STB FD 32760 3-29-96 D 62367 2/14

Consequently, for those exclusively served UP shippers who benefit from the above forms of competition due to the presence of SP, and *vice versa*, the merger of UP and SP will eliminate these competitive restraints. These are the same competitive restraints that prior to the merger prevented either UP or SP from raising rates on exclusively served shippers. The best way of measuring such effects is using the BEA-to-BEA analysis adopted by Dr. Grimm.

3. Determining what is an independent routing.

Once the BEA was chosen as the appropriate geographic market for determining origins and destinations, Dr. Grimm then focused on independent rail routes between two given BEAs. It is important to note what Dr. Grimm means by an independent rail route. Table I (on the following page) graphically illustrates a hypothetical BEA to BEA movement between Memphis TN, and San Antonio, TX. While there are five different rail routes involving five different carriers between these two BEAs, because either UP or SP was present in each of the five different routes, there are only 2 independent rail routes. While many would reject the notion that the interline/joint-line routes do not constitute effective competitive alternatives, for purposes of determining 2 to 1 corridors, Dr. Grimm's method for determining what constitutes an independent route is the accepted definition as contained in the Commission's regulations and precedents.[23]

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[23] The Commission has held that as long as a carrier serves as a bottleneck carrier in at least one part of a given movement, *e.g.* one leg of a joint-line movement, it will be able to take the maximum profit that it would have otherwise been able to achieve if it had moved the traffic single-line. *BNSF*, slip op. at 70-75; *UP/MP/WP*, 366 I.C.C. at. 538; and *CSX Control*, 363 I.C.C. at 572-573.

TABLE I

MEMPHIS BEA TO SAN ANTONIO BEA	
CURRENT RAIL ROUTES	MARKET SHARE FOR THAT ROUTE
SP DIRECT	17%
UP DIRECT	31%
BN - UP	4%
CSXT - UP	26%
NS - SP	22%

Accordingly, if UP and SP are allowed to merge, shippers originating traffic at the Memphis BEA and shipping to the San Antonio BEA will see their independent rail route options decline from 2 to 1. As noted above, even though three different joint line movements would still be available after the merger (BN-UP/SP, CSXT-UP/SP, and NS-UP/SP), such movements do not constitute alternative <u>independent</u> routings because UP/SP would be a bottleneck carrier in each move. It is also important to note that Applicants would not have considered this traffic to be 2 to 1 traffic because of the use of a BEA instead of a point. Further, even if Memphis was considered a "point" under Applicants' definition, Applicants would not have considered this "point" a "2 to 1 point" because of the presence of BNSF, NS, IC, and CSXT, despite the fact that none of these carriers ship directly to San Antonio without first having to interchange with UP or SP. Applicants' definition of a 2 to 1 point included no reference to city-pairs, origin/destination pairs, or independent rail routings.

4. <u>Conclusions for 2 to 1 traffic</u>.

Using this methodology, looking at BEA to BEA origin/destination pairs and independent rail routings,[24] Dr. Grimm, with the assistance of Snavely King Majoros O'Connor & Lee, Inc. (SK) was able to identify, using the 100% traffic tapes of UP, SP, BNSF, and KCS, all of the corridors that will see a reduction in independent rail routes (as defined above) from 2 to 1, including the relevant market shares for each type of routing, *e.g.*, direct or joint-line. The complete data that was relied upon by Dr. Grimm is contained in this filing, Vol. III, Highly Confidential Appendix. Dr. Grimm and SK were also able to identify the aggregate amount of each type of commodity flowing in these 2 to 1 corridors and the relevant distances involved in order to determine whether, based upon past Commission precedent, truck would be an effective substitute for rail in these corridors. V.S. Grimm at 208-13; Exhibit 1; Vol. III, Highly Confidential Appendix, p. 99-203; 373-412; 736-881.

The aggregate amount of traffic revenue flowing in each of these 2 to 1 corridors is graphically illustrated in the Figure appearing on the next page. The 2 to 1 corridors for this merger represents over $1.65 billion in revenues (1993 Waybill Data).[25] This is the amount of traffic revenue that would be subject to a rail monopoly if the UP/SP proposed transaction

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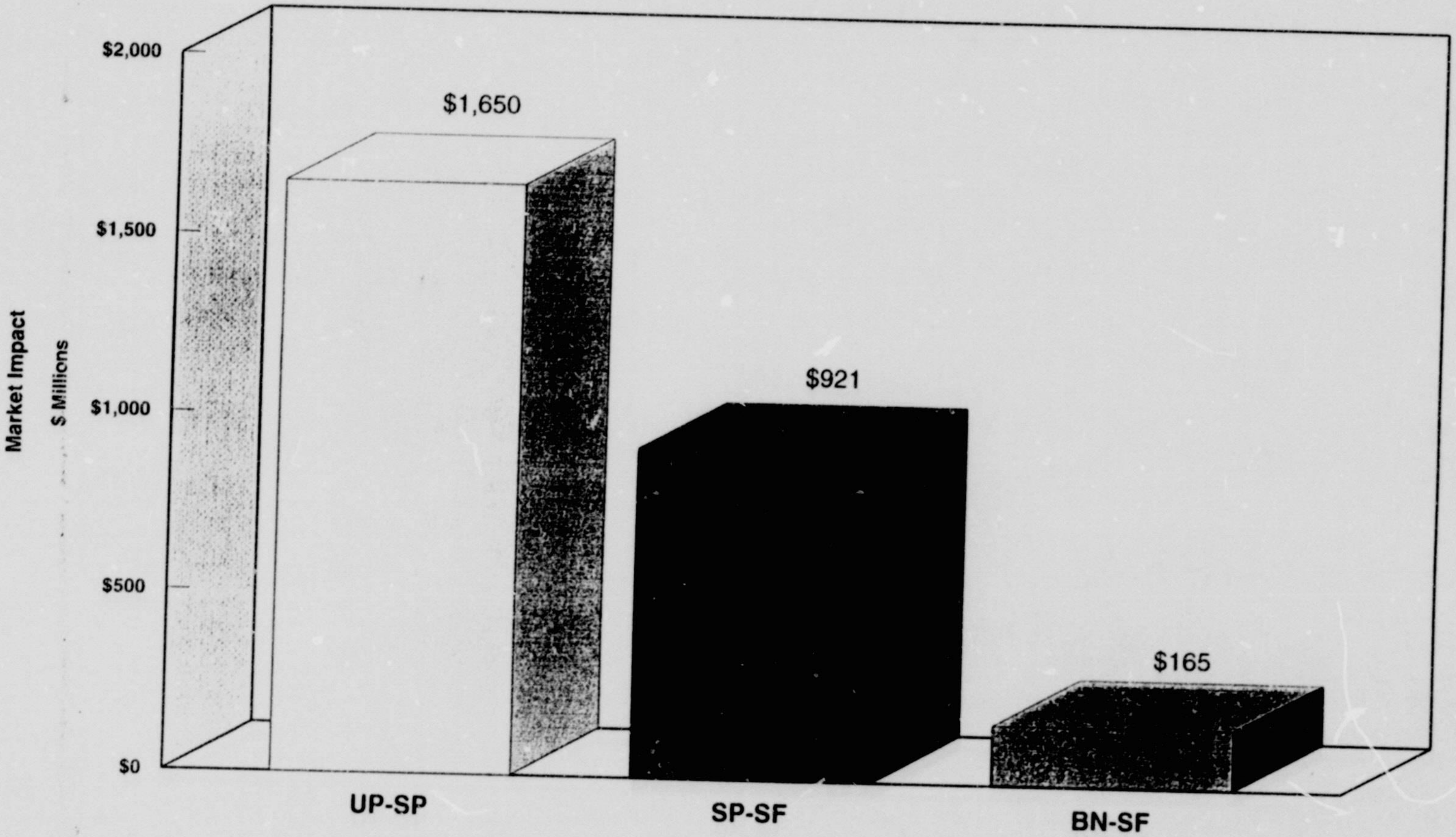
[24] This same methodology was utilized by Russell Pittman in SFSP and is the subject of his 1990 article. R.W. Pittman, "Railroads and Competition: The Santa Fe/Southern Pacific Merger Proposal," *The Journal of Industrial Economics*, 1990.

[25] Some, but not all, of Applicants' 2 to 1 points are reflected in this analysis. In that Applicants did not consider whether or not there was a monopoly carrier at destination and granted access to BNSF at all UP/SP commonly served points, some of Applicants' 2 to 1 points will not be reflected in Dr. Grimm's analysis. In this sense, Dr. Grimm's 2 to 1 corridor analysis actually understates the overall 2 to 1 effect.

UP/SP and Other Rail Mergers
Competitive Impact Comparison
2 - to - 1
1993 ICC Waybill Sample *



* Competitive effects less than $2 million excluded in UP-SP and BN-SF analyses.

Snavely King Majoros O'Connor & Lee, Inc.

is allowed to go forward without conditions. Using this same methodology and the 1994 100% traffic tapes, the revenue impact is significantly greater. As Figure 2.1 in Dr. Grimm's analysis shows, the 2 to 1 corridor impact of the proposed UP/SP merger is 10 times the size of the BNSF merger and almost twice the size of the rejected SF/SP merger.

As noted, Dr. Grimm's BEA to BEA corridor analysis is clearly consistent with the past practice of the ICC. Applicants were of course aware of the Commission's use of corridors, but instead of giving access to all shippers at an origin or destination city or BEA-pairs, Applicants chose instead to grant access to BNSF only at 2 to 1 points that were located at the origin city, without regard to the destination of the shipments, and then granted BNSF bridge/overhead trackage rights in the 2 to 1 corridor. This gives the appearance of resolving the 2 to 1 corridor problem, but as Dr. Grimm shows, there are numerous 2 to 1 shippers located at the origin or destination who were not granted access to BNSF but will nonetheless suffer competitive harm as a result of the merger.

Applicants' agreement with BNSF grants BNSF access to all Applicant-defined "2 to 1 points." Assuming BNSF is able to effectively utilize its trackage rights to replace the loss of direct UP and SP competition at such 2 to 1 points (which it will not) the agreement only grants BNSF access to $1 billion worth of revenue. App. Vol. I at 20; V.S. Peterson at 15; (Peterson Deposition at 66-67.) This is far less than the of total 2 to 1 impacts estimated by Dr. Grimm.

REDACTED

Furthermore, as discussed in the verified statements of Mr. Don Swanson, Mr. Joe Plaistow, Mr. A.W. Rees, and Mr. Hilary Rawert, even for those "2 to 1 point shippers" receiving access to BNSF (representing the $1 billion), the trackage rights granted to BNSF will not provide a sufficient competitive alternative for these shippers, yet alone provide effective corridor competition for those 2 to 1 shippers as defined by Dr. Grimm.

C. When Considering The Anticompetitive Effects Of The Proposed Merger, It Is Necessary To Consider The Effects Resulting From Reducing The Number Of Intramodal Competitors From 3 to 2

In his verified statement, Dr. Lawrence J. White, former Chief Economist of the United States Department of Justice during the Reagan administration and former member of the Federal Home Loan Bank Board during the Bush administration, sets out the well established principles that govern mergers in those markets involving few sellers, and difficult entry barriers, such as the transportation of freight by rail. Dr. White's analysis is important because his conclusions do not rest upon arguments over the proper definitions of 2 to 1 or whether or not such 2 to 1 shippers will be effectively served. Instead, his analysis thoroughly discusses the competitive effects of reducing the total number of intramodal carriers in the Western United States from 3 to 2. He also addresses the comments made by Applicants' witnesses Barber and Willig regarding the effectiveness of intramodal competition with two large, dominant rail carriers. By applying standard microeconomic principles, analyzing the empirical record, and reviewing the relevant evidence submitted by Applicants, Dr. White's conclusions bear repeating:

> It is my professional judgment that the proposed merger of the Union Pacific ("UP") and the Southern Pacific ("SP") would be anti-competitive and should not be allowed to proceed. It would reduce competition substantially in a large number of rail transportation markets, causing higher prices for transportation to shippers and their customers, and/or decreased quality of service, and/or slower innovation.
>
> * * * *

> If the merger is permitted to proceed, a necessary remedy to reduce the harms to competition must be to require that the merging parties first <u>sell</u> (divest) all duplicative (parallel) track (and the necessary complementary facilities) on the routes where the merger would otherwise cause the vigor of competition to decrease. The divestitures should be to able-bodied competitors who would be most likely to maintain the vigor of competition on the routes. The granting of trackage rights to rivals is wholly inadequate and unacceptable as a substitute for outright divestiture.

V.S. White at 2. *Accord*, **REDACTED** points as representing the reduction in competition from an unconditional UP/SP merger. (Ice Deposition, Exhibit 1.)

Because Applicants' agreement with BNSF only resolves shippers at 2 to 1 points, it does nothing to resolve the anticompetitive effects upon shippers located at 3 to 2 points--those shippers who currently have three railroads serving a plant, UP, SP, and another carrier (such as KCS, BNSF, IC, etc.). In addition, Applicants' agreement with BNSF does not address anticompetitive problems resulting from the reduction of 3 independent rail alternatives down to 2 in those BEA to BEA origin/destination corridors. Using the methodology described previously, Dr. Grimm has calculated the total amount of rail revenue that will suffer from a 3 to 2 reduction in independent rail alternatives at $4.77 billion (1994 Waybill Data). <u>None</u> of the anticompetitive impacts caused by the reduction of 3 to 2 independent rail routes is resolved by Applicants' agreement with BNSF.

Using 1994 100% traffic tapes and Dr. Grimm's methodology, the 3 to 2 impact of this merger is even greater. V.S. Grimm at 195-205. As explained by Dr. Grimm, many of these 3-to-2 situations are equivalent to *de facto* 2 to 1's because of BNSF's small market share in these corridors. V.S. Grimm at 212-13.

If the proposed merger is approved, BNSF and UP/SP, between the two of them, will have control over virtually all (over 90 percent) rail traffic in the entire Western United States. The amount of market share that would be controlled by these two railroads if the merger is approved is graphically illustrated (by BEA) in Figure 8.1, V.S. Grimm. Furthermore, BNSF will not be an effective competitor in many of those markets due to the nature, scope, and operational problems associated with the trackage rights arrangement between Applicants and BNSF. V.S. Swanson, Rawert, Rees, and Plaistow; *see also*, Conrail witnesses Hunt and Olderwald.

Applicants acknowledge the significance of 3 to 2 issues, but claim the reduction of rail carriers from 3 to 2 will not result in anticompetitive markets. V.S. Peterson 187-230; V.S. Barber at 466-478; V.S. Willig at 558-577. Witness Peterson relies on data in the San Antonio market, for grain in the Salina/Abilene grain markets in Kansas, and for the movement of construction aggregates in the Houston area, to show that 3 to 2 harms, those that parties alleged were going to occur in those markets in the UP/MKT case, did not in fact occur and that rail rates actually fell. As Dr. Grimm explains, rates in those markets may have fallen, but, due to the effects of deregulation, all rates were falling during this time. (V.S. Grimm at 153-56.) Without a specific analysis of the reasons why the rates in these markets fell, Mr. Peterson cannot validly claim that the rates declined as a result of the merger. It could be just as validly said that absent the UP/MKT merger, the rates would have fallen even greater. Thus, those shippers may have indeed suffered a competitive harm from the UP/MKT merger in that the rate of decline for their rail rates could have been even greater if that merger had not taken place.

The importance of intramodal rail competition in the post-Staggers Act railroad industry cannot be understated. A number of studies have shown the value of intramodal rail competition in lowering rates and improving shipper welfare.[26] The studies indicate that to the extent a given merger will result in increased rail concentration in relevant markets, rail rates would be expected to rise and shipper welfare would fall. When taken together, these studies provide important support for the notion that reducing the number of rail competitors from 3 to 2 will result in less competition, not more.

1. Mexican Traffic -- The McDonald Studies.

Due to the significance of rail traffic into Mexico, especially for grain movements out of Central Kansas to Southern destinations, both areas that will suffer a reduction of independent competitive rail routings from 3 to 2, the studies and work of James McDonald are of particular relevance. Applicants' witness Willig attacks McDonald's studies as invalid due to their use of the ICC's waybill sample, which Willig contends "masked" the actual contract rates, citing a 1994 letter from James A. Nash to UP's counsel. (V.S. Willig at 564.) Willig claims McDonald's studies are thus invalid due to what he assumed were

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[26] Grimm, C., *Horizontal Competitive Effects In Railroad Mergers*, Research in Transportation Economics, Vol. 2, Theodore Keeler, editor, JAI Press, 1985, pp. 27-53; McDonald, J., *Competition and Rail Rates For The Shipment Of Corn, Soybeans, and Wheat*, Rand Journal of Economics, Vol. 18, 1987; McDonald, J., *Railroad Deregulation, Innovation, and Competition: Effects Of The Staggers Act On Grain Transportation*, Journal of Law and Economics, Vol. 32, 1989, pp. 63-95. In the latter study, McDonald notes: "Competition among railroads has a statistically significant, fairly strong effect on rates. More competitors, as measured by RRCOMP, are associated with lower rates." *See also*, Winston, C., Corsi, T., Grimm, C., and Evans, C., *The Economic Effects of Surface Freight Deregulation*, Brookings Institution, Washington, D.C., 1990, and a follow-up article, Grimm, C., Winston, C., and Evan, C., *Foreclosure Of Railroad Markets: A Test of Chicago Leverage Theory*, Journal of Law and Economics, Vol. 35, 1992, pp. 295-310.

empirical inaccuracies of the data relied upon by McDonald. Mr. Willig's criticism is unfounded, however, because, as this Board knows, the "masking" of the ICC Waybill sample so as to hide the true contract rates did not begin to occur until 1986.[27] Professor McDonald's empirical studies relied upon data from 1981-1985, before the masking of the waybill data. (V.S. McDonald at 153.)

