benefits).

A. The KCS/Tex Mex Proposed Conditions Are Devoid of Logic and Factual Support and Should be Rejected

KCS/Tex Mex seek to expand "neutral switching" at Houston, thereby giving "1-to-1" UP shippers access to Tex Mex (and also to BNSF). It is radical in conception and lacks both a sound premise and factual underpinning.

(1) Tex Mex Has Derived Substantial Benefits From the Existing Conditions and Has Been Competitively Strengthened

Tex Mex has materially gained from the original conditions imposed by the Board. Those replaced SP with BNSF as Tex Mex's interchange partner and also gave Tex Mex trackage rights to connect with KCS for traffic moving over its Robstown-Laredo line. These rights have put Tex Mex on solid financial footing and made it a much stronger competitor at Laredo. Having also added a new yard at Laredo that allows it to handle auto and intermodal traffic, all the Board's objectives for it have been realized. Tex Mex admits as much, saying:

"Tex Mex incremental revenue from the additional intermodal traffic, automotive traffic, BNSF interchange traffic and extended hauls more than offsets the revenue reduction from lost carloads of SP interchanged traffic



resulting from SP's merger with the UP."  
(KCS-2 at 258.)<sup>25/</sup>

Tex Mex witness Plaistow has documented the degree to which the conditions put in place by the Board have strengthened Tex Mex, giving it more traffic and better finances. In what he calls his Base Case he restated Tex Mex's actual 1996 performance to show how the present conditions (not the new ones being sought by KCS/Tex Mex), without any emergency service order conditions being in effect, have benefitted Tex Mex (Plaistow VS, KCS-2 at 254-57). The Tex Mex Base Case results are distilled in Exhibit 7. With carloads up 23% the conditions -- by Tex Mex's own reckoning -- brought it to a healthy financial state, with more revenue, a higher operating income, a near fourfold increase in its net income, and a much-improved return on equity. Having recently achieved a 37% share of southbound traffic crossings at Laredo, Tex Mex has realized the Board's objectives. With the conditions having worked well -- all across the competitive spectrum -- there is no basis for the new, added conditions that are sought by KCS/Tex Mex.

Tex Mex's own waybill data confirm this conclusion.

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<sup>25/</sup> See also BNSF July 8 submission at 16 ("Tex Mex has more than replicated its pre-merger Corp's Christi connection with SP").

EXHIBIT 7

EXISTING CONDITIONS HAVE STRENGTHENED TEX MEX Base Year 1996		
Item	Actual Results (without present conditions)	Restated to reflect impact of present conditions
Total Operating revenue (000)		
Income from Operations (000)		
Net Income (000)		
Operating ratio		
Return on equity		
Carloads		

Source: KCS-2, Plaistow VS.

26/

Tex Mex Traffic Data.

27/

Exhibit 8

SELECTED TEX MEX LAREDO TRAFFIC - AVERAGE MONTHLY VOLUMES  
(INTERLINE AND HOUSTON TRACKAGE RIGHTS TRAFFIC, IN LOADS)

CATEGORY	DIRECTION	JAN-MAY 1996	JAN-MAY 1997	JAN-MAY 1998	NET GAINS (LOSSES) 1996-1998
UP/SP	Southbound				
	Northbound				
	Total				
BNSF	Southbound				
	Northbound				
	Total				
KCS	Southbound				
	Northbound				
	Total				
TEX MEX HOUSTON	Southbound				
	Northbound				
	Total				
TOTALS	Southbound				
	Northbound				
	Total				

Source: Tex Mex Traffic Records.

In addition, lest there be any question about Tex Mex's continued viability -- and Tex Mex's strong traffic gains indicate that there is not -- the Board must look not only to Tex Mex's own financial performance, but to the revenues that its interline partners earn on the Mexican traffic for which Tex Mex provides an indispensable link. Examination of Tex Mex's revenue divisions with KCS confirms

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KCS, Tex Mex and TFM share interlocking ownership, these overall revenues enrich all members of the corporate family.

(2) KCS/Tex Mex Wrongly Postulate That Competition Has Not Increased at Houston.

The KCS/Tex Mex requested conditions rest on several premises, each of which is wrong. It is claimed that the Board's conditions, imposed in Decision No. 44, failed to protect competition because they supposedly did not reduce UP's share of Houston originated traffic (KCS-2 at 11-12, 18-21). This rests on the proposition that in certain outbound corridors, UP's share had not changed from pre-merger levels. This, as shown earlier, is wrong. As explained earlier, the data for the first half of 1998 demonstrate that UP's share of Houston traffic, in total and in all the corridors listed in KCS/Tex Mex submission, has fallen and is well below the UP/SP pre-merger share.

What UP share KCS/Tex Mex would think acceptable is unknown other than that, apparently, UP's share should be reduced still more. In an earlier proceeding, KCS advanced the idea that competition will exist only when BNSF is able to capture the 38% share of Houston traffic SP held prior to the merger. (Finance Docket No. 32760 (Sub-No. 1), Decision

served Oct. 24, 1997, p. 5). This, too, is a fallacious test but even if it were used, the data indicate that BNSF is well along to achieving this goal. Of total Houston originated tonnage BNSF's share has grown January-June 1998. Given the added traffic for which it can compete, and its all points routes, it has in a short period of time proven that it has been more than a mere substitute for SP. Further, the SP pre-merger 38% share included traffic moving from "1-to-1" locations, which were not affected adversely by the merger.

From an economic standpoint, KCS/Tex Mex's emphasis on shares in misconceived "markets" as an index of competition is completely misplaced.<sup>28/</sup> Where, as here, a merger has taken place, all that the Board can do, all that it should do, is to correct the transaction's potential harms and establish the conditions for continued competition. This it has done, with BNSF substituted for SP at all "2-to-1" points and in all the "2-to-1" corridors, posturing it to compete aggressively against UP. And the single best indicator -- intense and persistent rate competition -- is now clearly evident. It is

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<sup>28/</sup> Even if all Houston traffic were jointly-served, KCS/Tex Mex's belief that there could be no effective competition at Houston so long as UP's share of traffic was larger than that of BNSF would be mistaken. This would be akin to saying that Toyota (maker of the number-one selling auto, the Camry) or Honda are not strong competitors in the auto-light truck market despite shares a third or less those of GM. Similarly, IBM was once thought to reign supreme in the sale of personal computers but it now ranks third worldwide trailing Compaq and Dell. Competition is a dynamic process and the key element is that rivals be able to contest from positions of strength.

this competition that will determine future UP and BNSF shares of Houston traffic. Setting some pre-specified share as a criterion is abhorrent to and inconsistent with competition. It is the latter which the Board has strengthened; and no more need be or should be done.

(3) KCS/Tex Mex Wrongly Assumed an Ongoing Service Emergency That Could Only End With Adoption of Their Plan

KCS/Tex Mex's second premise is that the merger, as conditioned, not only reduced competition in the Houston area (a false claim, as discussed above) but that this "reduction of competition" bears "a significant relationship to UP's unprecedented service failures" (KCS-2 at 11). The nub of the logic is that, given a UP share that in their view is "too high," the service emergency experienced earlier could not have ended. Indeed, in their July 8, 1998 submission, KCS/Tex Mex were of the view that the service problems "have persisted and are at least as bad as they were a year ago, and in many cases much worse" (KCS-2 at 18). However, on July 30, 1998, the Board found that the emergency had ended:

"Viewed objectively, it is inescapable that service to Houston has improved significantly . . . Indeed, the Houston area was fluid, and has been for several weeks." (STB Service Order No. 1518 (Sub-No. 1), Decision served July 30, 1998, p. 5.)

In other words, at the time KCS/Tex Mex made its July 8 filing, conditions had improved and traffic movements at Houston were "fluid." By its logic, however, this should not



have happened since by its druthers UP's share of Houston traffic was higher than KCS/Tex Mex deem acceptable. If UP's share really was a significant cause of the service emergency, by the KCS/Tex Mex theory the emergency would have continued -- until the conditions they urge had been adopted. That the service problem did end is powerful evidence that the emergency had a largely independent explanation and cure. It was brought to a satisfactory outcome because of many UP initiatives and success in inducing BNSF to join the Spring Dispatching Center. BNSF cooperation. Thus, there was, and there is, no need for the conditions urged by KCS/Tex Mex to deal with the service emergency. That emergency has ended and the service order has been terminated; yet KCS/Tex Mex would now have the Board make permanent provisions of the service order that the Board deems no longer necessary even temporarily.

By postulating the continued existence of the now-ended service emergency -- making it a key element in their logic -- KCS/Tex Mex seek to open up "1-to-1" (and "3-to-2") shippers in Houston (and also between Houston and Galveston) to Tex Mex access. Saying that when the service problem was at its most severe, shippers exclusively served by UP had been unable to switch to alternative rail services, it proposes giving them perpetual open access via a "neutral switching" railroad (KCS-2 at 12, 18-19).

Now that service is back to normal, however, there is no longer any basis for open access by "1-to-1" UP shippers since they were not harmed by the merger. The KCS/Tex Mex plan gives this no heed. It envisions establishing an expanded "neutral switching" service in the Houston-Galveston-Texas City area that would allow all shippers to access the neutral switcher to gain access to Tex Mex and BNSF as well as UP. The results would be bizarre, judged by the analytical criteria employed by the Board: pre-merger "1-to-1" UP shippers would be turned into "1-to-3" shippers. Pre-merger "2-to-1" shippers that are now served by UP and BNSF would gain service by a third carrier (Tex Mex); and pre-merger "3-to-2" shippers, which the Board concluded would enjoy stronger competition from the merged UP/SP and an expanded BNSF, would also gain access to a third.

The conditions advocated by KCS/Tex Mex lack any compelling logic. They are flawed in premise and rendered moot by the expiration of the service emergency, and not designed to remedy any harmful effect of the UP/SP merger.<sup>29/</sup> They are targeted at establishing new service and restructuring the pre-merger rail system in the Houston area.

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<sup>29/</sup> This same criticism applies to the applications for new conditions by CP&L, Dow, and Formosa. All pre-merger were in the "1-to-1" category but now seek to add another carrier; they fail to demonstrate they were harmed by the merger. DuPont was a "3-to-2" shipper pre-merger (UP, SP, BNSF). It continues to have competitive service from UP and BNSF and its effort to add Tex Mex service simply seeks to create new, added competitive service.

(4) The Merger's Potential Adverse Effects Have Been Dealt With and There Is No Need for the New Conditions Proposed by KCS/Tex Mex

Through its initial conditions the Board dealt well with the harmful effects that the UP/SP merger might have produced. BNSF was given access to the "2-to-1" locations and the "2-to-1" corridors. The result has been sharpened competition (UP's traffic share has fallen, BNSF's has increased, and rate competition is now pervasive). Where SP offered the only independent competition to UP, its presence has been more than replicated through BNSF expansion. No shipper, no route, was thus harmed by the merger as conditioned. Competition as it existed pre-merger was maintained, and improved, since BNSF was a stronger road than SP, with a larger Western route network).

Since the "2-to-1" location and corridor effects have already been resolved, with BNSF as the chosen carrier, giving KCS/Tex Mex new access to northbound/eastbound Houston traffic is surplusage, needless in terms of remedying any harmful effects of the merger. Those effects have already been dealt with and competition has been preserved, indeed incited, through the conditions previously imposed.

As for traffic moving via Tex Mex for Mexico over Laredo, the existing conditions have increased competition and placed Tex Mex on solid financial footing. Both Tex Mex and KCS have benefitted since they can now interchange traffic at Beaumont so long as it has a move over Tex Mex's Robstown-

Laredo line. Tex Mex can also handle southbound traffic at Houston via PTRA in addition to the substantial volumes it interchanges with BNSF at Robstown. All of the Board's objectives with respect to Tex Mex and competition at Laredo have been achieved.

Tex Mex, however, now says that it needs to be able to handle northbound/eastbound traffic at Houston free from the existing restriction that it have a prior or subsequent haul on Tex Mex's Robstown-west line. This, it contends, will allow it to move more southbound traffic for Laredo (KCS-2, Woodward VS at 220-24).<sup>30/</sup>

Examination of its traffic records fails to support the Tex Mex theory. During the period when the emergency service order was in effect the prior-subsequent restriction was temporarily removed, thus allowing Tex Mex to move traffic from Houston for connection with KCS at Beaumont. This permits Tex Mex's hypothesis to be tested: when it carried northbound traffic via KCS do the traffic data show that the effect was to generate more traffic southbound for Mexico? The answer is no.

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<sup>30/</sup> In the UP/SP merger proceeding Tex Mex had initially sought unrestricted trackage rights allowing it to move traffic north from Houston over Beaumont. It acknowledged, however, that this would be "a relatively minor benefit" and was not a central purpose of its request (TM-34 at 7, cited in Decision No. 44 at 149-50).

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It was traffic moving over Tex Mex via Laredo that the Board wanted to protect from possible competitive harm, not other Houston traffic. BNSF was seen as the strongest available choice to replicate SP's past participation in the latter category. This has worked well and there is no need for a condition that would add Tex Mex/KCS northbound Houston traffic to the equation. Where Tex Mex, with KCS and BNSF, was to play a competitive role was for southbound traffic moving via Laredo for Mexico, and Tex Mex has increased its share of Laredo crossings. The means adopted by the Board to preserve competition have thus worked and new conditions are neither needed nor justified in either respect.

Even without the new conditions proposed by KCS/Tex Mex, Tex Mex could handle most (78%) of the traffic it envisions.<sup>21/</sup> The reason is that this large share of the projected volume is for Mexico and thus can move via Tex Mex-Laredo under the conditions that presently exist. In very large measure, therefore, Tex Mex could right now -- under the conditions in place -- play a bigger, even more expansive competitive role for traffic over Laredo.

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<sup>21/</sup> I derive my 78% estimate as follows: KCS/Tex Mex forecast total loads of 144,288 (KCS-2 at 240). Of this, Tex Mex traffic moving via Laredo is projected at 112,778 loads (KCS-2 at 225). The latter is 78.2% of the former.

- (5) The KCS/Tex Mex Plan Would Cause Large Diversions From UP, Require Far-Reaching Divestiture, and Detract From the Merger's Public Benefits.

If the KCS/Tex Mex proposals were adopted, they estimate that the effect would be to divert \$155 million in projected annual revenue from UP (KCS-2 at 241). The principal beneficiaries would be KCS/Tex Mex, whose combined revenue would increase by \$120 million (\$64.8 million for KCS, \$55.3 million for Tex Mex).<sup>32/</sup> These measures, though, are but the tip of a much larger iceberg. UP's assessment is that the KCS/Tex Mex plan would expose \$134 million in its present traffic revenue to competition for "1-to-1" shippers that would via the neutral carrier be given new access to two more carriers (Tex Mex and BNSF) (see accompanying Peterson VS).<sup>33/</sup> These are measures of the private gain stemming from the reconstitution of Houston rail service contemplated in the Plan. I say "private gain" because no analysis is presented in the KCS/Tex Mex filing -- no claim is even made -- to show

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<sup>32/</sup> In the pending CN/IC control proceeding the applicants state that they plan to work with other so-called "Alliance" roads to create new services. This would encompass traffic moving to Mexico (and other points) via KCS/Tex Mex. The CN/IC rail diversion study projects that the overall impact would be to generate \$68 million for KCS and \$16 million for Tex Mex. Diversion would come primarily from UP (\$165 million), with BNSF estimated to lose \$54 million in revenue. Finance Docket No. 33556, CN/IC-7 at 11.

<sup>33/</sup> The CP&L, Dow, and Formosa proposals, converting them from pre-merger "1-to-1" status into "1-to-2" locations, alone would expose another \$115 million of UP revenue to newly-created competition (Peterson VS).

that adoption of these proposals would yield any public benefits. Inevitably, therefore, the gains realized by the plan's proponents would reduce the public benefits of the UP/SP merger (Decision No. 44 at 109) and provide no net public benefits or, for that matter, any public benefits at all.

The divestiture required to achieve the gains which KCS/Tex Mex anticipate would be extensive. UP would be required to sell a number of properties and to grant Tex Mex permanent trackage rights over its lines. In addition, UP's existing transportation service contracts for exclusively served "1-to-1" shippers would be annulled since they would be permitted to route traffic over the "neutral switching" road to Tex Mex or BNSF (no provision is made to compensate UP for this loss in value).

The full effects of the KCS/Tex Mex plan -- in terms of service quality (due to increased switching at Houston), future investment by UP in the face of reduced traffic and revenue, and overall operational efficiency by railroads at Houston -- have not been addressed by KCS/Tex Mex. It is these uncertainties that have caused several shippers to oppose the imposition of new conditions that could detract from what has been accomplished through the conditions established by the Board.<sup>34/</sup>

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<sup>34/</sup> Says Chrysler: "We see no need for the Board to revise the terms of its merger approval, and we oppose any changes  
(continued...)"



B. BNSF's Request for New Conditions Is Neither Justified Nor Necessary

BNSF seeks additional conditions in this proceeding to further bolster its position in the Gulf Coast area and especially as it relates to South Texas and traffic for Mexico. Most of these new conditions are of an operational character and will be considered by other witnesses but their competitive and broader public implications must also be considered. From an economic standpoint, all should be tested by four criteria: (a) do they deal with effects of the merger as distinct from an array of operating issues which are of a type that routinely arise when railroads are sharing common facilities; (b) would they help solve operational problems from the standpoint of all the railroads involved or simply shift about the burden, perhaps minimizing it for BNSF but increasing it for UP; (c) would they favor BNSF and thereby constrain UP's competitiveness, impairing realization of the goal of two strong, equally-postured railroads in the West; and (d) would the proposed conditions produce net public benefits, with all their impacts taken into account?

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<sup>34</sup>/ (...continued)

that would interfere with the benefits the merger has brought." See also the statements of Cascade Steel, Exxon ("we believe the conditions imposed by the STB to maintain competition have been effective"), Lubrizol, MMM ("3M feels there is no need to impose further conditions on the UP/SP merger"), and Volkswagen. (These statements are in UP's Second Annual Progress Report, July 1, 1998. Also see the September statements of the Ag Partners, APL and Shintech, among many others.)

(1) The Board's Conditions Have Benefitted BNSF and Allowed It to Compete Effectively for Laredo and Other Traffic

BNSF has enjoyed robust growth and made great progress in contesting against UP for traffic throughout the area that would be affected by its proposed conditions. In this proceeding, however, it seeks to convey the impression that its competitiveness is being "thwarted" by various "structural deficiencies" and a lack of a Tex Mex cooperation (meaning its unwillingness to agree to the revenue division share that BNSF would like) (BNSF July 8 filing at 5, 8-10). It is hard to square this assessment with BNSF's impressive record of growth.

While BNSF's July 8 filing speaks of the handicaps with which it feels it is burdened, only a week earlier -- on July 1 -- it submitted its Quarterly Progress Report and presented extensive data demonstrating the steep upward growth of its trackage rights traffic (see graphs and tables in its numbered Attachments). Over all the trackage rights lines BNSF has sharply increased its loads (and tons), including movements that are the subject of its instant proposals, particularly its interchange with Tex Mex for Laredo (and other destinations).

The most recent data, extended through July 1998 and presented earlier in Exhibit 3, show that month-by-month through July, comparing loads handled in 1998 vs. 1997, BNSF has been making increasingly intensive use of its trackage

rights. Loads moving over BNSF in July were up substantially for traffic moving south (for the interchange with Tex Mex for Laredo) and via Eagle Pass. Loads moving by BNSF over the Algoa/Corpus Christi/Robstown Line in July 1998 were up a third over July 1997.

Despite the recent and now-ended service problems that enveloped BNSF (and UP and Tex Mex), BNSF concludes in its July 1 Quarterly Progress Report that it "has been able to increase its traffic volumes," that its traffic volumes over the lines to which it received access as a result of the merger "continue to grow," and that "it expects that these traffic volumes will continue to increase" (*id.* at 60). While the service emergency no doubt had some constraining effect on BN, as it certainly did on UP, the traffic data show that BNSF does not need further conditions to allow it to continue as a viable competitor of UP.

- (2) BNSF's Divisions Dispute With Tex Mex Does Not Warrant Resolution Through a New Board Imposed Condition

BNSF states that the KCS-TMM Joint Venture Agreement has been "only recently disclosed" and that it was not aware of it until March 1998 (BNSF filing at 9 n.2).<sup>35/</sup>

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<sup>35/</sup> In fact, the December 1995 Joint Venture Agreement between KCS and TMM was disclosed in 1996. I quoted from it and discussed it in Rebuttal Testimony in the UP/SP merger proceeding (UP/SP-231, Tab 3 at 78-79, Apr. 29, 1996).

It is BNSF's position that without a long-term divisions agreement acceptable to it the BNSF-Tex Mex routing cannot be competitive with UP at Laredo (BNSF July 8 filing at 8). The merit of this claim is clearly drawn into question by the large and growing volume of traffic which BNSF has interchanged with Tex Mex for Laredo. This, it should be borne in mind, has been the case during an extended period of time when the revenue division supposedly has constrained BNSF's competitiveness.

competitiveness for BNSF via the Tex Mex/Laredo connection, despite its desire for a bigger division.

Although BNSF says that there have been "instances" (none are identified) where it has had to turn away business because of the divisions provided by Tex Mex (BNSF filing, Rickershauser VS at 32),

These examples indicate that BNSF has successfully used its Tex Mex interchange to build traffic over Laredo even though it gets a smaller division that it would prefer.

Revenue division disputes are as old as the railroad industry and there is hardly anything unique about the ongoing BNSF-Tex Mex dispute. If the parties cannot reach a settlement, then, in the present context, it would seem to make sense for them to ask the Board to intervene so as to preserve the integrity of the conditions it imposed.

The existing conditions have worked well but if the divisions matter needs resolution, the Board might well make a useful contribution. Instead, BNSF appears to have come to the position that it would be in its interest to pronounce the division dispute dead and largely to sever its interchange with Tex Mex, shifting 90% of the traffic it has handled with Tex Mex (including all Laredo traffic) to the UP San Antonio-Laredo route over which it now seeks trackage rights.<sup>36/</sup> This may imply BNSF frustration or reflect a commercial assessment that there is more revenue to be gained, none of which would have to be divided by seeking a condition allowing it to access the UP Laredo line. Whatever the motivation, advancement of BNSF's self-interest is not the standard by which to judge the merit of the new condition it seeks.

- (3) BNSF's Request That by Condition It be Given Trackage Rights Over UP's San Antonio-Laredo Line Should be Rejected Since It Does Not Replicate Pre-Merger SP Competition

In seeking trackage rights over UP between San Antonio and Laredo, BNSF is not replicating SP's pre-merger competition. SP did not operate over this line. It competed against UP via its interchange with Tex Mex and here the Board substituted BNSF for SP. BNSF has been moving more traffic over this routing than did SP, and, contrary to the claim that it has been handicapped in competing at Laredo against UP,

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<sup>36/</sup> The 90% figure is from BNSF's July 8 filing. Brown VS at 1, and Attachment 1 at 1-2.

BNSF has increased its interchange volume with Tex Mex -- materially helping Tex Mex gain a larger share of cross-border Laredo movements. BNSF's use, and continued robust use, of Tex Mex for Laredo traffic has taken place despite its ongoing debate with Tex Mex as to divisions.

The "post merger" developments to which BNSF refers do not stem from any inherent infirmity of the Tex Mex interchange routing for Laredo. Rather, they trace to the divisions dispute, which BNSF now would have the Board "solve" by giving it rights to operate over a heavily-used UP line along which SP never operated prior to the merger. This would benefit BNSF, for it would be enabled to offer a new service -- subject to the congestion problems that no doubt would affect both it and UP (other witnesses deal with this in more detail) -- that did not exist pre-merger. As such, the proposed condition is not aimed at addressing a harmful effect of the merger but at providing a draconian "remedy" for the failure of BNSF and Tex Mex to settle privately their division disagreement. That is what is at the root of BNSF's complaint and it is here where the Board's intervention might constructively be sought.

Relying instead on the conditioning process -- inferentially urging that a major condition be added even where it is not pointedly addressed to an effect of the merger but calls for the institution of a new, non-replicative service -- does not protect competition from harm caused by



that transaction. The effect here also would be to undermine the conditions that the Board imposed to bolster Tex Mex and make it, with BNSF, a stronger competitor at Laredo. By shifting 90% of the traffic it has interchanged with Tex Mex to its proposed trackage rights over the UP line BNSF would negate the Board's conditioning strategy.<sup>37/</sup> Invoking the Board's aid in bringing the division controversy to resolution is by far the preferable approach. Whether or not that course of action is pursued, there is no justification for BNSF's request for a condition giving it rights over the UP line to Laredo.

(4) The BNSF Proposal for Trackage Rights Over UP's Line to Laredo Would Divert \$103 Million From UP and Reduce Public Benefits

By BNSF's own estimate, the effect of giving it trackage rights over UP's line to Laredo would be to divert to it \$102.8 million from UP (BNSF July 8 filing, Brown VS, Attachment 1).<sup>38/</sup> Further, 90% of BNSF/Tex Mex 1997 interline traffic (13,297 cars out of 15,510) would be

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<sup>37/</sup> If BNSF's request were granted, it would also divert traffic from Eagle Pass to Laredo. Since a different Mexican railroad handles Eagle Pass than the one serving Laredo, the effect would be to harm intra-Mexico rail competition. This is of concern not just in terms of Mexican policy, which seeks to encourage rail competition, but also to American shippers who benefit from intra-Mexico rail competition. See Ferromex VS.

<sup>38/</sup> BNSF, by its diversion estimate, would take up to 50% of UP's present merchandise traffic moving over Laredo for the West, 50% of auto traffic moving from Mexico into the West, and 30% of UP intermodal traffic at Memphis, St. Louis, and Chicago. Brown VS, Attachment 1.

diverted to the new BNSF direct route. BNSF would gain \$4.3 million in annual revenue by diverting the Tex Mex interchange traffic.<sup>39/</sup>

These obviously are significant revenue gains for BNSF, but they represent private bounty. No claim is made that there will be any companion public benefits. However, UP's merger public benefits would necessarily be reduced since its traffic would decline. The economy ends up the loser.

III. THE NEW CONDITIONS PROPOSED BY KCS/TEX MEX AND BNSF ARE NOT ONLY UNJUSTIFIED AND UNNECESSARY BUT THEY WOULD IMPEDE PROGRESS TOWARD ACHIEVING TWO STRONG RAILROADS IN THE WEST

The UP/SP merger conditions imposed by the Board in Decision No. 44 have worked well in achieving their twin goals: remedying possible competitive harms of the transaction and laying a foundation for expanded competition. No new harms attributable to the merger have been discovered. BNSF is aggressively exploiting its trackage rights which gave it route parity with UP as well as competitive access to more traffic. The share of traffic at Houston and in the Gulf Coast Area for BNSF has increased; UP's has declined and UP has clearly gained nothing vaguely resembling market power;

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competition via Tex Mex at Laredo and via BNSF at other Mexico border crossings has intensified; and robust rate competition is now commonplace. In all these respects the conditions have worked well, very well indeed.

There is, though, one remaining competitive concern: the need for UP to catch-up with BNSF so that there will be two strong, well-balanced rail systems in the West at the earliest achievable time. Though UP has been weakened by the service crisis, the merger's potential remains as favorable as it was when it was approved by the Board in 1996 (see generally Decision No. 44 at 108-16). Integration of UP and SP routes will realize network economies as sub-system components are improved and internal synergies are optimized. This, though, will require massive capital spending, as was expected when the merger was proposed. What was not expected, however, was that serious transitional problems would develop, as they did late in 1997 and extending into 1998. These have had unanticipated adverse financial implications that have slowed progress in turning the merger's integration potential into greater efficiency, better service, and stronger competitiveness.

Creation of a strong two-carrier Western line-haul rail system -- with UP and BNSF each postured to contest from equal positions of strength -- was viewed as a goal that the UP/SP merger could achieve, with pro-competitive results. Two-carrier competition had led to lower rates under

deregulation (Decision No. 44 at 117) and the UP/SP merger was expected to create "a more efficient and competitive UP/SP rail system competing head-to-head throughout the West with BNSF, whose efficiency was greatly enhanced by its recent merger" (*id.* at 108). The two roads, though, had to be brought to parity.

BNSF was on solid footing to begin with, having brought together two roads (BN and ATSF) that were already financially well off. The UP/SP merger, by contrast, combined a weak SP (probably even weaker than was commonly thought) with a better-off UP that, though possessing many good routes, also had some important system gaps (it had no direct route in the Southern Corridor, for example, nor a direct north-south route in the Pacific Coast/I-5 corridor). The UP/SP merger (and the settlement agreement and the Board's conditions) filled in the principal route deficiencies of both UP and BNSF, but it left UP with a formidable challenge: it had to catch-up with SP's cumulative investment shortfall (its investment had lagged far behind the growth in its chemical and other traffic). And it had to put in place new investment needed to tap the potential of the consolidation.

When the UP/SP merger was approved it was understood that large-scale capital investment -- an estimated \$1.3 billion over four years -- would be required just to upgrade SP facilities, create better and more direct routes, and build new terminals and yards (Decision No. 44 at 114). Big though

capital spending would have to be, the assumption was that operating savings (cost economies) achievable through the merger would also be substantial (the Board quantified them at \$534.3 million annually) (Decision 44 at 109). Traffic and revenue would rise, it was projected, while unit costs would fall, resulting -- throughout all the merger's early years -- in "substantial earnings gains" (id. at 176).

These anticipated higher earnings were seen as support for the necessary capital spending that, in turn, would pay-off in better service and lower costs for UP and shippers and in resource-utilization gains for the economy as a whole. Investment is an essential prerequisite to the productivity and efficiency improvements that lower costs, constrain rates, and energize competition.

The recent service emergency knocked all these pleasant assumptions asunder. UP traffic and revenue declined, costs rose steeply, and earnings turned negative. Yet capital spending needs remained unchanged (some no doubt have increased as SP underinvestment effects are more fully identified). In its May 1, 1998 Report on Houston and Gulf Coast Infrastructure (submitted during the course of the Service Order No. 1518 proceeding) UP spelled out in detail the investment it plans to make in the Gulf Coast area (from New Orleans through Houston to San Antonio and south to the Mexican border). Over the next five years total UP capital expenditures in this area alone will exceed \$1.4 billion (\$600

million for capital expansion projects plus \$830 million for program capital projects such as track repair and improvement).

UP's capital spending needs are large and they also spread throughout its system. Because of network effects, investment in all geographic areas is sensitively interwoven, with each component affecting the West overall. Of traffic originated by UP at Houston, for example, a third moves to destinations in the 14-state Midwest and the 11-state Far West and almost half (46%) comes in from those two areas. From the perspective of Houston-area shippers and receivers, UP capital spending elsewhere is thus as important as investment by UP at Houston or in the Gulf Coast area. The same is true of shippers and receivers located in these other areas since they ship to and receive from Houston.

To the extent, therefore, that the new conditions being sought by KCS/Tex Mex and BNSF reduce UP revenue at Houston and in the Gulf Coast area through the special treatment they seek, shippers all over the West will be adversely impacted through the inhibition of UP's investment capacity. The many shippers, states, cities, and legislators -- often from areas outside of Houston and Texas -- who have submitted statements are right to be concerned. Action that would favor BNSF or shippers at Houston would indeed put them at risk due to the geographically-diffused investment-constraining effects on UP.

There is, at the bottom-line, only so much capital for UP to invest and this depends heavily on its revenue-generation. Cut the latter and available investment capacity is reduced and UP investment throughout the West will be hampered.

With capital spending needs holding fast (or escalating), but with recent earning statements in red-ink, UP's task of catching-up with BNSF has become more arduous. Nonetheless, capital spending remains urgent if for the sake of competition there are to be two strong railroads in the West. The earnings pinch recently experienced by UP has taken a toll, making it harder for UP to gain equal footing with BNSF.

This then is another important reason why the conditions proposed by KCS/Tex Mex and BNSF should be rejected. That they are unnecessary and without substantive merit has been explained earlier, but their effects are detrimental to competition itself. Diverting \$155 million annually from UP as KCS/Tex Mex concede, and \$103 million based on BNSF's estimate, would drain off resources that are vital to UP. (UP estimates that some \$768 million of its revenue would be placed at risk, as is explained in the Peterson VS.) It is those resources that support the capital spending UP must make, as quickly as possible, to achieve full competitive vigor and realize the merger's public benefits. The private gains that the Coalition Plan and BNSF's plan

would confer on their proponents thus run counter to competition and to the public interest.



APPENDIX

REGIONAL DEFINITIONS USED IN THIS APPENDIX

<u>North/Northeast</u>	<u>South/Southeast</u>	<u>Midwest</u>
Connecticut	Alabama	Arkansas
DC	Florida	Iowa
Delaware	Georgia	Illinois
Massachusetts	Kentucky	Indiana
Maryland	Louisiana	Kansas
Maine	Mississippi	Michigan
New Hampshire	North Carolina	Minnesota
New Jersey	South Carolina	Missouri
New York	Tennessee	North Dakota
Pennsylvania	Virginia	Nebraska
Rhode Island	West Virginia	Ohio
Vermont		Oklahoma
Ontario		South Dakota
Quebec		Wisconsin
Nova Scotia		

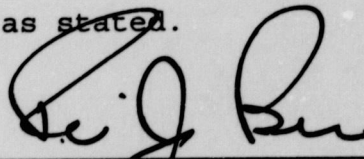
<u>Far West</u>	<u>Other</u>
Arizona	British Columbia
California	Alberta
Colorado	Miscl.
Idaho	
Montana	
New Mexico	
Nevada	
Oregon	
Utah	
Washington	
Wyoming	

HIGHLY CONFIDENTIAL  
APPENDICES NOT PROVIDED

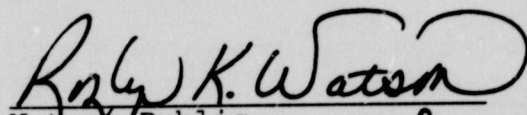
VERIFICATION

DISTRICT OF COLUMBIA        )  
  ) ss.  
CITY OF WASHINGTON         )

I, Richard J. Barber, being duly sworn, state that I have read the foregoing statement, that I know its contents and that those contents are true as stated.

  
\_\_\_\_\_  
RICHARD J. BARBER

Subscribed and sworn to before me this  
17<sup>th</sup> day of September, 1998

  
\_\_\_\_\_  
Notary Public  
My Commission Expires: 1/31/2001



VERIFIED STATEMENT

OF

RICHARD B. PETERSON

My name is Richard B. Peterson, and I am Senior Director-Interline Marketing of Union Pacific Railroad Company. In the UP/SP merger proceeding, I provided lengthy opening and rebuttal verified statements, filed on November 30, 1995 (UP/SP-23) and April 29, 1996 (UP/SP-231), analyzing the potential competitive impacts of the merger and the appropriateness of various conditions to address those impacts. I was also responsible for the preparation of, and personally verified, the portions of UP's two annual merger oversight reports that addressed competitive issues and the effectiveness of the conditions that were granted to BNSF and Tex Mex in the merger decision.

This statement has four parts:

Part I addresses the strength of competition in the West, and particularly in the Houston/Gulf area, following the merger. It briefly reviews the comprehensive information in our annual oversight reports showing that the BNSF and Tex Mex conditions have been highly effective, and that competition for all categories of competitively-relevant traffic has remained strong, and indeed been intensified in many ways. I provide supplemental information about the intensity of competition at the Eastern Mexico gateways, and of source competition for Gulf Coast chemicals. Finally, I address the

testimony of KCS/Tex Mex witnesses Grimm and Plaistow concerning UP's share of traffic in the Houston BEA, and demonstrate that they are quite wrong in claiming that UP has a rail monopoly, or anything remotely approaching it, in this geographical area.

Part II shows that none of the conditions that have been requested in this proceeding are necessary to preserve pre-merger competition.

Part III presents data concerning the amount of UP revenue that would be exposed to loss if the conditions were granted.

Finally, Part IV discusses UP's recent traffic and financial losses as a result of the service crisis that occurred during the past year, and the harmful impact on rail infrastructure investment that would result if the proposed conditions were granted.

I. COMPETITION WAS NOT REDUCED BY THE MERGER

A. The Merger Has Not Reduced Competition in the West, or, in Particular, in the Houston/Gulf Area

Our two annual oversight reports contain very comprehensive data showing that competition has remained strong in the West following the UP/SP merger, and has in fact been intensified in many ways, ranging from major reductions in reciprocal switch charges to major improvements in equipment supply and utilization. These reports review each category of traffic that was of concern to the Board in the

merger case -- "2-to-1" traffic, "3-to-2" traffic, Mexican gateway traffic, source competition constraints applicable to "1-to-1" traffic -- and show that they remain subject to strong, and in many ways intensified, competition.