This and other criticisms by witness Willig of Professor McDonald's empirical work are fully addressed in Professor McDonald's verified statement included in this filing. Upon cross-examination, Mr. Willig conceded circumstances under which Professor McDonald's study could have validity (Willig Deposition at 143-144.) As Professor McDonald's analysis shows, reducing the number of competitors from 3 to 2 will increase rates 6.7% for the movement of wheat and 10.9% for the movement of corn. (V.S. McDonald at 157.)

Such potential rate increases are of significant concern to the many grain shippers located in the Central Kansas grain areas. These concerns are also expressed in the filing of the Kansas Shipper's Associations filing. As is evident from these comments, such grain shippers will suffer competitive harm as a result of this merger.

These and other shippers were granted access to a third carrier due to the rights granted to SP in the Burlington Northern/Santa Fe merger, including access to Wichita, Topeka, Hutchinson, and the trackage rights over the BNSF from those areas to Ft. Worth, TX. A substitution of a qualified third carrier for the rights gained by SP in the BNSF

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[27] Wolfe, E. *The Interstate Commerce Commission's Public Use Waybill File: Concerns for Misinterpretation*, Journal of the Transportation Research Forum, Vol. 32, 1991, pp. 263-265.

proceeding will restore the competitive balance for Kansas grain shippers that will be lost as a result of the cumulative effects of the BNSF merger and the proposed UP/SP merger.[28]

2. <u>The examples of Department of Defense bidding data</u>.

As further empirical evidence of the impact on rail rates, KCS witness I. W. Ploth has provided a verified statement discussing the impact of going from 3 carriers to 2 on Department of Defense rail movements. Using DOD's own database,[29] Mr. Ploth was able to do two things: (1) look at individual bids for given movements; and (2) conduct an empirical analysis to determine the overall effect of reducing rail competition from 3 to 2. For example, for movements beginning in 1995 and ending in early 1997, DOD requested bids for the movement of 1,107 carloads of vehicles moving from Sealy, TX to Fort Bragg, NC. The results of the bidding were as follows:

SP Bid	$1,978,033.00
UP Bid	$2,323,440.00
Lowest Truck Bid	$3,058,184.00
ATSF Bid	$3,272,244.00

[28] See also V.S. Grimm at 215-16 for a detailed discussion of the competitive impacts on the movement of grain and grain products from Central Kansas and other grain producing regions to Texas and beyond into Mexico.

[29] The Department of Defense maintains a publicly available computer data base that includes all rail and truck bids submitted for given movements of DOD equipment and supplies. The data base shows all of the bids submitted, who was awarded the contract, and the revenues involved. For a discussion of the data base and its authenticity, see the Verified Statement of Ms. Nell Nunn, Chief Executive Officer, Nunn, Yoest, Principals & Associates, Inc. from whom Mr. Ploth obtained the data base.

SP was the lowest bidder and won the traffic. Obviously, the loss of the SP as an independent bidder will significantly affect the rail rates paid by the DOD. In a situation such as this, a post-merger UP, based on historical patterns, will no longer be constrained by lower SP bids and can increase its bid up to levels closer to the third lowest bidder. By studying bids submitted for 8,807 vehicles that will move from Sealy, TX to various locations, it was determined that SP was the low bidder on all of the proposed moves. On average, UP's bids were 17% over SP's bids, and ATSF's bids were 65% over SP's. (V.S. Ploth at 30.)

As Mr. Ploth explains, there is no reason to believe that DOD shipments are not representative of overall intramodal shipments. Furthermore, the fact that trucks may be available to participate in these moves does not make the 3 to 2 effects any less dramatic because where trucking represented the 3rd lowest bid, UP and SP being Nos. 1 and 2 and BNSF being No. 4 or above, the combination of the UP and SP would allow the merged entity, based on knowledge of bidding patterns, to raise its bid at least to the lowest bid offered by trucks. For example, in the Sealy, TX to Fort Bragg, NC move, the merger of SP and UP leaves the potential for the merged UP/SP to bump its bid to just below the trucking level, resulting in a 54% rate hike. (V.S. Ploth at 30.) Of course, where truck is No.3, the merger of UP/SP results in a 2 to 1 impact, and where BNSF was the No. 3 bidder, the merger results in a 3 to 2 impact.

Drawing on the past and present studies of Grimm, McDonald, and Ploth, and looking at the cumulative impacts as set forth in the verified statement of Dr. White, the importance of 3 carrier competition cannot be overstated. Without such 3 carrier competition, shippers face the prospect of potential rates increases.

D. Applicants Have Overstated The Amount Of Shipper Support For The Transaction

In an attempt to downplay this, Applicants make much of the fact that over 1200 shippers support the proposed transaction. What UP does not tell the Board is that UP contacted over (Document on shippers contacted C14-000001-000161, C14-100001-100077) shippers in an attempt to obtain shipper support. Thus, more than of the contacted shippers did not provide a statement. Considering that UP and SP have significantly more than shippers between the two of them, only a small fraction have provided statements.[30]

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Of the statements that were provided, very few were from chemical or bulk commodity shippers located in the Houston to St. Louis and Houston to New Orleans corridors. Most importantly, many of the statements that were provided are conditional statements, *e.g.*, support for the merger if appropriate competitive conditions are maintained.

The evidence in this proceeding also shows that Applicants offered shippers long term contracts or price breaks in exchange for giving a letter of support (HC45-003923) and many are afraid to speak out against the transaction for fear of "retaliation." *See*, Letter of March 4, 1996 from U.S. Department of Justice to the Honorable Jerome Nelson **REDACTED**

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[30] On March 26, Applicants filed another 223 statements of support from shippers, governors, and public officials. Applicants have had over four months since the November 29 filing to obtain additional support statements. As Applicants were able to obtain 1200 such statements during the three months prior to the filing, without the public actually having the benefit of reviewing the Application, it appears that the more the public reviews the actual Application, the less they like it.

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Vol. II, Highly Confidential Appendix, p. 1068)

A revealing example of this practice of linking favorable contract terms with support for the merger is demonstrated by SP's conduct toward a major Gulf coast chemical shipper

REDACTED . By virtue of SP's own internal policy prohibiting such conduct, SP admits that it would be improper to trade favorable contract terms for support for the merger.[31] Yet, in flagrant disregard of its own policy, in a series of internal SP communications from September through November 1995, SP left a trail of "smoking gun" evidence of conditioning favorable contract terms on support for the merger. Thus, in a September 25, 1995 SP internal E-mail message from Sam E. Meade, SP Director of National Accounts, to Mr. Gilbert Jara, Director of Plastics, Mr. Meade suggested that the following tactic be used to garner support for the merger:

REDACTED

REDACTED

REDACTED

(Gehring Deposition at 43-45, Exhibit 2, HC45-003923, emphasis added). As Mr. Jara's superior, Mr. Gehring received a copy of this message, but took no action to discourage the effort. (Gehring Deposition at 52-53.)

Thereafter, in an October 4, 1995 Price Approval Request Form, Mr. Jara made the following recommendation:

REDACTED

(Gehring Deposition, Exhibit 2 at HC62-000006, emphasis added.)

Finally, in a message of November 14, 1995, approval of the "deal" was confirmed:

* * * *

REDACTED

(This approval is predicated upon customer support of UP/SP merger.)

(Gehring Deposition at 60-62, Exhibit 2, at HC62-000003.)

have also had their contracts renewed since August, 1995 when the merger was announced.

Through other evidence, deal was not an isolated incident. Thus, in a November 10, 1995 letter from then SP President Don Orris conveying new contract terms, Mr. Orris states:

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(See, HC62-000001.) Counsel for Applicants has admitted that Applicants found five shippers where there were agreements that related in some way to the merger two from Southern Pacific and four from Union Pacific. (Transcript of February 9, 1996 Discovery Conference, pp. 1,167-68). It is a certainty that numerous more examples exist where Applicants used contract inducements or threats of retaliation to gather support. Thus, the statements of support should be reviewed with those factors in mind and with healthy, warranted skepticism.

Finally, the reaction of shipper groups to the proposed merger relies Applicants' assertion of widespread support by the shipping community. Major shipper groups, *e.g.*, NITLeague, Chemical Manufacturers Association, and the Society of Plastics who cumulatively have approximately 1,500 members, are filing comments in this proceeding asking for the imposition of additional conditions. Indeed, of the approximately 12,000 UP/SP shippers, only a small fraction of them have provided support statements.

IV. THE AGREEMENT BETWEEN BNSF AND APPLICANTS WILL NOT RESOLVE THE COMPETITIVE PROBLEMS

The statutory standard governing the conditioning power of the Board in rail mergers is found at new 49 U.S.C. § 11124(c), which replaces § 11344(c). In the ICC Termination Act, the conditioning authority contained within this provision was specifically modified from the old provision to make it explicit that:

> The Board may impose conditions governing the transaction, including the divestiture of parallel tracks or requiring the granting of trackage rights and access to other facilities. Any trackage rights and related conditions imposed to alleviate anticompetitive effects of the transaction shall provide for operating terms and compensation levels to ensure that such effects are alleviated.

While the ICC always had the authority to impose trackage rights or divestiture, divestiture was rarely, if ever, imposed as the remedy. By adding this language, Congress made it clear that divestiture was as valid a remedy as trackage rights. Of particular significance, however, is the new requirement that the Board specifically "ensure" that any trackage rights imposed to alleviate an anticompetitive effect actually contain "operating terms or compensation levels" to alleviate such anticompetitive effects.[32] The Agreement between Applicants and BNSF will not ensure that the anticompetitive effects of this transaction have been alleviated.

Applicants themselves realize that the BNSF will not be able to attract enough traffic to pose a competitive threat to the merged UP/SP. In a September 25, 1995 teleconference UP officials conducted with securities analysts to explain the BNSF trackage rights

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[32] Whether or not the changes made to section 11324(c) actually apply to this proceeding is not the issue. Regardless of the legal status of this change, Congressional intent as it relates to the <u>policy</u> of imposing trackage rights is clear--the Board should ensure that any trackage rights imposed do indeed resolve any anticompetitive effects.

agreement, UP stressed the limitations on access granted to BNSF, particularly as to overhead trackage rights. (Rebensdorf Deposition at 662-64, Exhibit 17.) It was as if UP was trying to assure the analysts (many of whom presumably rate UP and SP performance) that BNSF would not be as strong a competitive threat as might appear from Applicants' public claims concerning the agreement. Thus, the transcript reflects UP's Mr. Rebensdorf explaining that:

> Now we use the term 2-to-1 quite a bit. Let me define what we mean by 2-to-1 point. That is would be a point where there is industry and specifically a customer who is currently served by both UP and SP today and who would go from two railroads to one. Now let me use an example because I think there is some confusion on this point. In Houston for example that would clearly become a 2-to-1 point. However there is a lot of business in Houston that is exclusive SP or exclusive UP. And in fact in Houston itself, under this agreement the BN doesn't reach any customer that they don't already reach today. Now outside of Houston at some points which I will define in a few minutes they did get access but I only raise that because it is important to note that just because both UP and SP serve a particular city doesn't mean that all the customers within that city necessarily will be open to BN/Santa Fe.
>
> *   *   *   *
>
> I think it is probably fair to say this is probably the largest trackage rights transaction that has ever been done. But I don't think that mileage is necessarily the appropriate measure. I think that it is the access to address the competitive issues that is important and in the trackage rights agreement that we have negotiated with BN/Santa Fe there is a lot of long distances over which BN/Santa Fe is simply moving overhead.

(Rebensdorf Deposition at 2; Exhibit 17.)

> I might point out in looking at Houston to Brownsville, I heard some comments about that being the chemical coast. BN/Santa Fe will not be accessing any large chemical plants along the line.

(*Id.* at 3). In the discussion below, his observations are confirmed

A. Trackage Rights Are Not The Appropriate Solution For The Competitive Problems

In an attempt to resolve the acknowledged anticompetitive problems, Applicants have granted to BNSF over 3,968 miles of trackage rights and will sell 330 miles of track to BNSF. BNSF will, in turn, grant UP/SP trackage rights over 376 miles of its system. App. Vol. I, at 20. If the Board considers the effects of the trackage rights granted in the BNSF merger, where BNSF granted UP and SP "nearly 4,000" miles of track, the amount of trackage that would be shared between BNSF and Applicants is colossal. Applicants' own witnesses admit that a grant of trackage rights this extensive over such a large geographic area has never been tried before. (Rebensdorf Deposition at 176-177.) Despite the enormous scope of trackage rights granted, BNSF claims it will be an effective competitor to the merged UP/SP in all areas. BNSF-1.

Through the verified statements of Mr. Joe Plaistow, Mr. A.W. Rees, Mr. Hilary Rawert and Mr. Donald A. Swanson, a former Conrail Senior Vice President-Operations with years of practical experience in negotiating and administering trackage rights, KCS establishes that the attempt to use trackage rights of this magnitude to resolve competitive problems arising from parallel, horizontal effects, is doomed to failure. As shown by Mr. Swanson, trackage rights inherently present many difficult problems.[33] These problems involve issues surrounding labor, equipment, dispatching, maintenance, and derailments. (V.S. Swanson at 251-253.) Mr. Swanson elaborates on the general problems associated

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[33] The Applicants have stated for the record that because of the conflicting goals of companies, trackage rights are not always effective. (King, Ongerth Deposition at 698-699, 346; Yarberry Deposition at 118).

with trackage rights when compared to ownership and concludes that "the owning railroad has the tremendous advantage (of being able to control its own service) over a railroad trying to compete via trackage rights." (V.S. Swanson at 256.)

As is borne out in the testimony of John Gray, an SP officer involved in the negotiations with BNSF, there is no incentive for a landlord railroad to provide essential maintenance to tracks used primarily by tenants. (Gray Deposition at 133). In fact, Applicants have stated for the record that it is possible for a landlord railroad to "make life difficult" for the tenant railroad. (Rebensdorf Deposition at 741-742). The Commission itself has recognized these difficulties. SF/SP, 2 I.C.C.2d at 820 ("We recognize the inherent dispute between landlord and tenant in unique situations such as this, where compensation must be set at a level that enables landlord and tenant to compete against one another.")

The inherent problems related to trackage rights have also been recognized by other veteran railroad officials. In a *Forbes* magazine article dated December 18, 1995, Mr. Gerald Grinstein, then the Chairman of the Board of the BNSF, when asked about trackage rights on UP/SP, stated "It's service with some disability - you've got track maintenance issues and dispatch issues. It's quite different from owning your own track." Christopher Palmeri and Ann Marsh, *Can Drew Lewis Drive the Golden Nail?*, FORBES, Dec. 18, 1995, at 52. Mr. Grinstein confirmed and elaborated on these views in his deposition in this proceeding. (Grinstein Deposition at 69-71.) He explained that trackage rights do not necessarily insure unfettered competition; that "ownership is preferred to trackage rights, and if you own it... you can provide a better level of service than you can if its trackage rights, so there's some disability." (Grinstein Deposition at 69). Mr. Grinstein bolstered his view with specific examples (Grinstein Deposition at 70), and noted that BNSF is not able to provide "efficient and compatible service" on all routes where it currently operates through trackage rights. (Grinstein Deposition at 174-75.)

In his deposition in this proceeding, UP's Mr. Peterson gave further testament to the underlying difficulty in the administration of trackage rights, which historically has prevented major competitors from entering into such agreements on a broad scale. Mr. Peterson's testimony further supports the implausibility that the BNSF trackage rights agreement was intended to foster vigorous competition:

> We have done actually two cases where, you know, we [UP] got trackage rights on them [SP] and then they in turn got trackage rights on us
>
> * * * *
>
> <u>But my experience has been not two competitors, especially--its hard enough for two end-to-end railroads to come together and do something, its even harder for two railroads that often compete or sometimes compete to come to these agreements</u>.

(Peterson Deposition at 96.)(emphasis added).

In explaining why trackage rights would not be an adequate substitute for the UP/SP merger, which is in itself an admission of the difference between trackage rights and ownership, he recounted that:

> Railroads just have had a history of having difficulty even agreeing to the more straight forward trackage rights swaps and so forth. And, while we keep chipping away and each year doing more haulage agreements and more trackage rights agreements, <u>they tend to be localized and in areas where there aren't major competitive implications</u>.

(Peterson Deposition at 1011.)(emphasis added). This candid historical appraisal by one of UP's key witnesses should give the Board cause for concern as to whether the "leopard has changed his spots."--*e.g.*, whether contrary to history, the BNSF agreement was truly intended to resolve the admitted competitive issues or is simply a facade.

SP personnel are also fully aware of the inadequacy of trackage rights as an effective competitive solution. In the *UP/CNW* case, SP "through 13 verified statements, two of which are from former UP employees, SP shows that UP has regularly discriminated against SP where SP has trackage rights over UP in the Central Corridor," *UP/CNW*, SP-19 at 21. As M.D. Ongerth, the same Ongerth who submitted testimony in this case in favor of the transaction, said in *UP/CNW*, "During the 1980's and since, UP's discrimination against SP in connection with SP's operations over trackage rights has been widespread and serious. It came to be expected." *UP/CNW*, SP-20, at 170. Larry H. Henley, a former UP employee, said, "When the Cotton Belt (*e.g.*, SP) received authority to use the MP Line . . . they were given the lowest tier priority reserved for foreign line trains detouring over MP, a basement category in which they remained for the entire time I worked at the dispatching office." *UP/CNW*, SP-20, at 170.[34] There is no reason to believe that a merged UP/SP will treat BNSF any better than UP treated SP. This is especially true given the fact that the trackage rights in the Agreement are the most extensive ever granted, and the discriminatory effect can be expected to be even greater.[35]

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[34] While Mr. Ongerth has sought to recant this testimony in the context of this proceeding in his deposition, the earlier contemporaneous complaints are an accurate reflection of the problems that may arise in the administration of trackage rights. *Accord*, V.S. Swanson, and Grinstein Deposition.