For "2-to-1" traffic, our reports describe the continuing, dramatic growth in BNSF trackage rights (and haulage) volumes. (Charts updated with data for June and July of this year are attached to this statement.) As detailed in the reports, BNSF is operating regular, fully competitive train service in all the principal corridors where it received rights, including, specifically, all trackage rights corridors radiating from Houston. Its share of the relevant traffic, by its own account, is approaching 50%. The reports' Confidential Appendices lay out extensive, specific information about (a) traffic movements, including many in the Houston/Gulf area, that BNSF has captured using its rights, and the benefits that shippers have received from this competition, and, just as importantly, (b) traffic movements, again including many in the Houston/Gulf area, that UP has retained in vigorous competition with BNSF, and the benefits that shippers of these movements have received. The Confidential Appendices show that UP's rates for "2-to-1" traffic have fallen.

For "3-to-2" traffic, our reports also demonstrate strong post-merger competition. As detailed in Appendix K to



each annual report, each of the major automakers, for example, has negotiated much-improved contracts with either UP or BNSF which reflect the greater competitiveness of both UP and BNSF following the merger and the award of new routes to BNSF as conditions to the merger. As with "2-to-1" traffic, our rates for "3-to-2" traffic are down post-merger.

The reports also show that, following the merger, competition has been strong for Eastern Mexico gateway traffic, and source competition has remained strong. With regard to Eastern Mexico traffic, the reports detail numerous major traffic movements that BNSF has handled to and from Mexico using its new rights, particularly its trackage rights to the Corpus Christi/Robstown interchange with Tex Mex for Laredo traffic. They also show that Tex Mex has handled substantial volumes over the trackage rights it received to interchange with KCS at Beaumont.<sup>1/</sup> UP's rates for Eastern Mexico traffic are down since the merger. With regard to source competition, the reports show that UP's rates for chemicals have fallen since the merger, and the Confidential Appendices detail many chemical movements that BNSF has

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<sup>1/</sup> Tex Mex trackage rights volumes are down somewhat in recent months, though they are still substantial and reflect major growth since the merger. The recent decrease reflects a general drop in Laredo business as a result of international economic conditions and greatly reduced grain traffic due to poor market conditions and seasonal factors. UP's Laredo business fell from 8,182 cars in March of this year to 6,965 cars in July, at the same time as Tex Mex trackage rights volumes were declining.

handled to and from "2-to-1" points. I provide still further new data concerning Eastern Mexico gateway competition and source competition below.

This proceeding relates to the Houston/Gulf area, and it bears stressing that BNSF, with the rights it received in the merger, is particularly well situated to compete in this area. As the accompanying map shows, BNSF already had a massive network of lines spanning the West and many support facilities in the Houston/Gulf area, including at Temple, Houston, Cleveland, Silsbee and Beaumont. The rights granted to BNSF -- access to Houston/Gulf "2-to-1" points, Houston/Gulf corridors and gateways, and Mexican crossings -- connected efficiently with BNSF's huge existing Western network and benefitted from the close proximity of BNSF's many existing support facilities. BNSF gained key routes that it had been lacking: direct routes from Houston to New Orleans, to Memphis/St. Louis, and to Brownsville via Corpus Christi. The result was extraordinarily effective competition in the Houston/Gulf area, which only BNSF was situated to provide.

B. Eastern Mexico Gateway Traffic

To supplement our annual reports, we have conducted further studies of Eastern Mexico gateway traffic. In the relatively short time since the merger was approved, BNSF has proven itself to be an effective competitor at each of the three Eastern Mexico gateways to which it received rights in

the settlement agreement. After only two years, BNSF is already providing a stronger alternative than SP with respect to the combined traffic moving over all three gateways, and particularly over Laredo, the principal rail gateway between the United States and Mexico. It is also moving substantial amounts of traffic to Brownsville using haulage rights obtained in the settlement agreement, and has moved quickly using the enhanced access to Eagle Pass that it gained through the merger to increase greatly its traffic moving over that gateway.

The strength of post-merger competition for Eastern Mexico traffic can most easily be appreciated by comparing pre- and post-merger traffic shares at each gateway. At Laredo, for example, in the January through July 1996 period, Tex Mex's share of total Laredo crossings was 21.0% southbound and 0.5% northbound. In the January through July 1998 period, those shares were much higher -- 36.9% and 4.7%. Combining northbound and southbound, Tex Mex's share increased from 13% to 25%.

This dramatic increase in Tex Mex's share of Laredo traffic has occurred because traffic moving over the BNSF-Tex Mex interline route and the Tex Mex trackage rights between Beaumont and Corpus Christi/Robstown, both of which resulted from the merger, have more than replaced the traffic that SP and Tex Mex interlined before the merger. The grant of Tex

Mex trackage rights to Beaumont may have generated some tension between BNSF and Tex Mex, but the simple fact is that, as both BNSF and Tex Mex admit, the BNSF-Tex Mex interline route alone is handling more traffic than SP-Tex Mex were handling before the merger. In other words, BNSF has fully replaced SP as a competitor for the Laredo gateway, and Tex Mex has benefitted even further from the steady growth of Tex Mex-KCS interline traffic.

Ignoring the evidence that BNSF alone has already replaced SP as a competitor for interchange traffic with Tex Mex, KCS/Tex Mex witness George Woodward argues that UP now "dominates" Laredo, and that unless the package of rights KCS/Tex Mex seek is granted, UP will be left with an 85.6% share at Laredo. See KCS-2, Woodward V.S., p. 223. Woodward's market share estimates are based on an unexplained and unsupported model, and are demonstrably incorrect. As the data above show, UP's share of southbound Laredo traffic is in fact only 63.1%, and UP's share of total Laredo traffic is 75.3% -- well below Woodward's estimate.

BNSF is also proving itself to be an effective competitor at Brownsville. For example, in the January through July 1996 period, SP's share of total Brownsville crossings was 17.0% southbound and 40.3% northbound.<sup>2/</sup> In

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<sup>2/</sup> The high northbound share was largely the result of a General Motors parts movement that has been under contract.  
(continued...)

the January 1998 through July 1998 period, BNSF had already more than replaced SP for southbound moves, with a 26.3% share of the traffic, and although its share of the much smaller northbound flow was only 6.7%, its total traffic share was 21.7% in the January through July 1988 period, compared with SP's 25.0% in the January through July 1996 period. As detailed in our annual oversight reports, BNSF has been very aggressive and successful in moving grain products to Mexico over the Brownsville gateway.

BNSF has also developed into a formidable competitor at the Eagle Pass gateway. Although Eagle Pass was not a "2-to-1" gateway like Laredo or Brownsville, UP agreed as one of the "quid-pro-quo" elements of the settlement agreement to upgrade BNSF's access to Eagle Pass by providing it with trackage rights to replace the haulage rights it had previously obtained from SP. BNSF's traffic volume at Eagle Pass is well above pre-merger levels -- its traffic increased from 4,143 cars in the first seven months of 1996 to 15,111 cars in the first seven months of this year, and its share of total crossings increased from 4% to 21% between these periods.

At every gateway, the data show that BNSF alone or in combination with Tex Mex is providing intense competition

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<sup>2/</sup>(...continued)

BNSF can readily compete for that traffic when the contract comes up for renewal.

for UP, and is close to equalling, or has already exceeded, the competition SP provided before the UP/SP merger.

A second way to appreciate the post-merger intensity of competition for Eastern Mexico gateway traffic is to study all three gateways together and examine how traffic shares have shifted between 1996, the first seven months of 1998, and July 1998, the most recent month for which data are available. My study of the data confirms that competition at Eastern Mexican gateways remains at least as intense now as it was before the merger, and shows that the intensity of competition is in fact increasing.

In order to perform this study, we first divided the traffic that moved over the gateways into four categories: grain, autos, intermodal and other traffic. Within each category, we subdivided the traffic to indicate whether it was handled to or from the gateway via UP, SP or another combination of carriers (including BNSF, SP-Tex Mex, KCS-Tex Mex, and a small amount of UP-Tex Mex).

We then discarded any traffic that was not competitive at the U.S. end of the move. We assumed that all automotive and intermodal and most grain traffic was competitive. For all other traffic that moved to a gateway via UP or SP, we used actual routing information to determine which movements were competitive. We included as competitive all traffic where the point or junction at the other end of

the movement was served by two or more railroads. For BNSF traffic, we assumed that the percentage of competitive traffic would be equal to the percentage of UP's competitive traffic, given the fact that BNSF's network coverage is comparable to UP's. For KCS traffic, we assumed that 90% of its non-grain traffic was competitive, based on our knowledge of the KCS network, which is more limited than UP's and BNSF's and thus more likely to have traffic-generating points in common with those railroads.

Finally, we calculated the revenue associated with the traffic. Again, for UP and SP traffic, we used actual revenue data. For traffic moving on other railroads, we assigned revenues based on UP's average revenue per car for similar traffic.

The results of this analysis demonstrate that competition for Eastern Mexico gateway traffic remains as strong today as it was before the UP/SP merger. In 1996, UP had a 71% share of the revenues of competitive traffic moving over the gateways, SP had a 21% share, and Tex Mex and BNSF had a 9% share.<sup>2/</sup> In the January through July 1998 period, UP/SP's share was 72%, and Tex Mex and BNSF had a 28% share. In July 1998, UP/SP's share was down to 65% and the other railroads' share had risen 35%.

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<sup>2/</sup> Traffic was assigned based on the railroad serving the gateway.

The study results demonstrate that competition for Eastern Mexico gateway traffic has intensified since the merger, and they also demonstrate that the competition is poised to become even stronger in the future. For example, in 1996, UP and SP moved 74% and 26%, respectively, of high-revenue auto traffic. In post-merger periods, UP has moved virtually all of this traffic. But BNSF has recently taken steps that make clear it is targeting this traffic -- acquiring 1,100 tri-level autoracks and 600 bi-levels to go after upcoming contract movements -- and there is no reason why it could not capture a large share of this traffic from UP. Similarly, UP's share of intermodal traffic to the gateways is presently 100%. However, Tex Mex is completing the construction of a new intermodal facility at Nuevo Laredo, and this new facility will clearly reduce UP's share of intermodal traffic to Eastern Mexico gateways, and is working with KCS, CN and IC to capture automotive traffic.

Finally, it should be noted that rate data confirm the continued intense competition for Eastern Mexico gateway traffic. UP's revenues per ton-mile for traffic moving over these gateways experienced significant declines in the year after the merger, and, as we reported in the Confidential Appendices in the second annual oversight report, UP's revenue per ton-mile for Eastern Mexico gateway traffic in the second



year following the merger either held at this lower level, or for some types of traffic fell even further.

C. Source Competition for Chemicals

We have also conducted supplemental analyses of source competition, a particular focus of parties like SPI (which is part of the so-called "Consensus Group").

Our new studies confirm that the UP/SP merger did not cause an increase in UP's market power by reducing source competition. In fact, source competition -- including in particular source competition for Gulf Coast chemicals, a prominent concern of merger opponents -- increased as a result of the merger and remains strong two years later.

In my verified statement in the Application, I explained that UP/SP competitors would have wide access to Gulf Coast chemical production following the merger, keeping source competition strong. Indeed, the merger and the settlement with BNSF would increase source competition. The shorter routes, improved transit times, wider single-line service, and lower costs resulting from the merger, along with new access to shippers and new routes BNSF gained in the settlement agreement, would allow consumers to draw economically upon a wider range of suppliers, and would allow producers to market their goods economically to a wider range of buyers. This improved and expanded shipper access to rail service increases source competition, because UP must price

its services to take account of the additional competitive options available to shippers and receivers.

My analysis has proven correct, as demonstrated concretely by the many examples of new source competition contained in the Confidential Appendices that Applicants have submitted with their annual oversight reports. See UP/SP-345, July 1, 1998; UP/SP-304, July 1, 1997. The Confidential Appendices, which were compiled by me and my staff, are replete with examples of producers and receivers on both the UP/SP and BNSF systems that are now able to reach new consumers or rely upon new suppliers and thus generate new competition in those markets.

To respond to assertions that the merger would enable UP to "monopolize" Gulf Coast chemical shipments and thus harm source competition, I provided in my initial verified statement an exhaustive analysis of every major Gulf Coast chemical product. Our analysis of those commodities confirmed what UP knew to be the reality of the marketplace -- that after the merger UP would not have market power over any of those products. Our analysis showed that even where UP would account for a significant percentage of Gulf Coast rail originations of a product, it would face continual competitive pressure from other rail, water, pipeline, truck and source alternatives. I explained that UP would be forced to remain competitive by (1) substantial direct competition from other

Gulf Coast rail carriers; (2) substantial competition from other Gulf Coast non-rail carriers; (3) the fact that chemicals produced in the Gulf Coast represent only a fraction of total U.S. chemical production; (4) leverage available to Gulf Coast chemical producers through contracting and "swapping" to reduce transportation costs; and (5) the fact that the destinations for Gulf Coast chemicals would continue to have non-UP rail sources for chemicals. In the entire course of the merger proceeding, this comprehensive, detailed study was never even addressed, much less refuted, by any of the merger opponents.

The pivotal point for our analysis was the basic fact that, after the merger, rail carriers other than UP, as well as non-rail transporters, would continue to have access to substantial volumes of the commodities at issue, from both Gulf Coast and other North American sources. We demonstrated, for example, that while UP and SP together moved 69% of Gulf Coast polypropylene capacity and 67% of polyethylene capacity, other railroads would have access to 62% of Gulf Coast polypropylene capacity and 62% of polyethylene capacity. We also demonstrated that for 12 of the 18 chemicals we studied, other railroads would have access to 4 % or more of Gulf Coast capacity, and that for 17 of the 18 chemicals we studied, other railroads would have access to 40% or more of North American capacity. Moreover, these numbers understated other

carriers' access to Gulf Coast shippers, because all shippers have access to truck, and many can use water carriers and pipelines. In fact, in 1994, for all but 4 of the 18 chemicals, UP shipped less than 50% of Gulf Coast capacity.

UP's witness John L. Peterman explained with specific reference to the two highest-volume Gulf Coast chemical products -- polyethylene and polypropylene -- why the extensive access by other carriers that would remain after the merger would prevent UP from obtaining any market power over shipments of these products. Messrs. Barber and Spero also submitted testimony explaining why source competition would remain strong after the merger.

In its decision approving the UP/SP merger, the Board agreed with Applicants' evidence that the merger would not harm source competition. See Decision No. 44, p. 126. The decision was correct then and it remains correct today.

To demonstrate that source competition has not diminished in the two years since the merger, we have revisited and updated our original study using 1998 data from SRI and the July 1, 1997-June 30, 1998 traffic tapes created for the second annual oversight proceeding. The updated data show that for most chemicals, including the two most significant Gulf Coast chemicals we addressed in our initial study -- polyethylene and polypropylene -- the share of Gulf Coast capacity that UP actually moved has fallen since the

merger, and the amount of capacity open to other rail carriers has increased.

For example, UP actually moved only 36% of Gulf Coast polypropylene capacity and 56% of polyethylene capacity, according to the most recent data. These data show that other railroads have access to 68% of Gulf Coast polypropylene capacity and 62% of polyethylene capacity. For 13 of the 18 chemicals we studied (one more than for 1994), other railroads have access to 40% or more of Gulf Coast capacity, and for 17 of the 18 chemicals we studied (the same number as for 1994), other railroads have access to 40% or more of North American capacity. As in our earlier study, these numbers understate other carriers' access to Gulf Coast shippers, because all shippers have access to truck and many can use water carriers and pipelines. Data from the first six months of 1998 show that for 16 of the 18 chemicals we studied (two more than for 1994), UP shipped less than 50% of Gulf Coast capacity.

In other words, it is just as true today as it was when the Board decided the merger case two years ago that the merged UP system cannot "monopolize" Gulf Coast chemical traffic. In fact, the UP/SP share of shipments in relation to Gulf Coast capacity fell between 1994 and the year ended June 1998 for all but three of the chemicals studied. Carriers other than UP continue to have access to a very large portion of Gulf Coast chemical production. In fact, source

competition was increased when UP granted BNSF access to shippers on the SP line between Houston and Lake Charles and the associated branches. Also CSX has recently opened a truck-rail chemicals and plastics service for Texas/Louisiana Gulf shippers via a bulk intermodal facility in New Orleans, and NS recently inaugurated intermodal service via its new facility located on the KCS at Port Arthur, Texas, in the midst of the Gulf Coast chemical territory. Thus, source competition for chemicals continues to flourish.

Shippers recognize the continuing intensity of source competition for Gulf Coast chemical products. For example, in its statement submitted with this filing, Shintech -- a UP-exclusive chemical shipper located near Dow in Freeport, Texas -- states that "UP has committed to keeping us competitive with other shippers in our industry, even though we are a captive shipper on their line." This is the essence of source competition -- if UP does not keep Shintech competitive, other railroads will handle more of same products that Shintech produces and UP will lose business.

As another example, UP recently established new lower prices, volume incentives, and a contractual service guarantee to allow

traffic had been moving via BNSF from a PTRAserved facility in Houston.

As still another example, UP recently reduced its rates on

moving BNSF-Conrail from Houston.

In addition, UP frequently establishes prices on shipments to the Southeast to allow

UP recently reduced rates on

to compete against Eastern sources for

The intensity of source competition is also reflected in the decisions of shippers that have expanded their facilities at UP-exclusive locations since the merger. Amoco, for example, decided to expand its UP-exclusive plant at Chocolate Bayou, Texas, rather than expand jointly-served plants at other locations.

The bottom line is that competition for Gulf Coast chemicals traffic continues to be strong. As reported in UP's second annual oversight report, rates for Gulf Coast plastics

traffic are down for the second straight year. And after falling substantially in the first year following the merger, UP rates for other Gulf Coast chemicals remained steady this past year. Continuing intense source competition has been an important factor in keeping these rates low.

D. Houston BEA Traffic

KCS/Tex Mex witnesses Grimm and Plaistow submit a study which they claim shows that UP has a virtual monopoly of traffic in the Houston BEA. Using data for rail originations in that BEA in 1994, 1996 and the second half of 1997, they contend that UP/SP has very high shares -- generally, 80% or more -- of traffic moving between the BEA and certain destination regions, and that these shares barely changed between 1994, 1996 and the second half of 1997. The conclusion they draw is that UP has a virtual monopoly of rail traffic in the area, and that this is dramatically confirmed by the fact that UP's share barely budged during a severe service crisis.

Mr. Barber explains, and I emphatically agree with him, that it is incorrect to view the Houston BEA as a rail transportation market. The Board analyzed the relevant markets correctly in the merger decision. One must consider separately -- because they are affected in fundamentally different ways by the merger transaction -- "2-to-1" traffic, "3-to-2" traffic, and "1-to-1" traffic (for which source



competition is a relevant consideration). We have done that in our annual reports, as supplemented here, and that proper analysis conclusively demonstrates that the merger did not reduce competition for any rail traffic. The Grimm/Plaistow supposed Houston BEA "rail market" is not a market at all, and looking at shares of traffic in that geographical area can at best provide weak and secondary evidence of the effects of the merger on competition.

That said, it is also clear that the Grimm/Plaistow analysis of this geographical area is quite wrong. Mr. Barber, who had access to "Highly Confidential" BNSF, Tex Mex and KCS traffic tapes that I was not permitted to see, explains the many flaws that riddled the Grimm/Plaistow study. He shows that UP's shares of traffic in the Houston BEA in fact did drop significantly during the service crisis. Correcting data errors of Grimm and Plaistow, and looking at all traffic (originations and terminations, to and from all points), and at the more relevant period of January-June 1998, he shows that:

- The UP/SP share of Houston BEA rail originations fell eleven percentage points, from 80% in 1994 to 69% in January-June 1998.

- The UP/SP share of Houston BEA rail terminations fell five percentage points, from 64% in 1994 to 59% in January-June 1998.

- And the UP/SP share of all Houston BEA rail traffic fell seven percentage points, from 70% in 1994 to 63% in January-June 1998.

Even these reductions fail to account for the traffic losses that we experienced through "short-hauling," in which we agreed to hand over traffic to our competitors at nearby junctions in order to reduce congestion on UP lines.

This alone undermines the Grimm/Plaistow conclusions, because it shows that UP did lose a substantial percentage of its Houston BEA traffic to BNSF and Tex Mex during the service crisis. But we have taken Mr. Barber's analysis one step further. We have examined the traffic that UP handled in the January-June 1998 period and have broken that traffic down between traffic that was exclusively served by UP in the Houston BEA, and traffic that was competitive (including traffic to and from "2-to-1" points; "3-to-2" traffic on PTRA and HBT and at Texas City and Galveston; and intermodal and automotive traffic, all of which is rail-competitive). The results, which are set forth in detail in the accompanying table, show that 42% of UP's Houston BEA originations in January-June 1998, 62% of its terminations, and 52% of its overall traffic was directly competitive with other railroads.

What this analysis, together with Mr. Barber's data, implies can be stated in simple terms: Of all rail traffic in

STB FD 32760 (Sub 26) 9-18-98 B. 191210V2 3/5

**Analysis of UP Houston BEA Traffic Handled in the First Half of 1998**

	Originated				Terminated				Total			
	Units	%Units	Tons	%Tons	Units	%Units	Tons	%Tons	Units	%Units	Tons	%Tons
"1-to-1"	95,628	45.0%	8,268,310	58.6%	67,346	28.5%	6,084,211	38.1%	162,974	36.3%	14,352,521	47.7%
"2-to-1"	8,679	4.1%	752,028	5.3%	25,133	10.6%	2,564,106	16.0%	33,812	7.5%	3,316,134	11.0%
"2-to-2"	1,876	0.9%	167,817	1.2%	15,230	6.4%	1,629,115	10.2%	17,106	3.8%	1,796,932	6.0%
"3-to-2"	91,608	43.1%	3,641,265	25.8%	116,978	49.4%	4,777,166	29.9%	208,586	46.4%	8,418,431	28.0%
2/98 Agt	14,700	6.9%	1,291,510	9.1%	11,889	5.0%	921,216	5.8%	26,589	5.9%	2,212,726	7.4%

the Houston BEA, only about a third is exclusive to UP.

Another third was handled by UP, but open to direct competition from other railroads. And the final third was handled by other railroads.

This is clearly not the picture of a monolithic, unbudgeable monopoly that Messrs. Grimm and Plaistow try to paint. Even if the entire Houston BEA were viewed as a single rail market -- and it is not properly so viewed -- UP does not come remotely close to having a monopoly in that market.

## II. PROPOSED CONDITIONS

In this part of my statement, I address the principal conditions that are being sought in this proceeding and explain, I hope succinctly, why each is unnecessary to preserve pre-merger competition, and in fact would improperly add competition, in violation of the Board's fundamental policy as to the conditioning of rail mergers.

BNSF. BNSF's request for single-line access to Laredo very clearly constitutes new competition, not the preservation of pre-merger competition. Before the merger, UP had a single-line route to Laredo, and the joint-line SP-Tex Mex route provided the only alternative. The Board preserved that alternative by granting BNSF trackage rights to Corpus Christi/Robstown to interchange with Tex Mex, and it even went further and gave Tex Mex a connection with KCS at Beaumont.

Direct BNSF rights to Laredo would inject entirely new competition that never existed before.

BNSF also advances a number of requests for shorter or alternative routes. While these rights would certainly make BNSF more competitive, none of them are necessary to preserve the pre-merger level of competition. BNSF's request for trackage rights between Taylor and Milano, Texas, is a good example. The rights that BNSF received in the merger decision, from Kerr to Taylor to Smithville to its own system at Sealy, amply preserve the quality of competition that SP provided prior to the merger for Georgetown Railroad stone traffic bound to the Houston area. The Milano rights would give BNSF a second route, and would allow BNSF to gain much more efficient access to stone destinations northeast of Houston, in the Beaumont-Silsbee area, where SP provided no competition before the merger.

As described in more detail in the testimony of our operating witnesses, the same analysis applies, for example, to BNSF's requests for permanent, bidirectional rights between Caldwell, Flatonia and San Antonio/Placedo; for automatic directional trackage rights whenever UP shifts to directional running in any area throughout the West where BNSF already has trackage rights over a UP line; and for rights over every UP line in the Houston terminal.

B. KCS/Tex Mex

KCS/Tex Mex's "neutral switching" plan for the Houston area -- under which PTRA would acquire effective ownership of numerous UP lines in Houston and between Houston and Galveston and switch all the traffic on those lines for Tex Mex and BNSF as well as UP -- is a sweeping "open access" proposal that does nothing but add competition that is unnecessary to prevent any adverse competitive effect of the merger. It would convert hundreds and hundreds of solely-served and jointly-served facilities to service by three railroads. That is all that need be said to show that it is completely outside the proper scope of merger conditions. More details about the affected traffic and the huge potential cost of this proposal to UP are provided in Part IV below.

The Houston-north rights that KCS/Tex Mex seek have never been competitively justified, which is why the Board has rejected them three times. PTRA and HBT traffic, which went from three serving railroads (UP, SP and BNSF) to two (UP/SP and BNSF), like all other "3-to-2" traffic, gained stronger, not weaker competition. (The same point applies to DuPont's request for access to Tex Mex for its facility at LaPorte.)<sup>4/</sup>

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<sup>4/</sup> KCS/Tex Mex argue that without Houston-north rights Tex Mex will be unable to compete for Houston traffic moving to Laredo, because it will be unable to bid for an entire "package" of a shipper's business. However, as I explained in my testimony in the merger proceeding, as well as in prior cases, it is shippers, not railroads, that control what

(continued...)

Finally, KCS/Tex Mex's various proposals for forced sales of UP property (the Wharton Branch, Booth Yard in Houston, and a forced "swap" of UP's Beaumont Subdivision for trackage KCS/Tex Mex seeks to build on our Lafayette Subdivision) are all unnecessary to preserve pre-merger competition. The rights granted to BNSF fully preserved -- indeed, intensified -- competition in the Brownsville corridor, in the Houston-New Orleans and Houston-Memphis corridors, and for "2-to-1" traffic in the Houston area, as detailed in our annual reports. Forcing UP to provide its private property to KCS/Tex Mex for use in synthesizing a much-expanded railroad have nothing to do with preserving pre-merger competition.

C. Dow, Formosa, CP&L

These three shippers all seek BNSF access to facilities exclusively served by UP. These conditions would clearly add new competition, not preserve pre-merger competition.

III. EXPOSURE TO LOSS

In order to evaluate the potential financial impact on UP of the various conditions being sought in these proceedings, we have carefully analyzed the UP traffic that

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<sup>4/</sup>(...continued)  
traffic will be bid on, and shippers have every incentive to "unbundle" their movements whenever a railroad serving a particular corridor offers more attractive terms.



would be exposed to loss as a result of the shipper access proposals of KCS/Tex Mex, Dow, Formosa and CP&L, as well as the UP traffic that would be exposed to loss as a result of the new Laredo rights BNSF is seeking. This analysis shows that the various condition proposals that have been made in this proceeding would expose approximately \$768,000,000 of UP business to loss. Moreover, our analysis probably underestimates UP's exposure.

Our analysis can be most easily understood by describing it in three parts: (a) traffic at risk due to the KCS/Tex Mex condition proposals; (b) traffic at risk due to shipper condition proposals; and (c) traffic at risk due to new BNSF rights to Laredo.

A. KCS/Tex Mex Proposals

KCS/Tex Mex have proposed three conditions that would expose UP traffic to potentially massive revenue losses of approximately \$305,000,000.

First, what KCS/Tex Mex describe as a "neutral switching" scheme for SP's Galveston Branch and UP's line to Galveston would expose many millions of dollars of UP-exclusive traffic to three-railroad competition. The neutral switching condition would also expose large amounts of UP traffic for which two railroads now compete to new three-railroad competition, including traffic originated by TCT.

Second, KCS/Tex Mex have proposed to modify Decision No. 44 to allow Tex Mex access to PTRRA and HBT traffic regardless of whether the traffic had a prior or subsequent movement on Tex Mex's Corpus Christi/Robstown-Laredo line. Again, this condition would expose many millions of dollars in UP revenues to new competition.

Third, KCS/Tex Mex's proposed forced "swap," involving KCS ownership of UP's Beaumont Subdivision in exchange for new trackage they would build on UP's Lafayette Subdivision, would open shippers on the Beaumont Sub to Tex Mex service. The affected shippers would include some 19 exclusively-served shippers along the line and various shippers at Amelia, Texas, a "2-to-1" point to which BNSF has access and Tex Mex also presently has access limited to traffic to and from its own lines.

In order to identify the UP traffic at risk from these proposals, we first scrutinized UP's traffic records to identify the shippers located along the lines to which the proposals apply. Next, using UP switching tariffs, we identified whether the shippers were presently open to competitive service or served exclusively by UP. We then reviewed UP's traffic data to identify the traffic that moved to and from those Houston-area shippers in the January through

June 1998 period.<sup>5/</sup> Finally, using the revenue data in our traffic records, we totalled the UP revenues associated with the moves and calculated a revenue figure on an annualized basis.

Based on our analysis, we determined that the KCS/Tex Mex proposals would expose some \$305,000,000 of UP revenue to risk. Nearly half of this exposure, \$133,000,000, is associated with opening to new competition the UP-exclusive shippers located along the former SP's Galveston Subdivision at places such as Bayport and Strang. These shippers would become "1-to-3" shippers -- they are served by one railroad today. but if KCS/Tex Mex's proposed neutral switching condition were granted, they would be granted access to three railroads -- UP, BNSF and KCS/Tex Mex.

An additional \$118,000,000 of exposure would result from opening PTRA and HBT shippers to new competition by removing the restriction imposed by the Board on Tex Mex movements to and from these shippers. Finally, another \$42,000,000 of exposure would result from adding new competition for non-exclusive customers located along UP's and SP's Galveston lines and for customers served by TCT. All of

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<sup>5/</sup> We used January through June 1998 data for this portion of the analysis rather than the July 1997 through June 1998 data that we used elsewhere because the information that allowed us to distinguish between HBT, PTRA and other Houston-area originated traffic did not become available until after the TCS cutover in the Texas area in December 1997.

these shippers would become "2-to-3" shippers -- they are served by two railroads (UP and BNSF) today, but if KCS/Tex Mex's proposed conditions were granted, they would have access to three railroads.

Finally, the line "swap" proposal would expose some \$10 million in jointly-served and \$1 million in exclusively-served business to KCS/Tex Mex.

B. Shipper Proposals

Three shippers have requested additional merger conditions that would open their facilities to new competition and expose more than \$115,000,000 in UP revenue to new competition. Dow, Formosa and CP&L are seeking conditions that would open their exclusively-served facilities to new rail competition for the first time.

We assessed the potential revenue impact to UP from the shipper proposals in much the same way that we analyzed the potential losses from the KCS/Tex Mex condition requests. First, we reviewed UP's traffic data to identify the traffic that UP moved to and from the shippers' Houston/Gulf facilities in the July 1997 through June 1998 period. Then, we calculated the UP revenues associated with those moves.

We determined that the three shipper proposals would place at risk approximately \$115,000,000 in UP revenues. This would be "1-to-2" traffic -- that is, shippers served exclusively by UP today would be given access to a second

carrier if the condition requests were granted. For example, if CP&L obtains BNSF access to its Coletto Creek facility, this will place \_\_\_\_\_ of UP revenues at risk. New competition at Dow's UP-exclusive facility at Freeport would expose \_\_\_\_\_ of UP revenues to BNSF diversion. If Formosa succeeded in opening its UP-exclusive facility at Lolita, \_\_\_\_\_ in UP revenues would be exposed to BNSF.

C. BNSF Access to Laredo

BNSF's proposed Laredo rights would expose a tremendous amount of UP traffic to risk of loss. If this request were granted, there would be two carriers with direct, single-line routes to Laredo. Such new rights would inject a new single-line route where only one existed before the merger.

With respect to Laredo, we followed the basic steps I have already described in order to assess UP's exposure. First, we identified UP traffic moving to or from the Laredo gateway using UP traffic data for the period from July 1997 through June 1998. Next, we calculated the UP revenue associated with those movements. The results revealed that BNSF's proposed condition would expose some \$350,000,000 of UP traffic to new competition.

In all, the various additional conditions that have been proposed in these proceedings would place a tremendous amount of UP revenues at risk at a time when UP needs these

revenues to invest and to improve service. Moreover, our analysis probably understates UP's exposure, because the traffic data we relied upon included the period of UP's service crisis and thus probably understated what UP's revenues would have been in a more normal period.

These conditions are all unjustified from a competitive standpoint -- they would all create, not preserve, competition. Of the \$769,000,000 of UP revenues exposed to additional risk because of the conditions, fully \$249,000,000 of that exposure would involve "1-to-2" or "1-to-3" "open access" situations, in which closed shippers would obtain access to two or three railroads. Another \$170,000,000 would involve "2-to-3" situations, in which shippers presently served by UP and BNSF would gain new access to KCS/Tex Mex. Finally, \$350,000,000 of exposure would result from providing BNSF -- which has already used its merger-related rights to more than replace the pre-merger competition that UP faced from the SP-Tex Mex Laredo routing -- with a new and improved routing that is not competitively justified.

#### IV. IMPACT ON INVESTMENT

The proposed conditions would harm UP by placing substantial amounts of UP revenue at risk of loss at a time when UP is struggling to return to profitability. UP must turn the financial corner if it is to carry forward with the massive investment needed in the Gulf Coast and continue its

improvement efforts systemwide. Unless this happens, the balanced railroad competition that the Board envisioned for the Western United States will be lost.

In 1997 and the first half of 1998, UP has incurred some \$1.1 billion in additional costs related to the service crisis. UP's systemwide traffic declined by some 9%, while BNSF's has increased by a similar amount. UP's operating ratio has been above 100, while BNSF's has dropped into the low 70s. These factors have contributed to UP net losses of \$230 million (railroad level) in the last three quarters. Even though the service crisis has passed, UP carloadings are still well below where they need to be for the company to return to the kind of profitability that is necessary to support the investments needed to continue improving Gulf Coast and realize the full benefits of the merger.

The proposed conditions would make this already precarious situation worse. The conditions would exacerbate the growing imbalance between BNSF and UP, and as I described above, they would expose to loss hundreds of millions of dollars in revenue that UP needs to invest in its service and infrastructure, especially if it is to make up SP's investment deficit in the Gulf Coast region.<sup>5/</sup>

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<sup>5/</sup> SP's investment in its facilities in the Gulf Coast area lagged far behind the growth in the traffic it was serving. For example, Waybill Sample data show that chemical (STCC 28) traffic originating in the Houston BEA has increased

(continued...)

KCS/Tex Mex's witnesses Grimm and Plaistow argue that more competition would yield more investment, but they are wrong, and the examples they offer -- PRB coal and intermodal traffic -- are completely dissimilar from the situation here.

Competition itself will not lead to additional investment. The simple, obvious fact is that shifting traffic between carriers does not add to total investment capability. Moreover, although source and other competitive constraints prevent exploitation of any shippers, the type of "open access" conditions that are being sought will tend to depress rate levels and therefore reduce the total pie of investable funds.

The examples that Grimm and Plaistow rely upon actually demonstrate a different point. Competition for PRB and intermodal traffic has been intense, and investment has been high, because those situations involve efforts to expand the pie, not to slice it into smaller pieces, as the KCS/Tex Mex proposals here would do. Railroads have incentives to invest across their portfolio of business where they can earn adequate returns, so long as they have the overall prospect of revenue adequacy. But in a world of scarce resources, the

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§/ (...continued)

dramatically, from 8.9 million tons in 1976 to 25.4 million tons in 1996. SP's investment outlays were stagnant during the same period.



level of investment in a particular area will depend critically on the financial return railroads can hope to achieve. The condition proposals being advanced in this proceeding would merely shift Gulf Coast traffic (and revenue) from UP to other carriers. Thus, from UP's perspective, the conditions would have a net investment-depressing effect. This effect should be of particular concern to the Board, because the Gulf Coast area is one in which, as UP's recent service crisis demonstrated, investment is crucial to both shippers and railroads.