[35] In his testimony Mr. John Gray, an SP Vice President involved in the negotiations with BN/SF, described the tension that often exists between the top executives of a carrier who set performance targets and goals, and the personnel who must carry out the plans. Gray explained how this pressure from senior management creates great

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Applicants' witnesses, John Rebensdorf and others, have made the representation that trackage rights are a "way of life" in the railroad industry and are the standard method used to resolve competitive problems in merger proceedings. (Rebensdorf Deposition at 386-387.) Yet, the hard data shows that there must not be much "living going-on" over trackage and haulage rights. Joint Conrail/KCS witnesses David T. Hunt and William H. Oderwald examined the relationship between actual market share of a route and the percentage of total distance that the route utilized trackage or haulage rights. Analyzing various commodity categories, they were able to determine the percentage unit miles of that commodity that traveled via trackage/haulage rights. The results are:

Service Type	Total Unit Miles Analyzed (in millions)	Percent Trackage/Haulage Unit Mile of Total
General Merchandise	1,475	6.1%
Intermodal	4,232	4.2%
Coal/Bulk	1,258	2.5%
Auto Rack	527	6.5%

V.S. Hunt and Oderwald at 275.

It is clear from the four traffic service types that the average market share for routes using trackage/haulage rights is significantly smaller than for routes that do not use trackage/haulage rights. Based upon their analysis, Hunt and Oderwald were able to determine that "as the percentage of distance traveled on trackage/haulage rights relative to total distance increases, market share continues to decrease." V.S. Hunt and Oderwald at

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pressure on field level employees to do more business [for their own carrier] than they believe is possible. (Gray Deposition at 157-58).

275. In other words, the longer the distance a carrier must travel using trackage rights, the less likely it is to achieve a significant market share over that route. *Accord* V.S. Plaistow at 193.

B. <u>The Commission Cannot Fully Evaluate The Competitive Impact Of The BNSF Agreement Because Applicants Have Refused To Disclose Critical Aspects Of The Negotiation Of The Agreement</u>

As a threshold matter the Board should view with great suspicion, and should give little weight to, the BNSF trackage rights agreement because Applicants and BNSF have steadfastly resisted any discovery concerning the negotiation of the agreement. The Applicants quoted the agreement in press releases, throughout their Application, and in the Verified Statements of witnesses. Through the Statement of Mr. Rebensdorf, Applicants gave a limited, self-serving description of the negotiation of the Agreement, which was echoed by the statement submitted by BNSF of its chief negotiator Mr. Carl Ice that the Agreement was negotiated "aggressively and at arms length." (Ice Statement, p. 4, *BNSF Comments on the Primary Application*, BNSF-1, December 29, 1995.) These assertions were intended to convince this Board that the Agreement will resolve the competitive problems with the merger.

Yet when parties sought to explore or "test" the claims made in favor of the Agreement by questioning what points were negotiated, Applicants objected and refused to provide discovery based on an alleged settlement privilege. Thus, Applicants sought to have it both ways -- using the Agreement to support the Application, but avoiding discovery to test the Agreement.

This position was erroneous for several reasons. First, the Agreement was not the "settlement" of a disputed claim because BNSF, which was contacted by UP/SP about an Agreement, had made no decision to oppose the UP/SP Application and did not inform Applicants that they would oppose the Application. (Ice Deposition at 62-65; Davidson Deposition at 129.) The Agreement is merely titled an "Agreement" and does not state that it is the settlement of any dispute of claim.

Moreover, the Applicants waived any privilege and placed the negotiations squarely in issue by relying on the Agreement heavily in support of their Application and by offering a partial description of the negotiations in the statement of Mr. Rebensdorf. (App., Vol. I, V.S. Rebensdorf.) Likewise, BNSF's chief negotiator of these Agreement described the negotiations as "aggressive" to influence the Board in its decision. (Ice Deposition at 206-207.) Yet, Mr. Ice hid behind the privilege and refused to elaborate when asked to give examples of the purported "aggressiveness" of the negotiations. (Ice Deposition at 207)

Applicants have made their decision and now they must live with the consequences. Having failed to allow meaningful discovery concerning the negotiation of the Agreement, they should be estopped from relying on it. Applicants' fear of disclosing the negotiations should also raise a large question mark for this Board -- Does BNSF truly desire to compete over all the line segments and in all of the markets?

C. <u>The Trackage Rights Agreement Was A "Package Deal," And BNSF Was Forced To Take Access Over Lines That It Had No Desire To Operate</u>

Despite Applicants' attempts to suppress the truth about the negotiations, there is mounting evidence that the Agreement was a under which BNSF was forced by Applicants to take rights over corridors that it initially had no interest in (and hence

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routes in which it will not be an effective competitor) in order to obtain rights that it truly desired, primarily in the Western U.S.

Mr. Ice, BNSF's lead negotiator admitted that going into the negotiation he was given a "map" with the rights to be offered by UP/SP. (Ice Deposition at 177.) Of course, parties were not allowed to question Mr. Ice on what give and take, if any, took place in the negotiations concerning the routes in the map. In fact, all indications are that there was little give and take over the general corridors offered but rather that BNSF had to take all the routes in order to get any of them. Thus, Mr. Rollin Bredenberg of BNSF, who attended an internal meeting with Mr. Ice, Mr. Krebs and others to discuss the UP/SP offer, came away with the "working assumption" that the offer to BNSF was a "package deal." (Bredenberg Deposition at 68.) A subsequent telephone conversation with Mr. Bredenberg confirmed that BNSF was given an all or nothing, take it or leave it proposition. (Bredenberg Deposition, Exhibit 1).

Thus, in an October 5, 1995 "CALL REPORT" from Mr. Brad Skinner of the Tex-Mex Railway regarding a telephone conversation with Mr. Rollin Bredenberg of BNSF, Mr. Skinner recounts that:

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(Bredenberg Deposition, Exhibit 1). (This CALL REPORT is submitted in the Highly Confidential Appendix. A chart comparing the Call Report with the Bredenberg deposition, in which the content of the call report is substantially confirmed, is also included in the Highly Confidential Appendix.)

The conclusion that BNSF did not have the choice to reject certain routes offered by UP/SP (and thus took routes over which it will not be an effective competitor) is also confirmed by Applicants' testimony that they decided they wanted <u>one carrier</u> to provide a comprehensive solution to the competitive problems of the merger. If only one carrier (BNSF), rather than two or more, was required to take trackage rights over all the routes impacted by the combining of UP and SP, then by definition the "one carrier" did not have the choice to decline any of the routes. Thus, the likelihood that BNSF received routes in which it had less interest is increased.

Despite the opposition parties' best efforts, Administrative Law Judge Nelson has not allowed substantial discovery into these very relevant issues. (U.S. STB, Discovery Conference, Jan. 2, 1996, at 426-431 and March 1, 1996, at 1709.) During depositions, Applicants have often gone into the details of the negotiations between Applicants and BNSF when it serves their purposes of trying to establish why the agreement would provide sufficient competition; however, when parties have attempted to "test" those assumptions or particular issues, Applicants have directed their witnesses not to disclose any information, arguing that the Agreement is the Agreement, and it stands on its "four corners."

Furthermore, with respect to the Agreement between Applicants and BNSF, BNSF has not provided any operating details, management plans, traffic diversion studies, market analysis, financial information, or any form of environmental documentation with respect to its line purchases and trackage rights exemption requests filed with the Application (see Motion of KCS requesting further environmental documentation filed March 22,1996, KCS-31). Other than the Agreement itself, the Commission has precious little information to make an informed independent judgment with respect to BNSF's ability to provide a "fix" for Applicants' admitted competitive problems.[36] Accordingly, as a threshold matter, the Agreement between BNSF and Applicants should be viewed suspiciously and should be given little weight.

D. <u>UP Has A History Of Discriminating Against Tenants Competing With It Via Trackage Rights</u>

As noted previously, in the *UP/CNW* case, SP submitted 13 verified statements, including two from former UP employees, that showed UP was regularly discriminating against SP where SP had trackage rights over UP in the Central Corridor. Mr. Ongerth stated for the record in this proceeding that in certain situations in which SP was a tenant,

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[36] In this respect, KCS cannot be criticized for not providing such similar information with respect to the specific conditions it is requesting in this proceeding. Unlike Applicants and BNSF, KCS is not filing any line purchase or trackage rights applications at this time. If KCS were to obtain trackage rights or line ownership as a result of a condition imposed in this proceeding, KCS stands willing and able to provide any appropriate information, including the information that BNSF has refused to provide. The BNSF Agreement is a critical element in Applicants' proposed "fix," but the details of that element are conveniently omitted.

[illegible] 47). Moreover, UP has indicated on the record that UP's [illegible] on which BNSF will have trackage rights could operate to [illegible] Rebensdorf Deposition at 169-170, 191-193, 268-271.) UP also has [illegible] the record that there have been complaints by trackage right tenants with [illegible] implementation of trackage rights in the past. (King and Ongerth Deposition at [illegible] Describing the problems SP had with respect to its previous trackage rights, SP Vice [illegible]ident, Lawrence Yarberry stated:

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(Yarberry Deposition at 118). SP experienced delays due to UP's dispatching, (Yarberry Deposition at 193), and then complained about the priority that the landlord UP gave to the tenant SP's trains. (King and Ongerth Deposition at 346). Given this history and the fact that the longer the trackage rights, the less market share a tenant will get (V.S. Hunt and Oderwald at 275) BNSF will not be an effective competitor to the merged UP/SP, at least with respect to those points and corridors served by BNSF via trackage rights. Despite UP's past discriminatory treatment of SP in trackage rights matters, SP now urges the STB to accept the granting of trackage rights to BNSF as an adequate remedy for the anticompetitive effects of this proposed merger.

E. <u>BNSF's Operating Costs Will Be Significantly Higher Than UP/SP's And As A Result, BNSF Will Not Provide An Effective Competitive Substitute</u>

The trackage rights granted to BNSF are overhead or bridge trackage rights from the 2 to 1 point to a given destination. This means BNSF does not have the ability to pick-up or deliver traffic along the way. (This is in contrast to the "full trackage rights" granted UP/SP over BNSF lines.) For example, if implemented, the Agreement gives BNSF trackage rights from those 2 to 1 points located in Houston to take the traffic to Memphis. Along the route, BNSF can only add traffic, not otherwise originated in Houston, at specific 2 to 1 shippers located at Camden, AR, Pine Bluff, AR, Fair Oaks, AR, Baldwin, AR, Little Rock, AR, North Little Rock, AR, East Little Rock, AR, and Paragould, AR.[37] Accordingly, even assuming no problems with operations, discrimination, dispatching, or congestion, BNSF must be able to cover its operating (variable) costs plus earn a return on its equipment (capital) investment in order to be an effective competitor in the Houston to Memphis corridor and over all other corridors where it was granted trackage rights.

BNSF will not be able to cover its costs and earn a return on capital without charging shippers significantly more than what Applicants will be able to charge over the same route. Evidence of this is already beginning to appear as BNSF begins to market the rights that it hopes to get. For example, despite the fact that BNSF has not yet been awarded its trackage rights, BNSF is already trying to solicit shipper traffic from Houston to New Orleans using the trackage rights. But the rates quoted are simply too high.

> Phillips likewise is not persuaded that the agreement between UP and Burlington Northern will produce the effective competition espoused. Recently concluded contract negotiations with the BN yielded rates from Houston to New Orleans, contingent upon the SP/UP deal being approved, that have given us cause for concern. These rates proved to be considerably higher than other available rail options. If this is a preview of post-acquisition pricing, then the shipping public is in trouble!

V.S. Fred E. Watson, Phillips Petroleum Company, filed March 12, 1996.

If granting BNSF access only to the 2 to 1 points means BNSF cannot attract enough traffic to cover its costs plus earn an adequate return, BNSF will withdraw from the market.

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[37] Since no BNSF operating plan has been submitted, it is unclear whether BNSF is able to add cars picked up at locations in Houston that it already serves to the cars that it picks up at the 2 to 1 points in order to block a train for delivery in Memphis.

Thus, if Applicants are alleging that the BNSF agreement "fixes" all of the competitive harms (which it does not), the Board, consistent with Congressional intent, has an obligation, before imposing that Agreement as a condition, to ensure that the terms of the Agreement will in fact provide a competitive "fix" for those 2 to 1 point shippers.

Consistent with this Congressional intent, if the underlying economics contained within the BNSF agreement do not ensure that the anticompetitive effects of the merger are alleviated, at least with respect to the 2 to 1 point shippers, then the trackage rights fees within the Agreement must be adjusted so that competitive relief is provided. If there is no trackage rights compensation scheme that would permit effective competition, then a more effective remedy, such as divestiture, should be imposed. In his verified statement, Mr. Joe Plaistow, a former BN employee of 15 years where he served as Director of Costs and Economic Analyses, analyzed the costs and economics of the BNSF trackage rights. He concludes that even if one assumes that the only competitive harms of the proposed transaction occurred at 2 to 1 points (which, as Dr. Grimm, Dr. White, and others have shown is not true), BNSF will not be an effective competitive substitute because BNSF's costs will be significantly higher than UP/SP's costs, at least with respect to those parallel routes where BNSF and UP/SP will be competing. His conclusion is confirmed in the diversion analysis done by ALK Associates. V.S. Hunt and Oderwald.

KCS witness, Mr. Hilary S. Rawert, also provides analytical support for the notion that BNSF will not be an effective competitor to UP/SP for two significant reasons. First, the method established in the Agreement for periodically adjusting the trackage rights charges does not account totally for productivity savings on trackage rights lines, which places the tenant (BNSF) under a long term competitive and financial disadvantage. V.S. Rawert at 246. The index that UP/SP and BNSF will use to periodically adjust the trackage rights fees is the "Rail Cost Adjustment Factor" (RCAF) Unadjusted for Productivity. Thus, over a number of years, BNSF's cost of utilizing the trackage rights, not favored with price reductions due to increased total productivity, will exceed considerably UP/SP's costs on those segments, which have been reduced through productivity savings. V.S. Rawert at 246. Second, the trackage rights fees that BNSF must pay are simply too high. At the 3.0 mil per gross ton mile rate for trackage rights that UP/SP will assess BNSF for bulk trains (V.S. Rebensdorf, Table 1 at page 304), the cost for just this one cost item on a cost per train mile basis would equate to $48.44 per train mile (or $.42 per car mile). This fee is extremely high, and UP/SP would incur variable cost for this item of cost at a significantly lower level, thus, giving it a competitive advantage that will increase over time. V.S. Rawert at 248.

In fact, documents in the record indicate that BNSF knew it would not be competitive on many corridors. For example, an internal

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; See also Ice Deposition at 301-18). An expert testifying on behalf of Applicants has testified on the record that after the merger, if UP/SP efficiency gains are as predicted, it will be difficult for BNSF to compete for the Utah-Los Angeles route. (Sharp Deposition at 180.) Applicants have also testified that it is "possible" that the number of shippers switching to BNSF on the central corridor will be so small that the volume will not permit BNSF to provide competitive service. (Ice Deposition at 322-323.) In addition, Applicants acknowledge that BNSF may not be competitive in some non-major point-to-point comparisons, as well. (Rebensdorf Deposition at 167.)

F. Applicants Are Attempting To "Lock Up" Contracts To Prevent Effective Competition From BN/Santa Fe

Further support for the conclusion that BN/Santa Fe will not be able to attract a sufficient traffic base to cover its costs is found in the fact that Applicants have pursued a conscious policy to "lock up" as much business as possible to protect it from competition from BNSF if the merger and the trackage rights agreement are approved. Thus, in a September 25, 1995 internal SP E-mail message in regard to REDACTED in the context of trading a favorable multiyear contract extension for support for the UP/SP merger, SP's Manager of National Accounts stated:

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(Gehring Deposition, Exhibit 2 at HC45-003923 emphasis added.)

In a subsequent "Recommendation" in October 1995, Mr. Gil Jara, SP Director of Plastics Marketing, adopted and elaborated on this goal of preemptively protecting business form BNSF competition:

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(Gehring Deposition, Exhibit 2 at HC62-000006, emphasis added.) During a discovery conference at which Applicants objected to and sought to avoid any depositions on the REDACTED counsel for SP conceded that SP is doing all it can to lock up as much business as possible prior to the merger being approved. (*See* February 7, 1996 Hearing Transcript at 1181-82.)

G. <u>There Are Significant Operational Problems Associated With Both UP/SP's And BNSF's Planned Operations Over The Houston To St. Louis Corridor</u>

1. <u>The Bi-Directional Operating Plan</u>.

The UP/SP operating plan will employ directional routing of trains--segregating types of traffic on paralleled routes and creating large consolidated terminal hubs. App. Vol. I, V.S. King and Ongerth. This directional routing will include routes from St. Louis and Memphis to Houston and San Antonio and Dallas/Ft. Worth. The division of traffic by type on parallel routes between Houston and Memphis and between San Antonio and Dallas/Ft. Worth will require trains to operate in one direction over tracks now belonging to UP and in the other direction over tracks that now belong to SP.

While such directional routing of trains appears reasonable at first blush, as is established in the verified statements of Don Swanson and A.W. Rees, Senior Vice-President of Operations for KCS, this plan is extremely inefficient and the alleged convenience is outweighed by increased costs. As Mr. Swanson succinctly states:

> If a railroad had all of the money required to build a railroad between two major cities, they would build a single line of railroad consisting of multiple tracks, sophisticated signaling and required sidings and yard facilities. They <u>would not build</u> two lines of railroad with separate signaling, separate sidings and yard facilities, with separate problems such as additional road crossings, additional bridges and additional right-of-way maintenance.

V.S. Swanson at 265. While pure "bi-directional" operations might reduce the need for some sidings and signalling capability, V.S. Rees at 227, UP/SP do not propose pure "bi-directional" operations. Instead, they propose that local trains will continue to operate in both directions on both the northbound and the southbound routes. V.S. King, Ongerth at 55. It appears the primary reason for UP/SP's plan of directional routing is to utilize trackage "because it is there" . . . and perhaps to prevent another carrier from accessing the major Houston and St. Louis markets.

Directional routing, especially by types of traffic and speed of trains, presents many problems unresolved under the current proposal: balancing crew and locomotive assignments; achieving labor agreements; training; and implementing complicated maintenance procedures. V.S. Swanson at 265-266. More specifically, as detailed in Mr. Rees' statement, if, as UP/SP propose, northbound trains will use the UP route and southbound trains will use the SP route, UP/SP will experience an impossibly expensive situation with respect to crew utilization on the lines.

Furthermore, BNSF's trackage rights operations over these same routes will only complicate the bi-directional problems. The Agreement with BNSF contemplates that BNSF's trains, both northbound and southbound, will operate over SP's route, which UP/SP have designated for southbound traffic.[38] In addition, UP/SP local traffic will operate both

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[38] "It is pretty amazing to me that BNSF, supposedly intent on competing with UP/SP, did not demand access to both routes (for its own "bi-directional" operations) and settled for trackage rights over a route on which its northbound trains will operate in the teeth of UP/SP's southbound traffic." V.S. Rees at XX.

Northbound and Southbound. This will create complete operating, signalling, and dispatching problems that cannot be easily resolved. V.S. Rees at 225-226.

2. The Terminal Trackage Rights Issue.

Of major significance, however, is the fact that even if the Agreement is imposed as a condition, BNSF will not be able to implement its trackage rights absent a corresponding approval of UP/SP's terminal trackage rights application filed pursuant to the Board's authority under 49 U.S.C. § 11103(a) in Finance Docket No. 32760 (Sub-No. 9). In Sub-No. 9, Applicants have requested that the Board grant the BNSF trackage rights over the KCS trackage in the Houston-Memphis and Houston-New Orleans corridors pursuant to the Board's authority under 49 U.S.C. § 11103(a). The specific trackage segments at issue are located in Shreveport, Louisiana and Beaumont, Texas, two key points in the Houston to Memphis and Houston to New Orleans corridors.

As is established in KCS's separate comments filed in the Sub-No. 9 docket (filed contemporaneously herewith (KCS-33) and incorporated herein by reference) Applicants have totally failed to satisfy the burden of proof required for an award of trackage rights under Section 11103(a). Moreover, Applicants have not even addressed the proper standards. Accordingly, Applicants' request for an award of terminal trackage rights pursuant to Section 11103(a) should be denied. Furthermore, because there will be competitive harm in these corridors if the merger is approved, divestiture of these lines will not involve issues under section 11103(a) since divestiture would merely involve substituting one owner for another, not placing an additional carrier in that corridor as the BNSF trackage rights agreement would do.

Without access to East St. Louis, BNSF is at an extreme disadvantage because it can not successfully interchange with Eastern railroads without paying bridge and transfer fees for one of the terminal companies, TRRA, to haul its traffic across the Mississippi to East St. Louis. V.S. Rees at 233. Those fees have been historically high, amounting to several hundred dollars per car. Eastern railroads do not have to deal with this problem because they are already in East St. Louis with access to TRRA and A&S. V.S. Rees at 233.

Not only does BNSF incur bridge charges but they also experience considerable delays in getting trains across the bridge. This delays can only increase as BNSF agreed to give UP/SP control of operations over the McArthur Bridge in St. Louis, the bridge connecting the West St. Louis with East St. Louis. App., Vol. I, V.S. Rebensdorf at 328, Agreement, Section 7(b). Ceding control of such a critical gateway to an arch rival stands to put BNSF at a competitive disadvantage for St. Louis gateway traffic. V.S. Rees at 233-234.

KCS and Conrail witnesses have established that BNSF's costs to operate its trackage rights over the SP's Houston to Memphis line are significantly higher than UP/SP's; that operationally, BNSF trains will be at a significant disadvantage when compared to UP/SP trains; and that diversion models have shown that BNSF will get little, if any, traffic over this corridor. However, even if there is traffic, these trains will arrive at the west bank, pay a switching charge, and then cross the river over a bridge controlled by UP/SP. If Applicants are truly interested in providing former UP/SP 2 to 1 point shippers effective two carrier competition, Applicants would have allowed BNSF trains to continue utilizing its bridge trackage rights from Memphis to the east bank of St. Louis over the SP's line.

Curiously, there are even two to one point shippers from Memphis to St. Louis who are not granted access to BNSF via trackage rights. App., Vol. I, V.S. Rebensdorf at 353.[39]

Applicants may claim additional access is not required in the Memphis and St. Louis markets because after the merger, in addition to UP/SP and BNSF, KCS will serve those markets. Indeed, Applicants traffic analysis as put forth by Mr. Peterson and the various maps submitted with the Application reflect the trackage rights obtained by KCS in relation to the Agreement reached between KCS and BNSF during the course of the BNSF merger proceeding. However, while KCS and BNSF did reach an Agreement that would have allowed KCS to serve, via haulage or trackage rights, the Memphis and St. Louis markets, that Agreement has never been consummated or implemented. Indeed, because KCS filed a Petition to Reopen the BNSF merger, KCS-6 filed September 5, 1995, BNSF has considered KCS in breach of the BNSF/KCS Agreement. KCS-33, Vol. VII, Highly Confidential Appendix at 1,037-42. Accordingly, any traffic analysis or map that takes into account the rights granted to KCS by BNSF is simply inaccurate and unreliable.

Applicants' counsel, Mr. Roach, is fully aware of this situation. In fact, he himself wrote a letter on behalf of UP to KCS's Assistant General Counsel refusing to give KCS consent to allow BNSF over the Lettsworth to Lobdell, Louisiana trackage. Allowing BNSF over this segment was an integral part of the BNSF/KCS Agreement. Curiously, this is the

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[39] Extending BNSF's trackage rights from Memphis to E. St. Louis over the SP line would not violate the Commission's long standing rule of only ameliorating harms caused by the merger and not ameliorating pre-existing, anticompetitive conditions. *BNSF* slip. op. at 54. This is because those UP/SP 2 to 1 point shippers in the Houston to St. Louis corridor have always had access to E. St. Louis. In this sense, such former 2 to 1 shippers who will utilize BNSF are <u>worse off</u> under Applicants' "fix," despite Applicants claims to the contrary.

same track segment to which UP, in its Agreement with BNSF in this case, is unwilling to grant BNSF access. See Note to Applicants' Map #2. Applicants are thus being duplicitous in showing BNSF as having trackage rights from New Orleans to Shreveport.

H. <u>As Another Example, BNSF Will Not Be An Effective Competitor For Traffic To The Mexican Gateways</u>

KCS witnesses have established that the reduction of the number of rail competitors from 3 to 2 will have anticompetitive results. But, even accepting the notion that two rail competitors in any relevant geographic market are sufficient there is no reason to believe that BNSF either desires to be, or will be, an effective second competitor to UP/SP's dominance of traffic moving into Mexico. UP and SP currently dominate rail traffic into Mexico controlling 90% of all traffic through the Mexican gateways. V.S. Haverty at 142, citing data provided by ALK Associates. After the merger, UP/SP will control 90% of the traffic to Mexico. BNSF currently controls 10% of this traffic, V.S. Haverty at 142, and with the trackage rights, claim they will be an effective competitor to the 90% share controlled by Applicants. A serious examination of BNSF's claims leads one to question BNSF's ability to provide the competitive check. See also the filing of Tex-Mex's, V.S. Grimm discussing these issues in more detail.

It is clear from various documents that in negotiating the Agreement with UP, BNSF was not interested in serving the Mexican gateways directly, instead wanting to rely on Tex-Mex as its agent. (Davidson Deposition at 58-59; Draper/Salzman Deposition at 209-210.). For example, under the terms of the UP/SP Agreement, BNSF will receive trackage rights between Houston and Brownsville, Texas. According to Mr. Ice, who represented BNSF in the negotiations with UP and SP, BNSF was "very interested" in this route. (Ice Deposition at 582.) Mr. Ice acknowledged, however, that while BNSF obtained the "route" it sought, it did not acquire the specific "rights" it sought for operation on that line. (Ice Deposition at 482.)

BNSF sought the right to use a "contractor" or "agent" to operate its trackage rights between Houston and Brownsville. (Ice Deposition at 583.) According to Mr. Ice, the use of an agent might have put BNSF "in a better competitive position than we would otherwise assume with our trackage rights." (Ice Deposition at 585.) While Mr. Ice testified that there was no "presumption" that BNSF would have "automatically" selected Tex-Mex as its agent, he acknowledged that "[f]or most shippers Laredo is the preferred gateway" to Mexico (Ice Deposition at 585-86), REDACTED

(Call Report by Brad Skinner, 10/5/95, Bredenberg Deposition Exhibit 1.) Indeed, since the Tex-Mex operates a line between Corpus Christi (on the Houston-Brownsville route) and Laredo, the selection of Tex-Mex would have provided BNSF with improved access to the prime Mexican gateway. UP and SP, however, refused to grant BNSF the right to use an agent on the Houston-Brownsville route. According to Mr. Ice, UP and SP based their refusal on concerns that allowing BNSF to use an agent might put UP/SP "at a competitive disadvantage." (Ice Deposition at 583.) Indeed, UP specifically did not want Tex-Mex to be BNSF's agent for Mexican traffic because it didn't want "too much

(Bredenberg Deposition at 45-54.)

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states that BNSF has significantly raised its rates for grain and other traffic moving from BN origins to Texas and Mexico, effectively shutting off such movements and forcing such moves to BNSF destinations in the Pacific Northwest and California--hardly the actions of a railroad intent on competing vigorously for a significant share of the market.

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(Bredenberg Deposition at 66-68.)

(Bredenberg Deposition, Exhibit 1.)

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It was only at the request of Mexican government officials involved in the privatization process that BNSF consider bidding on privatization that BNSF said they would "consider it." (Bredenberg Deposition at 19-20 and 95-96.)

The reasons cited by the Mexican government officials for having BNSF submit a bid was the fact that they wanted "to make sure that there was full access to the Mexican system by more than one U.S. railroad." (Bredenberg Deposition at 95-96.) Implicit in this statement is the notion that unless a railroad is bidding on the Mexican privatization concession, it is not interested in being a strong competitor to the Mexican gateways. BNSF's electing not to bid on the Mexican concessions, together with its raising rates to Mexican gateways, and expressing concerns about not wanting to go to Brownsville in the negotiations with UP, indicate that BNSF will not likely be an effective competitor to the UP/SP's dominance of the Mexican gateways.

V. IF BN, SF, UP, AND SP HAVE COOPERATED IN A MANNER THAT MAY VIOLATE THE ANTITRUST LAWS, THE STB SHOULD NOT IMMUNIZE SUCH CONDUCT UNDER ITS AUTHORITY CONTAINED AT 49 U.S.C. § 11341

A. History Of Such Cooperation

1. Drafting the blueprint for a western rail duopoly.

According to Carl R. Ice, currently an officer of BNSF and then an officer of SF, the consulting group prepared one or more studies for SF in the early 1990's aimed at analyzing the potential (Ice Deposition at 134.) The of this effort was to evaluate the "consolidation of railroads." (Ice Deposition at 509.) Ostensibly developed

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available to SF, combinations." (Ice Deposition at 509-10.)

The fact that SF commissioned one or more studies of potential "combinations" in the western rail market is, by itself, quite unremarkable. What *is* remarkable, and indeed disturbing, is evidence suggesting that instead of relying on the analysis solely for internal strategic planning purposes, SF elected to share the study or studies with its competitors in the western rail market. For example, Mr. Grinstein testified that he recalled a study (not prepared by or at the direction of BN) analyzing the potential break-up of the Southern Pacific in the event SP went into bankruptcy. Indeed, Mr. Grinstein testified that Mr. Anschutz of SP "got mad about something, and it had to do, I think, with the bankruptcy study because he thought that if it got out it would scare off their customers and then have a chilling effect on his business." (Grinstein Deposition at 107.) While Mr. Grinstein was unable to recall specifically the source -- or the author -- of this study, an evaluation of a SP bankruptcy contingency may well have been part of the analysis of the potential

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2. Sharing confidential acquisition strategies with competitors.

The inference of collusive conduct among the parties to the BNSF merger and the proposed UP/SP merger is further bolstered by evidence in the record documenting instances in which the parties, rather than seeking to protect their sensitive acquisition strategies, opted to share that information with their competitors. For example, in the spring of 1994, Grinstein of BN advised Mr. Krebs of SF that BN was interested in acquiring KCS. (Grinstein Deposition at 109-11.)

An even more inexplicable disclosure of acquisition strategies occurred in a September 1994 meeting between UP and SP. According to Mr. Anschutz, he and other representatives of SP met with Mr. Lewis and officers of UP twice in 1994 to discuss a possible UP/SP merger. The first meeting, in July, was "very preliminary in nature." (Anschutz Deposition at 155.) Going into the second meeting, in September, SP's representatives "expected to talk about the next step in the discussions of a possible [UP/SP] combination." (Anschutz Deposition at 161.) And, in fact, the parties executed a confidentiality Agreement at the outset of the second meeting. (Anschutz Deposition at 160-61.) Instead of merger discussions taking place at that meeting, however, UP told SP it was interested in acquiring SF rather than SP. (Anschutz Deposition at 161.) Perhaps even more troubling, UP proceeded to inquire -- before even approaching SF -- as to whether SP was interested in negotiating a set of trackage rights in return for SP's agreeing to "stay out of the case" before the ICC if UP were successful in acquiring SF. (Anschutz Deposition at 164.)

If there were to be no UP/SP merger, what was the purpose of the confidentiality Agreement between the parties? Even Mr. Davidson, Chairman of the Board of UP and a participant in the meeting, could not answer this question. (Davidson Deposition at 22.) Moreover, despite the outcome of the September 1994 meeting with UP, SP later took actions inconsistent with those of a rejected potential merger partner. On November 7, 1994, SP engaged Morgan Stanley & Co. Incorporated to act as its

(Runde Deposition, Exhibit 2, HC26-000001)

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The merger Agreement between BN and SF was announced on June 30, 1994. (Davidson Deposition at 29-30.) UP did not approach SF, however, until Mr. Lewis and

Mr. Davidson met with Mr. Krebs and his outside counsel on October 5, 1994. (UP Schedule 14-D1, 11/9/94 at 20.) Mr. Krebs refused to entertain the offer from UP (UP Schedule 14-D1, 11/9/94 at 19-23), but the meeting marked the beginning of "[a]n active bidding contest" that involved "a see-saw battle of revised bids for Santa Fe" (UP Schedule 14D-1, Amendment No. 16., 1/27/95), and a lawsuit filed by UP in the Delaware Chancery Court seeking to invalidate a "poison pill" adopted by SF to thwart UP's efforts. (UP Schedule 14D-1, Amendment No. 16, 1/27/95.) UP's final offer for SF reflected a premium of almost 40% over the value of [SF's] original transaction with Burlington Northern." (UP Schedule 14D-1, Amendment No. 17, 1/31/95.)

A *Wall Street Journal* article published during this period quotes Mr. Davidson as saying that the expected acquisition of SF "positions [UP] as the strongest railroad in the West, in the U.S. and maybe in the world." (Daniel Machalaba, *Expansion-Minded Company Makes Progress with Santa Fe Proposal*, WALL STREET JOURNAL, Dec. 8, 1994.) Yet despite this apparent enthusiasm over the prospect of creating a world-class railroad, on January 31, 1995, UP suddenly dropped its bid for SF. (UPC Schedule 14D-1, Amendment No. 17, 1/31/95.)

According to Mr. Davidson, "one of the very clear reasons" for UP's decision to pursue SF was that "the price that BN was paying for Santa Fe was ridiculously low." (Davidson Deposition at 24.) When asked at deposition why UP ultimately dropped its aggressive campaign for SF, Mr. Davidson defended this seemingly inexplicable move as "the right decision at the time in view of the fact that, as the price rose, it became less a clear-cut choice that going higher was the right thing to do." (Davidson Deposition at 33-

34.) Yet the evidence suggests that UP may have withdrawn its bid because it had achieved

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Finally, the settlement Agreement between SP and BNSF for the BNSF merger included an unusual contingency clause that further suggests the sharing of sensitive acquisition strategies among competitors. The clause provides that the fees paid by SP to BNSF for trackage rights acquired from BNSF would increase in the event of a UP/SP merger.[40] The fact that this specific contingency clause was incorporated in a document drafted several months before the proposed UP/SP merger was announced publicly suggests a likelihood that BNSF may have received information from UP or SP concerning the upcoming UP/SP transaction.

3. <u>The trackage rights Agreement with The BNSF may be an outgrowth of this potential unlawful cooperation</u>.

After dropping its bid for SF, UP entered into settlement negotiations with BN and SF as part of the BNSF merger proceeding. Although it would have been in UP's economic interest to seek trackage rights along the vital Denver-Ft. Worth corridor, UP allowed those rights to go to its "competitor" SP. UP entered into a settlement Agreement with BN and SF on April 7, 1995. SP settled with BN and SF on April 13, 1995. SP received the prize Denver-Ft. Worth trackage rights. UP settled for trackage rights along the significantly less important route between Abilene, Kansas and Superior, Nebraska. When asked whether UP, some ten months after settling with BN and SF, had implemented its trackage rights along

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[40] The ICC invalidated this clause on the grounds that it could potentially undermine the efficacy of the trackage rights remedy that was being imposed. *BNSF*, slip op. at 92.

the line it received in return for agreeing not to oppose the BNSF merger, Mr. Rebensdorf, Vice President-Strategic Planning for UP, was unable to say "whether we have moved anything" on the line. (Rebensdorf Deposition at 741.)