Chart #1  
**BNSF Trackage Rights**  
**Number of Through Trains**

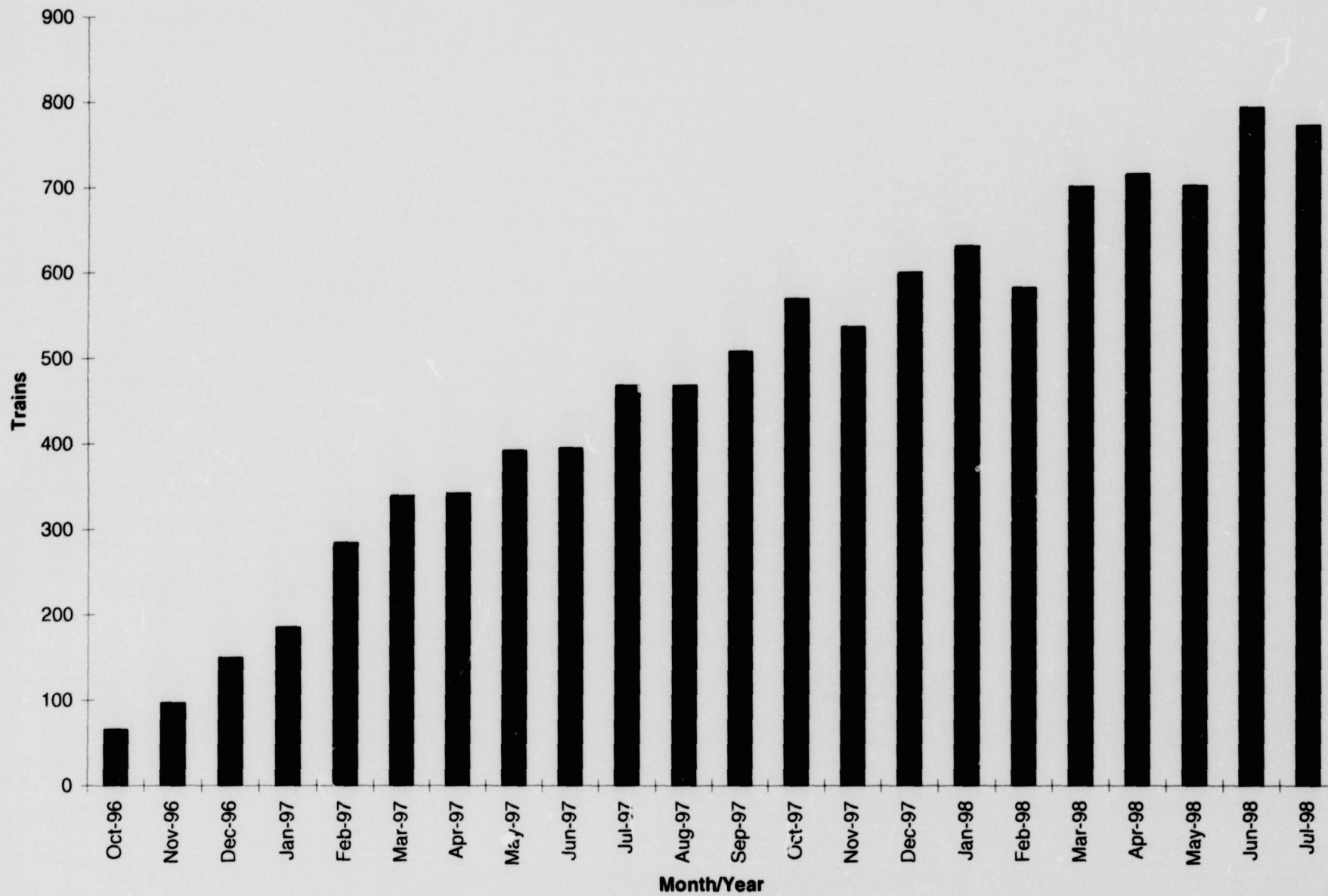


Chart #2  
**BNSF Trackage Rights**  
**Number of Cars (Through Trains)**

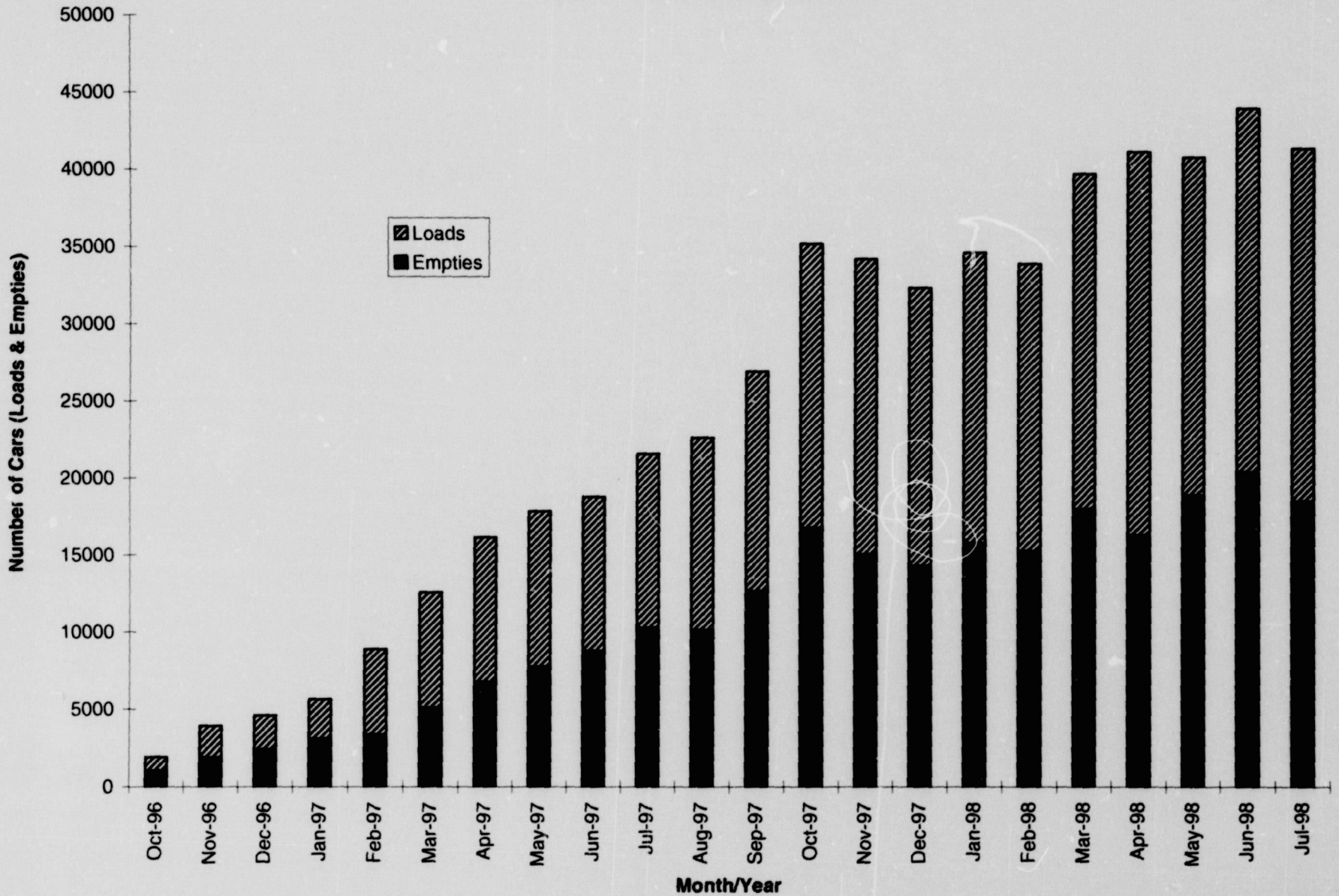


Chart #3  
**BNSF Trackage Rights  
Gross Tons (Through Trains)**

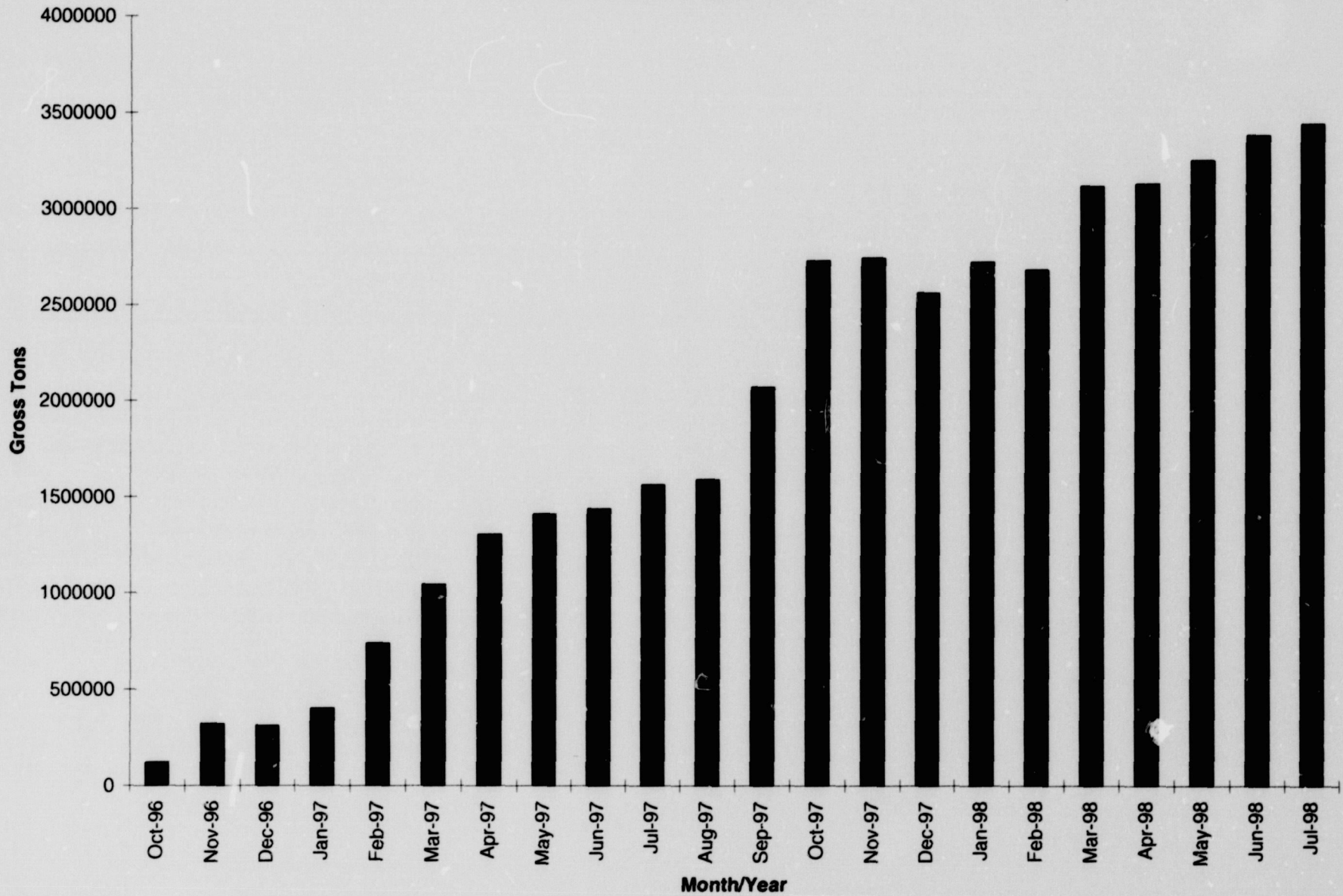


Chart #4  
**Tex Mex Trackage Rights**  
**Number of Through Trains**  
(All Traffic Included)

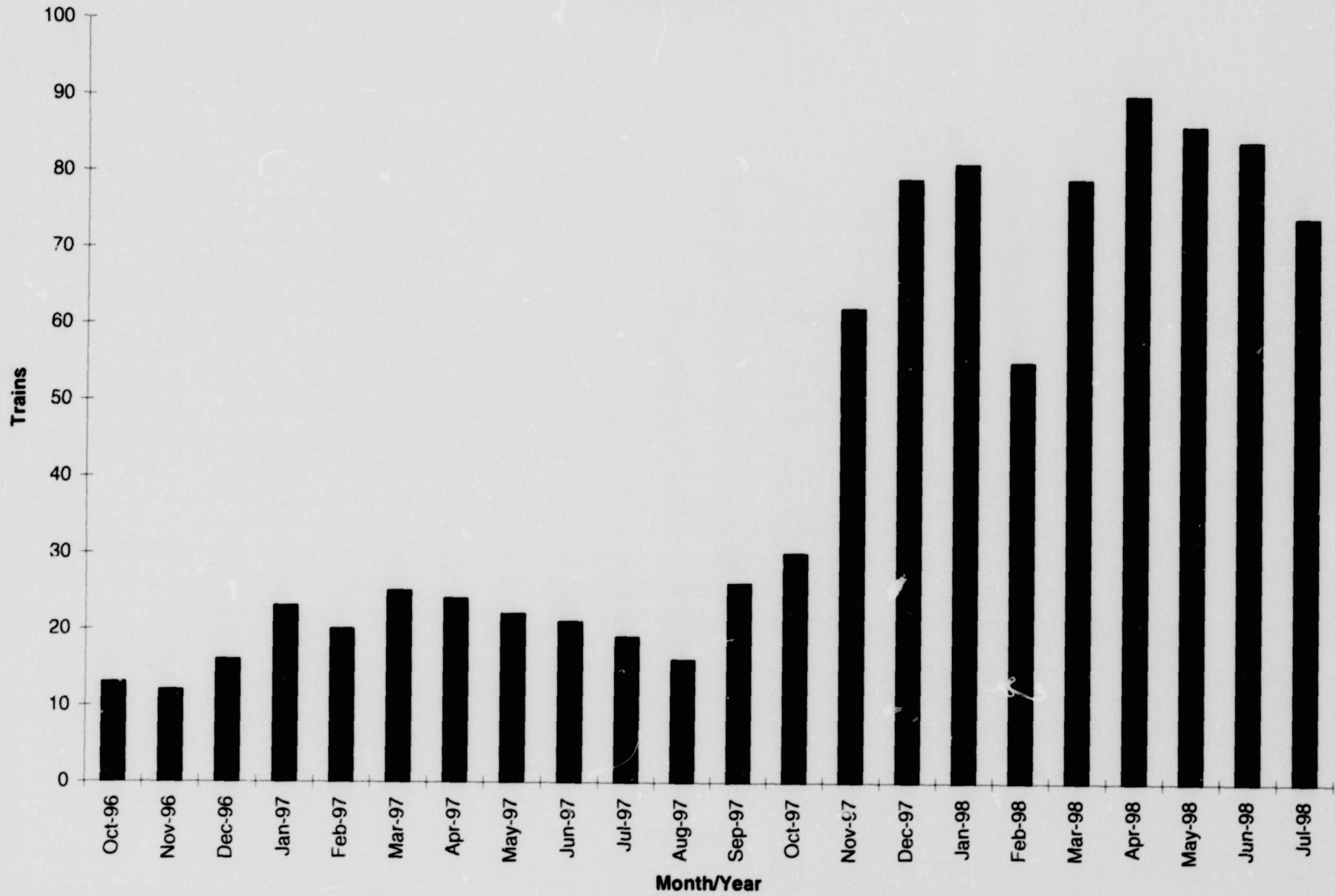


Chart #5  
**Tex Mex Trackage Rights**  
**Number of Cars (Through Trains)**  
(All Traffic Included)

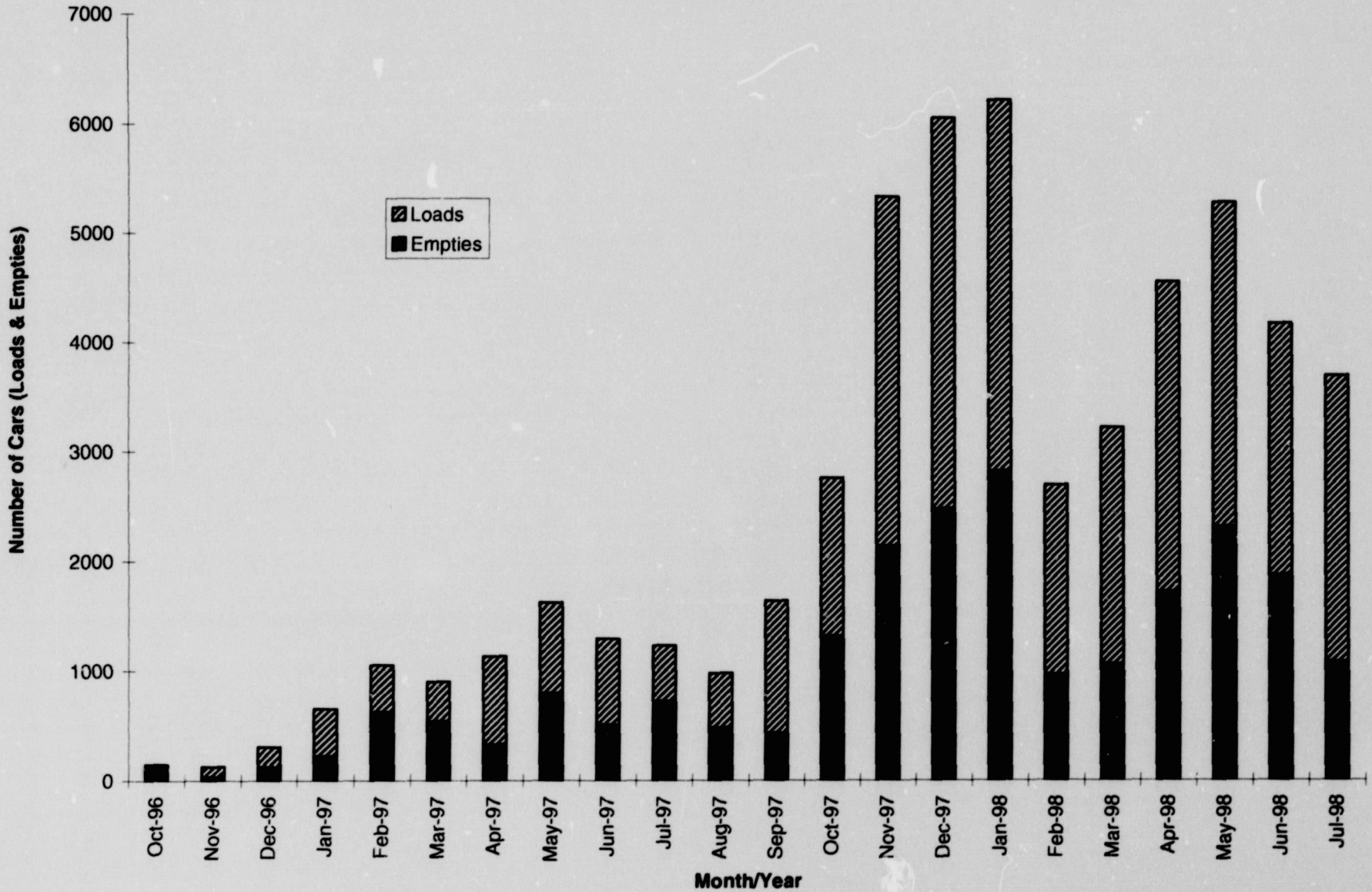


Chart #6  
**Tex Mex Trackage Rights**  
**Gross Tons (Through Trains)**  
(All Traffic included)

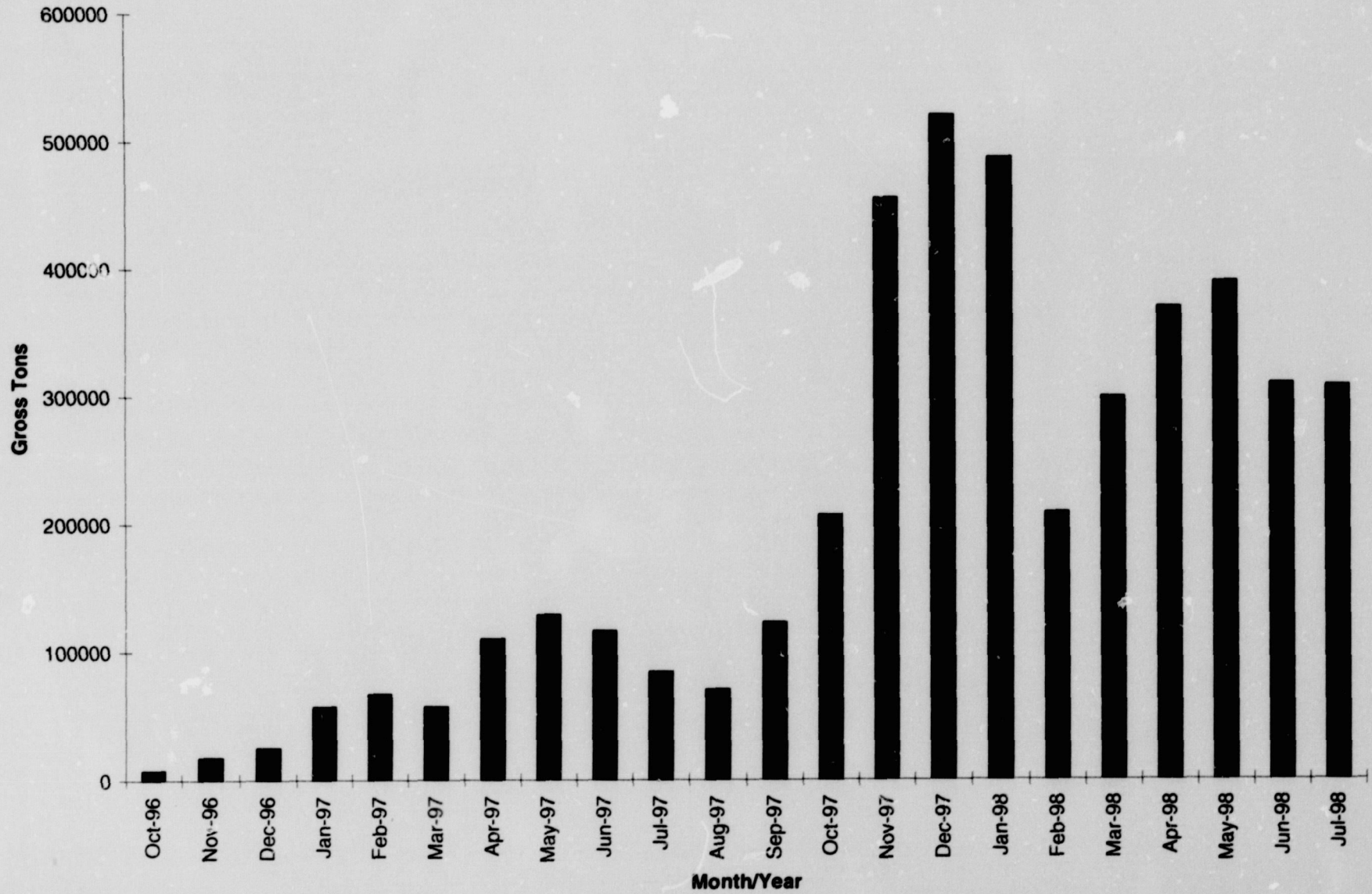


Chart #7  
**Tex Mex Trackage Rights**  
**Number of Through Trains**  
(Estimated Service-Order-Related Traffic Excluded)

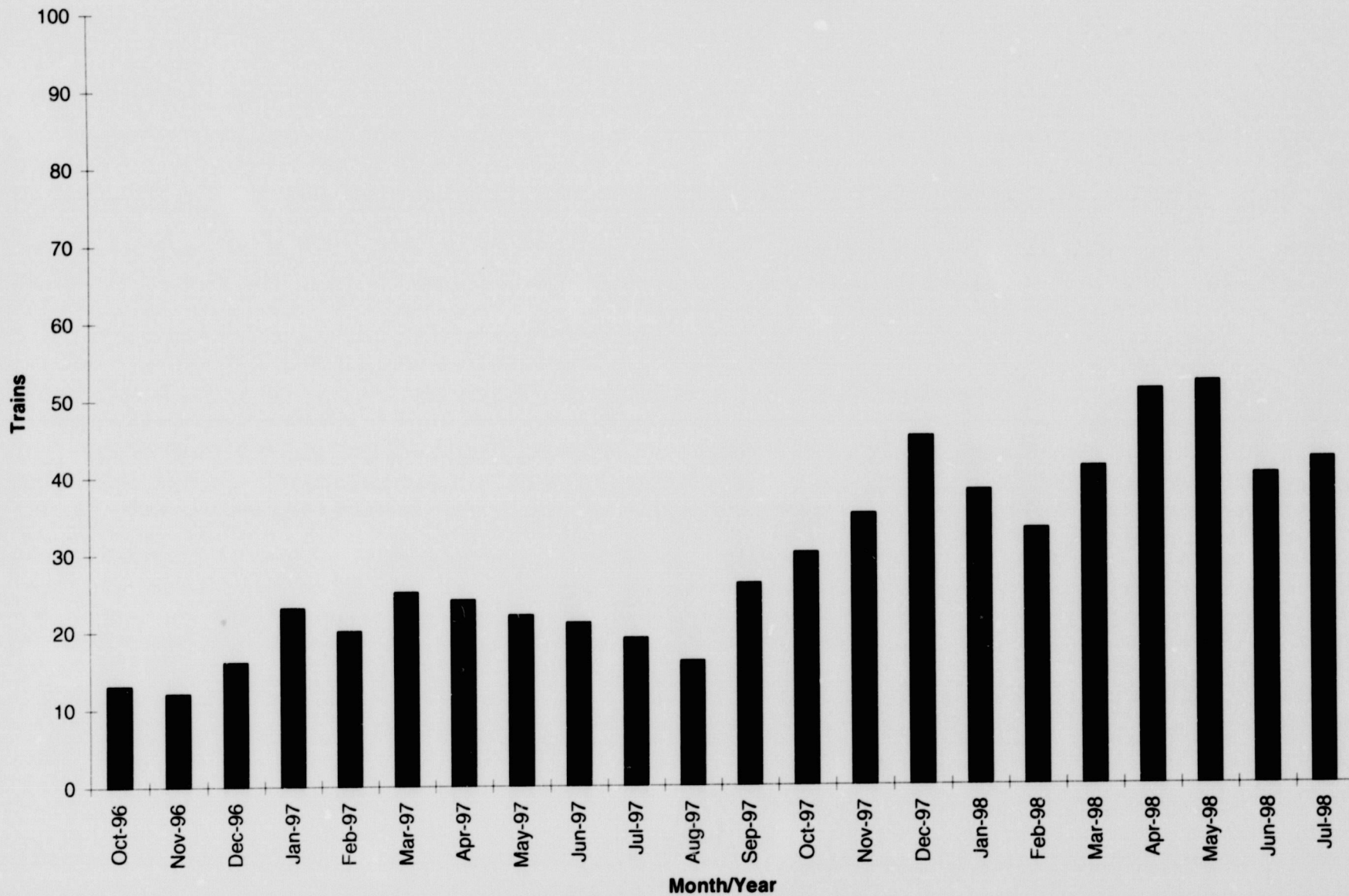




Chart #6  
**Tex Mex Trackage Rights**  
**Number of Cars (Through Trains)**  
 (Estimated Service-Order-Related Traffic Excluded)

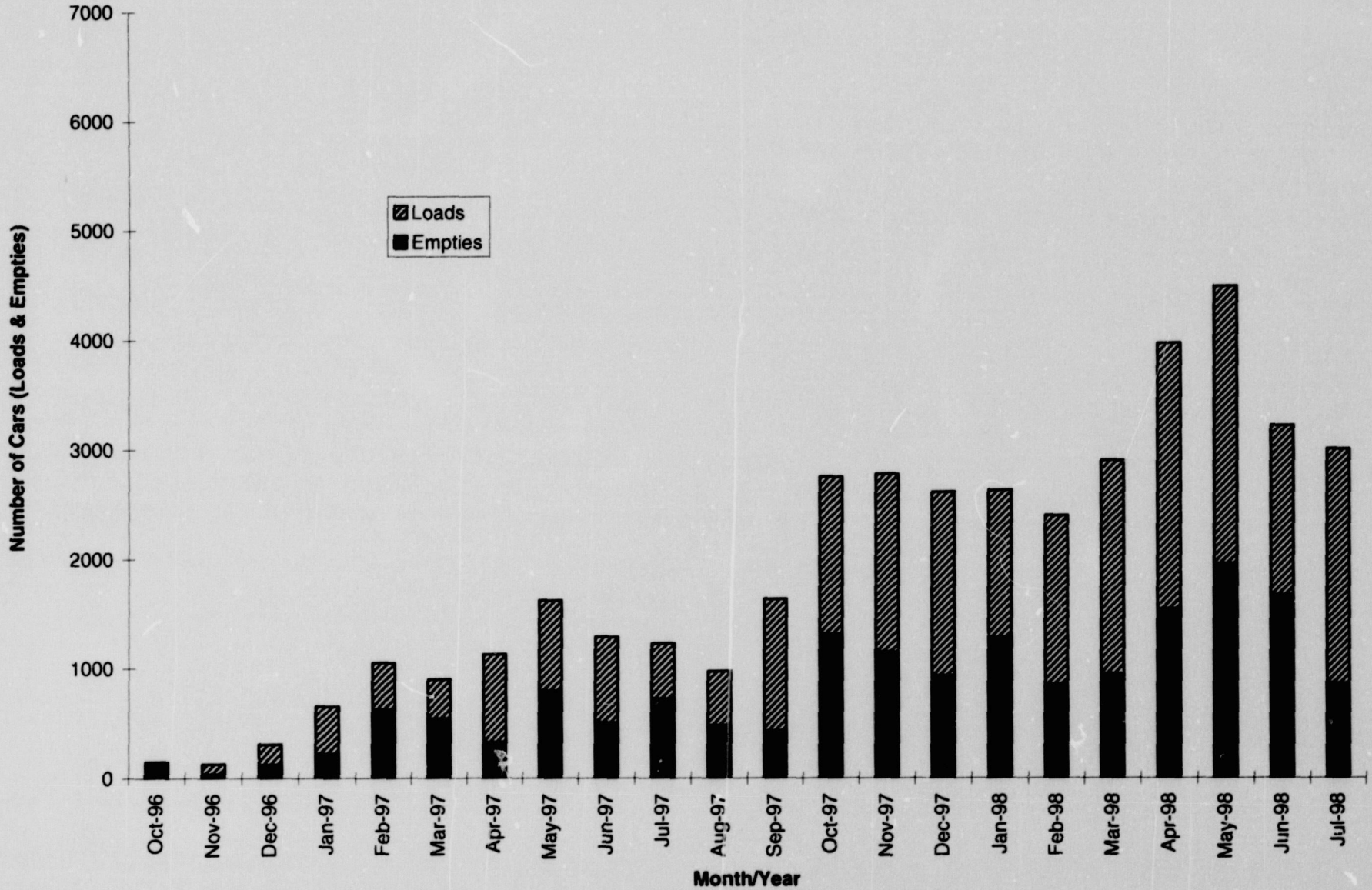


Chart #9  
**Tex Mex Trackage Rights**  
**Gross Tons (Through Trains)**  
(Estimated Service-Order-Related Traffic Excluded)

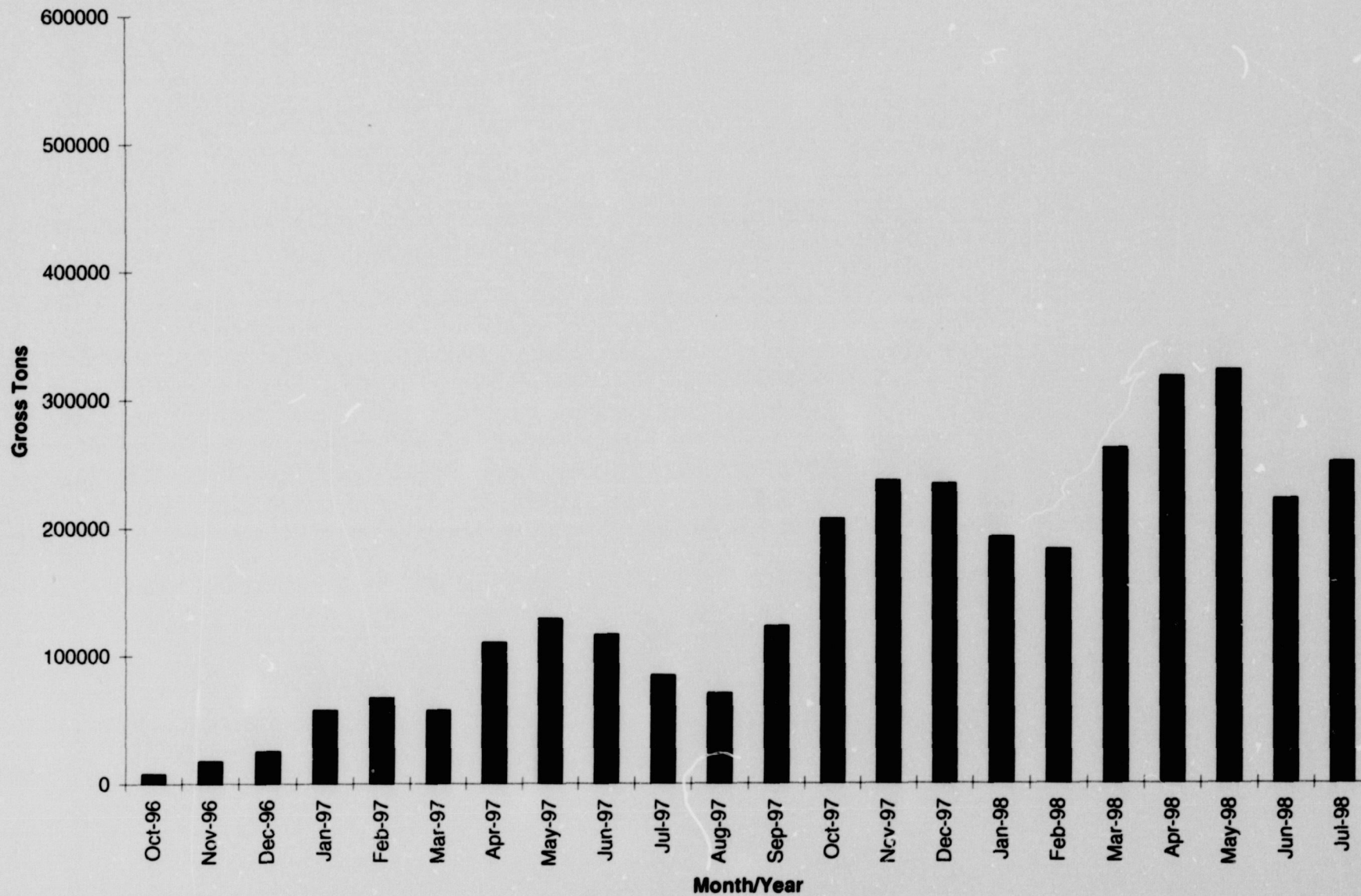


Chart #10  
Tex Mex Laredo Traffic  
(Loaded Cars)

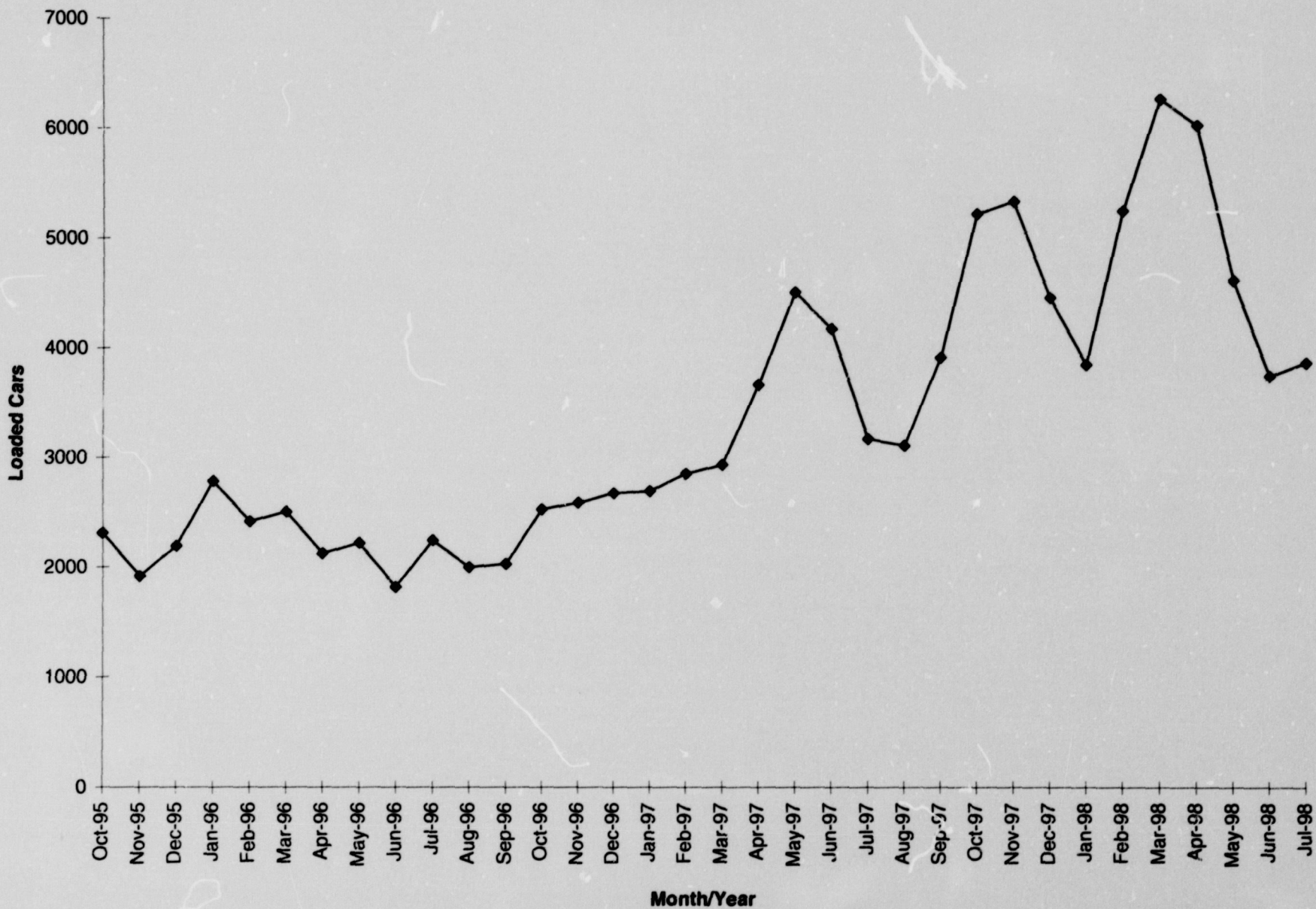
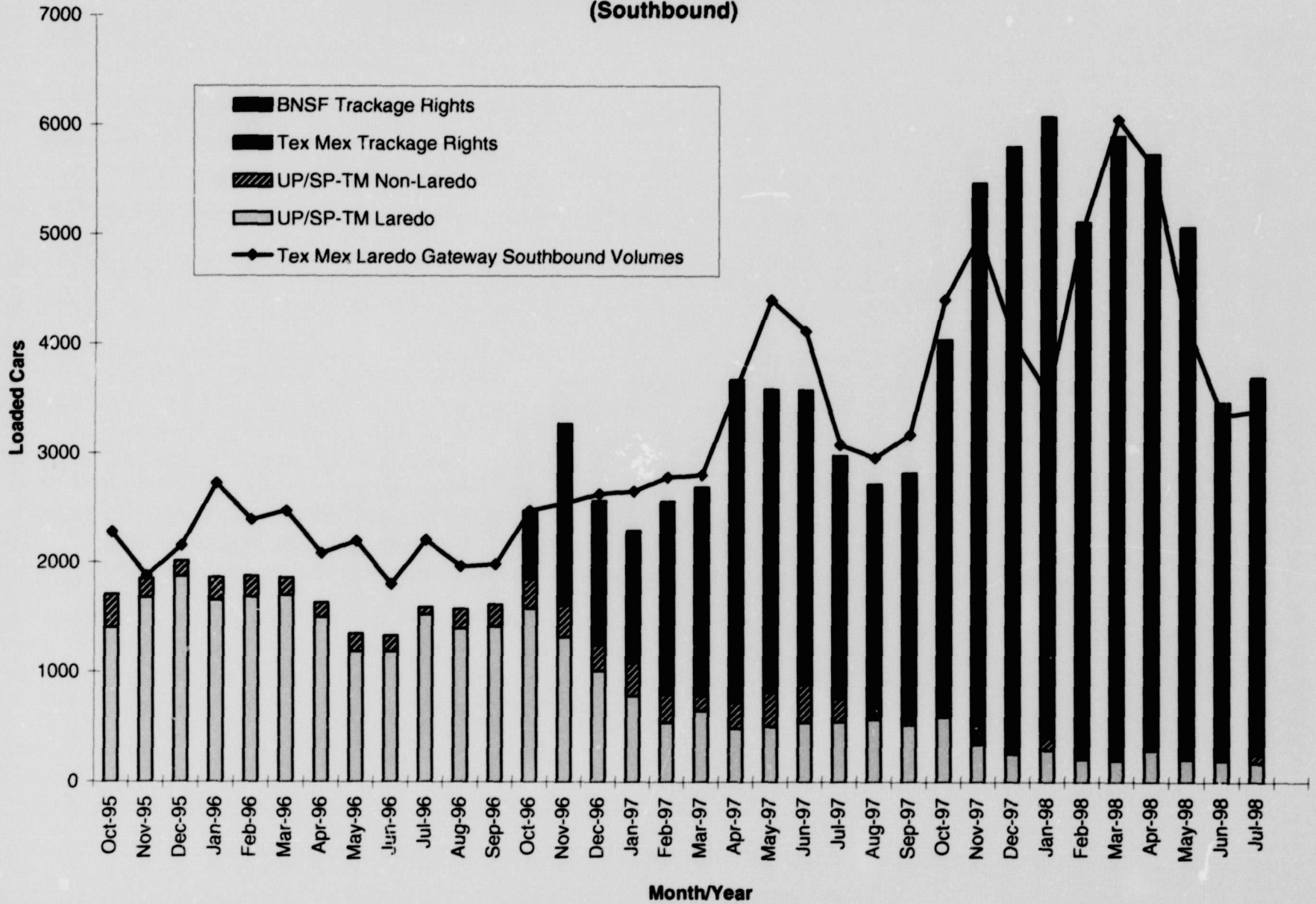


Chart # 11

**Tex Mex and BNSF Trackage Rights Traffic to Corpus Christi/Robstown and UP/SP-Tex Mex Interline Traffic (Southbound)**



VERIFICATION

STATE OF NEBRASKA    )  
                                  ) ss.  
COUNTY OF DOUGLAS    )

I, Richard B. Peterson, being duly sworn, state that I have read the foregoing statement, that I know its contents and that those contents are true as stated.

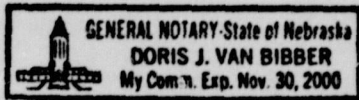
*Richard B. Peterson*

\_\_\_\_\_  
RICHARD B. PETERSON

Subscribed and sworn to before me this  
17th day of September, 1998

*Doris J. Van Bibber*

\_\_\_\_\_  
Notary Public





APPENDIX A

CONFIDENTIAL

INTER-COMPANY MEMORANDUM

FILE COPY

File:

TO: R.A. Batory  
A.M. Henson  
M.L. Wells  
H. Jay

FROM: C.T. Shurstad *C. Shurstad*

DATE: July 1, 1992

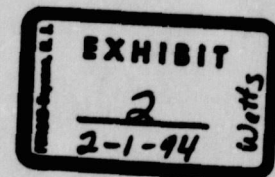
RE:

I have attached a report Pat Watts submitted on his recent trip to the Union Pacific's Harriman Train Dispatching Center. The purpose of Pat's trip was to assist in the startup of trains after the strike. During his visit he uncovered some interesting information regarding train dispatching and communications between our companies.

Please review this report and provide comments prior to July 10. I intend to schedule a meeting with E.S. (Kip) Hawley, Vice President-Transportation Services, Union Pacific, to present our issues.

CTS0026/ld  
Attachment

cc: G.P. Michael



110001



# CONFIDENTIAL

June 29, 1992

Mr. C. T. Shurstad  
Vice-President, Transportation Services  
Southern Pacific Transportation Company  
1515 Arapahoe  
Denver, Colorado 80022

Dear Mr. Shurstad.

Here is a written summary of the observations and my follow-up suggestions that I have made based upon my visit to the Union Pacific's Harriman Dispatching Center in Omaha, Nebraska, on Friday, June 26th, 1992. My suggestions are things that we could do, as a transportation company, to improve our operations over the Union Pacific's tracks where we have joint trackage rights.

1. There exists an inconsistency in train (SP) priorities that are programmed into the UP's CAD system. Although I doubt that the UP's upper management has ever, publicly, told their dispatchers to mishandle our trains, the UP's upper management has been responsible for assigning our "hot" trains a low priority in their CAD system.

When I asked the UP's CAD team for a list of priorities that have been assigned to our trains, they became very defensive and told me that this request would have to be made in writing through Etad King. Mr. King and other UP managers became very nervous, and almost hostile, when they thought that I was getting priority information from their own computer system. The fact remains that several of our premier trains (ESMFF, ESDAF, MFDAF, and PBROF) are given a Priority 6. VICOM is given a Priority 5. (The UP uses priorities of 1 through 9 so that CAD will know which trains need preferred handling. Amtrak is given a Priority 1, while SLOAZ is given a priority 2. The UP gives their coal trains a Priority 5 and their work trains and locals a Priority 6.)

I highly doubt that any UP dispatchers intentionally mishandles SP trains, but CAD is designed (and is enforced by UP management) to line 90 percent of all signals. By under rating the priorities of our trains, we are incurring unnecessary delays to our premier freight

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# CONFIDENTIAL

trains.

Brad King told me that he is willing to set down with us and discuss the priorities of our trains. I think that it is very important that we request such a meeting with Mr. King to discuss CAD's priorities. It is also my suggestion that we enter such a meeting with a list of our trains that operate over the UP with a priority number assigned to each train that reflects how we would like these trains handled.

2. The UP Corridor Managers have been told that there will be a joint UP-SP committee formed to meet and discuss problems relating to train operations between Bryan and Navasota. In discussing operational problems with the UP dispatchers, they told me that when their Corridor Manager receives a call on a SP train, the Corridor Manager enters this call information into CAD along with the time figure they are given on the arrival of the train. At the figure time, CAD automatically lines a signal, provided that the route is clear. A major problem is that our dispatchers in Houston do not call the UP dispatcher to update him on these time figures. If a SP train falls down, the UP dispatcher will knock down the signal and not line up the train until it shows up (in most cases already stopped).

The UP dispatchers also complained that they weren't getting the call on Amtrak trains. Trains can not be routed across the UP unless call information is entered into CAD. Subsequently, several times, Amtrak has shown up and been delayed while the information is being gathered and entered into the computer system.

My recommendation is that we do attend a joint problem solving meeting and try to resolve this operational conflict. I also recommend that our dispatchers in Houston communicate more freely with the UP dispatchers. (The UP dispatcher has a hot line number available to the ERTC and I have been assured that this number will be answered promptly.)

3. The SP incurs numerous hours of service tie-ups between Victoria and Corpus Christi/Harlingen due to a communication problem between some of the UP dispatchers and our forces at Victoria.

The UP's operation at Bloomington (just south of Placedo where we enter the UP's track) is such that they require a lot of switching on the main track and siding that prevents the operation of our trains through Bloomington at certain times.

There is also dark territory (non-signalized) between Inari and Sinton Jct and between Odem and Harlingen. With our two man crew operations in this region, we suffer extensive delays in meeting trains. When meeting another train in dark territory (with a two man crew), our conductor must line the switch at the entrance into a siding and stay at that switch until his train has cleared

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itself into that siding. The conductor must then return this switch to a normal position and walk to the head of the train. Once they have met the opposing train, the conductor must line the switch that permits his train to leave the siding. He must then remain at this switch until his train is on the main track, so he can normalize this leaving switch. The conductor must, once again, walk to the head of the train.

My suggestions for the train operations south of Victoria are to establish better communication between our forces in Victoria and the UP dispatchers. Victoria must not call trains unless they have been told that there is an open route through Bloomington. (Some past practices is to go ahead and call the train just to get it out of the yard)

I also suggest that we investigate the possibilities of installing spring switches at Woodford (on the UP between Inari and Sinton Det).

4. At City of Industry, our Crest Conductor (Yardmaster) is not giving the UP dispatcher an accurate time figure on when our trains are ready to leave. For example, on the day that I spent with the UP dispatchers, the Crest Conductor told the UP dispatcher that the Anaheim Local was ready to leave the yard. The UP dispatcher lined the Anaheim up, but it wasn't until 40 minutes had passed, that the local actually left. The UP dispatcher was disgusted because he delayed one of his stack trains because of an inaccurate time figure.  
Once again, this problem could be resolved with follow up communication from our Crest Conductor.
5. The UP's double main track between Topeka and Kansas City is a very busy corridor. All of our eastbound trains are routed into the 75 lead upon arrival. Upon pulling into the 75 lead, our trains change crews, leaving the rear of their train hanging out onto the UP's eastbound main. This causes all eastbound traffic to be delayed for up to an hour while one train changes crews. This practice has a tendency of stacking up the UP and SP trains in getting into Kansas City.  
There have also been complaints that we are holding trains out of Kansas City due to yard congestion.  
I would like to suggest that Rod Richardson explore another location for crew changes that would enable our trains to clear the UP's eastbound main without a delay. I also suggest that when yard congestion does occur, our Managers of Field Operations take a more pro-active role in communicating these problems to the UP dispatchers. At the present time, the UP's only source of information is the SP yardmaster.
6. I specifically asked every UP train dispatcher working joint trackage territory on the day of my visit what their

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opinion was of how our crews operated on their railroad. In every instance, I was told that our train and engine crews were top-notch and very respectful of the UP dispatchers. It was also stated, in more than one instance, that the UP dispatchers wished that their own (UP) crews were as good to work with as ours (SP).

It is my suggestion that we relay this praise to our crew members that operate in territory where we have joint trackage operations.

I hope this information, based upon my observations, proves useful and I am willing to answer any further questions that may arise.

Sincerely,



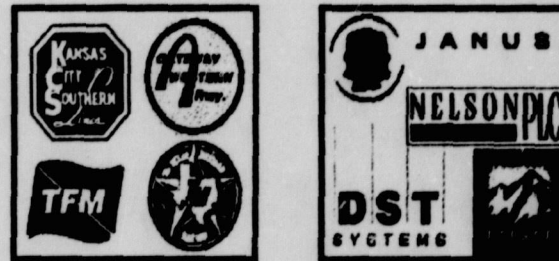
P. L. Watts

cc: Mr. Doug Rockwell  
Mr. Buck Rord

C 110005



**Kansas City Southern Industries, Inc.**



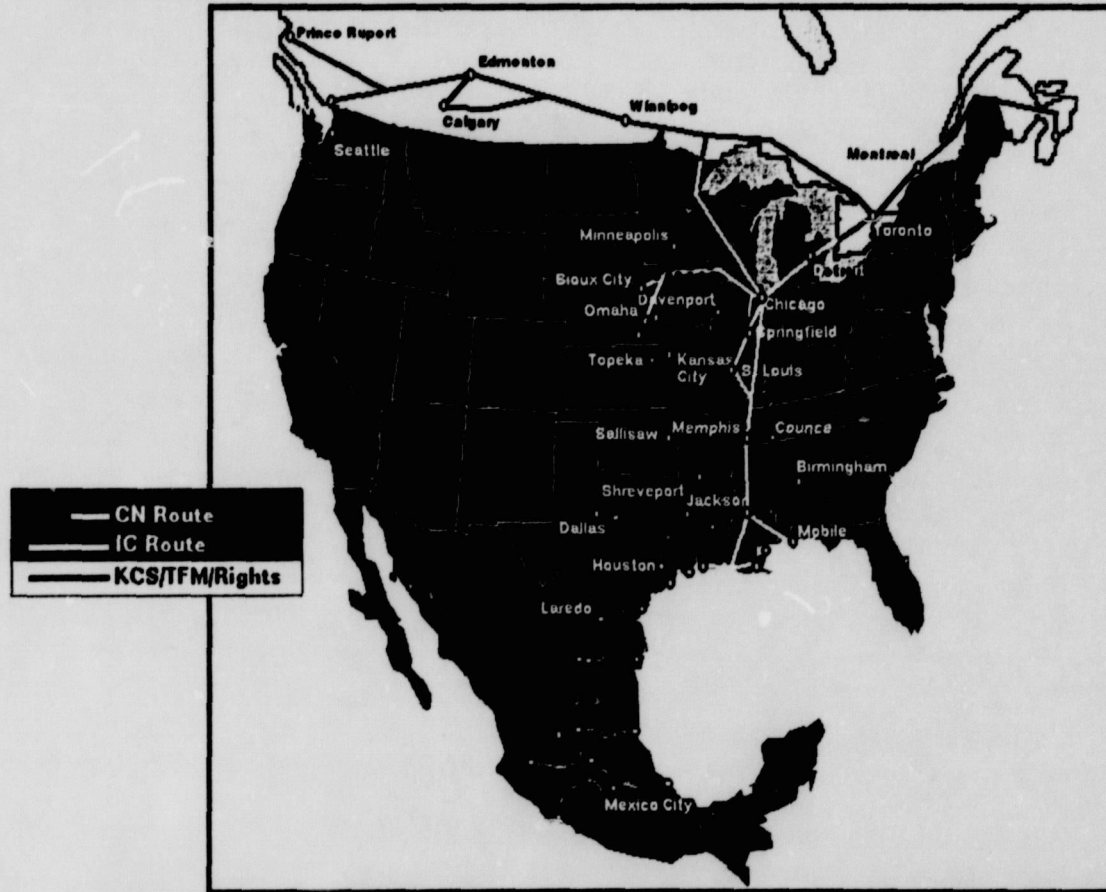
## **1998 First Quarter Presentation**

**Thursday, April 23, 1998**

[next back](#) [[Click here to restart](#)] -----Speaker: Landon Rowland, KCSI CEO

**Kansas City Southern Industries 4/23/98**

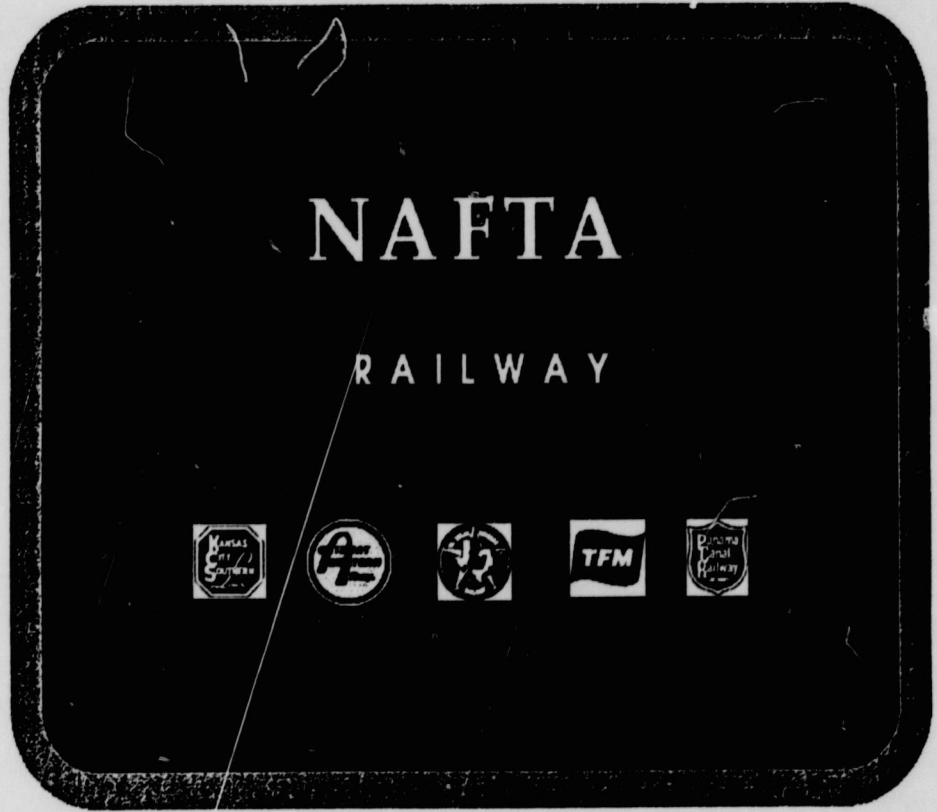
**KCS Today, including 4/16/98 Marketing Agreement**



**KCSI**  
8

next back [restart] -----Speaker: Landon Rowland, KCSI CEO

4/23/98



**Mike Haverty**

**KCSR President & CEO**

10

next back [restart] -----Speaker: Mike Haverty, KCSR CEO

4/23/98



## Key Results: Transportation Division

\$ millions

First Quarter 1998

	Results	\$ Variance from prev. year	
<b>Revenues</b>	<b>152.5</b>	<b>18.2</b>	<b>↑ 14%</b>
<b>Operating Income</b>	<b>32.0</b>	<b>18.0</b>	<b>↑ 129%</b>
<b>Contribution to KCS Net Income</b>	<b>9.2</b>	<b>6.2</b>	<b>↑ 207%</b>

11

next back [restart] -----Speaker: Mike Haverty, KCSR CEO



4/23/98



Transportation  
Division



## Key Results: KCSR

\$ millions

First Quarter 1998

	Results	Variance from prev. year	
<b>Revenues</b>	<b>135.7</b>	<b>+ 14.7</b>	<b>↑ 12%</b>
<b>Operating Income</b>	<b>29.2</b>	<b>+ 15.3</b>	<b>↑ 110%</b>
<b>Net Income</b>	<b>13.5</b>	<b>+ 9.5</b>	<b>↑ 238%</b>
<b>Return on Sales</b>	<b>10.0%</b>	<b>+ 6.7%</b>	
<b>Operating Ratio</b>	<b>78.3% from 87.4%</b>		

12

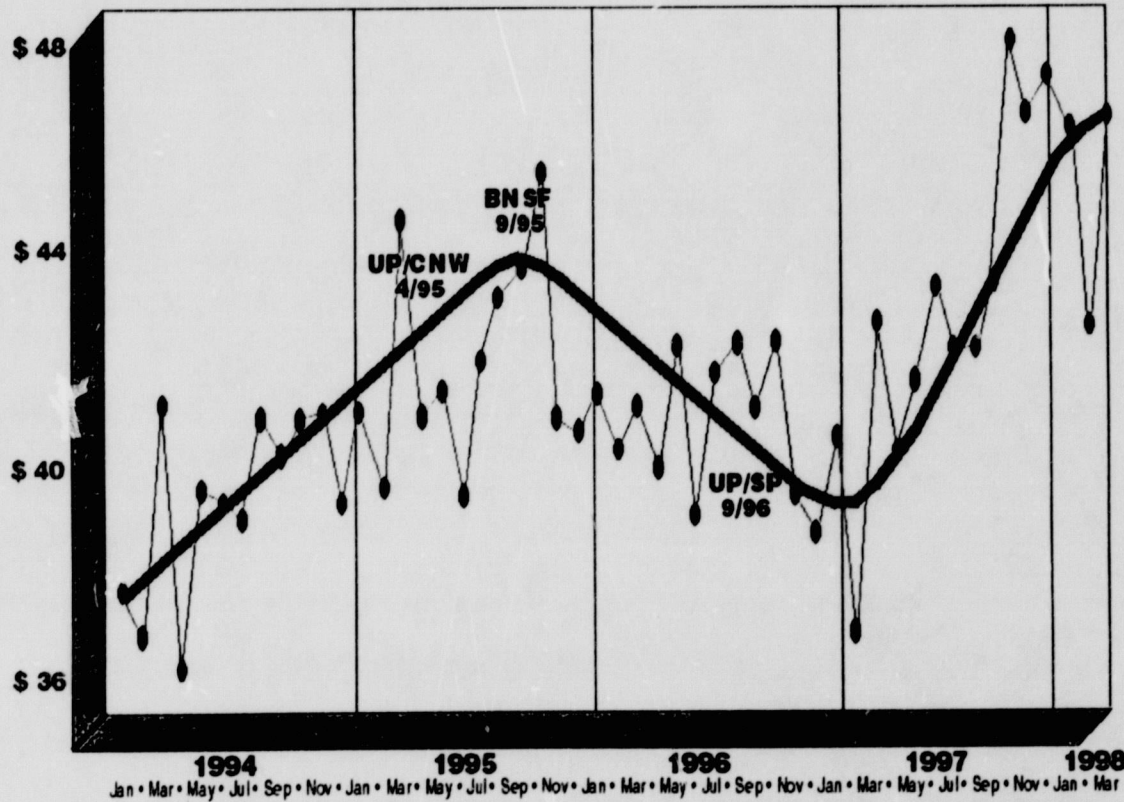
next back [restart] -----Speaker: Mike Haverty, KCSR CEO

4/23/98



### KCSR Revenue Trend & Mergers

monthly revenues in millions



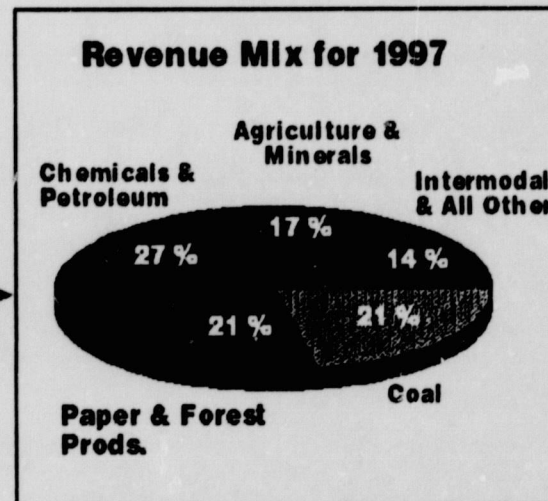
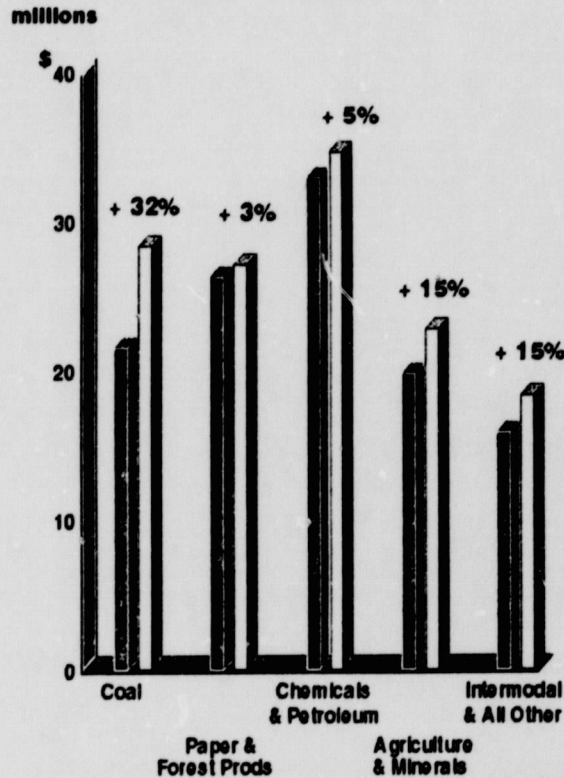
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[next back](#) [\[restart\]](#) -----Speaker: Mike Haverty, KCSR CEO

KCSR 4/23/98



### KCSR Revenues by Business Unit 1st Quarters 1997 & 1998



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[next back \[restart\]](#) -----Speaker: Mike Haverty, KCSR CEO

4/23/98



Transportation  
Division



## Key Results: Gateway

\$ millions

First Quarter 1998

	Results	Variance from prev. year	
<b>Revenues</b>	<b>11.2</b>	<b>+1.5</b>	<b>↑ 15%</b>
<b>Operating Income</b>	<b>2.2</b>	<b>+ .7</b>	<b>↑ 47%</b>
<b>Net Income</b>	<b>1.1</b>	<b>+ .5</b>	<b>↑ 83%</b>
<b>Return on Sales</b>	<b>10.3%</b>	<b>+ 4.0%</b>	
<b>Operating Ratio</b>	<b>79.9% from 84.7%</b>		

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next back [restart] -----Speaker: Mike Haverty, KCSR CEO

4/23/98



Transportation  
Division



## Key Results: Texas Mexican Railway

\$ millions

First Quarter 1998

	Results	Variance from prev. year	
<b>Revenues</b>	<b>13.0</b>	<b>+ 6.8</b>	<b>↑ 110%</b>
<b>Operating Income</b>	<b>.5</b>	<b>- .2</b>	<b>↓ 29%</b>
<b>Net Income</b>	<b>.3</b>	<b>- .1</b>	<b>↓ 25%</b>
<b>Return on Sales</b>	<b>2.6%</b>	<b>- 3.2%</b>	
<b>Operating Ratio</b>	<b>95.9% from 89.2%</b>		

STB FD 32760 (Sub 26) 9-18-98 B 191210V2 4/5

4/23/98



## Key Texas Mexican Railway Highlights

- **STB Extended Temporary Emergency Service Order**
  - Expires 8/2/98
  
- **STB Reopened UP-SP Merger Decision**
  - Will Consider Changes as part of Oversight Authorization
  
- **KCS/Tex Mex Proposal to Address Texas Rail Crisis**
  - Adds Capacity & Competitive Options
  - Establishes Neutral Switching & Dispatching in Houston
  - Calls for:
    - abandoned SP line
    - underutilized Booth Yard in Houston
    - UP line between Houston & Beaumont

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next back [restart] -----Speaker: Mike Haverty, KCSR CEO

4/23/98



## Key Results: TFM

\$ millions

### First Quarter 1998 \*

#### Results

<b>Revenues</b>	<b>100.1</b>
<b>Operating Income</b>	<b>9.3</b>
<b>Operating Ratio</b>	<b>90.7%</b>

\* estimated at April 22, 1998

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next back [restart] -----Speaker: Mike Haverty, KCSR CEO



4/23/98



### Operating Ratios by Quarter

	1997				1998
	first	second	third	fourth	first
<b>Kansas City Southern Railway</b>	87.4	88.4	81.4	77.6	<b>78.3</b>
<b>Gateway Western Railway</b>	84.7	85.4	79.9	80.4	<b>79.9</b>
<b>Texas Mexican Railway</b>	89.2	90.4	102.8	95.0	<b>95.9</b>

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next back [restart] -----Speaker: Mike Haverty, KCSR CEO

4/23/98



Transportation  
Division



## **Panama Canal Railway Update**

- **Atlantic/Pacific Land Bridge for Containerized Shipments**

- **Joint Venture: KCSL & MI-Jack Products**
- **50 year Concession**
- **47-Mile Line**

- **Rehab Will Provide Attractive Intermodal Link**

- **Construction Begins in late 1998**
- **Operations Begin by 2000**

- **Strong Revenue Potential**

- **Complements & Expands existing Canal Corridor**
- **Highway Alternative is Slow & Dangerous**

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next back [restart] -----Speaker: Mike Haverty, KCSR CEO

4/23/98



## **KCS/CN/IC Alliance**

- **KCS Continues to Exploit NAFTA Growth Opportunity**
  
- **Methodologies**
  - **Ow nerships (MidSouth, Gateway)**
  - **Investments (Tex Mex, TFM)**
  - **Marketing Agreements (I&M, NS, CN/IC)**

**• KCS/CN/IC**

- **Extends Market Reach**
- **Strengthens KCS Competitive Position - Is Pro-Competitive**
- **Will Generate New Revenue Sources**

21

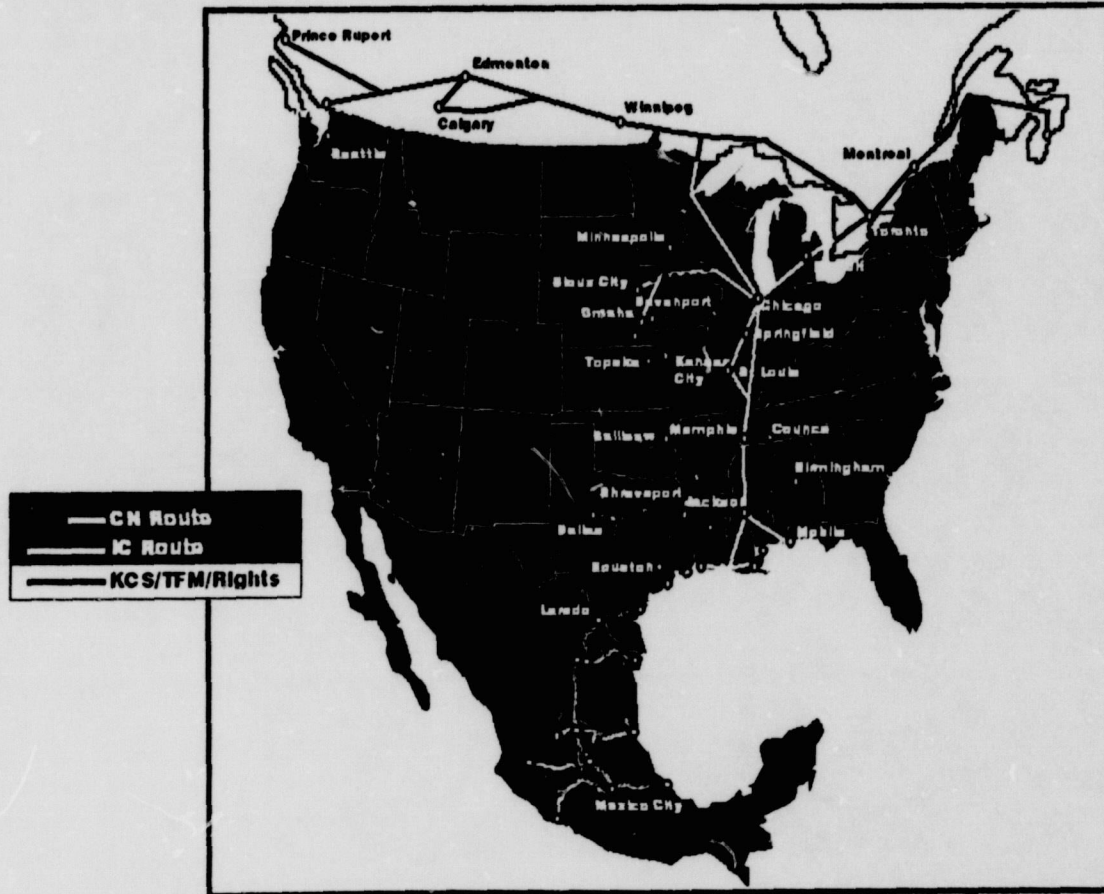
next back [restart] -----Speaker: Mike Haverty, KCSR CEO

4/23/98

### KCS Rail Network, Including 4/16/98 Marketing Agreement

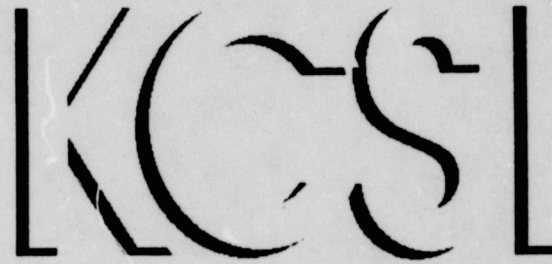


Transportation  
Division

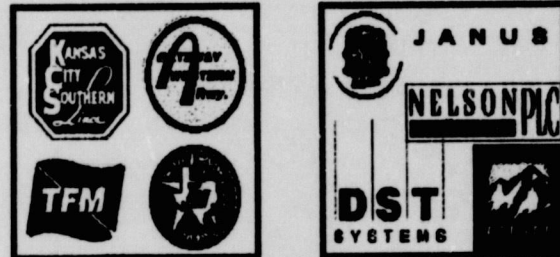


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Kansas City Southern Industries, Inc.