Notwithstanding UP's volunteered explanation that it never asked for the Denver-Ft. Worth rights because it knew BN and SF would never grant them (Rebensdorf Deposition at 611-13),

(Rebensdorf Deposition, Exhibit 8, HC62 - 100001-13.)

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." (Rebensdorf Deposition, Exhibit 8 HC62 - 100002.)

The inclusion of this issue on the meeting agenda suggests two possible scenarios that are inconsistent with proper conduct among competitors. First, any discussion of the "concessions" SP expected from BN and SF would have provided a perfect opportunity for UP and SP to explicitly coordinate strategies for their respective trackage rights negotiations with BN and SF -- including those on the vital Denver-Ft. Worth corridor. Second, even if no express Agreement not to compete for the Denver-Ft. Worth rights was reached, UP may have decided that it could afford to not pursue that route in its negotiations with BN and SF because those rights would be granted to the very railroad that UP expected to acquire in the coming months.

B. <u>This Past History Significantly Increases The Risk That Applicants And BNSF Will Not Be Effective Competitors In The Future</u>

As troubling as the foregoing evidence may be in and of itself, it is especially problematic when viewed in light of the duopoly market structure that would be created if the UP/SP merger is approved. Indeed, by accepting a "package deal" that included access over lines in which it had no interest; agreeing to operating terms that will give UP control over crucial areas, such as the McArthur Bridge in St. Louis; and agreeing to trackage rights fees which undoubtedly will give UP/SP a cost advantage, the actions of BNSF are inconsistent with vigorous competition and suggest an understanding not to compete.

Furthermore, Applicants and BNSF have put in place a structure that may facilitate such continued close cooperation and hamper effective competition. On September 26, 1995, BNSF, UP and SP announced that they had entered an Agreement to "preserve and intensify rail competition following the UP/SP merger." (See BNSF Depository Document numbered BNSF-05250.) On its face the Agreement appears to do just that; in fact, however, the contrary is true. Rather than preserving competition and far from intensifying it, the "Agreement" between BNSF, UP and SP will further erode competition in the Western U.S. rail market that will have been recently hobbled by the UP/SP merger.

The Agreement creates the structure necessary to carry out coordination between the parties and creates a means for unfettered future collusion. (*See* Verified Statement Lawrence J. White at 125, 127-28.) The Agreement calls for the establishment of a "joint service committee to regularly review operations over the trackage rights lines." (Agreement at Paragraph 9, subparagraph d).) Moreover, the Agreement involves trackage rights to nearly 4000 miles of rail. (Rebensdorf Deposition at 176-178.) Oversight of such an enormous grant of trackage rights will necessarily require virtually a standing committee, eliminating the need for clandestine meetings, and creating the opportunity for unfettered cooperation between the only remaining rail competitors of significance in the Western U.S. *See*, Affidavit of Lawrence J. White at 127-28 ("The extension dealings between the landlord, and the tenant concerning trackage rights, scheduling, etc. could become a vehicle for the exchange of extensive competitive sensitive information and thus a means by which the two firms could monitor and reassure each other.") In fact, contrary to all principles of vigorous competition, Applicants have acknowledged that the joint service committee will allow UP/SP and BNSF to "know what each other's priorities are." (King and Ongerth Deposition at 186-187.)

Further justifying the close coordination between the ostensible post merger competitors, Applicants have made clear that the Agreement cannot be implemented without further negotiation (Rebensdorf Deposition at 168-170, 184-185, 200-203, 151-152, 209-210.) and that substantial further communication between the parties will be required to resolve such issues as haulage fees. (Rebensdorf Deposition at 392-393, 430, 471. See also Ice Deposition at 21.) These negotiations will require interaction that would facilitate further collusion. Moreover, Applicants have stated on the record that they will share with BNSF dispatch records and other competitively sensitive information, not ordinarily shared with competitors, as part of the administration of the trackage rights. (King and Ongerth Deposition at 184-185.) The practical effect of the Agreement thus will be to create a conduit between the parties, whereby they can freely and openly exchange competitively sensitive information.

C. <u>The STB Is Not An Antitrust Court And Should Not Immunize Conduct That May Otherwise Violate The Antitrust Laws</u>

Since the STB is not a trier of fact as to allegations of anticompetitive activity and it does not make determinations regarding compliance with the Clayton, Sherman or other antitrust laws, it could approve this transaction even if it violates the antitrust laws. *Burlington Northern, Inc. and Burlington Northern Railroad Company -- Control and Merger -- Santa Fe Pacific Corporation and The Atchison, Topeka and Santa Fe Railway Company*, 1995 ICC LEXIS 214 at *135 (Aug. 16, 1995); *Northern Lines Merger Cases*, 396 U.S. 491, 511-14 (1970). An STB ruling may not provide a shield as to anticompetitive activity, however. Neither Congress nor the courts has granted the STB the ability to immunize anticompetitive behavior that violates sections 1 and 2 of the Sherman Act, *e.g.*, horizontal Agreements to divide territories or monopolize a market.

In *Pinney v. Dock & Transport Co. v. Penn Central Corp.*, 600 F. Supp. 859, 867 (N.D. Ohio 1983), the district court rejected the defendants' argument that an ICC approved rate bureau Agreement insulated them from an antitrust challenge.

> [N]othing in the present record indicates that the ICC ever "approved" or even was aware of defendants' alleged predatory conspiracy to boycott and eliminate plaintiff as a competitor. The 1950 Eastern Railroads Agreement, which merely establishes the procedures for discussing rate matters and reaching rate Agreements, cannot be read as impliedly or expressly "approving" such a predatory conspiracy.

The former ICC consistently acted in accordance with its policy of "not [sitting] as an antitrust court in determining compliance with the Clayton Act, Sherman Act or related antitrust acts." *Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company -- Control -- Chicago and North Western Transportation Company* *and Chicago and North Western Railway Company*, 1995 ICC LEXIS 37 at *148 (Mar. 7, 1995); *Rio Grande Industries, Inc., SPTC Holding, Inc., and The Denver and Rio Grande Western Railroad Company - Control - Southern Pacific Transportation Company*, 4 ICC 2d 834, 1988 ICC LEXIS 267 at *42; *Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company -- Control -- Missouri-Kansas-Texas Railroad Company, et al.*, 4 ICC 2d 409, 1988 ICC LEXIS 155 at *33; *Union Pacific Corp., Pacific Rail System, Inc. and Union Pacific R.R. - Control - Missouri Pacific Corp. and Missouri Pacific R.R.*, 366 ICC 459, 1982 ICC LEXIS 16 at *50 (Sept. 24, 1982). Accordingly, in *Burlington Northern, Inc. - Purchase (Portion) - Chicago, Milwaukee, St. Paul and Pacific R.R.*, 363 ICC 298, 1980 ICC LEXIS 60 (Aug. 21, 1980), even though there was evidence of discussions that may have constituted "collective activity during the bidding process," the transaction was ultimately approved. In so doing, however, the Commission expressly foreclosed any argument that its approval could be interpreted as ratification of the anticompetitive actions.

> We do not, however, mean by our action today to condone any negotiations which may have violated the antitrust laws. We specifically withhold any antitrust immunity which might be implied in proceedings under the MRRA upon the negotiations conducted between BN, UP, and the Milwaukee trustee and any resulting agreements. We will refer this matter to the Department of Justice, since it is that agency's statutory responsibility to enforce the antitrust laws.

The STB should therefore follow the precedent of the former ICC and establish that its rulings do not condone or provide insulation to violation of the antitrust laws.[41]

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[41] Because of the potential that some form of anticompetive behavior may have occurred between BN, SF, UP, and SP during the *BNSF* proceeding, the Board should consider reopening the record in that case in order to fully analyze the trackage rights give in that

D. <u>As A Corollary Matter, The Impact Of The Proposed Merger On Rail Commerce To And Through The Republic Of Mexico Would Have So Substantial An Impact On The Foreign Commerce And Foreign Policy Of The United States As To Cast Doubt On The Jurisdiction Of The Surface Transportation Board Over This Aspect Of The Transaction</u>

As a result of the proposed merger, rail traffic through Texas to the Republic of Mexico would be effectively controlled by the merged entity. The lack of incentive and, for that matter, capacity of BNSF to provide effective competition to UP/SP has been hereinabove explained. Similarly, the unexplained conduct of BNSF in avoiding the most competitive routes and imposing unexplained rate increases corroborate its lack of will or capacity to compete in facilitating the foreign commerce of the United States. The UP/SP dominance would be especially severe, of course, with respect to products such as chemicals that are particularly dependent on rail transportation.

In addition, the foreign commerce and foreign policy of the United States are directly implicated by the competitively efficient through transportation from Texas to various points in the Republic of Mexico. Thus, the presence of U.S. bidders in the privatization of the Mexican rail system has important ramifications for these concerns. The Johnny-come-lately, vacillating, and unreliable statements of interest of BNSF in participating against UP/SP as such a bidder entitle it to no credence as a competitor.

These issues raise serious and substantial questions involving the foreign commerce and foreign policy of the United States. They deal directly with U.S. trade with a NAFTA partner. They are inextricably interwoven with our foreign relations with the Republic of Mexico, not only as a trading partner but as a source of both investment and operational

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participation in the Mexican economy. As a consequence, the Constitutional responsibility of the President, and therefore the executive branch, to conduct the foreign affairs of the United States become paramount and may well override the jurisdiction of the Board as to this aspect of the transaction. U.S. Const., Art. II

VI. THE PROPOSED TRANSACTION WILL NOT ACHIEVE THE CLAIMED PUBLIC BENEFITS

A. Past Mergers Have Not Resulted In The Claimed Benefits

Applicants make much of the notion that the U.S. railroad industry has had a remarkable rebirth since the 1960's and 70's. While much of what Applicants say is true, Applicants attempt to give credit for that rebirth to the Commission's merger policy, *e.g.* these benefits occurred due to the numerous mergers that have taken place. Applicants have made no attempt to analyze the prior mergers to test this hypothesis. One would expect that if the claimed benefits from prior mergers did in fact occur, then Applicants hypothesis may indeed be correct--although one still must understand that all post-Staggers Act mergers have been end-to-end and not parallel. However, if the claimed benefits did not occur, the success of the railroad industry could not be attributed to mergers, but instead, must be attributed to other causes, such as the Staggers Act and the Commission's policies toward abandonments, shortline creations, and pricing flexibility.

At least three studies are relevant to these issues. Two of these studies reviewed mergers that took place prior to the Staggers Act, and one, the R.L. Banks study, is a 1995 study done for the Canadian government reviewing post Staggers Act mergers.[42] These three studies are analyzed and relied upon in the verified statement of Mr. Tom O'Connor and Mr. John Darling and submitted in this filing.

The October 1978 study released by the Secretary of Transportation focused on two mergers, one of which was the N&W-Wabash-Nickel Plate merger. Among the Secretary's major findings were the following:

- Mergers achieved only a portion of their projected cost savings
- Availability of capital was a constraint on achieving the savings
- Change was restricted by the need to preserve certain service arrangements
- Merger savings were hampered by the extended period of time required to implement the merger

Similarly, the report prepared for the FRA by Gellman Research Assoc., Inc. that also analyzed the N&W-Wabash-Nickel Plate merger found that claimed savings were over estimated by 33% and that capital costs were under estimated by 24%.

Since many of the problems discovered in these reports were removed due to the Staggers Act and the Commission's merger policy, one would expect to find that in post Staggers Act mergers, the projected costs savings were not overstated. However, the R.L. Banks study found, in reviewing four post-Staggers mergers, that estimated cost savings were

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[42] Analysis of N&W-Wabash-Nickel Plate Merger, Prepared for Federal Railroad Administration by Gellman Research Associates, December, 1977; A Prospectus for Change in the Freight Railroad Industry, A Preliminary Report by the Secretary of Transportation, U.S. Department of Transportation, Washington, D.C., October 1978; and R.L. Banks & Associates, Inc./KPMG Management Consulting, *Railway Merger Initiatives: The U.S. Experience, A Report to the Ontario [Canada] Ministry of Transportation*, 84 pg., plus Appendices A-D (March 1995)(The study has not been publicly released, and it is therefore attached as part of the verified statement of Messrs. O'Connor and Darling.

overstated. In fact, there was no noticeable improvement in financial performance, and in general, the claimed efficiencies were either slow to occur or did not occur at all. While the amount of overstatement of costs savings and understatement of capital costs and other such factors may not have been as significant in comparison to the respective claimed benefits of pre-Staggers mergers, nonetheless, claimed benefits did not accrue as estimated in the merger applications.

In the most recent merger capable of analysis, the *UP/CNW* merger, O'Connor and Darling establish that despite UP's claimed benefits, UP has so far been unable to achieve those benefits. For example, based on actual reported revenues, if UP and CNW had been merged in 1994, the effect on UP's gross revenue would have been a net increase of $1.08 billion, or about 21%. While this is a significant increase, it is <u>less than</u> half the $3.01 billion (a 49% increase) contemplated by the UP's merger application. V.S. O'Connor/Darling at 288.

Regardless of the many years of study and preparation and the forecasts in the applications, UP has experienced unprecedented problems in attempting to achieve its claimed benefits. Among the unforeseen problems:

- Locomotive and crew shortages leading to extensive car and train delays
- Shortages of qualified train and engine crews leading to further train delays
- Route congestions which caused still further train, engine, and crew shortages
- Labor savings were delayed or deferred as termination dates were extended
- Shipper switching services were delayed or significantly suspended

V.S. O'Connor/Darling at 288. Problems became so bad that UP's Vice-President of Operations, Ron Burns, had to issue a widely reported public letter to all shippers and customers apologizing for the problems.

B. Most Of The Benefits Enjoyed By The Railroad Industry Are Due To Deregulation

Both the 4-R Act and the Staggers Act greatly liberalized the ICC criteria and procedures for rail pricing, abandonments, and line sales. It is these policies, and not the Commission's merger policy, that have contributed to the remarkable rebirth of the U.S. rail industry. These are policies of which the Board (as successor to the Commission) should be proud. The U.S. railroad industry has experienced a dramatic improvement in its financial condition since the Staggers Act.[43] Dr. Grimm co-authored conducted one of the most comprehensive studies of the effects of both rail and truck deregulation, employing a counter-factual methodology.[44] According to this study, railroads reaped annual profit gains of $2.9 billion dollars per year (1988 dollars) from deregulation, however, with cost savings of over $3 billion dollars due to deregulation (pp. 15-41). This confirms that deregulation has resulted in substantial financial benefits to the railroads, with cost savings being the most prominent. Customers have also reaped substantial benefits from both rail and truck

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[43] Rail bankruptcies provided the primary motivation for railroad deregulation. Indeed, by 1979, almost one-fourth of Class I rail mileage was in bankruptcy and from 1971-1980, railroad return on equity averaged less than 3 percent. MacDonald, M. "Rails Climb Back into the Ring," *Traffic Management*, December, 1993, pp. 40-41. Since Staggers, not one major railroad has gone bankrupt and the financial condition of the industry has improved dramatically.

[44] C. Winston, T. Corsi, C. Grimm and C. Evans, The Economic Effects of Surface Freight Deregulation, Brookings Institute, Washington, D.C. 1990.

deregulation. In sum, U.S. deregulation was intended to provide a greater reliance on free markets to promote railroad profitability and public benefits, and it has. Most of these benefits are from deregulation, however, not mergers.

C. Applicants Have Significantly Overstated The Public Benefits

In light of the fact that past claims of merger benefits have not materialized to the extent predicted, Applicants' claimed public benefits of $750 mill[illegible] per year (App., Vol. I, at 93)(Normal Year) are also suspect. Indeed, Messrs. O'Connor and Darling have conducted an extensive segment by segment analysis of Applicants' claimed benefits and determined that these benefits are vastly overstated. By way of comparison, their conclusions are contained in Exhibit 6 in the O'Connor/Darling verified statement and can be briefly summarized as follows:

Category of Benefits	Applicants' Claimed Benefits ($ Thousands)	O'Connor/Darling Restatement ($ Thousands)
Total Public Benefits:	750,648	434,804

V.S. O'Connor/Darling at Exhibit 6.

As discussed above, any attempt to "forecast" future benefits of a rail merger has been shown to be affected by subjective judgement calls of the forecaster. Thus, it cannot be said with certainty that Applicants' numbers are correct, or Darling and O'Connor's restatement is correct. However, in light of the prior studies finding that predicted benefits were greatly overstated and KCS's restatement of those benefits above, it is clear that Applicants' projected benefits will not prove to be as significant as Applicants claim. Furthermore, the competitive effects of this transaction far outweigh any claimed benefits.

This is so whether or not you accept Applicants' acknowledged 2 to 1 competitive harms ($1 billion) or Dr. Grimm's analysis -- $2.04 billion, not counting any 3 to 2 harms. Whatever the exact amount of efficiency benefits or the exact amount of competitive harm, the benefits do not outweigh the harm to competition. Consistent with the legal principles in *McLean Trucking Co. v. United States*, 321 U.S. 67, 87-88 (1944), which require the Commission to balance the potential harm to competition against any potential efficiencies, this merger, as currently structured, must be denied, or appropriate conditions structured that will alleviate the harm to competition while maintaining some of the benefits. As the Commission has previously stated:

> Revenue transfers that result in reduced competition, the exaction of monopoly profits, and the reduction of efficient transportation services reflect private benefits harmful to the public.

SFSP, 2 I.C.C. 2d at 725 (1986).