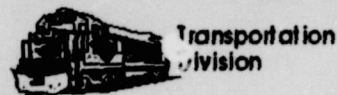


## 1998 Second Quarter Presentation

Wednesday, July 29, 1998

[next back](#) [[Click here to restart](#)] -----Speaker: Landon Rowland, KCSI CEO

7/29/98



**Mike Haverty**

**KCSR President & CEO**

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next back [restart] -----Speaker: Mike Haverty, KCSR CEO

7/29/98



## Key Results: Transportation Division

\$ millions

	Second Quarters			YTD 6/30		
	1997	1998		1997	1998	
<b>Revenues</b>	139.9	152.9	↑ 9%	274.4	305.4	↑ 11%
<b>Operating Income</b>	14.1	29.8	↑ 111%	20.1	61.8	↑ 120%
<b>Contribution to KCSI Net Income</b>	3	9.4	↑	5.1	18.6	↑ 464%

13

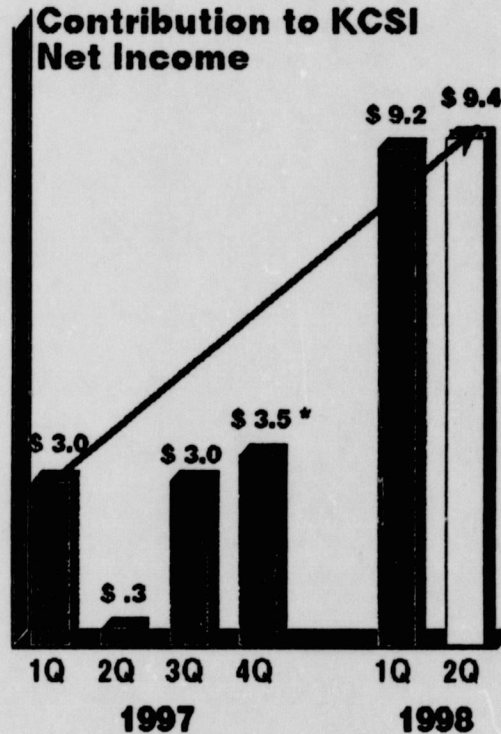
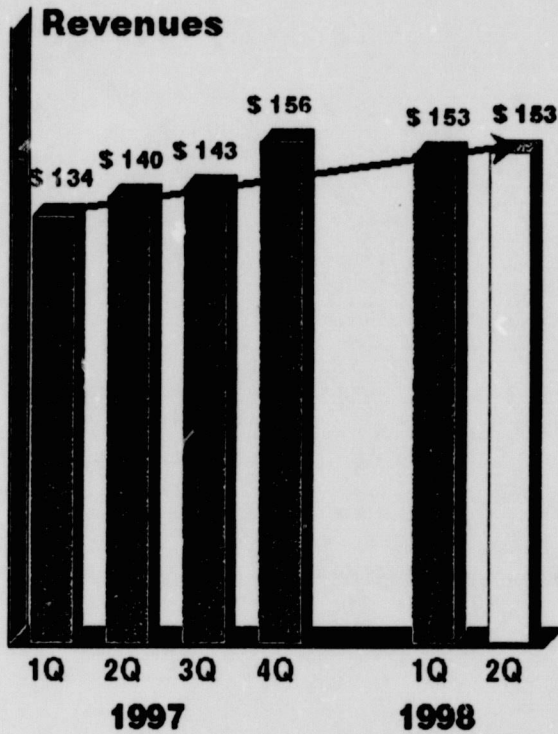
[next back](#) [\[restart\]](#) -----Speaker: Mike Haverty, KCSR CEO



7/29/98



**Transportation Division**  
\$ millions



\* exd. one-time restructuring charges

next back [restart] -----Speaker: Mike Haverly, KCSR CEO

7/29/98



Transportation  
Division

### KCS Core Rail Network



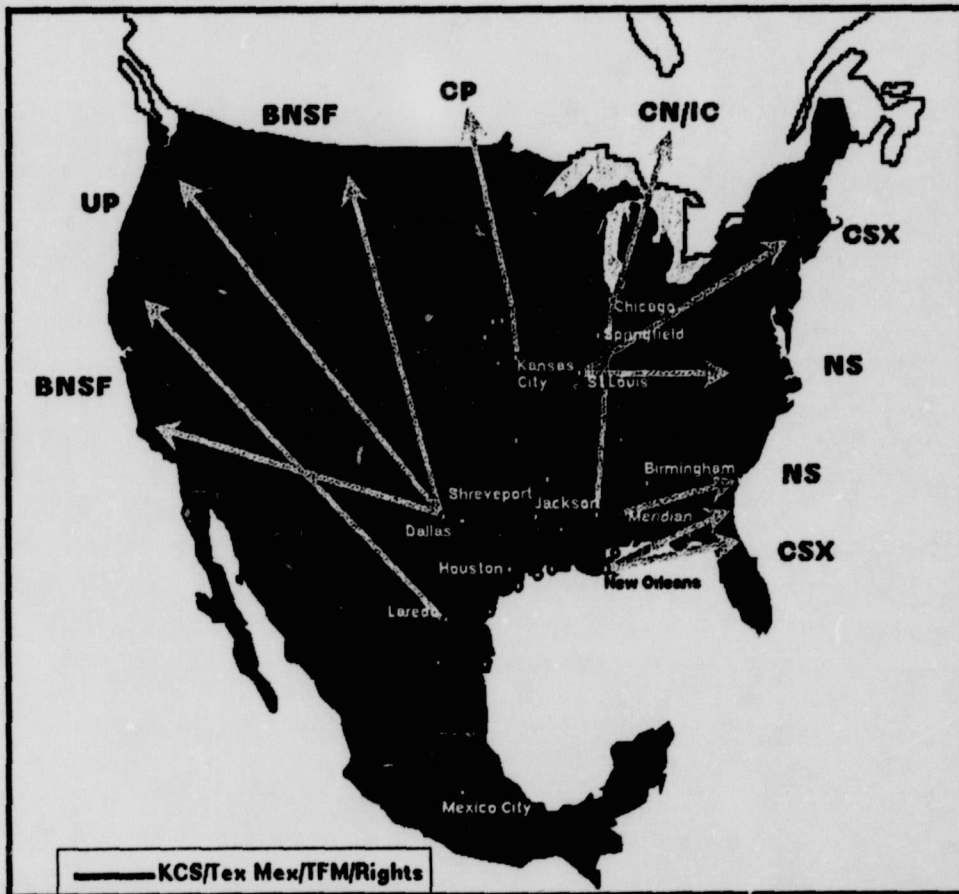
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next back [restart] -----Speaker: Mike Haverty, KCSR CEO

7/29/98



### KCS Core Rail Network



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[next back](#) [\[restart\]](#) -----Speaker: Mike Haverty, KCSR CEO

**JOINT VERIFIED STATEMENT**  
**OF**  
**GEORGE C. WOODWARD AND MICHAEL H. ROGERS**

**Introduction**

My name is George C. Woodward. I am Senior Vice President of ALK Associates, Inc. (ALK), a management consulting and information technology development firm located in Princeton, New Jersey. I have been with the firm since September 1991. I currently lead ALK's strategic consulting services and have participated in numerous studies of major rail industry transactions, including the BN/SF merger, the proposed Conrail acquisition of SP's eastern lines, KCS's joint venture with TMM and Tex-Mex, and the privatization of TFM. Prior to joining ALK, I was Executive Vice President-Distribution Services and Senior Vice President-Marketing and Sales at SP from 1987 to 1991. Prior to that, I was with Conrail from 1978 to 1987, most recently as Vice President-Marketing. Before Conrail, I was with SP from 1972 to 1978 in various engineering, operating, and marketing positions. I hold a B.S. in Physics from the Georgia Institute of Technology and attended the M.B.A. program at the University of Arizona. I have completed the Advanced Management Program at the Harvard Business School.

My name is Michael H. Rogers. I am Vice President of ALK Associates, Inc. I have been associated with the firm's strategic planning practice since June 1989. I have nine years of experience in analyzing railroad restructuring studies, including analyses involving Conrail, CN, ATSF, SP, KCS, Tex-Mex, and TFM. I hold a B.S.E. in Electrical

Engineering from Princeton University and an M.B.A. with honors from Columbia University.

ALK Associates has developed and maintained a comprehensive set of rail network and traffic databases, traffic flow models, and traffic diversion systems that are widely used in planning corporate restructurings in the rail industry. The STB and its predecessor, the ICC, have contracted with ALK since 1979 to collect and process the annual Rail Waybill Sample. ALK maintains a detailed computerized representation of the North American rail industry network and associated routing algorithms. These systems and databases are used in processing the STB Rail Waybill Sample and in several licensed ALK software products. ALK's PC\*RAIL<sup>®</sup> software generates routes and mileages over the North American railroad network. It is currently licensed to over 100 rail carriers, shippers, and equipment lessors. ALK's Princeton Transportation Network Model and Graphic Information System (PTNM/GIS<sup>™</sup>) enhances the features of ALK's PC\*RAIL network with visual traffic flow capabilities. PTNM/GIS is used as the basis for a variety of strategic planning, costing, marketing, and operations planning applications. It is currently licensed to four North American railroads. ALK's principal traffic diversion methodology, the Advanced Traffic Diversion system (ATD), has been used to study virtually all the major rail industry mergers, line acquisitions, and other corporate restructurings over the past two decades. Within the past four years, seven of the largest North American railroads retained ALK to utilize the ATD to study railroad corporate restructuring opportunities.

During our careers at ALK, we have personally directed numerous railroad traffic diversion and merger studies. Combined with industry experience, ALK's merger and

acquisition analysis has provided us with in-depth knowledge of rail industry traffic flows and commercial considerations. Biographies detailing our professional experience are attached to this statement as Appendix I.

We were asked by Applicants in this proceeding to assess rail-to-rail traffic diversions that would result from CN's proposed acquisition of IC. In order to do so, we performed five separate diversion analyses for various service types, each encompassing both extended hauls for CN/IC, and traffic that neither CN nor IC participated in during the base year 1996. As discussed in detail below, these analyses show in total that over \$217 million in new traffic would be attracted to a new CN/IC system through rail-to-rail diversions. These revenues do not include the \$7.5 million in revenues resulting from diversions of port traffic found in the CN analysis discussed in the Verified Statement of Mr. S. Craig Litzzen, or the \$23.4 million in revenues resulting from truck-to-rail diversions found in the analysis performed by Reebie Associates and described in the Verified Statement of Mr. Joseph G. B. Bryan. Altogether, the above gains amount to approximately \$248 million in new gross revenues for CN/IC.

In Part 1, below, we discuss the scope of our analysis. We then describe our general assumptions in Part 2, followed in Part 3 with an overview of our analytic methodology. (A detailed description of our methodology is provided in Appendix II.) Finally, in Part 4, we discuss the specific findings of each of our five analyses.

## 1. Scope of the Traffic Analysis

We analyzed the impact of the proposed CN/IC Transaction with the combined traffic synergy of the CN/IC/KCS Alliance and the CN/KCS Access Agreement. (We use the term "Transaction" in this statement to refer both to CN's proposed acquisition of control of IC and to the integration of the operations, services, information systems and marketing function of the two railroads.) The Transaction, Alliance, and Access Agreements are described in detail in the Joint Verified Statement of Gerald K. Davies and Donald H. Skelton.

As described more fully in the next section of our statement, our analysis was based on the operation of CN and IC as a single integrated system, taking into account the CN/IC/KCS Alliance and the key elements of the CN/KCS Access Agreement (which are contingent on approval of the Transaction). Each of our analyses was based on 100% CN 1996 waybill traffic data, 100% IC 1996 waybill traffic data, and the 1996 Rail Waybill Sample for other rail carriers (including CCP and KCS), with Canadian traffic terminations augmented using 100% KCS 1996 waybill traffic data.

Separate ATD traffic diversion networks were modeled for general merchandise, automotive (finished vehicles), intermodal, coal/bulk, and reload. For purposes of each analysis, the CN and IC networks were "familized" in our Advanced Traffic Diversion Model -- that is, treated as if they were part of a single, integrated railroad family -- to estimate the opportunities for extended hauls over the CN/IC system and also to attract traffic to the combined system that was not carried by either CN or IC in 1996.

Our analysis generally does not cover potential changes in rail traffic origin and destination patterns (source alternatives), growth or decline in traffic due to general economic conditions, or potential shifts in traffic between rail mode and other transportation modes. The one exception to the modal shift exclusion is the fact that our reload diversion analysis, which is described below, assumes that certain movements now carried by rail could be delivered by truck from IC's reload centers as part of a diversion to CN/IC. (This analysis did not in any way overlap the Reebe truck-to-intermodal rail analysis.)

## **2. General Assumptions**

Our analysis relied on the following general assumptions common to each of the studies:

1. Railroad corporate structures are as they existed in the base year 1996, except the post-Transaction structure would include:
  - a. The proposed CN/IC Transaction
  - b. The CN/IC/KCS Alliance, including the following elements:
    - Springfield, Illinois to become the principal gateway for traffic moving between CN territories or northern IC territory on the one hand, and KCS territory in the midwest on the other.
    - Jackson, Mississippi to become the principal gateway for Alliance traffic moving between CN/IC served territories and southern KCS territory or Tex-Mex (Mexican traffic).
    - A new formal cooperative relationship between KCS and CN/IC in the utilization and operation of the terminal at Jackson, Mississippi.
  - c. The CN/KCS Access Agreement, including the following elements:



- KCS access to certain Geismar traffic, with CN/IC to provide haulage and switching for KCS between Geismar yard and Baton Rouge, and with CN/IC in addition providing haulage service to KCS between Baton Rouge and Jackson, Mississippi, for traffic moving to specified Mid-Atlantic and Southeastern origins and destinations.<sup>1</sup>
  - KCS overhead trackage rights on CN/IC between Jackson, Mississippi and Palmer, Mississippi for non-coal traffic.
  - KCS overhead haulage rights on CN/IC between Hattiesburg, Mississippi and Mobile, Alabama for non-coal traffic.
  - CN/IC to provide switching for KCS to and from the Terminal Railway Alabama State Docks for non-coal traffic.
  - CN/IC overhead haulage rights on KCS between Hattiesburg and Gulfport, Mississippi.
  - KCS switching for CN/IC to and from the port of Gulfport.
  - Investments in intermodal terminals as required to carry additional traffic, including intermodal facilities at Dallas and Kansas City, the expansion of the Memphis intermodal terminal, and the development or availability of automotive transloading facilities at Dallas, Jackson, Kansas City, Memphis, Chicago, Shreveport (Reisor), and the New Orleans area.
2. CN/IC will operate as a single integrated system.
  3. Traffic volumes are estimates of those that would be diverted by the third year following the Transaction; changes in operations proposed by CN/IC are assumed to be completed.
  4. CN has unrestricted haulage rights between Duluth/Superior and Chicago.

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<sup>1</sup>Diversion revenues for CN/IC and for KCS were adjusted for these overhead haulage and switching fees.

5. Gateways between CN, IC, KCS, and other railroads for interline traffic which were open in 1996 will remain open. Primary gateways for CN/IC extended haul traffic with U.S. carriers are St. Louis, Memphis, and Jackson.
6. A railroad intermodal (TOFC/COFC) facility in a metropolitan market will provide access to intermodal traffic to or from points within the entire metropolitan market. We assumed that intermodal carriers serving a metropolitan market will compete with other intermodal carriers in that market and that drayage delivery services from the intermodal facilities to customers within the metropolitan market would be available.
7. A railroad automotive transloading facility in a metropolitan market will compete to terminate finished vehicle (auto rack or multi-level) traffic with other rail transloading facilities within the metropolitan market. We assumed a carrier's effective area of competition would be broadened by the availability of truck delivery to automotive customers within a metropolitan market.
8. Any rail carrier serving a station at an assigned standard point location code ("SPLC") has access to all shippers at the SPLC and at all stations assigned to the SPLC, except for known locations where shippers and consignees of one railroad cannot be accessed by another railroad. At SPLCs where a terminal company or shortline railroad provides switching services, any railroad served by the switching carrier at that SPLC may compete for the line haul portion of the traffic.

9. Traffic was ~~not~~ diverted if it was known to be under contract for a period likely to exceed the three-year Transaction implementation period. This assumption was applied to certain movements including automotive traffic of Ford Motor Company currently using the mixing centers of another carrier and certain potash from Saskatchewan under a long term contract to another carrier.
10. Terminal investments contemplated under the CN/KCS Access Agreement upon approval of the CN/IC Transaction will be made as appropriate to support traffic (see Part 1, above).
11. Traffic to or from Mexico will move across the border at Laredo, Texas; Tex-Mex will have adequate intermodal and automotive facilities available to handle such new traffic.

### **3. ATD Methodology Overview**

The ATD system is a simulation of rail industry traffic flows that predicts and quantifies the traffic re-routing and diversion effects of restructurings of the North American railroad system. The ATD contains a flexible methodology that enables analysis of a wide variety of rail industry restructurings, including mergers, divestitures, commercial alliances, line transfers, and abandonments.

Our ATD system uses three primary data inputs:

1. A traffic data file containing a set of pre-Transaction movements for which the ATD will assess the effects of the Transaction.
2. A railroad network database describing the pre-Transaction network configuration.
3. A railroad network database describing the post-Transaction network configuration.

The primary output of the ATD is a traffic file recording post-Transaction services for the file of pre-Transaction movements. This post-Transaction traffic file is the basis for tallies of summary statistics on the effects of the Transaction.

Our ATD system uses a five step analytical process. Using the ATD, we:

1. Define the scope of the traffic analysis, including the relevant origin-destination pairs and service types (e.g., general merchandise, automotive, intermodal).<sup>2</sup>
2. Determine the candidate post-transaction rail routes for each origin, destination, and service type combination.
3. Calculate the post-transaction market share for each candidate route.
4. Assess re-routes and diversions and allocates traffic to candidate routes based on calculated market shares.

---

<sup>2</sup>For purposes of our diversion analysis, we use the shorthand term "market" to refer to such an origin-destination pair. We do not mean to suggest, however, that an origin-destination pair is a "market" in the sense that an economist would use that term.

5. Allocate revenue among carriers when traffic is allocated to multi-carrier post-transaction routes.

The ATD process calculates the changes in traffic flows from the base file to the diversion files and allows analysis of changes by carrier, service network, and market. A detailed description of the ATD is presented in Appendix II.

#### **4. Findings**

We used the ATD system to quantify the total traffic shifts that could be expected from the CN/IC Transaction. Based on our analyses and discussions with Applicants, we have found no point where CN and IC compete for traffic today and, therefore, no point at which competition would be reduced by the Transaction. The table below shows gains and losses by carrier and by traffic service type. Although railroads were analyzed using their corporate structures as they existed in 1996, for purposes of this table, carriers have been combined to their current structure (e.g., UP/SP/SSW have been combined).

**Table 1: CN-IC Transaction  
Rail Diversion Summary  
Change in Revenue in Thousands**

CARRIER	Gen'l					Total
	Merch.	Interm.	Auto	Coal/Blk	Reload	
CN-IC	\$128,505	\$13,760	\$61,195	\$3,581	\$10,098	\$217,139
KCS	\$25,761	\$6,179	\$35,127	\$1,330	(\$307)	\$68,090
TEX-MEX	\$4,936	\$3,011	\$7,988	\$0	\$0	\$15,935
UPSP	(\$66,404)	(\$13,889)	(\$83,770)	\$2,068	(\$2,696)	(\$164,691)
BNSF	(\$26,071)	(\$2,554)	(\$17,321)	(\$5,429)	(\$2,464)	(\$53,839)
CR	(\$18,135)	(\$222)	(\$162)	(\$54)	(\$3,634)	(\$22,207)
NS	(\$11,852)	(\$3,329)	(\$1,883)	(\$536)	(\$3,327)	(\$20,927)
CSX	(\$13,547)	(\$265)	(\$1,262)	(\$263)	(\$8,644)	(\$23,981)
CP <sup>1</sup>	(\$13,145)	(\$2,627)	\$135	(\$633)	(\$2,903)	(\$19,173)
Other	(\$10,047)	(\$62)	(\$47)	(\$64)	\$13,877 <sup>2</sup>	\$3,657

<sup>1</sup> CP losses include lines sold to IMRL in 1997. Losses attributable to those lines equal \$7.134 million.

<sup>2</sup> Includes revenue losses to other rail carriers of \$2.265 million, revenue gains by trucks of \$10.984 million, and revenue gains in transloading fees of \$5.158 million (assuming \$300 per carload), which fees have been netted against CN/IC's reload revenue gains above.

A description of the results of each of the segment studies is provided below, along with traffic density maps for each service type and for each of the major commodities within the General Merchandise group.

#### 4.1 General Merchandise

Because CN and IC meet end-to-end, much of the traffic diversion impact of this Transaction would be due to extended hauls on each of the carriers. CN originated and terminated traffic destined to Texas, for example, would be interchanged at Memphis by connecting with UP or BNSF for Dallas and Houston, or by interchanging with KCS at Jackson for Dallas and Mexico. As shown in the following table, the most significant

general merchandise traffic diversions would be for forest products (\$45.1 million annually), chemicals (including hazardous materials) (\$39 million annually), potash (\$19.5 million annually), and auto parts (\$9.9 million annually).

**Table 2: CN-IC Transaction  
General Merchandise  
Revenue Change in Thousands**

**CATEGORY**

<u>Carrier</u>	<b>Forest Products</b>	<b>Chemical w/HazMat</b>	<b>Potash</b>	<b>Auto Parts</b>	<b>Other GM</b>	<b>Grand Total</b>
CN-IC	\$45,075	\$38,951	\$19,467	\$9,881	\$15,131	\$128,505
KCS	7,940	\$11,488	(\$2)	\$1,370	\$4,965	\$25,761
TM	\$1,646	\$829	\$0	\$819	\$1,641	\$4,936
UPSP	(\$18,217)	(\$22,135)	(\$9,529)	(\$6,979)	(\$9,544)	(\$66,404)
BNSF	(\$12,155)	(\$10,248)	(\$2,703)	\$649	(\$1,613)	(\$26,071)
CR	(\$3,624)	(\$7,640)	\$101	(\$3,752)	(\$3,220)	(\$18,135)
NS	(\$4,235)	\$349	(\$3,055)	(\$1,856)	(\$3,054)	(\$11,852)
CSX	(\$3,656)	(\$6,501)	(\$2,017)	\$85	(\$1,458)	(\$13,547)
CP	(\$6,336)	(\$3,737)	(--)	(--)	(\$3,072) <sup>1</sup>	(\$13,145)

<sup>1</sup> Includes CP potash and auto parts losses.