C. Applicants Would Be Able To Maintain A Significant Amount Of Their Claimed Benefits Even If Parallel And Duplicative Lines Are Divested

A systematic examination of the geographic distribution of the Applicants' claimed costs and benefits attributable to the proposed merger clearly reveals the Applicants' plans and intention to focus their efforts on obtaining the benefits available to them in the Pacific Northwest, West and Southwest (excluding East Texas), at the expense of the Midwest and East Texas, *e.g.* the Houston to St. Louis Corridor. V.S. O'Connor/Darling at 359-62. This objective is discernible not only in Applicants' revenue projections, but also in the operating plan and capital investment program that would serve as the foundation for the merger, should it be approved.

Applicants' operating plan proposes the consolidation and elimination of many putatively redundant or duplicative activities and facilities now being performed or operating across what would become the merged system. Applicants propose to achieve most of their claimed benefits by consolidating or closing many activities and facilities that are situated at points that would become common to the new railroad. V.S. O'Connor/Darling at 359-360. However, an examination of the Applicants' claimed daily terminal car switching work load (*c.f.* Application, Vol. 3, pp. 373-375) shows that, in addition to the economies of scale attributed to the new system, there is a profound shift of activity from the Midwest, which experiences a projected decrease of more than 800 cars handled per day, to the West, particularly California and the Pacific Northwest, where the Applicants' projections show an increase of nearly 600 cars handled per day. V.S. O'Connor/Darling at 360. Obviously, not only is there a net growth of traffic in the West, but Applicants are positioning their operations to concentrate on the services offered to Western shippers and markets.

Applicants' strategy is even more fully illustrated by an examination of the geographic distribution of the proposed capital investment program that underlies the operating plan. The workpapers supporting the Application identify capital investments to be made over the first five years following the merger amounting to more than $1.3 billion. Of this total amount, more than 75 percent--or almost $1 billion--is to be invested in the West. The balance is about $300 million, nearly $100 million of which is to be invested in equipment and systems to support the new railroad, thus leaving only about $200 million for capital improvements in the Midwest and East Texas. V.S. O'Connor/Darling at 360.

The foregoing capital investments do not, however, include, or even consider, the huge labor costs of effecting this consolidation--should it occur. Labor protection payments, severance costs and employee transfer expenses amounting to over $260 million will be incurred to achieve the labor savings claimed by the Applicants. V.S. O'Connor and Darling, Exhibit 6. Much of this cost is related to the proposed reductions of employment at SP locations in the Midwest that are going to be eliminated in favor of UP facilities and locations. These reductions reflect the staffing levels believed adequate to handle the reduced, Midwest regional work loads. Additionally, other costs are going to be incurred at UP's Western locations where Applicants propose to train new employees to perform the duties of former employees unwilling or unable to leave the Midwest. V.S. O'Connor/Darling at 361.

It is therefore quite apparent from Applicants' operating plan, and its attendant capital budget, that the management of this new railroad looks to the West as the source of all merger benefits. It is in the West that the new traffic will be captured and served. The Midwest--with some isolated exceptions--would seem to be regarded by the Applicants as an obstacle that has to be survived in order to reach the West. Moreover, the glaring discrimination in the capital program leads to speculation of what other unidentified markets in the Midwest may be abandoned by the Applicants in the years soon to come.

The Applicants appear not to see a long term future in the Midwest, especially in the Houston to St. Louis corridor. Accordingly, a readily apparent strategic investment alternative would be for Applicants--or the STB--to seek other investors for that and similar corridors. Interested investors would not only reduce the cost of the merger to Applicants (with little or no erosion of Applicants' realizable benefits), but they may also have complementary strategic interests that could improve the opportunity for everyone to share in increased regional markets.

VII. SP'S FINANCIAL VIABILITY SHOULD NOT BE A FACTOR IN THE BOARD'S PUBLIC INTEREST ANALYSIS

While Applicants make much of the claimed benefits of the merger, they also have employed a version of the "failing firm" doctrine, utilized in standard antitrust cases and the DOJ Horizontal Merger Guidelines, as justification for the merger. In other words, Applicants would have the Board believe that SP is such a weak carrier that it cannot stand alone and may go bankrupt if not allowed to merge with UP.

Even if the "failing firm" doctrine was applicable in ICC proceedings (which it is not) Applicants have not established that SP should be treated as such. A party asserting a failing firm position in a merger proceeding has the burden of establishing that the merger is the only alternative to the elimination of the failing firm's assets from the relevant market. *United States v. General Dynamics Corp.*, 415 U.S. 486, 507 (1994) ("[The failing company doctrine] presupposes that the effect on competition and the 'loss to stockholders and injury to the communities where its plants were operated' will be less if a company continues to exist even as a party to a merger than if it disappears entirely from the market."). In order to satisfy this standard, Applicants must show that SP: (1) is in a financial position such that its failure is imminent," (2) is unable to reorganize in bankruptcy, (3) is unable to find another buyer whose purchase of the firm would pose lesser anticompetitive risks, and (4) without the merger, is in such a poor financial state that the SP's assets will exit the market.

See Joint Department of Justice and Federal Trade Commission 1992 Horizontal Merger Guidelines (Merger Guidelines), § 5.01. *See also, General Citizen Publishing Co., v. United States*, 394 U.S. 131, 137 (1969) (*citing International Shoe Co. v. FTC*, 280 U.S. 291 (1930)).

A. Applicants Have Failed To Establish That SP Faces A Clear Probability Of Business Failure

In order to establish that a company faces a clear probability of business failure, the failure must be imminent as evidenced by the company's finances, its relationships with financial institutions, and its available working capital at the time of the acquisition. Evidence of a decline in sales and profits is insufficient by itself to establish a failing firm defense. *See, e.g., Heartransfer Corp. v. Volkswagenwerk, AG*, 553 F.2d 964, 974, 982-3 (5th Cir. 1977), *cert. denied*, 343 U.S. 1087 (1978); (company determined not to be failing despite 85% decline in sales just prior to acquisition); *United States v. Reed Roller Bit Co.*, 274 F. Supp. 573, 581-84 (W.D. Okla. 1967) (prospect of losing all sales was insufficient to support a failing company defense). Even the fact that a company intends to go out of business unless the attended merger is approved will not, by itself establish a failing firm defense. *See, e.g., General Citizen Publishing Co.*, 394 U.S. at 136-37; *SFSP* at 709.

Moreover, "evidence of a decline in market position and varying profits and losses cannot be elevated to the status of a 'failing company' by subjective statements of management intention or desire to go out of business." *United States v. Phillips Petroleum Co.*, 367 F. Supp. 1226, 1260 (C.D. Cal. 1973), *aff'd mem.*, 418 U.S. 906 (1974); *SF/SP* at 249-57 (finding that SP was not a "failing company", notwithstanding applicants' attempt to get approval of their merger on the basis of a failing firm defense evidenced by self-serving "forecast[s] of impending doom for an independent SPT.").

In properly rejecting SP's claim ten years ago that it was a failing firm, the ICC considered the absence of "a precipitously low and declining" ratio of net worth to total debt, and its sole creditor's threatening "both a cut-off of credit and foreclosure." *Id.* at 257. The ICC also considered SP's conduct:

> [T]here is evidence in the record that steps have been taken to upgrade SPT's performance. In the past several years SPT's management has invested heavily and devoted substantial attention to improving SPT's plant operations...SPT improved maintenance of both track and equipment, expanded its locomotive fleet, upgraded its track structure, reduced slow orders by 70 percent, increased train speed, reduced terminal time by 20 percent, doubled the miles of track surfaced,...Productivity also improved according to important measures, including ratio of net ton-miles to gross ton-miles, reduced expense for crew wages per thousand trailing gross miles, and improved trailing tons per gallon of fuel.

SFSP at 255-56. The ICC also found that SP's statements in its SEC filings, outside the context of those issued in connection with the contemplated transaction, "did not mention any deterioration in SPT's ability to compete effectively for rail traffic, nor the allegation that SPT may soon become unable to pay its obligations as they come due." *Id.* at 254-55.

Ten years later, notwithstanding its ability to stay in the market and avoid bankruptcy, SP is making the same self-serving, unsubstantiated claims of a failing company in order to facilitate its merger with UP. Instead, however, SP's financial condition, as evidenced by its own SEC filings is far from "imminent failure." Although SP reported net losses of $66.8 million in the second quarter of 1995, just prior to the announcement of its intention to merge with UP, those losses resulted from a "$112.6 million pre-tax special charge for the cumulative effect of a change in accounting or post-employment benefits...[thus] [t]he company had an operating...income of $57.6 million excluding the special charge."

Southern Pacific Transportation Company Form 10-Q For the Period Ended June 30, 1995, at 11.

At the same time, SP also reported:

> the capital and debt transactions completed over the last two years have substantially improved the Company's liquidity. For the next few years, cash flows generated by rail operations will be insufficient to meet its cash needs including acquisition of equipment and other necessary capital expenditures. In order to satisfy these cash flow requirements, as well as satisfy financial covenants in its credit facilities, the Company must continue to improve its operating results and obtain equipment financing while maintaining its bank credit facilities for use from time to time as required....As of June 30, 1995...[t]he Company had $300 million available under its revolving credit facility and $150 million available under a separate term loan facility...

Id. at 15. Moreover, SP reported that, "[t]he Company is continuing its plan of expansion and upgrading of its locomotive and freight car fleets principally through capitalized leased financing, . . . [which] has [been] completed . . . for 278 of the new locomotives, 17 of the remanufactured locomotives and all of the new and used hopper cars" *Id.* at 16.

With respect to revenue per ton miles, SP reported:

> For the second quarter of 1995, carloads increased 1.2% and revenue ton miles increased 9.2% compared to the same period in 1994. The average net freight revenue per ton-mile...declined by 8.8% compared to the second quarter of 1994 due principally to an increase in traffic volume for commodities which generate lower revenue per ton-mile (*e.g.*, coal traffic).

Id. at 8. SP also reported increased train and engine crew employment, and thus increased employment costs of 1.7%, in order to "improve customer service." *Id.* at 10-11.

Although SP may be experiencing some cash flow problems, these are due largely to its expansion, upgrading and improved service modes, hardly the types of operations entered into by failing firms. Instead of evidence of a "precipitously low and declining ratio of net

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worth to total debt, SP's financial statements evidence the contrary. Contrary to evidence that its sole creditor is going to cut it off and foreclose on existing loans, SP has evidenced its continued ability to obtain the capital necessary to expand and upgrade, enabling it to be an even stronger more viable competitor.

B. Applicants Have Failed To Consider Reorganization

The requirement that reorganization prospects be unsuccessful flows from the requirement that the contemplated merger be the only option for keeping the assets of the "failing" firm in the market. *See, e.g., Citizen Publishing Co.*, 394 U.S. at 138. If reorganization is possible, the firm could remain a viable market participant without the merger. There is no evidence in the record that SP has even considered reorganization as an alternative to its financial condition. Thus, SP cannot argue that reorganization prospects would be unsuccessful. In fact, the record evidences that SP only engaged in analyses of its financial condition within the context of its successful merger with UP.

For example, SP's financial officer responsible for analyzing a restructuring of SP should the merger with UP not succeed testified that no such analysis had been performed and that he had not participated in any discussions regarding any possible alternative sources of capital for SP as a stand-alone company. (Gray Deposition at 179-80.) Another officer testified that SP had not analyzed the option of reducing some of its service or even the cost of financing as an alternative to being acquired by UP. (Yarberry Deposition at 142, 144.) This testimony is inconsistent with a claim that reorganization in bankruptcy was an option unavailable to SP. Instead, this evidence establishes that SP never even considered bankruptcy as an option, nor did SP consider that its railroad assets would not be operated.

SP decided that it would be a more profitable company if it were acquired by UP therefore, pursued only that strategy.

C. The Record Evidences That There Are Other Willing Purchasers Of SP Who Would Have Posed Fewer Anticompetitive Problems

Before a "failing company" defense can sanction a merger, it is necessary for Applicants to establish that there are no alternative buyers interested in acquiring the failing firm that may provide a less anticompetitive acquisition. This requirement generally is satisfied upon a showing that a good faith, diligent search was undertaken and that no willing alternative buyers were available. *See, e.g., Golden Grain Macaroni Co. v. FTC*, 472 F. 2d 882, 887 (9th Cir. 1972) (where there is evidence of other logical buyers, merely pointing out that they declined to buy the target is not enough to prove that the acquiring party is the only purchaser); *Black & Decker Mfg. Co.*, 430 F. Supp. at 781, n. 96 ("mere announcement of merger plans does not constitute an appropriate search for an alternative purchaser").

Applicants are in no position to make any such claim regarding the absence of alternative buyers. Instead of engaging in any type of search for alternative buyers, SP

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(Yarberry Deposition at 95). Moreover, SP instructed its investment banker, Morgan Stanley REDACTED (Runde Deposition at 103-104.) As a result, Morgan Stanley f

even though Mr. Runde was aware that KCS and Conrail each had expressed interest in acquiring a portion of SP. *Id.* at 25, 85, 103-106. Indeed, as discussed in the verified statement of Mr. Jack Grocki, Executive Vice-President of GRI, Inc., there are numerous parties that have indicated the desire to purchase numerous segments of the SP. (V.S. Grocki at 351)

D. Applicants Should Not Be Allowed To Circumvent The Public Interest Standard On The Basis Of A Weakened Competitor Defense

Applicants would lead this Board to believe that UP must be allowed to merge with SP in order to protect SP from imminent financial problems. Yet, even if SP were on the verge of bankruptcy (which it is not), the STB should not approve an otherwise anticompetitive merger simply to preserve SP as a viable, corporate entity--wholly intact. As this Commission has said numerous times, its focus is on protecting competition, not competitors. *Rio Grande Industries, Inc., -- Purchase and Trackage Rights -- Chicago, Missouri & Western Railway Company and Line Between St. Louis, MO, and Chicago, IL*, 5 I.C.C. 2d 952, 1989 ICC LEXIS 284 at *33 (1989) ("In contrast, a showing of expected substantial harm to a particular competitor as a result of a transaction is not equivalent to a showing of harm to competition"); *Blackstone Capital Partners L.P. -- Control Exemption -- CNW Corporation and Chicago and North Western Transportation Company*, 5 I.C.C.2d 1015, 1019-20 (1989) (harm to a particular carrier is not equivalent to harm to competition). In fact, this is reinforced in the Commission's own policy statement regarding rail mergers:

> We have seen that the bankruptcy, liquidation, or abandonment of lines by a carrier does not necessarily mean the cessation of rail service to the public. The emergences of short line carriers and community owned or subsidized lines has demonstrated that where there is a demand for a service that service can be provided. <u>We will not artificially and unnecessarily restrict the action of the marketplace by placing too great an emphasis on the harm to individual carriers. The preservation of corporate entities is not the same as the preservation of competition or essential service</u>.

Railroad Consolidation Procedures, 363 I.C.C. 784, 788 (1981) (footnote omitted) (emphasis supplied).

Applicants are fully aware of this principle and have argued in numerous cases that conditions should not be imposed simply to protect a particular carrier from the results of the marketplace. Indeed, Applicants' Witness Barber echoed strong support for this notion in his deposition:

> A. I've noted that in my testimony, but that has not anything to do with competitive harm. The emphasis in the law is the effect on competition with the emphasis upon the last three letters, i-o-n.
>
> Q. So you don't have [sic] view the revenue diversion as a harm to competition?
>
> A. If because others are in a better position to compete and are postulated to provide greater competition somebody else loses something as a result, assuming that they are not able to indeed increase and improve their own competitive position, I don't see that as a harm to competition.

(Barber Deposition at 45-46).

While these statements were made with regard to a competitor weakened by a merger, they hold in equal force with regard to a competitor strengthened by a merger. Much of Applicants' case asserts arguments that UP will be strengthened by the merger, and that the merger is thereby "pro-competitive." Many witnesses raise serious questions with regard to both the degree to which UP and SP need strengthening as competitors and the degree to which this merger provides such strengthening. V.S. Grimm at 161. Given Mr. Barber's statement, it is curious that Applicants now claim that the STB should approve this transaction in order to save SP from financial weakness and that approval of the merger would strengthen UP. Regardless of how the STB ultimately rules on these issues, the impact on Applicants, as competitors, has no legitimate role in the analysis of the merger's impact on competition.

Ten years ago, the ICC rejected to a claim by SP in connection with its failed attempt to obtain approval of its merger with SF that "the financial weakness of a merging firm may prevent a threshold determination that a merger will reduce competition," SFSP at 832. Ten years later, notwithstanding its earlier predilections of impending doom unless it were allowed to merge with SF, SP is still an independently operating railroad. Just because SP does not have profit margins as high as some of its competitors, SP has no basis for claiming that this enables it to bypass review by the Surface Transportation Board's, reduce rail competition and be free to merge with UP.

VIII. THERE IS A COMPREHENSIVE DIVESTITURE SOLUTION AVAILABLE THAT SIGNIFICANTLY REDUCES THE COMPETITIVE HARMS, ALLOWS APPLICANTS TO MAINTAIN THE MAJORITY OF THEIR PUBLIC BENEFITS, PROVIDES AN ADEQUATE RETURN TO SHAREHOLDERS, AND PRESERVES JOBS

A. Divestiture Is Consistent With The Board's Legal Standards For Imposing Conditions

In evaluating whether a merger is in the public interest, the Board should to determine what competitive harm is directly and causally related to the merger and distinguish that harm from any pre-existing, anticompetitive condition or disadvantage that other railroads, shippers, or communities may have been experiencing. It is the harm that is causally related to the merger that the Board will ameliorate with conditions. *BNSF* at 54. The Board will not impose conditions "to ameliorate longstanding problems which were not created by the merger," nor will they impose conditions that "are in no way related either directly or indirectly to the involved merger." *BN/Frisco*, 360 I.C.C. at 952 (footnote omitted); *see also UP/CNW*, slip op. at 97.