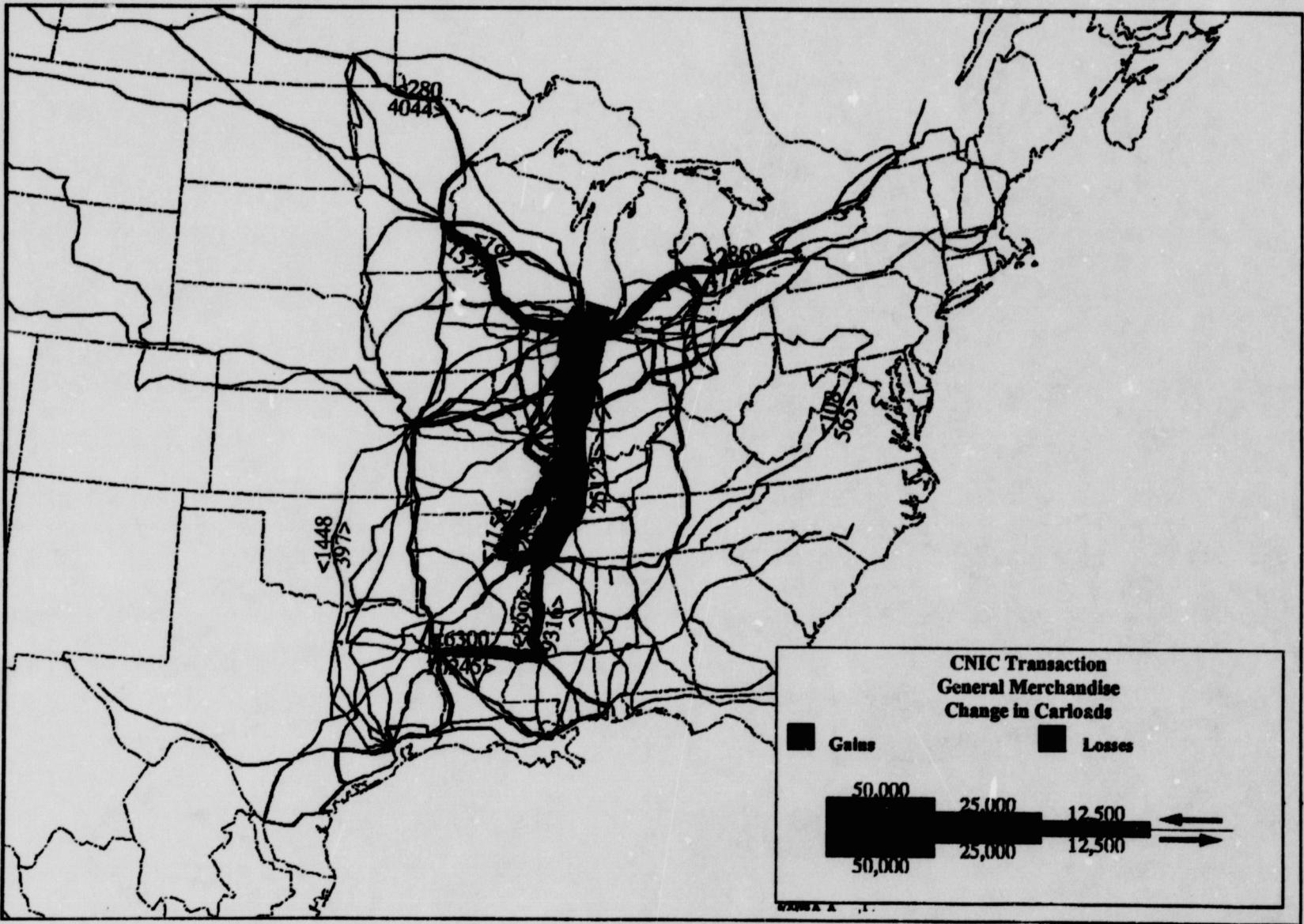


Figure 1: General Merchandise



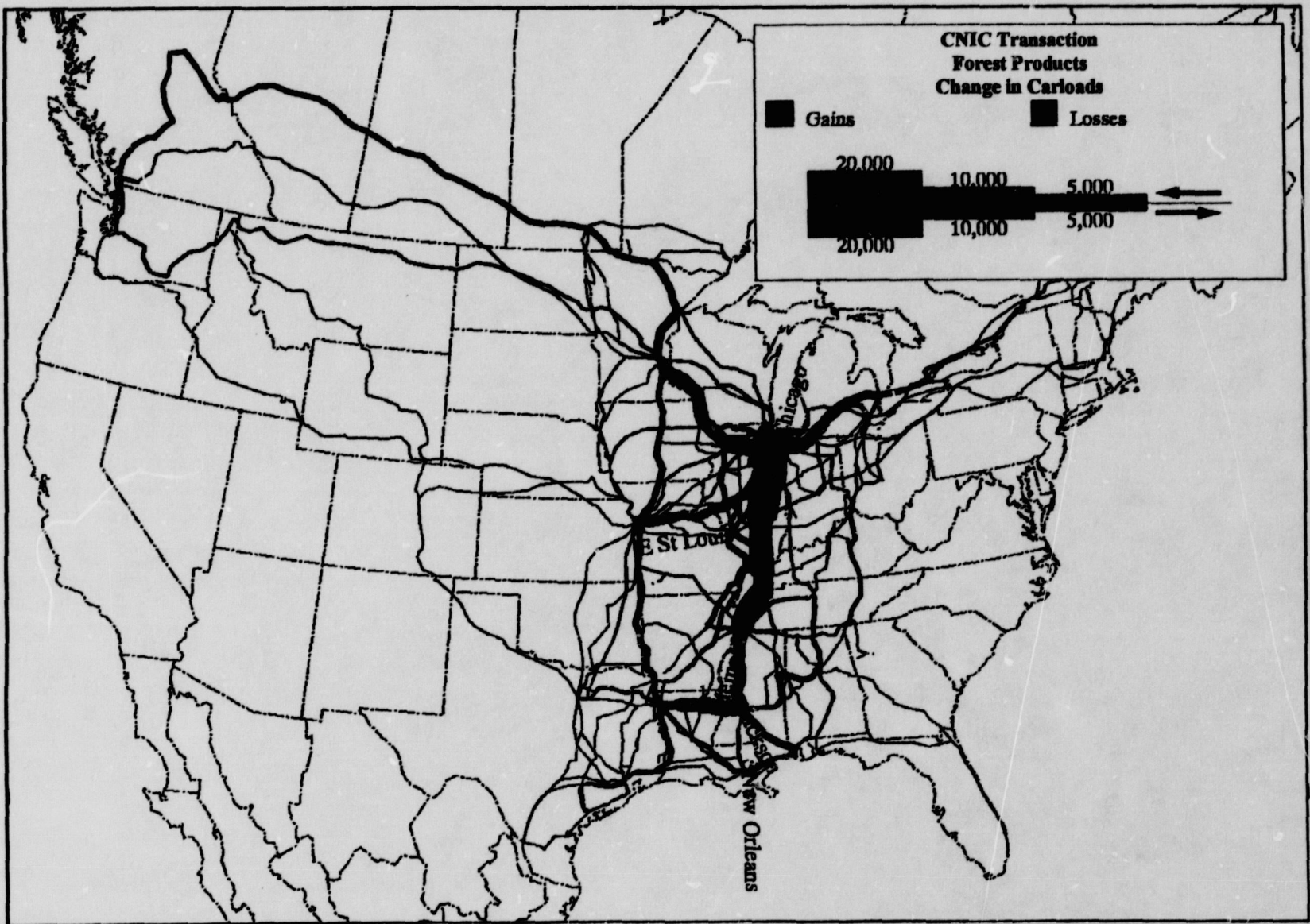


Figure 2: Forest Products

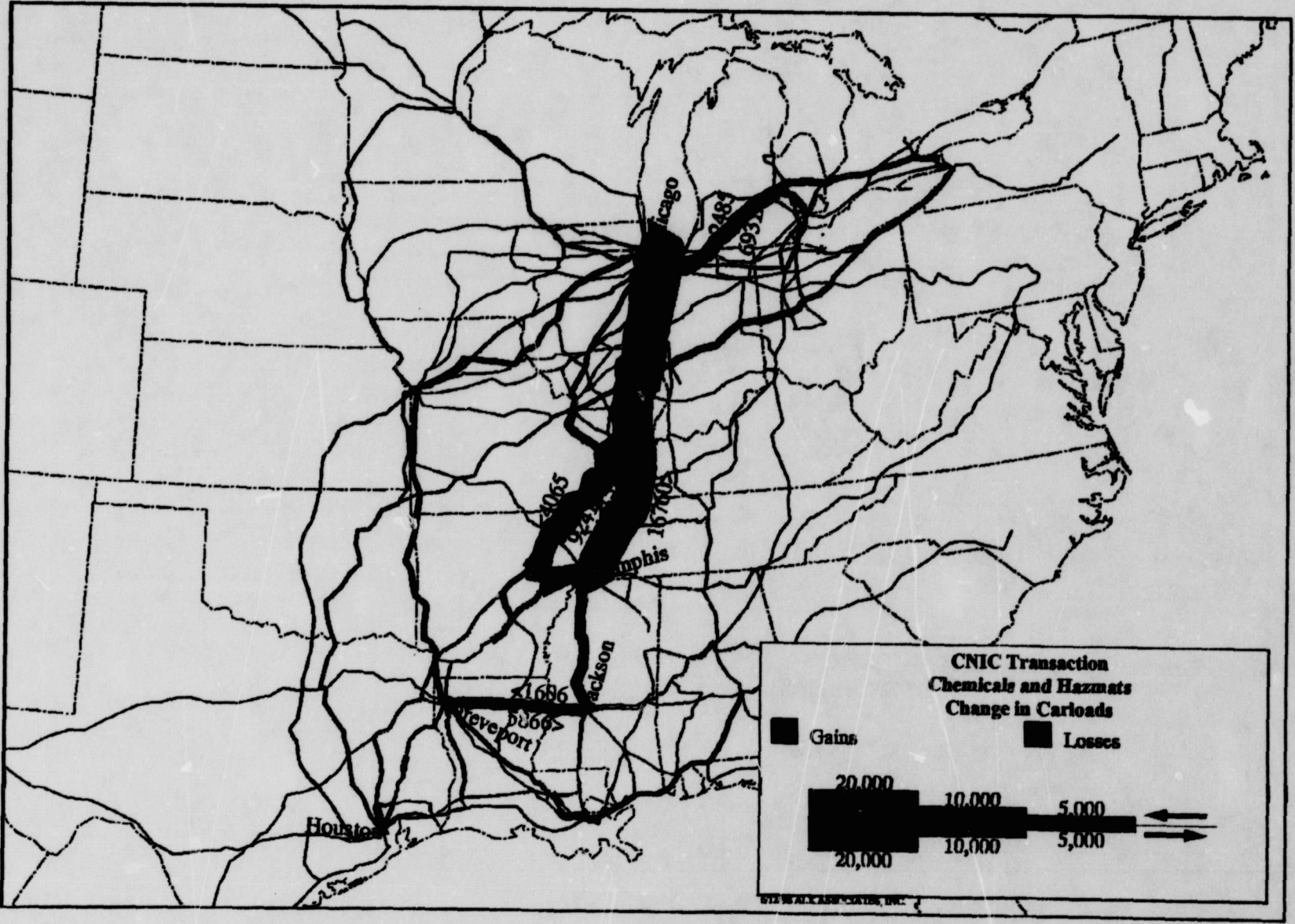


Figure 3: Chemicals and Hazardous Materials

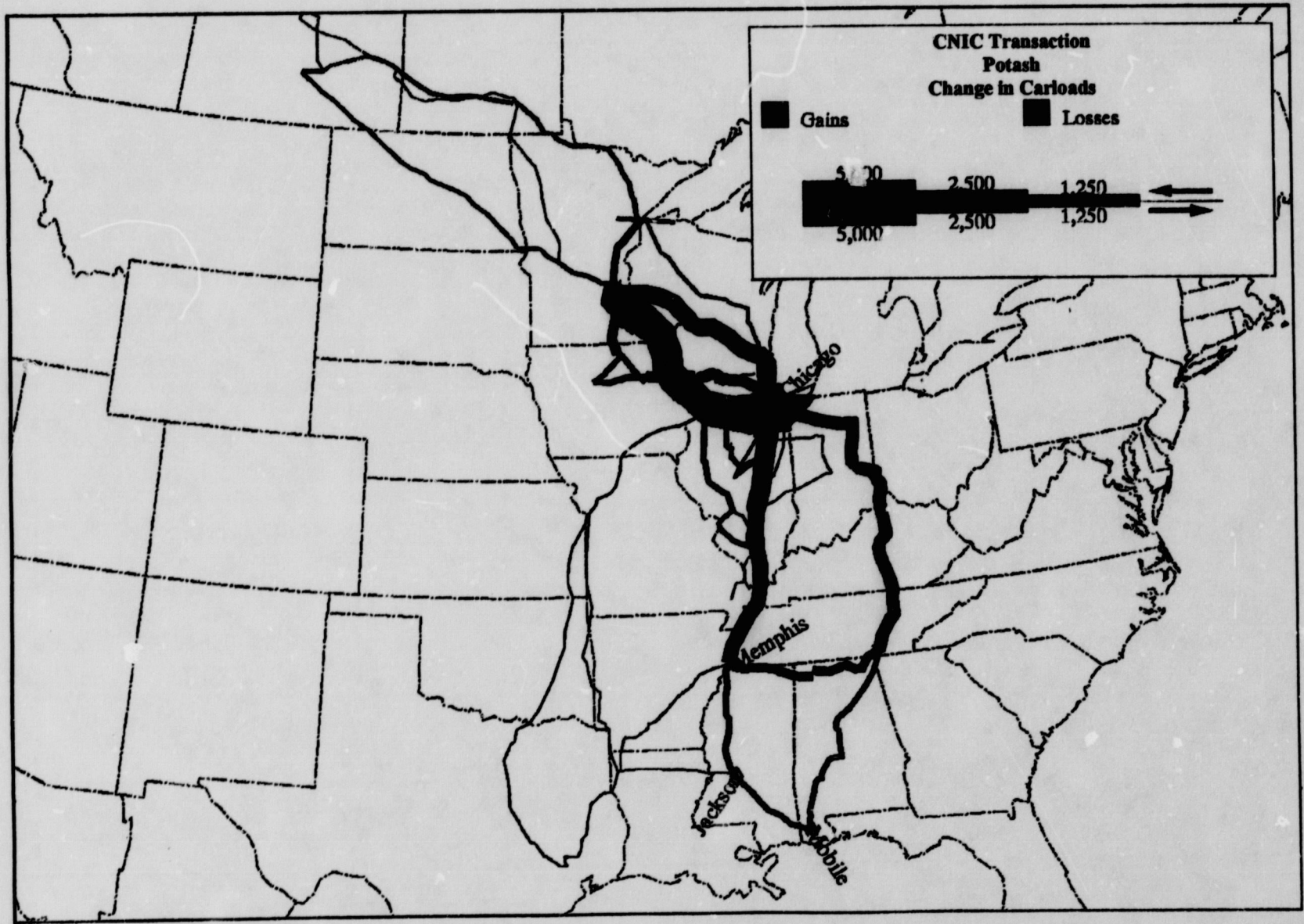


Figure 4: Potash

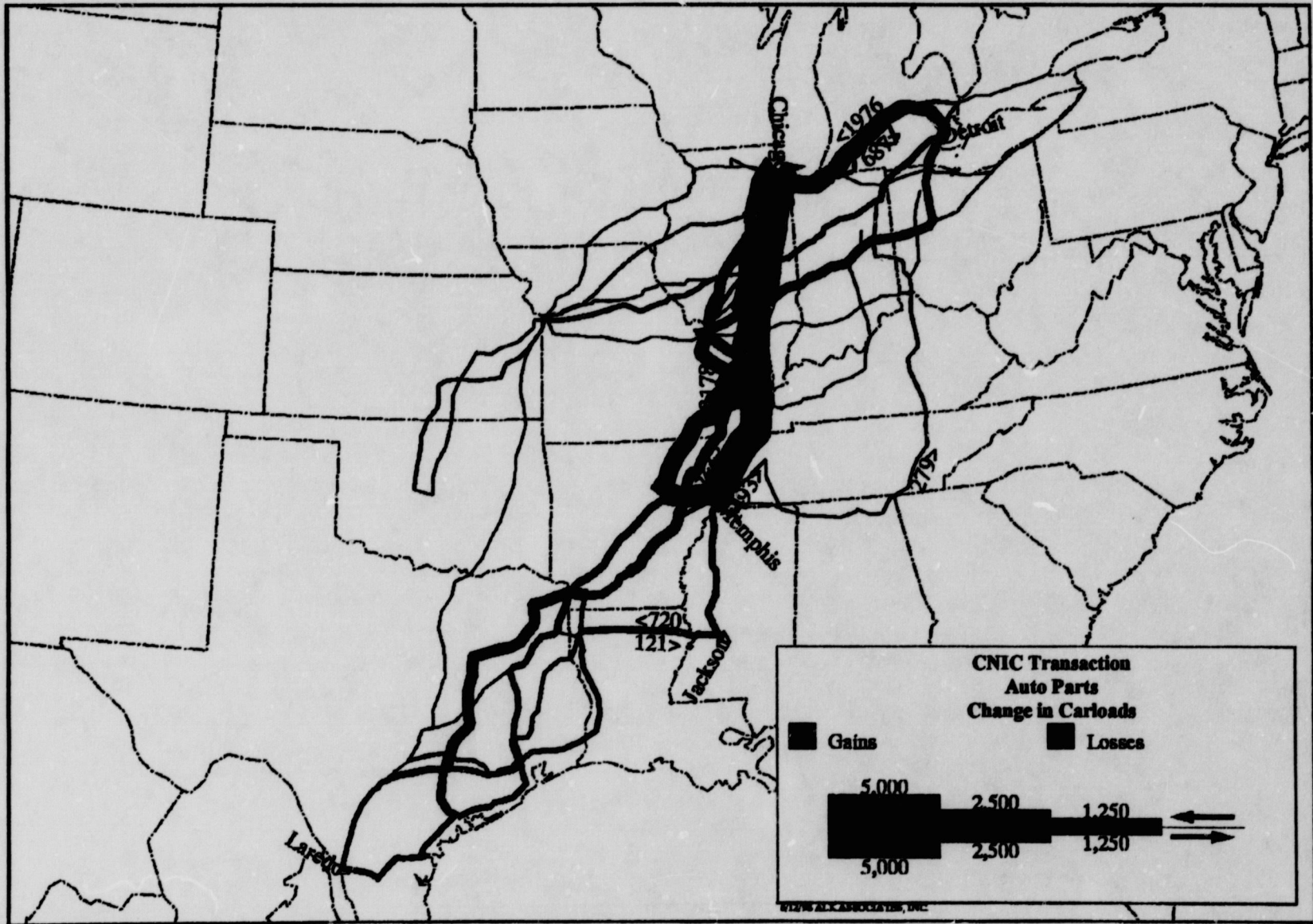


Figure 5: Auto Parts

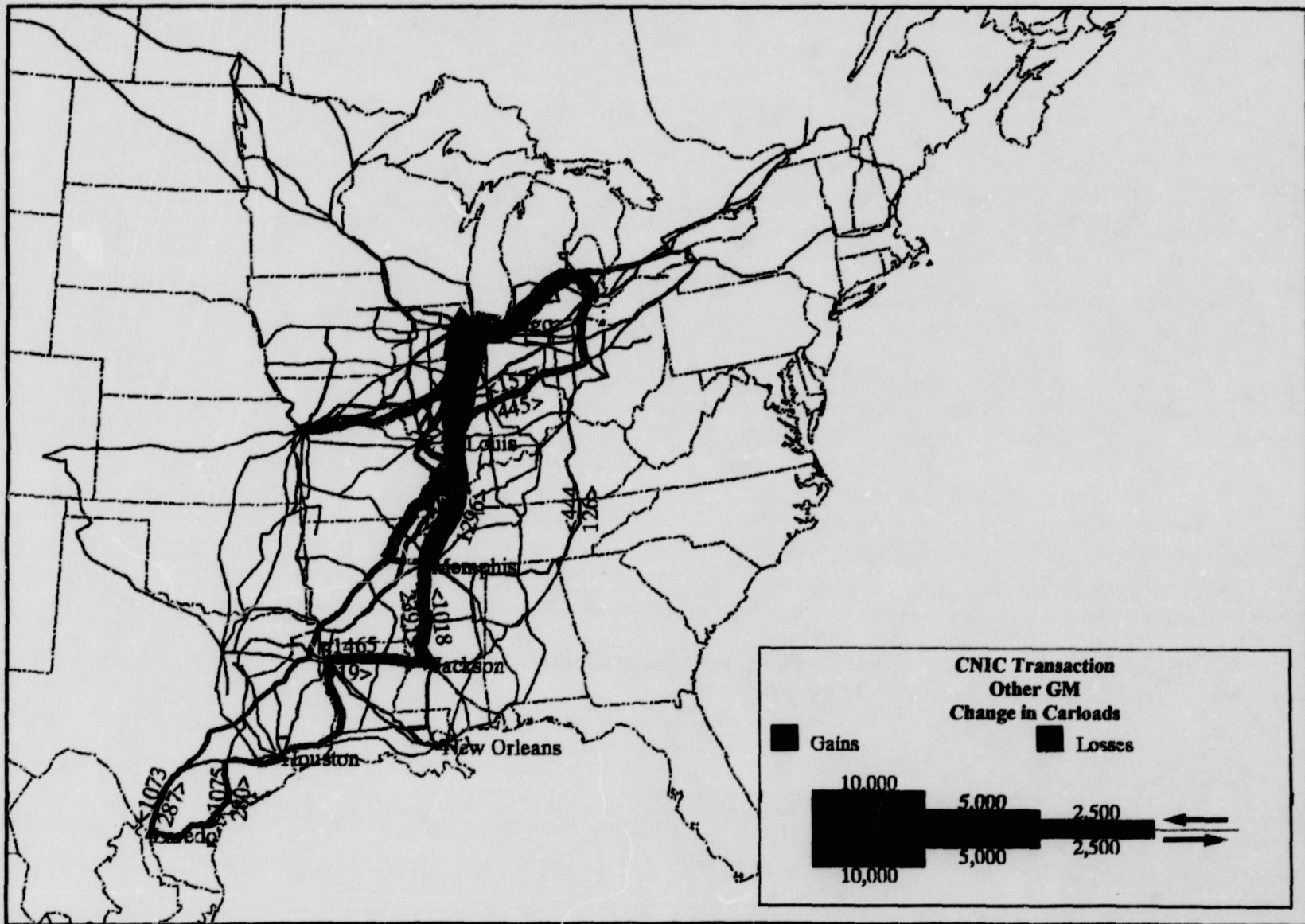


Figure 6: Other General Merchandise

#### 4.2 Automotive (Finished Vehicle)

The CN/IC Transaction in conjunction with the Alliance would improve opportunities for finished vehicle shipments originating at CN-served assembly plants to reach markets in the Southwest and Southeast U.S., as well as Mexico, utilizing new integrated service and routings to major metropolitan areas including Dallas, Houston, New Orleans, Shreveport and, to a lesser extent, Laredo (for traffic destined to Mexico). In addition, automotive vehicle shippers at Shreveport (Reisor), Arlington, Texas, and Kansas City, Missouri as well as Mexico would have access to new rail routings that connect manufacturing concentrations in Canada, the U.S. Midwest, and Mexico. Automotive traffic diversions suggest the creation of a strong NAFTA carrier that can provide direct benefits to the automotive and associated manufacturing industries. Western shippers also stand to benefit from efficient new automotive service CN/IC plans to inaugurate from Flint, Michigan, to Chicago's Markham Yard, and then over the lines of the former CCP to Council Bluffs, Iowa, for interchange with UP. Our analysis indicates that \$61.2 million per year of finished vehicle traffic would divert to the CN/IC system.

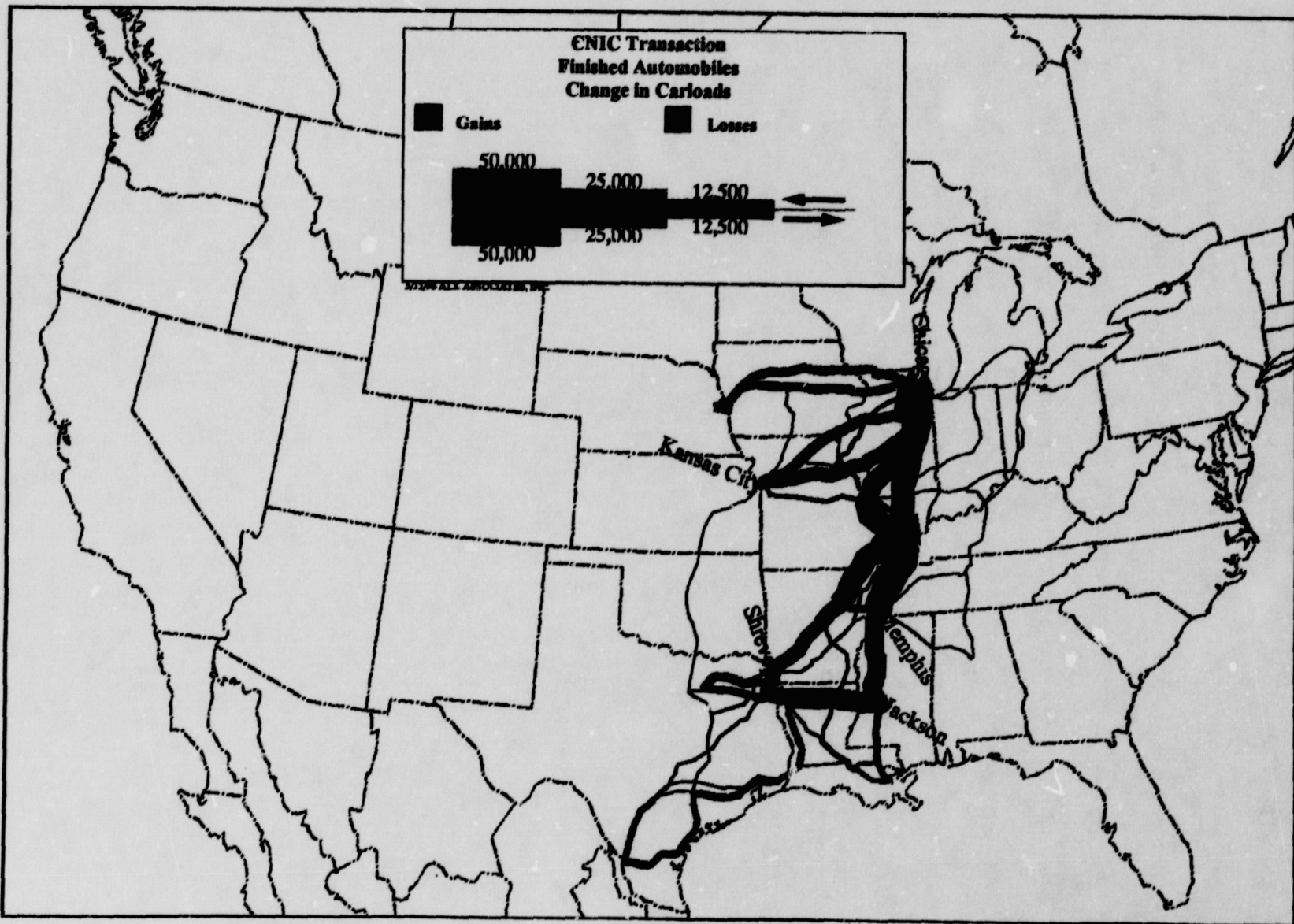


Figure 7: Finished Automobiles

### 4.3 Intermodal

The results of our intermodal traffic diversion analysis suggest that approximately \$13.8 million per year in existing rail intermodal traffic could be diverted to the new CN/IC system. (These results do not include CN/IC's gains from CN's separate port diversion study discussed in the verified statement of Mr. Litzzen.) A significant portion of this traffic will benefit from synergies between the Transaction and Alliance, which should create more competitive service for movements to and from the Dallas or Kansas City areas, or in Mexico. Intermodal rail traffic did not generally divert to or from the Houston area. None of the Alliance members has direct access to Houston, and the trackage rights of KCS's affiliate Tex-Mex do not permit that carrier to solicit Houston originating or terminating traffic absent a prior or subsequent haul on its route to and from Mexico.



**Table 4: Intermodal  
Change in Revenue in Thousands**

<b>CARRIER</b>	<b>CHANGE</b>
CN-IC	\$13,760
KCS	\$6,179
TEX-MEX	\$3,011
UPSP	(\$13,889)
BNSF	(\$2,554)
CR	(\$222)
NS	(\$3,329)
CSX	(\$265)
CP	(\$2,627)

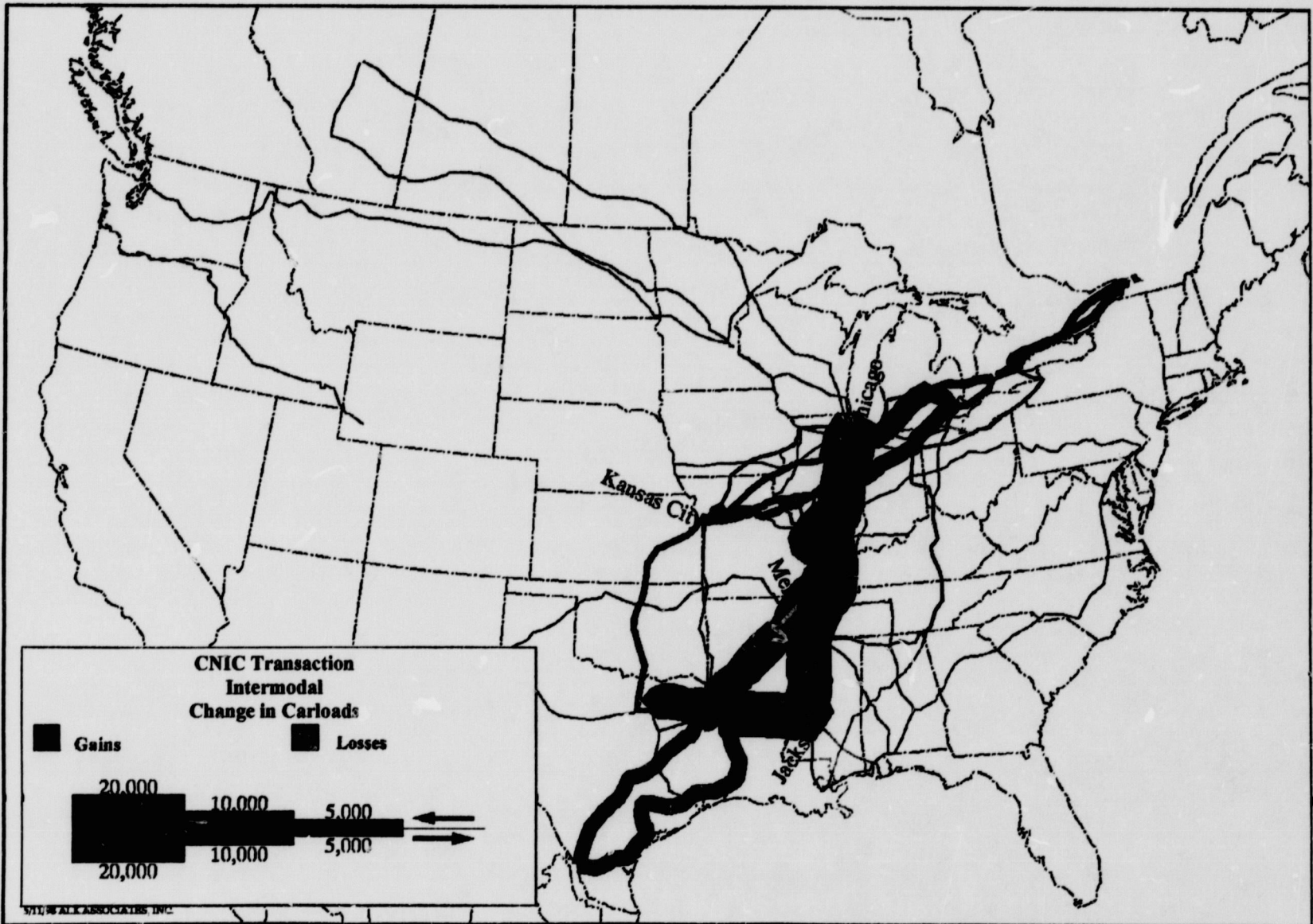


Figure 8: Intermodal

#### 4.4 Coal/Bulk

Our analysis shows very limited diversions to the CN/IC system for coal/bulk traffic flows -- approximately \$3.6 million annually. Relatively meager diversions of coal traffic are not surprising given the fact that neither CN nor IC is a major coal-hauling carrier in the affected markets. The small diversions of revenue for grain traffic reflect the fact that there are relatively small volumes of transborder grain movements, and that the ATD analysis (as noted above in Part 1) does not address potential shifts in traffic origin and destination patterns.

**Table 5: Coal/Bulk  
Change in Revenue in Thousands**

<b>CARRIER</b>	<b>CHANGE</b>
CN-IC	\$3,581
KCS	\$1,330
TEX-MEX	\$0
UPSP	\$2,068
BNSF	(\$5,429)
CR	(\$54)
NS	(\$536)
CSX	(\$263)
CP	(\$633)

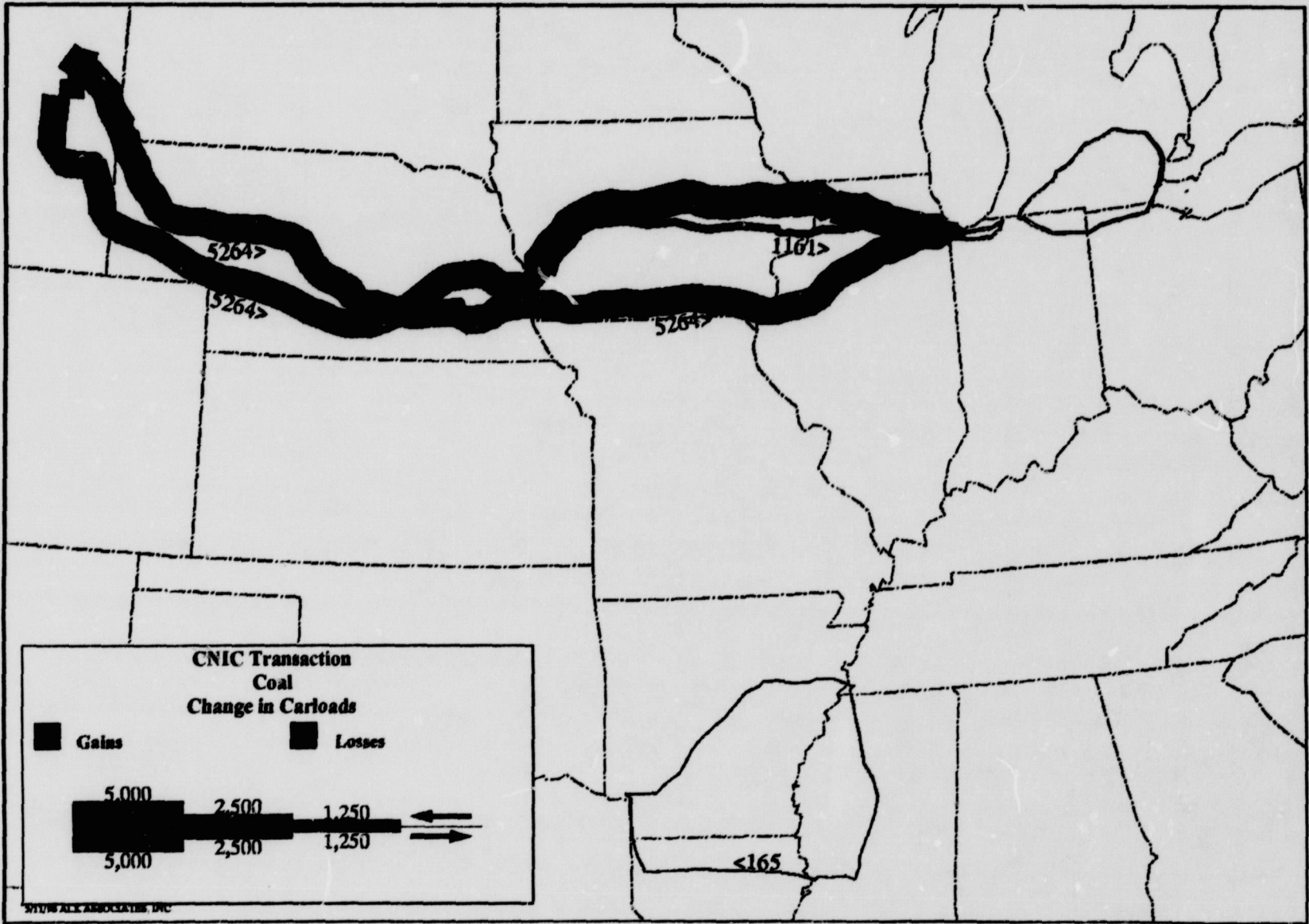


Figure 9: Coal

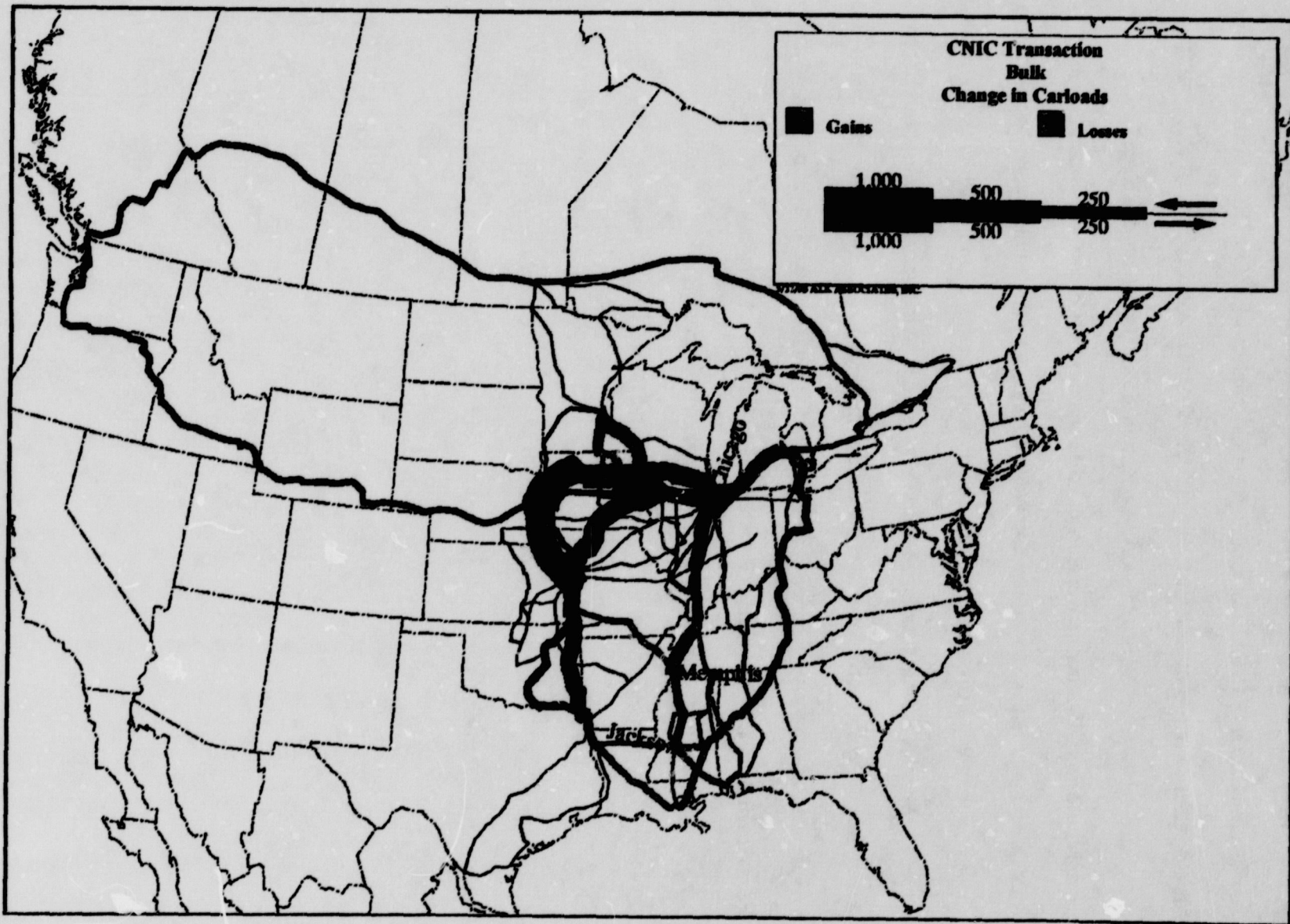


Figure 10: Bulk

#### **4.5 Reload Traffic**

Working with CN/IC, we analyzed various commodities and determined the potential for diversions to rail-to-truck reload centers. Our analysis considered which commodities could practicably be reloaded from existing IC reload centers, and then included as candidates for rail diversion movements of those commodities on other railroads terminating within a 150 mile radius (a reasonable drayage distance) of those reload centers. This would allow, for example, a CN-served forest products manufacturer to ship to an IC-served reload center in Memphis for transloading and delivery by truck to a destination that was formerly served directly by rail (or through a shorter dray) within a 150-mile radius of Memphis. For purposes of this study, we assumed there to be a \$300 per carload transloading cost, which we deducted from CN/IC's reload diversion revenues in the table below (as well as in Table 1, above). In addition, the waybill revenues attributable to direct rail that would now be supplanted by truck delivery were deducted from CN/IC's diversion revenues. As shown in Table 6, our analysis showed approximately \$10.1 million of annual revenue diversions as a result of the CN/IC Transaction, the great majority coming at the expense of CSX. A breakdown of those diversions by location and commodity is provided in Table 7.

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**Table 6: Reload  
Change in Revenue in Thousands**

<b>CARRIER</b>	<b>CHANGE</b>
CN-IC	\$10,098
KCS	(\$307)
TEX-MEX	\$0
UPSP	(\$2,696)
BNSF	(\$2,464)
CR	(\$3,634)
NS	(\$3,327)
CSX	(\$8,644)
CP	(\$2,903)

**Table 7: Summary of the Diversion Revenues for Reloads**

<b>Reload by Location</b>		<b>Reload by Commodity</b>	
<b>Baton Rouge</b>	(\$7,627)	<b>Lumber</b>	\$4,225,587
<b>Indianapoliss</b>	\$2,655,516	<b>Woodpulp</b>	\$466,458
<b>Jackson</b>	\$325,221	<b>Paper</b>	\$4,332,416
<b>Memphis</b>	\$758,566	<b>Metal/Const.</b>	\$1,074,119
<b>Omaha</b>	\$1,239,695		
<b>Paducah</b>	\$5,127,209		
<b>Grand Total</b>	<b>\$10,098,580</b>	<b>Grand Total</b>	<b>\$10,098,580</b>



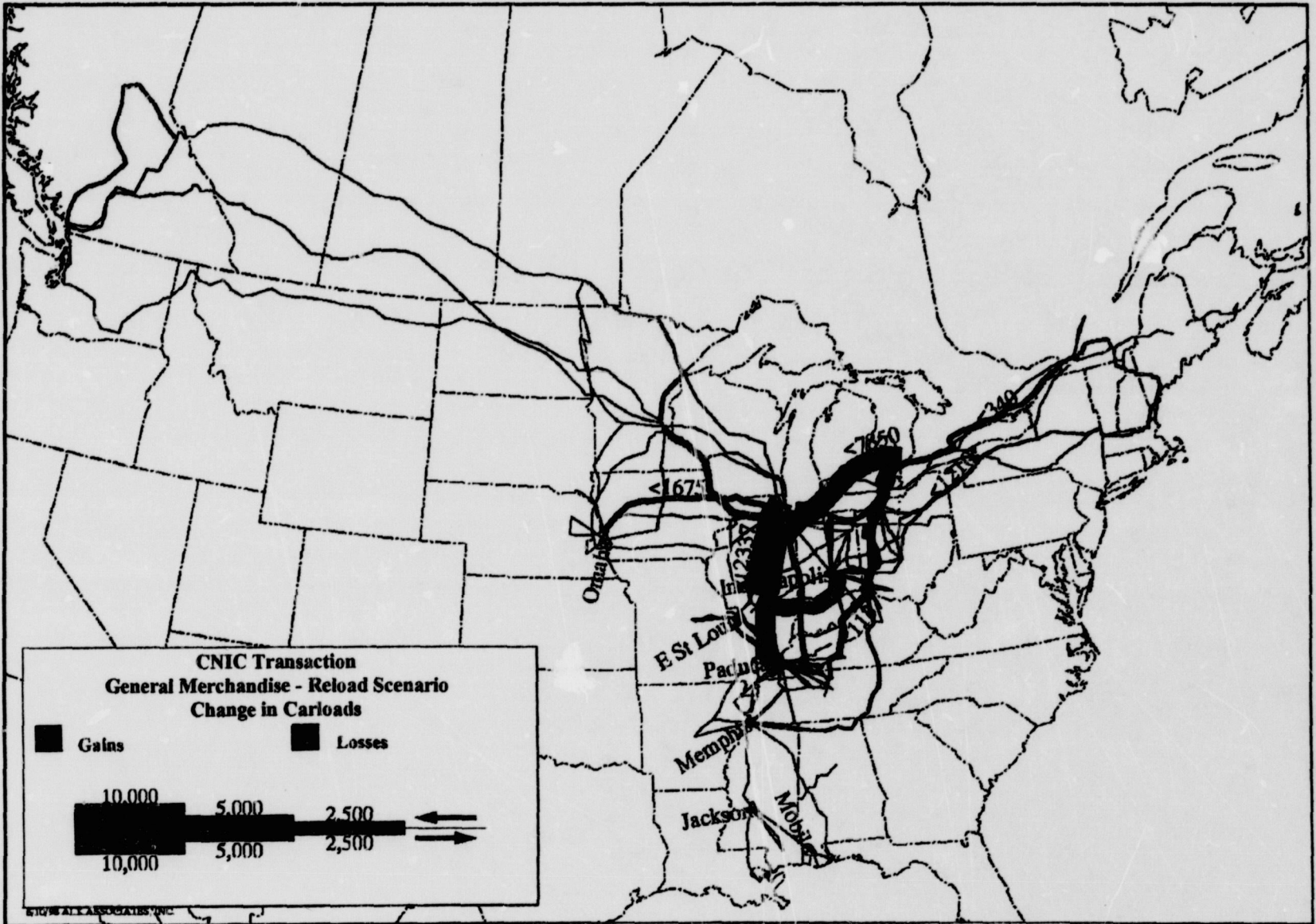


Figure 11: General Merchandise - Reload Scenario

## **Summary**

**Our analysis of the proposed CN/IC Transaction using base year 1996 suggests that CN/IC would gain approximately \$217 million in gross revenues from rail-to-rail traffic diversions due to the CN/IC Transaction. When added to the \$23.4 million in truck-to-rail intermodal diversions found by Reebie Associates, and the \$7.5 million in port diversions found by CN's intermodal team working under the direction of Mr. Litzzen, total gross revenues from diversions for CN/IC would equal \$248 million.**

**UNION PACIFIC RAILROAD COMPANY**

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**VIA UPS NEXT DAY AIR**

The Honorable Linda Morgan  
Chair, Surface Transportation Board  
1925 K Street N.W.  
Washington, D.C. 20423

Dear Chairman Morgan:

I am writing to respond to the letter sent to you by Mr. Kenneth Cotton on behalf of the "Houston and Gulf Coast Railroad." In his letter, Mr. Cotton states that his "business is threatened and almost destroyed" by Union Pacific Railroad Company's ("Union Pacific") "anti-competitive, racist management." Mr. Cotton's inability to obtain business from Union Pacific is not a result of racism or anti-competitive conduct. To the contrary, an examination of the facts reveals that Mr. Cotton's charges are totally unfounded.

As a threshold matter, while Mr. Cotton proposed two business schemes to Union Pacific, he never demonstrated that he had the resources to deliver on his plans. Union Pacific has been unable to locate any information indicating Mr. Cotton is running a viable business capable of performing the contracts he proposes. In conversations with Union Pacific's representative, Jack Patton, Mr. Cotton indicated the Houston and Gulf Coast Railroad operated out of a spare bedroom of his apartment.

In the first scheme Mr. Cotton proposed to Union Pacific, he made a series of "offers" to purchase or lease Union Pacific's right of way between Houston and Galveston and Eureka Yard to operate a commuter rail line (Exhibit "A"). Mr. Cotton's offers contained no details on how he could finance the transaction. Id. Union Pacific declined these offers (Exhibit "B").

Mr. Cotton subsequently filed suit against Union Pacific and others for forty million dollars in a suit styled: Cause No. C.A. No. H-94-4268, Kenneth Cotton vs. Metropolitan Transit Authority, Union Pacific Railroad, Southern Pacific Railroad, Burlington Northern Railroad, and Houston Belt & Terminal Railroad, in the United States District Court for the Southern District of Texas, Houston Division (Exhibit "C"). In this suit, Mr. Cotton alleged the Metropolitan Transit Authority and the railroad defendants monopolized commuter rail in Houston and colluded to prevent him from opening a commuter rail system because of his race. Id. Mr. Cotton's complaint was dismissed with prejudice by the United States District Court as a matter of law (Exhibit "D"). In its opinion the

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The Honorable Linda Morgan

Page 2

June 25, 1998

Court found that Mr. Cotton had failed to produce any evidence that he was "capable of financing a commuter rail line, that he made any contracts in furtherance of a commuter rail line, or that he has the background and experience in the commuter rail industry." *Id.* at 15. This dismissal was upheld on appeal by the United States Court of Appeals for the Fifth Circuit (Exhibit "E").

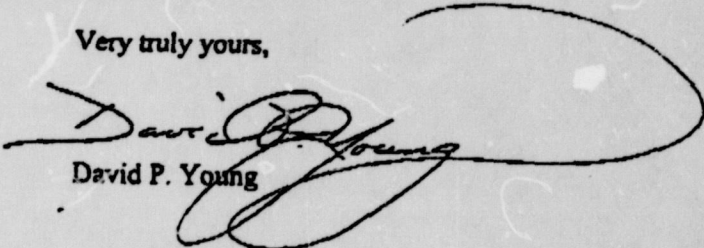
Mr. Cotton even took his proposal for a commuter rail operation to the Interstate Commerce Commission ("ICC"). In December, 1994, Mr. Cotton filed a Feeder Line Application with the ICC again seeking sale of Union Pacific's trackage between Houston and Galveston (Exhibit "F"). Mr. Cotton's Feeder Line Application, however, was apparently never processed because he did not pay the required filing fee (Exhibit "G").

As we understand Mr. Cotton's latest scheme for doing business with Union Pacific, he proposes to store cars near Wharton, Texas. The proposed storage site is an abandoned sulphur mill located near Cane Junction (the "Site"). Mr. Cotton has told Union Pacific that he does not own the Site but that he could obtain rights to use it if Union Pacific enters into a long-term contract with his company. Even assuming Mr. Cotton could obtain the Site, Mr. Cotton's proposal is unfeasible from an operational standpoint and would impede fluid operations in this area. Moreover, Mr. Cotton has proposed that Union Pacific pay an exorbitant price for storage. Union Pacific has notified Mr. Cotton that it is not interested in pursuing his latest proposal (Exhibit "H").

Union Pacific takes strong exception to Mr. Cotton's allegation that its management is either racist or anti-competitive. Union Pacific is an Equal Opportunity Employer and maintains affirmative action programs which promote minority business enterprises. The only reason Mr. Cotton's proposals have failed is that they are technically and economically unfeasible. Furthermore, Mr. Cotton has no apparent resources to perform his obligations under the proposals. Union Pacific has no obligation to conduct business with everyone who makes a proposal.

If you need additional information, please contact us.