The divestiture conditions requested by KCS involve the exercise of the Board's conditioning power under former section 49 U.S.C. 11344(c) and are specifically directed at resolving harm related to the merger. Section 11344(c) gives the Board broad authority to impose conditions governing railroad consolidations. As has previously been discussed, the ICC Termination Act specifically modified the conditioning authority contained within this provision to make it explicit that "[t]he Board may impose conditions governing the transaction, including the divestiture of parallel tracks." While the ICC always had the authority to impose divestiture, divestiture was rarely, if ever, imposed as the remedy. By adding this language, Congress was making it clear that divestiture was as valid of a remedy as trackage rights. ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803 (1995); H. Rep. No. 104-422, 104th Cong., 1st Sess. 191 (1995).

A requirement of divestiture is not an unprecedented condition for a merger in the transportation industry. As described in the Verified Statement of Mr. Lawrence J. White, divestiture has been required as a pro-competitive remedy in a merger case involving airlines. V.S. White at 131-32. In 1986, Texas Air sought to acquire Eastern Airlines. In order to preserve airline competition in the Boston-New York-Washington corridor, the U.S. Department of Transportation conditioned its approval of the merger on the requirement that Texas Air sell takeoff-and-landing slots at National, LaGuardia, and Logan Airports (including airport gates at LaGuardia and Logan) to a competing airline. A similar condition is necessary to remedy the anticompetitive effects of the UP/SP merger.

Because conditions generally tend to reduce the benefits of a consolidation, they are imposed only where certain criteria are met. *UP/MKT*, 4 I.C.C. 2d at 437. The criteria for imposing conditions to remedy anticompetitive effects were set out in the *UP/MP/WP* decision, 366 I.C.C. at 562-565. There, the Commission stated that they will not impose conditions unless they find that the consolidation may produce effects harmful to the public interest (such as a significant reduction of competition in an affected market), and that the conditions will ameliorate or eliminate the harmful effects, will be operationally feasible and will produce public benefits (through reduction or elimination of the possible harm) outweighing any reduction to the public benefits produced by the merger.

The divestiture conditions requested by KCS meet all of these criteria. Dr. Grimm's analysis details the 2 to 1 competitive harms that will occur throughout the country, including the Houston to St. Louis, Houston to New Orleans, and Houston to San Antonio markets. He also shows the harms that will occur in 3 to 2 markets, such as for grain shipments from Central Kansas and shipments into Mexico. V.S. Grimm at 213-216. *See also*, filing of Tex-Mex, V.S. Grimm. In general, these harms will occur because there will be reduction of independent rail routings in these corridors, and that truck and source competition are not adequate substitutes for the loss of this competition.

Applicants admit the existence of competitive harm, at least with respect to 2 to 1 point shippers, and in order to resolve those harm, they have requested the Board to impose the BNSF trackage rights Agreement as a condition to the merger. Thus, neither party disputes the notion that there is competitive harm (the argument is over the extent to which there is competitive harm). The issue for the Board to determine is what is the best way to resolve that competitive harm.

The Commission's words in the SFSP case profoundly speak to these issues:

> [W]e have before us proposed conditions which, when viewed narrowly, appear to alleviate some of the anticompetitive problems, while continuing or creating others, and rearranging traffic patterns in ways that may have unforeseen consequences. . . We are compelled to deny this merger proposal in the absence of a solution that would both resolve the identified anticompetitive problems and furnish us with a basis to expect that the merged carrier would become and remain a strong and effective competitor.

SFSP, 2 I.C.C.2d at 827 (1986). The Commission does not have to deny this merger. It is clear that divestiture, and not the grant of trackage rights to BNSF, is the solution that would allow Applicants to maintain most of their efficiency benefits in all major corridors while at the same time protecting shippers from competitive harm.

The divestiture solution is the most consistent with the principles established in *UP/MP/WP* for imposing conditions. For a condition to be imposed, it must ameliorate or eliminate the harmful effects and be operationally feasible. As numerous verified statements establish, the trackage rights Agreement will not ameliorate the competitive effects for a variety or reasons: it does not preserve shippers' build-out options; it does not resolve situations where shippers could transload to either the UP or the SP, it forces shippers to find new receivers for their product; it does not take into account shippers who currently benefit from product and source competition between UP and SP; it will result in increased rates because BNSF rates will be much higher than those that had previously existed.

Furthermore, as established by KCS witnesses Swanson, Rawert, Rees, and Plaistow, and the filing of Conrail, the BNSF trackage rights will not be operationally feasible for a variety of reasons: BNSF's costs will be significantly higher than UP/SP's; BNSF does not have the storage capacity available; UP/SP's bi-directional operations will interfere with

BNSF's operations; and BNSF's interchanges with eastern carriers at St. Louis will be significantly impaired.

In that the BNSF trackage rights will not ameliorate the competitive harm and will not be operationally feasible, divestiture becomes the rational solution. Divestiture of parallel track and duplicative facilities in those corridors suffering competitive harm is actually more consistent with the policies surrounding the imposition of conditions than are trackage rights. Divestiture to a qualified buyer resolves most, if not all, of the problems. Because there will not be two competing companies operating over the same tracks and facilities, as there are with trackage rights, none of the inherent operating difficulties associated with trackage rights are present. V.S. Swanson at 12 ("Ownership provides the ability to be truly competitive.")

Divestiture of parallel tracks and facilities, at least in those relevant markets where the benefits of the transaction do not outweigh the harm to competition, means that every shipper who will see a reduction of competition from two carriers to one, not just a small few who happen to fit Applicants' definition of 2 to 1, will have its competitive options preserved.[45]

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[45] In some recent line sale contracts, the purchasers of branch lines which the Class I has sold are required to exclusively deal with the seller or to interline with the seller the preponderance of traffic originating and terminating on the branch line. *BNSF*, slip op. at 102. Such exclusive dealing arrangements, if imposed upon the purchasers of lines which the STB may order divested as a condition to the proposed UP/SP combination, could be used by UP/SP to undermine the efficacy of these very divestitures. Thus, any ordered divestitures must be conditioned further through the prohibition of any exclusive dealing obligations attached to those sales.

Applicants will of course strenuously object to divestiture on the grounds that the condition (divestiture) is not narrowly tailored to remedy the anticompetitive effects and will put its proponent in a better position than it occupied before the consolidation. *Citing, UP/CNW*, slip. op. at 97; *See also, Milwaukee--Reorganization--Acquisition by GTC*, 2 I.C.C. 2d 427, 455 (1985); *Soo/Milwaukee II*, 2 I.C.C.2d at 455; *UP/MP/WP*, 366 I.C.C. at 564. Yet, divestiture is the only remedy that does not violate these guidelines.

Requiring the sale of one of the parallel lines in the Houston to St. Louis corridor, for example, does not place any shipper in a better position than it was before the merger. It simply replaces one owner, SP for example, with another owner, KCS for example. Every shipper on the UP line (which parallels the SP from Houston to St. Louis) who had benefited from the fact that SP also served that corridor, would they have KCS serving over the exact lines and facilities between the exact origin and destination BEA's. No shipper is placed in a better position than before the merger.

On the other hand, the conditions requested by Applicants, *e.g.*, imposition of the BNSF trackage rights Agreement, will actually place some shippers in a better position than before the merger.[46] As noted in Dr. Grimm's statement, Applicants granted BNSF access to all 2 to 1 point shippers regardless of whether or not trucks, barges, or other forms of competition may have restrained UP/SP's rates after the merger. Applicants also granted

[46] This analysis takes Applicants' assumptions regarding the ability of BNSF to compete on face value. If the Board were to impose the BNSF Agreement, and only that Agreement as a condition, it would be agreeing with Applicants' assumption. However, if the Agreement is imposed given those assumptions, this may actually place some shippers in a better position than they were before the merger, thus violating the criteria established in *UP/MP/WP*.

BNSF access to all 2 to 1 point shippers regardless of whether or not there may have been a monopoly bottleneck carrier at destination or origin. Dr. Grimm's analysis focused on 2 to 1 and 3 to 2 impacts in those corridors that involved independent rail routings and thus took into account the effects of bottleneck carriers. In this sense, divestiture in those corridors identified by Dr. Grimm is a significantly better remedy than the BNSF Agreement because divestiture in those corridors places all shippers in the same situation as before the merger, no better and no worse, and does not favor some shippers over others, as the BNSF Agreement does.

Applicants may also object to divestiture on the grounds that divestiture in those specific corridors requested by KCS will significantly reduce the public benefits of the transaction contrary to the criteria contained in the *UP/MP/WP* decision, 366 I.C.C. at 562-565. Yet, Mr. O'Connor and Mr. Darling have clearly established that the majority of Applicants' claimed benefits are not in the Houston to St. Louis or Houston to New Orleans corridors, but are concentrated in the West. V.S. O'Connor/Darling at 358-362. Indeed, Applicants themselves argue that a large majority of the benefits come from the proposed actions in the I-5 Corridor and the Southern/Sunset Route. App., Vol. II, V.S. Peterson at 22-40; 45-53; 59; 81; and 83-85. While Applicants do discuss reasons why Houston to St. Louis and Houston to New Orleans traffic will not be subject to Applicants' monopoly power, curiously missing from their analysis is any discussion of the public benefits that will accrue in the Houston to St. Louis and Houston to New Orleans corridors.

B. SP Does Not Need To Merge To Remain Financially Viable

Most significantly, however, is the fact that SP, while certainly no financial powerhouse, has had consistently improved earnings over the past few years and recently has begun to earn annual profits. Although SP reported net losses of $66.8 million in the second quarter of 1995, just prior to the announcement of its intention to merge with UP, those losses resulted from a "$112.6 million pre-tax special charge for the cumulative effect of a change in accounting or post-employment benefits...[thus] [t]he company had an operating...income of $57.6 million excluding the special charge." Southern Pacific Transportation Company Form 10-Q For the Period Ended June 30, 1995, at 11.

The notion that SP is a financially viable entity is confirmed by the empirical work done by Mr. Frank Berardino, President of GRA, Inc. Mr. Berardino has done an analysis of SP's financial status using the statistical bankruptcy model first developed by Edward Altman.[47] The statistical model developed by Altman produces a so-called Z-score, which summarizes the relative financial strength of carriers. By using a sample of data that included both solvent and insolvent carriers, Altman was able to discriminate between the two groups effectively. Although the inputs into the model are financial ratios, typically used by financial analysts, the results of the model are purely empirical. That is, the classification of railroads as healthy or unhealthy requires no individual judgment by the analyst. V.S. Berardino at 283.

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[47] Altman, Edward J., "Predicting Railroad Bankruptcies in America," Bell Journal of Economics, Vol. 4, No. 1, 1973.

Financial data were taken from submissions (to the Interstate Commerce Commission for the year ending December 31, 1994) by Southern Pacific, Conrail, CSX, Norfolk Southern, Santa Fe, Burlington Northern and Union Pacific (see Appendix A), and the model applied to this data. The results of the Z-score model were as follows:

1994 Z-SCORE	
Southern Pacific	.79
Conrail	1.76
CSX	6.35
Norfolk Southern	5.30
Santa Fe	2.12
Burlington Northern	3.37
Union Pacific	3.25

Source: V.S. Berardino, Appendix A.

The Z-scores for all seven railroads exceeded the -1.465 level below which bankruptcy is likely. Through the application of Altman's model, Mr. Berardino states that "Southern Pacific Railroad (SP) would be financially viable if it remained independent, and would remain so in the near-term (at least two years)." V.S. Berardino at 283.

Moreover, if divestiture is imposed as a condition, two options are possible: (1) the Commission could allow immediate consummation of the transaction subject to divestiture of the named lines within a given period of time; or (2) divestiture could be a pre-condition for consummation. If the latter option is chosen and Applicants choose to go forward with the transaction, there may be concerns about the status of SP during the divestiture process. Mr.

Berandino's analysis makes it clear that, even if the divestiture process takes two years to complete, SP will continue as a viable financial entity during that process. If the first option is chosen UP can consummate the transaction and begin assimilation of all assets not ordered divested. During this process, the SP lines will also continue to provide a revenue stream to UP's earnings and can continue to remain financially viable. Furthermore, since KCS is not calling for divestiture of SP's lines in the I-5 Corridor or in the Southern Corridor, the areas where the public benefits of the transaction quite possibly outweigh the competitive harms, Applicants will begin to achieve these benefits during the divestiture process.

C. Allowing The Market To Choose A Buyer Is Consistent With Commission Precedent

KCS is not asking the STB to grant approval for KCS to purchase the lines that should be divested. Instead, KCS is requesting that such a divestiture and trackage rights be ordered as a condition to the merger and then a market supplied solution be provided. Allowing a market supplied solution to a competitive problem is what the ICC in effect did in the *UP/MKT*, 4 I.C.C.2d 409 (1988), case. In that case, the ICC found an adverse impact on competition in the movement of grain originating in the area north and west of Kansas City. The ICC concluded that the adverse impact on grain movements would be alleviated by a grant of trackage rights to either ATSF, SP or KCS and did not specify what carrier should get the access. The applicants were required to negotiate a trackage rights Agreement with one of the three railways. 4 I.C.C.2d at 417, 452-458. KCS eventually acquired these rights.

A similar process was followed in the *BNSF* proceeding where the BNSF was directed to grant trackage rights to one of the three carriers able to serve the Oklahoma, Gas & Electric's Sooner Stations. The Commission did not select the carrier that would be awarded these rights, but relied upon BNSF and the marketplace to provide the solution. *BNSF*, slip op. at 68 (1995).

A similar process should be allowed to occur in this proceeding. A review of the public record indicates that there are numerous parties that have expressed both the willingness and the capability of purchasing certain parallel lines if such lines were ordered divested. Indeed, Mr. Michael Haverty, Chief Executive Officer of The Kansas City Southern Railway Company, has submitted a verified statement expressing both the desire and the willingness of KCS to purchase the lines in the Houston to St. Louis, Houston to New Orleans, and Houston to San Antonio markets. He also states that KCS has both the financial capability and the operational capability of purchasing these lines and related facilities. V.S. Haverty at 142-144.

In addition, if the parallel lines from Kansas City to California along the Central Corridor are also divested, which are corridors that Dr. Grimm has found will suffer competitive harm, KCS is willing to cooperate with any carrier that acquires those lines. Specifically, KCS endorses the concept as put forth by the "Joint Shipper Statement In Opposition To Merger Unless Conditioned As Proposed In Responsive Application of Montana Rail-Link, Inc," the joint filing of the Western Shippers Coalition, the Mountain-

Plains Communities & Shippers Coalition, and others which proposes a comprehensive solution for the harms in the Central Corridor. V.S. Haverty at 144.[48]

D. KCS Is A Ready, Willing, Able, And Financially Fit Buyer

Mr. Haverty also expresses the desire of the KCS to "step into the shoes" of the SP with respect to those trackage rights granted to SP in the BNSF proceeding in order to serve the Central Kansas grain markets. This would restore the competitive balance in that area that will be lost as a result of the merger. V.S. Haverty at 144.

If KCS is the successful bidder for any lines ordered divested, KCS is prepared to submit, pursuant to any statutory and regulatory requirements, all necessary information to allow the Board to make an informed judgment as to KCS's ability to provide adequate service in order to restore the competitive balances in those corridors that will see a reduction of competition after the merger. V.S. Haverty at 143.

UP claims that it reached an Agreement with BNSF because BNSF was the only carrier capable of providing the required access to mitigate Applicants' admitted competitive harm. Mr. Anschutz says "its the customers that have said, if you're going to do this deal, we want you to bring in a real competitor. And that's the BN/Santa Fe." (Anschutz Deposition at 205.) Mr. Rebensdorf says "customers were making their views known in particular about the need to have a strong carrier." (Rebensdorf Deposition at 111.) Yet, when questioned what shippers had expressed a preference for BNSF over KCS, he was able

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[48] KCS is also willing and able to work with any of the other parties that have expressed an interest in purchasing and operating the Central Corridor lines.

to name only one, claiming that certain unnamed marketing people had told him of the shippers preference for BNSF.

It is peculiar that UP claims KCS is too small of a railroad to provide shippers with a competitive solution, (Anschutz Deposition at 204-206), but then completes an Agreement with the Illinois Central (IC), a carrier of similar size to KCS, to give IC first preference, after BNSF, to any lines or trackage rights that may be awarded as a condition of the merger. (Redacted Version) Applicants' Submission of Settlement Agreements with Utah Railway and Illinois Central, Exhibit B, (UP/SP 74). Curiously, the lines for which IC will be given "first choice" to buy are precisely the same lines which KCS asked to buy during its negotiations with UP and for which UP refused to sell to KCS because KCS would be an ineffective competitor.

The Agreement with IC establishes beyond any doubt that Agreements or conditions granted to regional railroads with less scope than the BNSF is an acceptable means, in UP's own view, of addressing competitive harms not already addressed in the BNSF Agreement. The Agreement with IC is also a tacit acknowledgement by UP that there may anticompetitive problems that are not covered by the BNSF Agreement.

E. There Are Numerous Buyers For SP Lines

Finally, according to press reports, UP has stated its intention to "walk away from the deal" if SP's Houston to St. Louis line (the Cotton Belt) is required to be divested. Watson, *More Access May Scuttle UP/SP Deal*, Journal of Commerce, Jan. 11, 1996, A1. First, this is a not so thinly veiled threat to the independent judgment of this Board. It is for the Board, and not UP, to determine what is best for the public interest. If requiring a divestiture condition is necessary to preserve competition, it should be imposed without respect to UP's desires. Second, according to the article, Mr. Bromley, UP's spokesperson, stated that if KCS's requested conditions are imposed, "it guts the benefits of the merger." Curiously, as the vast majority of UP's claimed public benefits are in the West and only a small percentage of the claimed benefits are in the Houston to St. Louis corridor, V.S. O'Connor/Darling at 258-362, one must wonder what "benefits" UP refers to when it claims a sale of the Cotton Belt will gut its benefits.