Very truly yours,

  
David P. Young

DPY:klh

Attachments 8

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The Honorable Linda Morgan

Page 3

June 25, 1998

copy: Mr. Vernon A. Williams  
Secretary, Surface Transportation Board  
1925 K Street N.W.  
Washington, D.C. 20423  
**VIA UPS NEXT DAY AIR**

Mr. Kenneth B. Cotton  
3203 Areba  
Houston, TX 77091  
**VIA UPS NEXT DAY AIR.**

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June 19, 1998

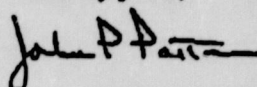
Mr. Kenneth B. Cotton  
Houston and Gulf Coast Railroad  
3203 Areba  
Houston, Texas 77091

Dear Mr. Cotton:

After reviewing your proposal to store cars on the Houston and Gulf Coast Railroad, we have decided to decline your offer. We believe your proposal is both technically and economically infeasible.

Union Pacific Railroad Company is not interested in any further negotiations at this time.

Sincerely yours,



Jack P. Patton

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APPENDIX B

HIGHLY CONFIDENTIAL

MATERIAL OMITTED



STB FD 32760 (Sub 26) 9-18-98 B 191210V3 1/4

191210

BEFORE THE  
SURFACE TRANSPORTATION BOARD

Finance Docket No. 32760 (Sub-No. 26) 2/



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 --  
HOUSTON/GULF COAST OVERSIGHT

UP'S OPPOSITION TO CONDITION APPLICATIONS

VOLUME 3 - VERIFIED STATEMENTS

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Corporation, Union Pacific  
Railroad Company and Southern  
Pacific Rail Corporation

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Part of  
Public Record

September 18, 1998

2/ Including related sub-dockets.

VOLUME 3

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**VERIFIED STATEMENT**

**OF**

**ALAN D. DeMOSS**

My name is Alan D. DeMoss. I am a consultant in the transportation industry. I offer this statement not as a retained consultant, but, rather, in the interest of historical accuracy to record my personal perspectives, as a former Southern Pacific senior executive, on the development of Southern Pacific's infrastructure in the Houston area. I am providing this statement voluntarily and without compensation. I have no contract with Union Pacific ("UP") or Southern Pacific ("SP"). I have no stock ownership in Union Pacific.

Prior to my retirement in 1985, I was an employee of Southern Pacific Transportation Company (SPT) and its predecessor, Southern Pacific Company, for 42 years. Initially, I was employed as a draftsman and chief of field survey party in the Engineering Department. I then advanced through the Engineering and Maintenance Departments, first as General Track Foreman, then as Assistant Division Engineer on three divisions, and as Division Engineer at Ogden, Utah. I also served for a time as Assistant Superintendent and Superintendent at operating divisions.

I was then assigned as Assistant Engineer of Maintenance for Southern Pacific System Track and Structure Maintenance with responsibility for rail and crosstie renewals throughout the SPT system.

I was then promoted to Vice President of Purchasing for all materials and equipment for Southern Pacific, St. Louis Southwestern Railway Company (SSW), and all other subsidiary companies, including the SP Pipelines and the Land Company.

Next, I was appointed Vice President in Southern Pacific's Executive Department, where my responsibilities included corporate insurance, pension plans, the Bureau of Transportation Research, several major subsidiary companies, railroad merger studies, abandonment and sale of rail lines, and discontinuation of commute passenger service and subsequent successful negotiations of subsidies.

I was Vice President-Operations for SPT and SSW in the 1978-1980 period, when SPT/SSW was faced with ever increasing traffic from an expanding U.S. economy in grain export, increasing coal shipments, expanding petrochemical markets, and increases in automotive and intermodal traffic. In that same period, SPT had a severe locomotive shortage, with out-of-service ratios of up to 30%, coupled with a pressing need to rehabilitate and expand substantial mileage of track in the Gulf Coast area.

My next assignment was as Senior Vice President with responsibility for various rail studies and for serving as SPT's representative on the Association of American Railroad (AAR) Research Committee.

In the last four years of my career with Southern Pacific, I was the Chairman and President of its trucking subsidiary, Pacific Motor Trucking Company (PMT), during a period of motor carrier deregulation in which PMT was suffering severe losses but become profitable prior to my retirement in 1985.

I graduated with honors from Sacramento State College with a major in mathematics and a minor in physics, and, later, I attended the Graduate School of Business at Stanford University under an Alfred P. Sloan Foundation fellowship grant.

In 1988, I offered testimony before the Interstate Commerce Commission ("ICC") in support of Kansas City Southern's competing bid against Rio Grande Industries' bid to acquire SP. I supplied that testimony because I believed that Rio Grande's business plan, in which it planned to forego investment in SP's Sunset Route and to reroute traffic from that line to the SP-DRGW Central Corridor line over several mountain grades, would prove unsuccessful. I opined that SP should invest in the Sunset Route, which I believed needed substantial capacity expansion, as it does today. Also, I testified that Rio Grande Industries' plan was deficient in the purchase of new locomotives. Looking back, I believe that history has confirmed the accuracy of my views.

I offer this testimony, based on 42 years of railroading experience with SP, to explain how SP's unique history resulted in inadequate infrastructure in the Houston area. To explain how this came about, I must describe SP's difficult, and probably impossible situation more than three decades ago, and how SP management responded to its predicament.

SP was a weak and financially troubled railroad for so many years that many people may not recall its earlier successes. As late as the 1950s, SP was a profitable and respected company in the West, reviled by generations of California politicians for its power and influence. Reflecting its strength, SP during the 1950s operated several of the nation's premier passenger trains. I recall that from 1956

through 1960, that in the harvest season the company regularly ran 10 daily sections of 100-car trains of refrigerated perishables out of the Salinas and Central Valleys, over the Sierra Nevada through Reno and across the desert to Ogden and the interchange with UP. Almost as many perishable trains departed Southern California every day over the Sunset Route for interchange to the Rock Island at Tucumcari.

Many of SP's strengths in the 1950s were also its future weaknesses. In my opinion, SP faced a number of disabling handicaps as it moved through the 1960s and into the 1970s. Reviewing each of them would take too much space for this statement, but I will list a few:

- SP lacked a solid base of bulk traffic such as coal and grain. It relied on commodities that often fluctuated with business cycles, such as lumber, automobiles, canned goods and perishables.
- SP traffic was especially vulnerable to the impact of the Interstate Highway System. Before those highways were built, SP could count on hauls of 500 miles and up to provide a traffic base and profits. Aided by the new Interstate Highway System, truckers could and did attack SP's short and long hauls. Interstate 5 took away a large portion of SP's West Coast lumber traffic to Los Angeles. Within a 12-year period after 1960, SP's perishable traffic declined from 10 trains per night through Roseville to 2 or 3, and by 1981 we were down to only one train. We also lost much of the canned goods traffic to motor carriers. Nothing took the place of those traffic flows.



- SP depended heavily on automotive traffic, especially from General Motors. As motor vehicle imports began to flood the West Coast, General Motors decided to close most of its West Coast manufacturing plants. This cost SP between \$300 and \$400 million dollars in annual revenue, an amount that would be much larger in today's dollars.
- Unlike many other railroads, SP had large-scale terminal operations. We originated and terminated a large share of the railroad carload business in Southern California, Northern California and Oregon. UP, by comparison, operated in those years primarily as a bridge carrier between the Missouri River and Ogden. Terminal operations are disproportionately expensive and require large amounts of switch engines, fuel, crews and supervision.
- In my view, no major American railroad faced the physically demanding conditions and costs SP confronted year in and year out. Every major SP route in the West surmounted mountain passes, most with 2.2% grades or worse. Our north-to-south West Coast route crossed the Cascade Mountains in Oregon with heavy grades, tunnels, sharp curvature and unstable subgrade with slides which cost millions to mitigate. Our alternative route over the Siskiyou was even tougher, with 14-degree curves and grades over 3%. We were forced to deal with severe curvature and gradients in Northern California and operated through numerous tunnels in the Sacramento River Canyon. Our Coast Line between the San Francisco Bay Area and Los Angeles passed over the 2.2% Cuesta Grade near San Luis Obispo, and the San Joaquin Valley Route climbed over the

Tehachapi Pass on 2.2% grades and on 10-degree curves through several tunnels. All eastbound traffic for Chicago and Houston leaving Southern California went over Beaumont Hill and another summit near Benson, Arizona. Our Central Corridor route climbed from sea level to 8,000 feet at Donner Summit, then climbed another steep grade near the Nevada/Utah line.

- SP had more timber tunnels, snowsheds and trestles than any other railroad. These were expensive to maintain and often caught fire.
- At any time, somewhere on this far-flung railroad, nature was at work with blizzards, forest fires, washouts, dust storms, floods, earthquakes, snowstorms and hurricanes, all of which cost millions of dollars to correct. The most expensive example in recent years was the rise of the Great Salt Lake to historic water levels in the early 1980s, which cost SP tens of millions of dollars to maintain rail service over the new \$50 million, 11-mile long, earth fill that replaced the 1903 timber trestle in 1958.

During the 1960s and 1970s, under the leadership of D.J. Russell and B.F. Biaggini, SP struggled with the effects of its declining revenue base. Although the railroad was profitable during the Russell years, executive management pressed for a steady profit growth, even though the revenue stream was no longer sufficient to support such growth. With inadequate revenues to maintain the railroad, management had little choice but to reduce capital investment and ordinary repairs now known as "capitalized maintenance." From about 1960 onward, SP had insufficient funds to meet all maintenance requirements, to say nothing of adding needed capacity. We usually spent

what we had to spend on the physical plant to stay in business, with only a few dramatic investments such as the Great Salt Lake Fill project in the 1950s and the Palmdale Cutoff and West Colton Yard, in the 1960s.

During those years, SP's maintenance-of-way budget was determined less by what was needed to maintain the railroad than by what was needed to keep profits growing. We cut the maintenance-of-way budget to the minimum level necessary to keep the railroad running. We spent more than the bare minimum only if we had funds left over after meeting the profit target. For example, in 1964 the budget included only 400,000 ties and only 70 miles of new rail, not nearly enough to sustain the railroad over the long run. We had to deploy the cross-ties as "safety ties," replacing only enough of the defective ties to make sure that the railroad was safe to run. At other times if we approached the end of the year with more money than was needed to make the profit target, we tried to spend more money than could be efficiently utilized in a short period of time.

The maintenance-of-way deficit was worse east of El Paso stretching to St. Louis and New Orleans on the St. Louis Southwestern (SSW) and the Texas & Louisiana lines (T&L). Before about 1970, the SP Pacific Lines west of El Paso, the SSW and the T&L were operated almost as though they were separate companies with separate management. Managers rarely moved from one property to another. The three operations had their own cultures and approaches to railroading and maintenance.

During the 1960s, the SSW and the T&L did not receive their fair share of maintenance funds considering their soft subgrade conditions and increasing traffic levels. Train schedules in Texas placed stresses on the track structure which was not consistent with its strength. SSW and T&L branches and yards ultimately fell into disrepair. Throughout the Gulf Coast area, the unstable gumbo mud subgrade condition was a major problem. The T&L was not provided funds necessary to build a solid subgrade in unstable territory, so the track structure degraded quickly. For example, when the T&L built trackage along the Houston Ship Channel, it used an inadequate subgrade to handle the heavy chemical traffic. The track structure failed under the load, requiring 5 m.p.h. slow orders and frequent repairs. The T&L was late in receiving CTC signal controls and continuous welded rail.

The central and south Texas area does not have good sources of hard ballast such as granite or hard limestone. Much of the T&L was ballasted with soft Texas limestone in the west and seashells in the east, which was quickly pulverized under the increasingly heavier rail car axle loads. Making matters worse, in the early 1960s, top management decreed that SP would allow shippers to overload cars 10% above their rated capacity as long as the cars were "captive" to the SP, meaning that they would not be interchanged to other railroads, which would not accept them. These heavy cars pulverized the T&L's limestone. After the limestone broke down and was subjected to West Texas flash floods, it turned into cement, leaving a roadbed with no resilience. This caused the rails to fail in the joint area, and train slow orders were required.

The SSW and T&L had more than their share of dramatic derailments caused sometimes by track and other times by human error. For example, I recall a derailment near Staraps, Arkansas, where a train derailed on a superelevated curve at excessive speed. Most of the ties were rotten and most of the spikes were loose, so the outside rail threaded through the traction motors of a locomotive and then through a boxcar, coming to rest 30 feet beyond the right-of-way fence. Other derailments destroyed steel bridges. Making the situation worse, train and engine crews were encouraged to run trains such as the Blue Streak Merchandise above the authorized speed limits.

I do not know how these differing maintenance standards emerged, but in the 1960s and early 1970s, managements on the SSW and T&L seemed to be proud of running railroads on less rather than more. SSW and T&L managers were not aggressive in obtaining increased maintenance budgets. The culture, especially on the T&L lines, was what we would today call a "macho" attitude in which no one was willing to admit that there were problems and "we can take care of ourselves." Conversely, Pacific Lines managers west of El Paso were very familiar with the hazards of undermaintaining lines in Oregon, California, Nevada, Arizona, New Mexico and Utah, and I must confess we made sure that all was secure in the far west.

During the late 1960s, SP made a business decision that resulted in extraordinary motive power maintenance requirements. It purchased more than 600 SD-45 locomotives, a 20-cylinder locomotive to use on its heavy grades for many hours of continual tractive effort. By the early 1970s, after several years of heavy service, these

locomotives suffered from cylinder assembly water leaks, "A" frame cracks and AR10 alternator failures. These repairs cost SP many horsepower hours and, although the manufacturer finished materials under warranties, it did not pay the labor costs of the repairs.

Mr. D.J. Russell retired in 1970 and Mr. B.F. Biaggini became Chairman and CEO. He made several changes over the following years, although SP's inherent problems remained. Some changes worked well, while others were much less successful. For example, Mr. Biaggini began to look beyond traditional sources for managers. He hired some non-railroaders for management positions. He also started tapping the business schools for promising talent, such as Steve Burd, now CEO of Safeway Stores; Rob Krebs, who now runs BNSF; Rollin Bredenberg, who is now an executive with BNSF; and Mike Ongerth, who is now an official with UP.

Mr. Biaggini also invested in non-railroad businesses. One of those investments turned out quite well. Based upon its railroad microwave system, SP created SPRINT Communications. Although SPRINT was struggling against AT&T and MCI, GTE bought it for \$1 billion, giving SP a profit of some three-quarters of a billion dollars. SP's investment in the TICOR Title Insurance Company was far less successful because the recession beginning shortly after 1980 was not kind to the real estate market.

Mr. Biaggini recognized some of the track conditions on the T&L and SSW, and he initiated signal and track rehabilitation. The T&L started installing continuous welded rail and CTC on the Sunset Route between El Paso and Flatonia, Texas, as well as elsewhere in the years 1972-73.

In the mid-1970s, SP's Mechanical Department made what I consider to be a serious mistake, although I can make that judgment only in retrospect. A consulting firm was employed to revise SP's locomotive maintenance procedures, compensating the consultants on the basis of the short-term savings it generated. Many who worked on SP at the time viewed this experiment with great concern. The consultants recommended that SP transform the process of locomotive running maintenance at servicing terminals from a "job-shop" process to a "production" line. Electricians who would normally "troubleshoot" problems at intermediate terminals were transferred to production lines in major locomotive shops.

When I became Vice President-Operations in 1978, locomotive availability had dropped to between 70% and 80% of the fleet of about 1,600 active locomotives. One of my first acts was to discontinue the use of the consulting firm. SP had proved that a railroad cannot perform locomotive running repairs on a production-line basis. I do not believe a railroad can perform even heavy locomotive maintenance that way, because each unit's problems are unique. Repairing locomotives is not like manufacturing new automobiles.

When I replaced R.L. King, whom I consider to be a great operating officer, as SP's Vice President-Operations we were out of control. With more than one out of every five locomotives out of service and rail traffic surging, SP had difficulty moving trains. Because of complaints from shippers on the West Coast, the ICC placed us under an emergency service order that required us to move every car in a terminal every 24 hours. This made the situation much worse. For example, we were not

allowed to stage cars for shippers whose facilities were full. We had to move them, even though there was no reason to move them, or an ICC inspector would fine us. Without my knowledge at the time, some of our division officers moved trains in the wrong direction just to comply with the order to move cars every day. Then they moved the trains back the next day.

The worst place on the SP system in 1978 was the Texas Gulf Coast area, and it kept getting worse. To overcome the problems I declared "World War III," since I had experienced World War II as a rifleman. In my opinion, World War III erupted because of heavy grain traffic, combined with a surge in petrochemical and intermodal traffic on weak trackage and no added capacity for that volume of traffic. World War III lasted more than two years from the fall of 1978 to the fall of 1980.

Shortly after becoming Vice President-Operations, I went to Houston to see the situation for myself. Sidings and branch lines all over the region were occupied by trains and cuts of cars that were not moving. Yards could not accept inbound trains because they were blocked with outbound trains. We were short of serviceable locomotives, and the situation was getting worse because active locomotives were idle in trains set-out in sidings. We were short of train and enginemen because the crews were failing to make it across their districts under the federal 12 hour law due to congestion and, as a result, were unavailable to move additional trains.

I recall that I tried to get some rest at my motel during my first weekend in Houston. I never did, because there were too many derailments. At one derailment, the rail was so badly worn that the flange of the wheel was riding on the web of the rail.



In the LaPorte area south of our big Englewood yard at Houston, I saw 10 new covered hopper cars loaded with plastic pellets on their sides caused by defective cross-ties. When I asked the men working on the derailment about their work, they told me that they spent every weekend rerailling cars. After the cars were rerailed, I went back to my motel. Shortly after, I received a call. The same cars had derailed roughly a quarter of a mile away from the first derailment site. At Englewood Yard, the largest SP classification yard in Texas, switch engines could not move faster than 5 m.p.h. without risk of derailing at the trim end of the "bowl."

The SP managers in Houston were very experienced railroaders familiar with their territories and their jobs. They were overwhelmed by the increase of traffic, the lack of capacity and the physical condition of the track structure.

I knew that it would take three or four years to rebuild the SP physical plant in the Rio Grande Valley, the greater Houston area and Houston to New Orleans, and to add enough capacity to handle the traffic shippers were giving us, but our immediate challenge was to remain in business. We worked up a program to rebuild facilities in 8 months under traffic. We rehabilitated large parts of the Houston-New Orleans line, improved the signal system on that line, including some CTC, rebuilt Glidden Yard, reconstructed the Houston Light & Power Lead in the LaPorte area, rehabilitated the Bayport Loop, and rebuilt the big Englewood yard using a cement treated earth base to stabilize the subgrade. I did not have a budget or authority, but I spent \$40 million in the summer of 1979.

We did what we had to do to stay in operation. Most of these projects did not add capacity, but rebuilt existing assets. We made numerous operational changes as well and changed the traffic mix. For example, we established a high switching charge to discourage inefficient traffic that was clogging Englewood. Even the forces of nature were against us. It rained one inch per hour for 12 hours one day at Englewood Yard. We fixed the inoperative track scale at Strang south of Houston, only to have lightning strike it the next day, which made the Arco and DuPont traffic managers even more angry.

When a railroad collapses as SP did in Houston during World War III, it is the result of many years of underinvestment. When a railroad gets that far into a hole, it is very hard to climb back out. We had to hire and train large numbers of new train and engine crew members, even though we knew we needed them only because we were operating so inefficiently. We had to bring large numbers of locomotives onto the system as well. I recall that N&W had a strike at the coal mines, so we borrowed about 100 of its locomotives. When N&W's strike ended, N&W asked for the locomotives back. SP operating officers all over the system refused to let the units go, because our situation was so desperate. It is important to note that railroads (a) don't usually move fast to invest in line capacity for theoretical traffic in the future and (b) when they are swamped by an unexpected surge in traffic volume the process of assembling capital, labor and materials for added line capacity takes months and sometimes years for completion.

SP's emergency investment, hiring, operating changes and commercial actions positioned SP to recover from World War III by late 1980. In my opinion, though, SP would not have recovered then had the economy not slipped into a downturn and, by 1981, a recession. Facing a sharp traffic decline, SP in 1982 reduced budgets and discontinued plans for line capacity. The Mechanical Department budget for locomotive maintenance no longer was a high priority. SP had purchased more than 100 new locomotives for World War III, but they were immediately stored in mothballs at El Paso, Texas.

Beginning in 1981, I served as President of Pacific Motor Trucking, SP's trucking subsidiary, which I returned to profitability in a deregulated environment. Based on my observations from that position and as a student of the transportation industry, it appears to me that from 1982 until the UP merger, SP added very little capacity to its track structure, and none in the Houston area. After the recession of 1982-83, SP was preoccupied with the possibility of a merger with Santa Fe for several years, a merger that would have eliminated the need for new capacity on parts of the Sunset Route. For a time after the ICC denied Santa Fe's merger with SP Railroad, SP management was under the trusteeship of banks. This was not helpful. At the same time, the UP-MP-WP merger provided increased competition for SP, and trucks continued to make inroads on SP's historic traffic which is susceptible to highway diversion. After a successful merger, the new Rio Grande management of SP seemed to focus on other parts of the system and apparently tried to route large amounts of traffic over the Central Corridor, unsuccessfully in my opinion. Only after Mr. Moyers took over did

the railroad again add mainline capacity, when it removed some double track rails from the Central Corridor and relaid them near Tucson on the Sunset Route. SP needed this capacity urgently, but it also needed capacity in the Gulf Coast area.





**VERIFIED STATEMENT**

**OF**

**DENNIS J. DUFFY**

I am Dennis J. Duffy, Executive Vice President-Operations for Union Pacific Railroad Company, 1416 Dodge Street, Omaha, Nebraska 68179. I am responsible for overseeing the entire UP Operating Department. I assumed this new position on September 1, 1998. Previously, I served as Senior Vice President-Safety Assurance & Compliance Process for approximately one year. During my 24-year career with UP, I have worked in Operations, Customer Service, Finance and Marketing & Sales. My operations assignments have included Trainmaster, Superintendent of Transportation and General Superintendent at various locations across the Union Pacific system. I also served as General Director of the National Customer Service Center.

I filed a verified statement in connection with UP's Reply in Opposition to the Joint Petition for Further Service Order on July 28, 1998. In that statement I discussed why, from a service perspective, there was no longer a transportation emergency in the Houston/Gulf Coast area. The purpose of this statement is to update that discussion, reinforcing our conviction that the Houston/Gulf Coast area service problems are over. There is no service-related reason to grant the conditions requested by other railroads or customers in this proceeding.

A. Service Improvement from the Customer Perspective

Once again, my conclusion that the Houston/Gulf Coast area service problems are behind us is based on measurements that we compile to evaluate our own performance and service to our customers.

1. Transit Times to Major Gateways

Transit times from Gulf Coast complexes to all major eastern gateways remain substantially faster than during February and March, when we were implementing directional running. Transit times in most of these corridors have improved since my July verified statement. The following chart shows that transit times are up by over 50% in six of the corridors with significant traffic.

<b>Origin</b>	<b>Gateway</b>	<b>Percent Improvement Since February/March</b>
Bayport/Strang	Chicago	35%
	E. St. Louis	35%
	Memphis	40%
	New Orleans	48%
Baytown	Chicago	42%
	E. St. Louis	47%
	Memphis	56%
	New Orleans	59%
Bloomington/ North Seadrift	Chicago	23%
	E. St. Louis	29%
	Memphis	36%
	New Orleans	52%
Formosa/Lolita	Chicago	43%
	E. St. Louis	39%
	Memphis	51%
	New Orleans	50%



<b>Origin</b>	<b>Gateway</b>	<b>Percent Improvement Since February/March</b>
Freeport/ Chocolate Bayou	Chicago	31%
	E. St. Louis	35%
	Memphis	58%
	New Orleans	45%
Spring Storage	Chicago	48%
	E. St. Louis	32%
	Memphis	58%
	New Orleans	47%

2. Transit Times for Specific Customers

All of the customers that requested conditions in this proceeding complain about excessive transit times. I have reviewed our transit time data for each of those customers. While shipments to and from the facilities of many of these customers suffered major delays during the service crisis, transit times have improved significantly and in a large number of instances have returned to pre-crisis levels or better. Several of our customers, including some of those discussed below, acknowledge to us our improved service but are unwilling to state this publicly, in part to avoid taking positions in conflict with industry groups.

Beginning in late June and ending just over one week ago, we experienced congestion in the West due, in part part, to the learning curve for SP employees after the TCS cutover. As a result, transit times to and from California were adversely affected. On the Sunset Route, train speeds have more than doubled in the last month and a half, and trains held are down from dozens to at most two per day. UP held no trains on the Sunset Route for the last three days. Transit times will improve as a result.

a. Dow Chemical

We track on-time performance in 23 strategic corridors that Dow selected. In these corridors, Dow shipments have arrived either on-time or early more than 90% of the time every week but one since the end of June 1998. During the first week in September, shipments in these corridors arrived on-time or early 97.2% of the time. Transit times in all high-volume lanes are at pre-crisis 1997 levels. Dow shipments between Freeport and Griffith (Chicago) slowed for a few weeks in August due to a temporary transition in our transportation plan that required some of the traffic already in transit to be switched an extra time, but the transition is over. During the first week in September, the average transit time in that corridor exceeded the pre-crisis April 1997 average by less than three hours.

Dow ships cars from Plaquemine to Chicago for interchange with CN at Griffith. Since at least the end of May 1998, weekly average transit times in that corridor have outperformed the average achieved during pre-crisis April 1997, with the exception of only two weeks. During the first week in September, the average transit time in this corridor was better than the April 1997 average by more than a full day.

UP interchanges Dow shipments from Plaquemine with Norfolk Southern at New Orleans. Since at least the end of May 1998, the average weekly transit time for Dow shipments in this corridor has been within one day or below the pre-crisis April 1997 average transit time, with the exception of one week in June. Since June 11, the average transit time between Plaquemine and Freeport has been equal to or within three hours of the average transit time for April 1997.

b. Formosa

UP's service to Formosa has improved significantly since the fall of 1997 and early 1998. Since April 1998, monthly average transit times to all high-volume gateways are at or better than April 1997 transit times. Service to Southern California has not yet returned to where UP and Formosa would like, but now that the congestion in that area has cleared in the last 10 days, transit times should improve significantly.

In March 1998, the average monthly transit time from Formosa to the Chicago gateway was 11.06 days. Transit times have fallen each month since then, and the monthly average was 6.24 days in August and 5.5 days for the first two weeks of September. This compares to average monthly transit times of between 6.38 days and 8.73 days during the first six months of 1997. Transit times on empties returning from Chicago to Formosa have also returned to early 1997 levels. During the first six months of 1997, transit times on these cars ranged from 7.25 to 9.13 days. Since April 1998, transit times have been below nine days every month, and were lower in both July and August than during any month of 1997.

Service from Formosa to the East St. Louis gateway has also returned to pre-crisis levels. Average monthly transit times ranged from 5.14 to 7.07 days for the first six months of 1997. Since April 1998, transit times have been between 5.44 and 7.85 days, with a September average to date of 4.95 days. Transit times on empties returning from East St. Louis are well within pre-crisis levels. During the first six months of 1997, the monthly average return transit time was between 6.17 and 10.42 days. Since April 1998, monthly averages have ranged from 4.69 to 7.36 days.

Transit times from Formosa to New Orleans were very high between October 1997 and March 1998. Since then, they have fallen every month and have been within one day of pre-crisis 1997 times since May, reaching a low of 4.74 days for the month of August. This compares with a range of 3.4 to 5.19 days during the first six months of 1997. The average thus far in September is 3.43 days.

Since June 1998, transit times to Memphis have been within one day of pre-crisis 1997 levels. Transit times in this corridor have fallen dramatically since February when they averaged just over 10 days. The monthly average has been below seven days since May, and was 5.15 days for August. The August average is better than three of the first six months of 1997. The average for the first two weeks of September was better yet, at 4.37 days.

Monthly average transit times on shipments from Formosa to Sweetwater, Texas ranged from 5.34 days to 6.39 days during the first six months of 1997. The July 1998 average was 6.08 days, and the August 1998 average was 5.59 days. Empties are also returning from Sweetwater in pre-crisis transit times. Between April and August 1998, monthly average transit times ranged from 8.62 days in May to 4.86 days in August. This is tremendous improvement since the March 1998 average of 17.41 days, and compares with monthly transit times between 5.52 and 7.95 days during the first six months of 1997.

c. Shell

Major destinations for petrochemicals produced at the large Shell plant in Deer Park, Texas, include the eastern gateways of East St. Louis and New Orleans.

Since May 1998, service to New Orleans, the highest-volume corridor for these shipments, has consistently been at or below pre-crisis levels. During the first six months of 1997, the average transit time in this lane fluctuated between 3.44 and 4.74 days. During the worst of the service crisis, transit times reached 8.42 days in March 1998. Service to Shell has returned to normal levels and reflect that the difficulties of the service crisis are over. In July 1998, shipments between Deer Park and New Orleans averaged 3.15 days, reflecting better service than any month of 1997, and an improvement of 63% over March. Again in August, the transit time in this corridor averaged 3.48 days, better than every month of 1997 except February, and has remained low, averaging 3.75 days for the first two weeks of September. Similarly, the average transit time between Deer Park and the East St. Louis gateway has been at pre-crisis 1997 levels since April 1998, and was better in August 1998 than any month of 1997, having improved almost 78% since the worst month of October 1997.

Since March 1998, empty cars have consistently been returning from both New Orleans and East St. Louis to Deer Park more quickly than at any time during 1997. The best transit time achieved in 1997 was 5.71 days in January of that year. In August 1998, empty cars reached Deer Park from New Orleans in an average of only 3.54 days. This is dramatic improvement from the 13.79 day average of December 1997. To date in September, empty transit time has averaged only 2.49 days. In February 1997, empties returned to Deer Park from East St. Louis in an average of 5.3 days, which was the lowest monthly average during that year. During four of the five months of April through August 1998, empties returned from East St. Louis in less than

five days. This trend has continued through the first two weeks of September, with empty cars returning in an average of 3.39 days.

d. DuPont

DuPont criticizes UP for excessive transit times from its plant at LaPorte, Texas. For the last three full months, transit times from LaPorte to the Memphis gateway have been at or below pre-crisis 1997 transit times. Transit times averaged between 4.9 and 6.6 days during the first six months of 1997. Because of SP data infirmities and inaccurate reporting during the TCS cutover, we do not have reliable transit time information for the months September 1997 through January 1998. Transit times reached as high as 10.5 days in February 1998. DuPont then began shifting traffic away from UP and onto Tex Mex, before returning to UP in June. Since DuPont brought its LaPorte traffic back to UP, we have been serving that facility at pre-crisis levels. Average transit times to Memphis for the months of June, July and August were 5.0, 5.4 and 4.8 days, respectively. The average transit time between September 1 and September 10 was 4.5 days.

Since April 1998, transit times from LaPorte to the Salem gateway have been better than, or within half a day of, pre-crisis 1997 monthly averages. Transit times averaged between 4 days and 6.3 days for the first six months of 1997. Since April 1998's average of 6.7 days, monthly transit times through August have remained below 6 days, and below 5 days each month since June. The average for the first ten days of September was 4.5 days.

Service at other of DuPont's Gulf Coast facilities has returned to pre-crisis levels. From both Bloomington and Orange to New Orleans for interchange with CSX and NS, transit times have been at, or within one day of, pre-crisis 1997 levels each month since June, and have remained at that level in September.

DuPont is correct that our reciprocal switching service to Tex Mex at LaPorte was not impressive. Getting traffic from DuPont to Tex Mex required us to move it in a way we would not normally use.

e. Central Power & Light

UP's monthly average round-trip transit time for trains operating between the Southern Powder River Basin and Coletto Creek has fallen from 312 hours in March of this year to approximately 221 hours in August. Between September and December 1997, the average round-trip transit time on trains operating between Axial, Colorado and Coletto Creek remained well above 330 hours, reaching a high of over 380 hours in November. UP's service between Colorado and Coletto Creek has improved dramatically since that time, and the round-trip average transit time for the month of August was 209 hours.

3. Switching Reliability

UP continues to track its daily switching performance for over 50 customers located in the Houston/Gulf Coast area. Again, for purposes of this statement, I have disregarded those instances when accurate information was unavailable. As of the date of my last verified statement, I reported that since May 1, we had provided timely switching to these customers at least 93% of the time. This remains

true today, but since June 3 through yesterday, our switching performance has been above 96% every day but one. This means that there was only one day in this time period when we failed to switch more than two customers on a day when switching was scheduled. The one exception was last Saturday, when high water prevented us from switching two customers and we switched a third very late.

Because the KCS/Tex Mex parties want to take our Strang/Bayport Loop facilities, we measured our service to a group of 19 customers located on the Loop to determine accurately how often they are receiving switches within a designated time period, or "window". We asked our train crews to fill out forms. At times, however, a crew did not return the form and we were unable to verify whether or not a switch occurred within the scheduled window. For purposes of my statement, those instances are disregarded. Since the last week of August, our crews have switched these customers within the window at least 96% of the time. We have noticed that there is one customer that consistently receives a switch two hours after the close of the switching window. We are taking action to correct that situation.

B. Service Improvement from the Railroad Operating Perspective

1. Car Inventory

I explained in my verified statement filed on July 28 that our informal internal goal for Texas/Louisiana inventory is 98,000. One week ago, the Texas/Louisiana inventory was 95,301, some 15,000 cars fewer than were on that territory at the high point of September 26, 1997. UP achieved this reduction despite the fact that several Gulf Coast plastics producers are storing excessive numbers of



surplus empty cars on our system. Each week, UP tracks the number of surplus cars these customers are storing on the Southern Region. To determine what constitutes "surplus," we analyzed the number of cars that we must have available to satisfy each customer's demand for one week. We began this process on May 22, 1998, and our weekly review of this situation reveals that since that time we have consistently been storing well over 1,000 surplus cars for these customers. As of last Friday, we were holding nearly 2,000 surplus cars on the Southern Region. In July, one customer had over 500 surplus cars on our system. That customer has now noted significantly-improved transit times and agreed to move the large majority of those cars off of our system. We also have over 6,700 loaded SIT cars on the system today.

2. Mainline Operations

One measure of mainline operations is the number of sidings blocked. Last fall, and again in February and March, as we restructured the railroad for directional running, we often found over 100 sidings blocked south of Kansas City, on mainlines throughout Texas, Oklahoma, Arkansas and Louisiana. I reported on July 28 that 21 sidings were blocked at the start of that week, which I noted is a normal number given the need of every railroad to hold trains temporarily for a variety of reasons. This measurement continues to improve, and is now below UP's internal goal of 20. On Tuesday, only 17 sidings were blocked south of Kansas City, and during the entire month of August, an average of only 14 sidings blocked in that area. These numbers reflect fluid operations on these mainlines.

Another measure of the fluidity of mainline operations is the number of trains held on the lines. In my last verified statement, I reported great improvement in the number of trains held. I noted that on Monday of that week, only 36 trains were held for any reason south of Kansas City, which is a reasonable level, representing an 83% improvement since March. As of this Tuesday, there were only 32 trains held south of Kansas City, which is an 87% improvement since March. The average number of trains held daily during all of August was 30. As of Monday, the number of trains held for power and crews had decreased precipitously since the worst days of the service crisis. The number of trains held for power has declined by 70% since that time, and the number of trains held for crews has declined by 80%.

Train speeds on directionally-operated lines between Texas and southeastern Missouri and Memphis continue to rise. At the time of my last statement, the average speed was 14.4 m.p.h. Average speed on these lines is now approximately 15.5 m.p.h., an improvement of over 70% since the slowest point in March, when the average speed fell to 8.9 m.p.h. Trains on those lines are operating substantially faster than they were before we implemented directional running. Between Houston and Victoria via Flatoria, train speeds have remained well above where they were last winter and in March of this year. The average train speed on that line is now 12.4 m.p.h., which is an improvement of 134% over the March average of 5.3 m.p.h. On the "Rabbit" line between Houston and Shreveport, Louisiana, the average speed is now

over 17 m.p.h., having risen 86% since March. Between Houston and Iowa Junction, trains are running a full 121% faster today than in March. As of yesterday, average train speed on the lines between Dexter Junction, Missouri, and Memphis on the north and Pine Bluff on the south was up by more than 250% since February 1.

In the Houston/Gulf Coast area, trains speeds on bi-directional lines have increased dramatically since March. On the line from Laredo to Houston via San Antonio and Smithville, which includes most of the rock- and cement-producing territory, trains today are running 145% faster now than in March. On the Alexandria, Beaumont and Lake Charles Subdivisions, train speeds are 79% faster than March speeds, and average train speed on the SP line between Houston and Ft. Worth is 65% above its March level.

### 3. Yard Performance

The five major yards serving the Gulf Coast area are still functioning well and at levels much higher than they had been in March. Dwell times are down significantly at almost every major yard. At North Little Rock Yard, which primarily handles northbound traffic on the directional running lines in Arkansas, dwell time is down by 37% since March. Pine Bluff handles the southbound traffic on these lines and its dwell time is down by 52% since March. Englewood Yard is the primary inbound yard in Houston, serving local customers and points south. Dwell time at Englewood has declined by 40% since March. Dwell time at Settegast, the major outbound yard in Houston, has not been as fluid as Englewood in the last week, but it has fallen by 19% since March, and generally has been doing better than that. At Livonia Yard,

average dwell time has declined by 33% since March, and average dwell time at Centennial Yard in Ft. Worth is down by 30%.

I reported in July that all of these yards were fluid and generally accepting inbound trains without delay. This remains true today. My Exhibit traces the sharp decline in the number of trains held for these yards over the last several months. By the end of July, the total number of trains "laid down" for these yards had generally been below 20, and fell below 10 on a few occasions. Since that time, the total number of trains held was below 20 every day between July 29 and September 10, and was 10 or below on 24 out of the 38 days on which the number of trains held were counted. For two days in August there were no trains held for any of the yards. On Friday, we held only two trains for Englewood Yard and none for Settegast.

C. Safety Improvements

In July, I described the efforts UP has been making to change the safety culture on the railroad. I headed up that effort and I am proud to report that system-wide, FRA reportable injuries are down 17% January through August 1998 compared to the same period of 1997, highway-rail grade crossing incidents are down by 19%, and the number of lost work days was down by 20% for the first seven months of the year compared to the same period last year. For the Southern Region, reportable injuries are down 27.6% through August 1998 compared to the same period in 1997, lost day cases are down 27% and grade crossing injuries are accidents are both down by 33%.

In addition to the fatigue reduction and other efforts I detailed in July, we have a dedication to hazardous material accident training and prevention unparalleled by

any other railroad. In the first six months of 1998, we trained almost 14,000 UP employees and over 4,000 non-employees (primarily firemen and other emergency response personnel), on how to deal with hazardous materials. This is a far more extensive effort than any engaged in by any other railroad. We conducted over 4,700 tank car inspections during the first six months of 1998, also a far more extensive effort than that of any other railroad. UP has developed a Core Emergency Response Plan for handling hazardous material leakages that includes descriptions of the particular roles of personnel at every level, how to prepare a job safety briefing and site safety plans upon arrival at an incident, the availability of emergency medical treatment, necessary protective equipment, termination procedures and training requirements. In addition, some locations, including both Englewood and Settegast Yards, have specific procedures that must also be followed when responding to hazardous materials emergencies.

D. Hiring

Current year-to-date hiring figures through September 16 are comparable to the numbers I detailed in my July verified statement, with a notable increase in new Transportation Department hires throughout Texas. In Houston, UP has hired, or is in the process of hiring, 209 new Transportation Department employees, and three employees have transferred into the Transportation Department in Houston. In Houston, UP has also hired or is in the process of hiring 35 new employees in the Car-Mechanical Department, 21 in Engineering Services and 17 in the Locomotive-Mechanical Department. Throughout all of Texas, UP has hired, or is in the process of hiring, 754 new Transportation Department employees. Other statewide hiring figures include 91

new employees hired, or in the process of being hired, in the Car-Mechanical Department, 109 in Engineering Services, and 44 in the Locomotive-Mechanical Department. Current hiring statistics for Louisiana reflect that UP has hired, or is in the process of hiring, 68 new employees in the Transportation Department, 23 in the Car-Mechanical Department, 2 in Engineering Services, and 8 in the Locomotive-Mechanical Department.

E. Why It Happened

Every UP employee has probably reflected many times on the causes of the service crisis. I know I have. As we put it further behind us, we gain more perspective on what happened and why. We now have a better understanding of how vulnerable the SP operation in the Houston area was to disruptions. SP in Houston had a history of congestion periods, especially at Englewood Yard. Because of its design, Englewood is not a good yard for building long trains. We no longer use it that way because it gets congested easily. It also was so physically deteriorated that the FRA from time to time took tracks out of service until we could rehabilitate them. The entire Houston terminal complex continues to be very short of track space, and almost every train going through the complex gets delayed due to conflicts with other trains.

We have described a number of times the stresses that affected the SP operation in Houston, where the crisis began, during 1997. These include a major derailment that tore up the hump track at Englewood Yard and effectively shut down the yard as a classification facility, derailments and weather-related outages at key locations on line of road, and backups on our eastern connections. Prior to and during the

privatization process for the Mexican rail line serving Laredo, rail traffic backed up throughout the UP system, forcing us to declare an embargo and blocking our efforts to improve service.

In retrospect, the most serious stress affecting the Houston area in 1997 was the effect of selling the SP Sunset Route mainline between Avondale (New Orleans) and Iowa Junction, Louisiana. Former SP officials agree that this line segment and the yards located on it were the safety valve for the congestion that periodically hit Englewood Yard. SP would run trains through Houston and switch them at Avondale or Lafayette, reducing the switching burden on Englewood. We sold that line to BNSF and lost the use of those yards.

Beginning April 1, BNSF took that line out of service for up to eight hours a day at each end to work on bridges and replace defective ties. Most of the trains affected were UP trains because BNSF had very few trains on the line at the time. This caused severe backups at Englewood, because we were no longer able to get trains in and out of the yard to and from the east. As Englewood became more and more congested, UP no longer had the safety valve of running trains to Avondale and Lafayette. It was as though a line carrying more than a dozen freight trains a day had been blockaded. Sometimes BNSF shortened its maintenance curfews, but usually it could not because of the expense and need to get the work done. BNSF's top officers in 1996 were experienced SP operating officials who had managed the Englewood facility and were familiar with the Sunset Route as a safety valve, so they must have known what was happening but probably felt they had to proceed.

UP compounded the problem by making several operating mistakes in an effort to improve service. Two of these were severe enough that they had to be reversed almost immediately. First, to try to reduce congestion on the Sunset line, which was getting worse by the day, UP attempted to reduce on-line switching at Dayton, Texas, which is located on the Lafayette Subdivision northeast of Houston. This had the effect of moving more cars into Englewood, which created more congestion in Houston. UP also tried to discontinue classification work at Strang Yard, which also shifted switching activities to Englewood. Englewood could not handle the additional traffic. Both of these experiments failed. We had to reverse them within two weeks, but they had already caused severe backups.

Many people claim that UP fired SP's experienced managers in the Houston area. That is not true. We lost a number of experienced managers, because some left by choice long before we made any personnel decisions and because BNSF hired a number of them from us. Many months after the merger, senior UP and SP operating officials in each region met to decide how to staff management positions throughout the system, including the Houston area. Our goal was to find the best qualified people from either company for every position. Where there were redundant positions, we had to choose one. Whenever possible, we based our decisions on performance evaluations and assessments of each officer made by their supervisors. As a result of this process, we offered positions to all but five of the SP senior managers and all but one of the UP managers. Those five are the only SP operating officers in the



Houston area who did not receive offers to remain in Houston. We offered these people managerial positions elsewhere on the railroad. The majority of the operating officers in Houston after this process were experienced SP officers.

The service crisis reached its most severe point during late summer and early fall of 1997. In the latter part of October, however, the situation was improving steadily. Our CEO, Dick Davidson, was optimistic that that improvement would continue.

We made the judgment, which I still believe was correct, that the only way to be sure that we could get out of the service crisis and also be certain that it would not recur on the vulnerable SP facilities, was to proceed with implementing the merger. In November, we took the essential step of implementing UP's TCS system on SP. We had trained people in advance of this change, but to learn any new computer program people need to use it. The implementation process resulted in a period of about 60 to 90 days during which service deteriorated again. We lost cars, cars went to the wrong yards, cars that we thought were empty turned out to be loaded and vice versa. As SP employees began to use the new system and to apply it more effectively, the railroad again started to recover during January.

The final major transition was the move to directional running at the beginning of February. This was the most sweeping operating change ever attempted at one time by an American railroad. From southeastern Missouri all the way down to Houston, every train operation, every yard activity, and every train block had to be changed. Crews had to operate on new tracks. Yards performed new functions. New

trains were created. Like any major change, this one caused another round of disruption. By the end of March, however, we saw very significant and steady improvements. By April, we knew we had turned the corner.

F. Allegations of Discrimination

I read with dismay the many assertions that UP "discriminates" against Tex Mex trains or that we mishandled BNSF trains or cars. Those claims are untrue.

I want to assure the Surface Transportation Board and all other parties that it is Union Pacific policy to treat all tenant rail operations equally with our own on all joint facilities. I believe that we have applied that policy consistently and effectively. In my opinion, the allegations of discrimination and mishandling are a combination of recollections of our severe service problems months ago, opportunism by our competitors who want the government to give them our traffic, and natural and almost universal tendency to believe that landlord railroads are preferring their own business. It is important for tenants to manage their own operations as they would on their own railroads, but UP and its people treat them fairly.

We encourage the Board and its staff to talk directly to our train dispatchers and their supervisors. Those train dispatchers are professionals who, like train dispatchers throughout the country, want more than anything else to get trains off their railroad. They do not care whose trains they are. Jerry Wilmoth presents automated data showing that we do not discriminate against BNSF and Tex Mex trains.

G. Spring Dispatching Center

BNSF wants UP to move two new dispatching territories from Omaha to the Spring dispatching center. One of the territories is the former SP Lufkin Subdivision between Shreveport and Houston, the "Rabbit" line. The other is UP's Houston-Longview line. UP agrees that both of these territories should be in the Spring center. We will move the Lufkin Subdivision into the Spring center on September 28.

We think it is more important, and in BNSF's interests as well as ours, to move other territories to the Spring center before we bring in the line to Longview. The first several miles of that line, from Houston to Spring, are already dispatched out of Spring. From Spring to Longview is operating directionally, with all trains moving away from Houston, so coordination between the dispatcher at Spring and the Houston dispatcher is not very important for the Houston terminal. We think it is much more important to put our effort into bringing in line segments that deliver trains to Houston.

In addition to the Lufkin Subdivision, on September 28 we will relocate the dispatchers for UP's Valley Junction-Houston line and the former SP Hearne-Houston line to the Spring center. By the end of January, we plan to bring the Glidden Subdivision and the Ennis Subdivision, which include the SP line between San Antonio and Houston, into Spring. The SP line delivers large amounts of traffic to Houston. At that time, we also will relocate dispatchers for the Austin Subdivision from Laredo through San Antonio and Austin to the Spring Center. This change is important because it will allow us to improve coordination for rock service between Austin Subdivision

shippers and consignees throughout the Gulf Coast area. Eventually, we will bring the Longview line into the Spring center, but we think our colleagues at BNSF will understand why that is not our first priority.

We plan to make one other change in Spring as soon as possible. Based on a recent study, we have concluded that the two dispatching positions responsible for the Houston terminal complex, which we designate STO1 and STO2 are overburdened. We plan to add an STO3 position and reallocate their work among three dispatchers as soon as we can obtain qualified people. We hope to have the STO3 position in place by the end of January.

#### H. BNSF's Conditions and Houston Congestion

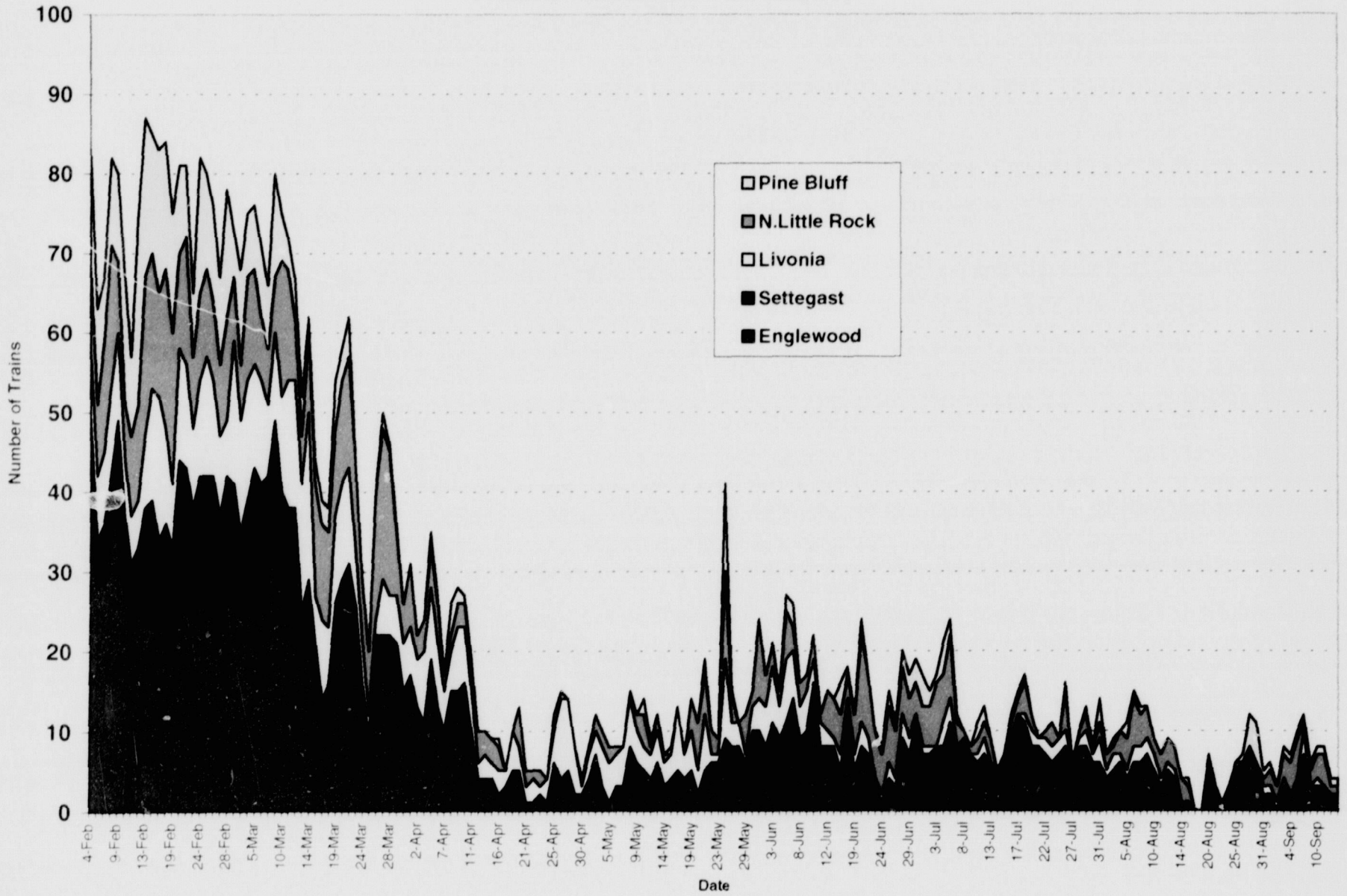
BNSF repeats over and over that a major purpose of its conditions is to take traffic out of the Houston terminal where our service crisis had its worst impact. I have studied each of the BNSF proposals. I do not see how any of them could have any effect on the number of cars passing through the Houston terminal complex. One or two might cause BNSF to route fewer cars on its track through Rosenberg and Algoa, but that track is many miles outside the Houston complex where UP had service problems. It is noteworthy that the joint BNSF/UP Houston terminal dispatchers (positions ST01 and ST02) do not have dispatching control over that line.

The following chart shows UP's assessment of the effects of each BNSF condition on traffic through the Houston complex where UP suffered its problems in Houston. In each case, no cars will be added to or subtracted from the complex.

<b>Condition</b>	<b>Impact on Houston Terminal</b>
San Antonio-Laredo rights	None. Diverts traffic from UP and Tex Mex to BNSF through Central Texas; might reduce a few cars on Algoa Line.
Caldwell-Flatonia-San Antonio rights	None. Affects routes between Temple and San Antonio only.
Caldwell-Flatonia-Placedo rights	None. Would reduce traffic on Algoa Line.
Harlingen-Brownsville rights	None. Hundreds of miles south of Houston.
"Neutral switching supervision"	None. Would not affect traffic flows.
Taylor-Milano rights	None. 100 miles northwest of Houston; Houston traffic would use same route to Houston whether or not granted.
PTRA operation of Clinton Branch	None. Would not affect traffic flows.
Directional rights on UP lines	None. Houston routes already directional.
Transfer UP dispatching to Spring	None. Would not affect traffic flows.
Rights to use all routes in Houston	None. May affect routes through Houston, but not traffic volume through Houston.

One of BNSF's proposed conditions would adversely affect Houston traffic volumes. When capacity is adequate, UP plans to terminate directional running south of Houston. BNSF asked the Board to preserve its operations on our line between Caldwell and Placedo via Flatonia. Those rights would limit our ability to reroute traffic from the Rio Grande Valley toward the Midwest, which now runs through Houston, to the bypass route through Flatonia.

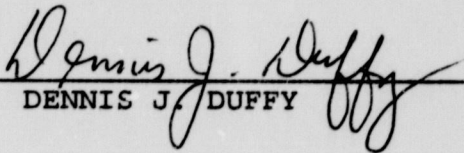
# Trains Destined "Laid down"



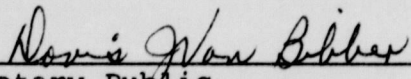
VERIFICATION

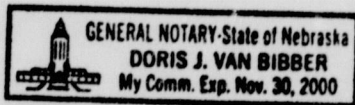
STATE OF NEBRASKA    )  
                                  ) ss.  
COUNTY OF DOUGLAS    )

I, Dennis J. Duffy, being duly sworn, state that I have read the foregoing statement, that I know its contents and that those contents are true as stated.

  
\_\_\_\_\_  
DENNIS J. DUFFY

Subscribed and sworn to before me this  
17th day of September, 1998

  
\_\_\_\_\_  
Notary Public







**STATEMENT**  
**OF**  
**PAUL FAHRENTHOLD**

My name is Paul Fahrenthold, President of Fahrenthold & Associates, Inc. I received my B.S. in chemical engineering in 1960 from the University of Texas, my M.S. in the same subject in 1962 from Rice University and my doctorate in chemistry in 1966 from the University of Houston. Also in 1966, I was a Postdoctoral Fellow at Florida State University. Before forming Fahrenthold & Associates in 1988, I worked in both the public and private sectors for over twenty years. After working as a research chemist at Texas Eastman Company in 1966-67 and serving as Technical Assistant to the President and later Vice President of Calumet Petrochemicals from 1967 to 1972, I held numerous technical positions at the U.S. Environmental Protection Agency between 1967 and 1972. My last position there was Chief of Organic Chemicals Branch. After leaving EPA, I was a senior consultant at Woodward Clyde Consultants (1982-86) and Vice President, Waste Management/Water Resources Group (1986-88).

At UP's request, I conducted a study of changes in capacity and utilization of capacity since 1971 at 486 petrochemical facilities in the Gulf Coast area between Lake Charles, Louisiana, and Corpus Christi, Texas. To perform this study, I obtained information on the production capacity and location of chemical and petrochemical production facilities from the Directory of Chemical Producers ("Directory"), published annually by Stanford Research Institute. The Directory is a series of volumes that identify each facility, its location, the products produced at that facility and its estimated production capacity for each product. I obtained volumes of the Directory for the years

1971 through 1997 at Stanford University Chemistry Library, the University of Houston Library, Rice University Library, and the library at Texas A&M University. The Directory is the leading source of information on the production capacity of these facilities.

In order to organize the Directory data, I extracted it from the narrative form of the Directory and entered it into a spreadsheet. I grouped the production capacity data into six geographical areas identified as major chemical production centers: Channelview, Houston, Beaumont, Freeport, Corpus Christi and Lake Charles.

I performed two adjustments necessary to make the production capacity data usable. Over the nearly thirty years of the survey, some plants were sold. Where possible, I traced the identity of the plant to provide a continuous record of production capacity. On rare occasions, the Directory provides production capacity in short tons, gallons, long tons, or other units. I converted those values to pounds per year using the proper conversions. In a few instances, the Directory did not contain data for a specific product for a specific year at a specific facility.

These types of plants attempt to achieve a consistently high level of utilization of their capacity, because it is uneconomic to produce at lower levels of utilization. In fact, they usually use their facilities at a high level even if the market is not available to purchase all the product.

Information about the levels of capacity utilization at specific facilities is not available and would be commercially sensitive. In the absence of capacity utilization data for these facilities, I instead obtained capacity utilization data from the Board of

Governors of the Federal Reserve System for both total U.S. industrial production and for individual categories within the chemical industry. These data are available for years 1967 through 1997.

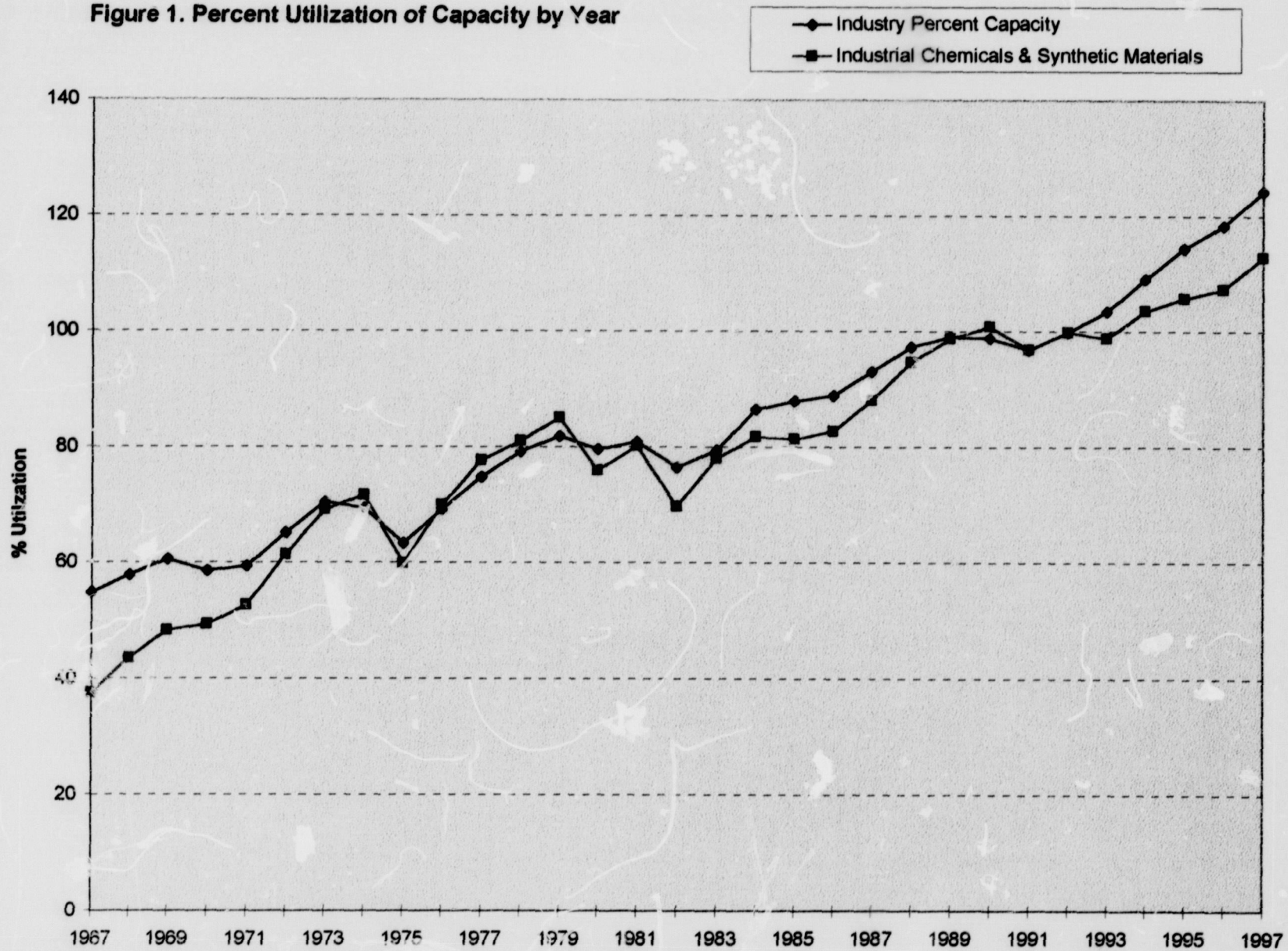
The attached graph shows both the changes in aggregate capacity of the chemical and petrochemical production facilities in the Gulf Coast area between 1971 and 1997 and changes in U.S. industrial capacity utilization. To provide a scale for measuring both, I followed the Federal Reserve Board's practice of normalizing data to 1992, with the baseline set at 100, and comparing the data for other years to that baseline.

As the chart shows, production capacity rose sharply from 1975 through 1979, increasing by approximately 25 percentage points compared to the 1992 base. U.S. plant utilization rose at a similar pace during those years. As is characteristic of the chemical and petrochemical industries, capacity plateaued between 1979 and 1986, before spurting upward again from 1986 through 1989. Based on both my professional experience and these data, I conclude that the chemical and petrochemical industries pass through such growth spurts, when many facilities add capacity. Capacity then outstrips demand, and capacity plateaus until the next spurt.

Between 1989 and 1993, industry capacity again plateaued. Beginning in 1993, the industry started adding capacity again. Industry capacity rose by approximately 15% between 1993 and 1997, with the strongest gains in 1997. Based on my investigations and reviews of industry press, this capacity expansion has continued at a rapid rate into 1998. At the same time, use of capacity -- a measure of efficiency -- has

advanced strongly throughout the economy since 1992, even outstripping growth in capacity itself.

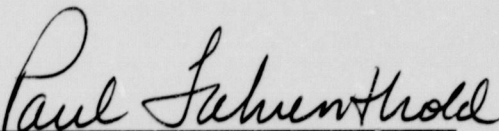
Figure 1. Percent Utilization of Capacity by Year



**AFFIRMATION**

I, Paul Fahrenthold, declare under the penalty of perjury, that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Statement.

Executed this 16<sup>th</sup> day of September, 1998.

  
\_\_\_\_\_  
Paul Fahrenthold



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**VERIFIED STATEMENT**  
**OF**  
**HOWARD HANDLEY, JR.**

My name is Howard (Eddy) Handley, Jr. I am employed by Union Pacific Railroad Company ("UP") as General Manager-Southern Region, with an office address of 24125 Aldine Westfield Road, Spring, Texas 77373, and I have responsibility for UP's overall operations in the states of Texas and Louisiana and the southern portion of Arkansas up to Little Rock.

I began my railroading career in 1957 as a switchman-brakeman on the Missouri Pacific. I entered Missouri Pacific's management training program in 1964 and was appointed Assistant Trainmaster later that year. I rose through the ranks of the Operating Department and eventually became an Assistant General Manager. I served for 13 years, from 1981 through 1994, as the General Manager of the Port Terminal Railroad Association ("PTRA") in Houston. From 1994 through October 1997, I was a Safety Project Coordinator for FRA, based in Washington, D.C. I returned to UP as an Assistant General Manager in 1997 and I was promoted to my current position on January 1, 1998.

I have spent most of my professional career in Houston, and I know Houston railroads well. I managed PTRA for 13 years, transforming it from America's most unsafe terminal railroad to its safest in only a few years. Because of my many years at Missouri Pacific and the PTRA, I am thoroughly familiar with the UP lines in the Houston area. I am also very familiar with the HBT, both because MP used HBT's Settegast Yard as its principal switching yard in Houston and because the HBT was, in

effect, the MP (and later UP) mainline through Houston, connecting our lines from the north and east with the Brownsville Subdivision to Corpus Christi and Mexico. Over 80% of the movements on HBT main tracks are UP trains. Finally, in my recent position, I have been responsible not only for operations on UP lines but also on SP's extensive routes in the Houston terminal.

A. Houston's Rail Network Is Exceptionally Complex

The Houston railroad network is one of the most complex and difficult to operate in the U.S. It serves the nation's largest petrochemical complex, and it terminates, originates and processes thousands of cars every day. One factor that makes the Houston rail complex very unusual is that it has a steadily-expanding industrial base of rail-served carload shippers. In most other parts of the country, such as throughout the Rust Belt, the manufacturing base that used carload shipments declined for many decades. In Houston, the petrochemical industries and other industries, which ship heavily by rail, have been growing steadily, and they continue to grow today.

Many of these plants are located along the Houston Ship Channel east of central Houston and in the Strang/Bayport Loop area south of the Channel, an area SP developed beginning about 30 years ago. Every freight car these industries load, whether on PTRR or on UP trackage in the Strang/Bayport Loop area, moves through the heart of Houston. The only connections between these producing areas and the rest of the national rail system are within a few miles of downtown.

Although traffic has grown over the years, railroad capacity in the core of the Houston terminal has not kept up. Only in the last year or so have significant

improvements been made to the main rail routes through Houston. With state highway funds, trackage on the HBT West Belt was recently realigned to remove a choke point. UP has been making a number of improvements to its Houston-area trackage, including two new connections at Tower 87, reconstruction of trackage and general upgrading at Englewood Yard, track construction at Coady Yard and installation of thousands of ties on chemical routes. Until recently, though, the major Houston rail routes looked much as they did 15 years ago.

Another feature that makes the Houston terminal difficult to operate is that there are no grade-separated rail crossings. In the entire Houston terminal, there is not a single location where one mainline track crosses another different grades. At Englewood Yard, the hump is elevated above the HBT East Belt below, but the East Belt crosses the SP mainline at grade just north of the hump. Otherwise, every track that crosses another does so at grade.

The rail lines in central Houston are interwoven like a pretzel. A train using almost any route through Houston must cross or intersect other mainlines every few miles. The most difficult route is probably the HBT East Belt, which in the course of about 15 miles from south to north crosses the GH&H mainline between Houston and Galveston, intersects the Booth Yard Lead, crosses the SP Galveston Subdivision, joins with PTRAs North Yard Lead and UP's Baytown Subdivision, crosses UP's Sunset Route mainline at Tower 87, passes the entrance to Settegast Yard, joins with the UP Beaumont Subdivision and crosses the UP Lufkin Subdivision before ending at Belt Junction. At every one of these busy crossings and intersections, one

train may be delayed by another at any time of day. Other lines in the complex have fewer crossings, but high risk of delay.

Most of the mainlines through Houston also serve numerous industries, with industry tracks often diverging from the mainlines directly into the plants. In many other terminals, the railroads have built more switching leads or drill tracks in industrial areas, so they can switch industries without interfering with through movements. In Houston, industry switching is more likely to disrupt mainline operations. On the HBT East Belt, it is often difficult to coordinate industry switching with transfer moves and through train operations.

I have had the opportunity to provide familiarization tours to a number of visitors to Houston, especially in the last year. The Houston area track network is so complex that it is very difficult for newcomers to grasp it. The best way to see it is from the air. From the air, Houston is a maze of tracks with trains moving in every direction all day and night. I am told that only the southwest side of Chicago comes close to matching the network of tracks and operational complexity of the Houston terminal.

B. PTRA

I am, of course, extremely familiar with PTRA and its history over the last twenty years. KCS, Tex Mex and the other organizations that join them in asking for a major expansion of PTRA are very complimentary of PTRA, but PTRA was not always so successful. When I became General Manager of PTRA in 1981, the railroad was in poor physical condition. It was under-maintained and safety performance was

inadequate. PTRAs injury rate was high with 187 reported injuries in 1980, and there were many derailments due to human factors and track conditions. When I arrived on the property, PTRAs safety record ranked 24th out of 24 terminals and switching carriers in the U.S.

At the time, the Port of Houston had final approval of all investments in PTRAs. The Port of Houston did not want to make major investments in the PTRAs, because it had to fund investments out of its revenues. Because of the PTRAs condition, the member line railroads negotiated an agreement with the Port of Houston to take over the funding of upgrading and expanding the PTRAs facilities. That is why the Port of Houston has not been a member of the PTRAs Board of Operations for 15 years.

The PTRAs turned around quickly. After my first year as General Manager, we won the Harriman award as the most improved railroad in our class. A year later, we won an E. H. Harriman safety award. Over the next few years, PTRAs won the bronze, silver or gold Harriman medal for our category every year from 1982 through 1990.

The linehaul railroads were willing to keep our operating budget at a stable level. As we reduced PTRAs operating expenses and expansion, we began to save cash, which we then used for track maintenance. That is why PTRAs is in excellent physical condition today.

Because of this history, I have some concerns about the Port of Houston's desire to resume a comprehensive management role at PTRAs. The Port's interests are not always the same as those of the railroads serving Houston or of their shippers. The

Port is also a customer of the PTRA, as it is trying to increase its intermodal shipments to and from its newly-enlarged container facility at Barbours Cut and a future Bayport facility.

UP and BNSF have agreed to invite the Port to participate in PTRA management on the condition that it not vote on investments and rates. The Port should be excluded from those votes because, under PTRA By Laws, any action can be taken only by unanimous vote. That would give the Port veto power over any decision on which it can vote. I have no such concerns about Tex Mex's full membership because it does not have the Port's potentially-conflicting incentives, and I understand that BNSF, Tex Mex and UP have reached agreement on Tex Mex membership.

Over the years PTRA has established a reputation for providing good service to its customers. It deserves its reputation. PTRA's reputation for service to its shippers results partly from its ability to prevent total gridlock by refusing inbound traffic. When the PTRA gets badly congested, it pushes the congestion back to the UP and BNSF.

PTRA prevents itself from being overwhelmed by scheduling every inbound movement for a specific time slot. PTRA conducts a conference call with the line-haul railroads in Houston every eight hours. During those calls, PTRA assigns time slots to arriving trains and transfer jobs. If PTRA is unable to take traffic, it will not assign a slot. Many times this spring, PTRA could not take or would limit inbound traffic, and it frequently refuses to take or delays a particular movement. PTRA refused

to accept more than one track full of cars from Englewood Yard this spring, even when Englewood had hundreds of cars switched and ready to move to PTR A.

When UP was having serious problems with PTR A rejecting our traffic this spring, we started keeping records. Our records confirm that PTR A was not able to take our traffic on many occasions. For example, PTR A is supposed to send an engine to Englewood Yard every morning to pull cars for PTR A's North Yard. Usually PTR A sent the engine to Englewood, but it did not on a number of instances, leaving the cars in Englewood. UP also makes three deliveries to the PTR A every day, in addition to delivering a through train from Pine Bluff. Since March, we have been ready, willing and able to make those deliveries virtually without fail, but PTR A sometimes was unable to accept them, forcing us to hold cars in our yards. It sometimes was unable to accept our trains from Pine Bluff, which forced us to leave the trains in sidings on our mainlines or to store them in our yards.

When PTR A gets in serious trouble, it sometimes even refuses to honor the slots it assigns. One of the more disruptive examples of this occurred less than two months ago. PTR A had agreed in a conference call on July 28th to take BNSF train AMAPTR1-26, which was arriving from Amarillo, in a 6:30 p.m. slot. It was important for BNSF to deliver the train on time, because the BNSF crew was to run out of time under the federal Hours of Service Law at 7:15 p.m. The BNSF train arrived right on time. It went by West Junction at 5:20 p.m. and Tower 81 (also known as T&NO Junction) at 6:00 p.m., reaching Basin Yard at 6:30 p.m. for delivery to PTR A.

PTRA was unable to take the train. The crew then "died" under the Hours of Service Law at 7:15 p.m. When the crew died, the train was stuck on the HBT East Belt mainline of the at Basin Yard, blocking one of two main tracks of the most congested rail line in Houston.

BNSF sent its Job 209 crew from South Yard to the train at 11 p.m. PTRA was unable to accept the train for the next four hours, causing this crew to run out of time under the Hours of Service Law at 3 a.m. without ever having moved a wheel. The train still blocked the East Belt mainline.

BNSF again recrewed the train with its Job 335, on duty at South Yard at 7 a.m. This third BNSF crew boarded the train at 7:30 a.m., and PTRA finally allowed it to move at 9:15 a.m. For almost 15 hours, the BNSF train, through no fault of BNSF or UP, blocked one of HBT's mainlines.

This situation might cause someone who did not know what was happening to think that UP is mismanaged and does not know how to run a railroad. No railroad wants to block a mainline for almost fifteen hours. But UP was the innocent bystander in this situation. The train did not belong to UP, and UP does not control PTRA's decisions. This example is not unique.

When we complained to PTRA management earlier this year about PTRA's unusual inability to take trains and cars, or about its failure to pick up cars at Englewood, PTRA tried to blame us. It tried to tell us that it does not accept our cars because we are not picking up cars from the PTRA. We have kept records of that, too.