1. Despite UP's claimed public benefits, UP really wants private benefits in the form of increased rates.

Mr. Jack Grocki, Executive Vice-President of GRI, Inc., performed a financial analysis of UP's claimed benefits. His analysis was based upon SP's stated intention to sell the entire railroad "intact" and UP's proposal to buy the SP as a "whole" and not "sell off" any of the pieces. Based upon Applicants' claimed "synergies" between UP and SP, Mr. Grocki finds that the value of SP (to UP) falls somewhere in the range of \$14.18 per share to \$21.27 per share. This range of values represents the maximum price UP should be willing to pay for the SP based upon the synergies. Since all of these values are below the minimum offer of \$25 per share in the merger proposal, UP appears to be paying a premium for the SP. V.S. Grocki at 340-43. It is unlikely that UP would accidentally overpay for an acquisition. Therefore, UP must intend to make up the premium from a source not reflected in its merger application. The likely source will be through increased margins on existing business--in other words, through increased prices to shippers. V.S. Grocki at 343-44.

Based purely upon this financial analysis, if UP/SP chooses to apply a rate increase across the board to all shippers in order to make up the premium, the result will be a rate increase in the range of 0.6 percent to 2.0 percent. However, since competition may hold down UP/SP's prices in some areas, UP/SP will selectively apply price increases to those commodities and traffic lanes where competition is less vigorous, *e.g.* where UP/SP can exercise near monopoly power. If UP/SP selectively applies a rate increase to only those shippers susceptible to monopoly pricing, the result will be a rate increase in the range of one percent to as much as 21 percent.[49] V.S. Grocki at 344-45.

2. Divestiture of SP lines is fair to SP shareholders.

If certain conditions are imposed and UP does "walk away from the deal," the Board should not be concerned about SP's financial viability. As Mr. Berandino established, SP could continue as a financial viable carrier if the proposed merger was denied. In addition, as is clear from the public filings, there are many carriers who desire to purchase portions of the SP. Unfortunately, in Mr. Anschutz's zeal to keep the SP intact, he has not even considered the option of selling certain viable SP lines to different rail carriers. Indeed, Mr. Anschutz, the controlling stockholder of SP, instructed his analysts not to consider any

, (Runde Deposition at 103-04; Anschutz Deposition at 142-143, 178-179).

One would expect that since the value of SP (to UP) falls somewhere in the range of $14.18 per share to $21.27 per share and that UP is paying $25 per share that SP

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[49] Using a modified set of data supplied by Mr. John Darling, Mr. Grocki predicts that the rate increase ranges will be even higher again depending largely on the portion of UP/SP traffic susceptible to monopoly pricing. V.S. Grocki at 346-347.

shareholders should be satisfied.[50] Yet, Applicants have not requested a finding under *Schwabackher v. United States*, 334 U.S. 142 (1948) that the price paid to SP shareholders is fair and that minority shareholders will not be disadvantaged due to the transaction. Perhaps Applicants have not done so because such a finding could not be made under the current proposed transaction.

Since the announcement of the proposed UP/SP merger, numerous shippers, carriers and other interested parties have publicly indicated an interest in acquiring portions of the Southern Pacific lines. Included among the carriers that have expressed such an interest are:

- Kansas City Southern
- Conrail
- Montana Rail Link
- Wisconsin Central
- Gateway Western
- Texas Mexican

Mr. Grocki performed an analysis that evaluated the price that these carriers either independently or in combination would pay for the various lines and whether it would result in an increased value of the SP to its shareholders, versus the sale of the SP intact to the UP.[51] He evaluated a number of break up scenarios for the SP. Nearly all of the scenarios

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[50] The fact that SP shareholders are receiving a "premium" for their shares does not detract in any way from the anticompetitive aspects of this transaction. Indeed, what is occurring is precisely what one would expect to occur when a buyer is attempting to purchase a company that would give it monopoly control---the buyer is willing to pay more for the shares than their true worth, and the shippers, who are going to be subject to the monopoly, are concerned about price increases.

[51] In performing his analysis, Mr. Grocki did not speak with any of the carriers interested in acquiring the various line segments. His opinion as to the amount a carrier would be willing to pay for a given SP line segment is based purely on his independent analysis.

studied indicated that the SP was more valuable broken up than if sold intact to UP. Analysis of scenarios involving the sale of a significant portion of the SP indicated a range of premiums from 7.7 percent to 23.9 percent over the value of intact SP. In one scenario, a premium of $727 million over the SP's intrinsic value was obtained through sale of portions of the SP to a combination of the KCS and Montana Rail Link (MRL). This premium represented a 23.9 percent increase in value over the intact SP. V.S. Grocki at 359. Based on this analysis, he concluded that the SP is more valuable broken up with sales of key lines to other parties than the intact SP would be in a merger with the UP.

KCS does not advocate the "breaking-up" of the SP. Instead, as previously noted, KCS believes that if proper conditions are placed on the merger, such as the divestiture of certain parallel and duplicate lines and facilities, this merger could be approved. Such a scenario would allow UP to maintain the preponderance of the public benefits while at the same time preventing competitive abuse. However, if UP does "walk away" from the deal, it is clear from the above analysis that there are many parties willing to purchase portions of the SP. Such a scenario would actually provide more money for SP shareholders, under certain circumstances, than the currently proposed UP transaction.

F. Divestiture Is In The Public Interest

The "Comprehensive Solution" calling for divestiture, through sale by Applicants, of one of two parallel and duplicate lines and facilities in those corridors where there are anticompetitive effects that are not outweighed by the efficiency gains is in the public interest. Among the areas that should be subject to divestiture include one of the two parallel lines between Houston and St. Louis, Houston and New Orleans, Houston and San

Antonio, and the Central Corridor from Kansas City to San Francisco. KCS believes these lines should be divested to a qualified buyer in a market driven process, subject to the approval of the Surface Transportation Board. All lines proposed for divestiture are parallel and duplicative, and some of the lines are already scheduled to be downgraded by UP/SP.

Unlike Applicants' proposal, KCS's proposal is the true free market solution that benefits both shareholders and preserves the public interest. The Comprehensive Solution ameliorates competitive harms, retains all service benefits, and provides UP/SP the vast majority of the benefits they project for their merger. The BNSF Agreement mitigates only some of the worst, but, nevertheless, a minority portion of competitive harms, substitutes constrained BNSF service for unconstrained SP service and price competition, and provides UP/SP all the benefits they project for their merger.

IX. AS A FINAL MATTER, APPLICANTS' ABUSE OF THE DISCOVERY PROCESS SHOULD NOT BE CONDONED

As has been previously discussed, Applicants absolutely refused to provide any meaningful discovery with respect to the Agreement between Applicants and BNSF. This process was not unique, however, as Applicants have attempted, at every turn, to prevent any meaningful examination of their own analysis of the competitive effects of this merger. This refusal to provide open and fair discovery has prevented KCS from fully exploring the competitive effects of the transaction.

A. Negative Inferences Should Be Drawn From Applicants' Resistance To Discovery In This Proceeding

The Board should take note of and draw appropriate negative inferences from Applicants' refusal to provide meaningful discovery on key issues relating to the competitive impact of the merger. Other than referring to the statements of its witnesses and the "workpapers" of the witnesses,[52] Applicants objected to virtually all discovery requests of KCS and other interested parties. As to basic questions such as describing the course of the negotiations that led to the proposed merger (KCS-7, Interrogatory No. 1), providing internal analysis of the proposed mergers as well as prior mergers, the negotiation of the trackage rights Agreement with BN/Santa Fe (*e.g.*, KCS-7 Interrogatories 12-14) and instances of competition and potential competition between UP and SP (*e.g.*, KCS-7, Interrogatories 20-23, 25, 27 and 28), Applicants resisted at every turn asserting undue burden and irrelevancy, and provided only limited information, if any. (*See, e.g.*, UP/SP-30, Applicants' Objections to KCS's First Discovery Requests wherein Applicants objected to 33 of KCS's 40 discovery requests as vague, unduly burdensome and overbroad alleging that the requests sought information not relevant to this proceeding.) Accordingly, a discovery conference was necessary on almost a weekly basis to seek to compel responses to even the most basic information concerning the competitive impact of the merger.

This issue is not one of procedure (*e.g.*, whether the ALJ did his best to rule on these matters and strike compromises, or whether the objections could have been appealed to the

[52] Discovery disclosed that what Applicants placed in their depository as "workpapers" did not contain all documents relied on by witnesses in forming the opinions that are the basis of their statement, but rather a selective set. (*e.g.*, Ainsworth Deposition at 47-49, 109; Willig Deposition at 28.)

Board), but rather goes to Applicants' true motives behind and beliefs about the proposed merger. If Applicants were motivated solely by legitimate public interest objectives and had nothing to hide, they would have willingly provided interested parties and this Board with "full disclosure" of their current competitive posture *vis-a-vis* each other with regard to particular shippers and other carriers, the genesis of the merger Agreement itself and the negotiation of the BN/Santa Fe trackage rights Agreement. Since they did not offer, and in fact strenuously resisted any such "full disclosure," the Board should seriously question Applicants' assertion on each point.

For example, Applicants limited their search of files to a limited list of top executives, <u>excluding</u> personnel in charge of key commodity groups and marketing management, who actually carry out company policy and have the best opportunity for knowledge of competitive situations. As a further example, no issue could be more important to this Board's decision than the identification of current situations where Applicants compete or have the potential to compete. Yet, Applicants fought to avoid disclosure of the details of actual instances of competition between Applicants, *e.g.*, instances of shippers' playing UP and SP off against each other to obtain improved rates or service (KCS Interrogatories 20, 22, 63); source competition (KCS Interrogatories 21, 62); build-out situations (KCS Interrogatories 27 and 28); and transloading opportunities. Applicants first limited their obligation to respond to merely 200 out of their thousands of shippers, and even then objected to providing information as to this limited group. Because of Applicants' refusal to fully disclose on these key points, it can be assumed (1) that competition between Applicants (including aggressive competition by SP) is more extensive and intense than Applicants concede and (2) that opportunities for competition from transloading, source competition and build-in options is more pervasive and realistic than Applicants concede.[53]

With regard to Applicants' main objection -- undue burden -- if the time, effort and expense expended by Applicants on resisting the discovery, had instead been devoted simply to obtaining and producing the requested information, the Board could have access to the information it needs to make a decision in accordance with the substantial evidence requirement of the Administrative Procedure Act.[54] Apparently, something else was at work here, a fear of disclosure or fully "testing" the Application.

Moreover, the quantity of Applicants' production is shown to be irrelevant when one considers the key areas in which Applicants objected and provided little or no responsive information. Thus, Applicants pointing to the fact that it may have made available over 200,000 pages of documents (much of which was irrelevant portions of shipper files, form contracts and operation information) can be seen as a "smoke screen" to hide the fact that it refused to reveal to the parties, or this Board, meaningful information on key issues.

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[53] Thus, while Applicants assert that only one or two locations were "feasible" for build-ins, because of Applicants resistance to discovery on the issue, the Board should assume that many more realistic possibilities exist.
counsel enclosing "Project Normandy

REDACTED

[54] For instance, Applicants both had their in-house counsel at almost one-half of the discovery conferences to plead their case for resisting discovery. The time, expense and disruption to their employers of bringing these key individuals to Washington from Omaha and San Francisco could have been better spent in providing responses to the requested discovery.

Applicants fear of "full disclosure" carried over to their refusal to make available for deposition employees with knowledge concerning key issues. Thus, Applicants' public witnesses often admitted they had no information to support an assertion in their statement, but instead had relied on information supplied by other employees. Applicants then would not make available the employees with the relevant knowledge. For example, key Applicant witness John Rebensdorf, and Executive Vice President, said that he relied on specific UP Marketing Department personnel for portions of his statement (relating to identifying 2-to-1 points and shippers' views on the BN/Santa Fe as a competitive alternative). (Rebensdorf Deposition at 111-114.)

Likewise, Mr. Robert Willig, who said he performed no independent investigation but relied solely on information provided by Applicants, testified that he also relied on UP Marketing Department personnel for information on competitive conditions that formed the basis for conclusions in his sworn statement. (Willig Deposition at 28-36.) Yet, UP refused to make any of those Marketing Department personnel available for deposition. (*See*, KCS Letter to Applicants' counsel, January 24, 1996 in Vol. III, Highly Confidential Appendix at 1072-1073.) In the same vein, on the issue of "buying" shipper support for the merger through offering favorable contracts, and with regard to the **REDACTED** discussed above, SP refused to make any witnesses available.[55] (See HC45-003923) Thus,

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[55] On KCS' Motion to Compel, the ALJ ordered a Mr. James Gehring to be deposed, because he was an executive copied on relevant correspondence. However, Mr. Gehring, who is in the Marketing Department, "passed the buck" for responsibility for gathering shipper statements saying that the Sales Department, headed by Mr. Rickershauer, was responsible for gathering statements of shipper support for the merger. KCS had requested the deposition of Mr. Rickershauser, and SP refused. (*See* Letter of February 7, 1996 from KCS counsel to Applicants' counsel, Vol. III, Highly Confidential Appendix at 1070-1071.)

the Board should disregard the Statements of Applicants' witnesses because of their refusal to make available witnesses with information to back up their statements. In the alternative, negative inferences should be drawn against Applicants and their case.

B. Applicants Have Abused The Highly Confidential Designation Of The Protective Order And Have Denied KCS Its Full Rights To Participate In This Proceeding

In addition to resisting discovery, UP and SP have stymied the full participation in this proceeding by KCS (and other parties) by Applicants' wholesale use, resulting in abuse, of the "Highly Confidential" designation of documents and deposition transcripts. This abuse deprived KCS counsel of the right to share information with their clients, which deprived KCS of the opportunity to analyze, evaluate, critique and respond to the information in the fullest and most meaningful manner. This handicap resulted in a denial of due process to KCS. This harm is especially acute to KCS, which, as the carrier most impacted by the proposed merger, has been deprived of the opportunity to fully utilize the expertise of its executives, employees and in-house counsel to respond to the Application.

In regard to depositions, Applicants followed the arbitrary process of advance designation all portions of all depositions as "Highly Confidential" subject to a later declassification by Applicants. These declassifications of portions of the depositions, if at all, then came weeks, if not a month after the deposition, with such partial declassification still rolling in at the time of this writing.[56] This tactic by Applicants, to which KCS

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[56] By way of example, by February 15, 1996, at least 17 depositions had been taken with only 4 having been partially declassified, and even as to those with the following delays - Rebensdorf took 16 days; Stephen Month - 8 days; LaLonde - 10 days (only to have it determined that no confidential material was contained); and Runde took 1 month.

objected from the outset, effectively denied KCS counsel the right to share any portion of any deposition with its client unless and until a designation belatedly arrived. Indeed, the mere number of redactions from the "Public Version" of these comments confirms that most, if not all, of the important points in evidence and deposition were designated "Highly Confidential" thus preventing the public from obtaining full disclosure of the true evidence in this proceeding. As a result, KCS was deprived the basic right of confrontation of witnesses because its client could not see the testimony for analysis, feedback, and suggestions for further inquiry and rebuttal.[57]

The absurd extent of this practice was followed in the deposition of Mr. Gerald Grinstein, former chairman of the Board of BN/Santa Fe. By following Applicants' practice, BN/Santa Fe initially designated as "Highly Confidential" testimony concerning Mr. Grinstein's remarks in an article that appeared in the December 18, 1995 issue of *Forbes* magazine, a national publication. Even with the declassifications, Applicants (and BN/Santa Fe) continued to make unwarranted use of the "Highly Confidential" designation to shield portions of testimony from KCS.

Applicants' misuse of the "Highly Confidential" designation to hamper the use of documents by KCS and others was equally egregious. The Protective Order of August 28, 1995 referred to "material containing shipper-specific rate or cost data or other competitively sensitive information" as the type of information that might be appropriate for a "Highly

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[57] Because of the compressed deposition schedule, which began on January 16, 1996 and included one, and sometimes two, witnesses on almost every day through March 4, 1996, Applicants were able to prejudice KCS. Since every day meant another witness, each day, week or month the Highly Confidential designation remained in place deprived KCS of the opportunity to fully utilize the previous depositions for all witnesses deposed in the interim.

Confidential" designation. (Decision No. 2 at 5.) Yet, Applicants (and BN/Santa Fe) used the designation to restrict the full and effective use of information that they merely found damaging to their Application. Thus, by way of example, Applicants used this designation to shield a written presentation to the UP Board in which

REDACTED (Rebensdorf Deposition, Exhibit 14.) While embarrassing and condemnable, and perhaps harmful to their chances for approval of this Application, this statement is not deserving of a "Highly Confidential" designation. This statement of a UP objective is not the type of "competitively sensitive" information the Protective Order intended to protect from disclosure to the very carriers UP intends to "dominate."

Applicants also applied this designation to its already vague description of subsequent meetings that took place between UP and SP in March of 1995 to discuss a merger. Thus, even the fact of the meetings, who was present, the agendas, and matters relating to the perceived advantages of a merger (besides "shipper-specific rate or cost data") was afforded the "HC" classification. (*See* Supplemental Response to KCS Interrogatory 12, HC 52-000001-000002.) SP's presentations at the March meetings, which discuss many of the same categories of information in the Application, also received the HC designation. (*See* Peterson Deposition, Exhibit 18; Rebensdorf Deposition, Exhibit 8). In conclusion, as a result of the abuse of the Commission's Protective Order, many conversations with KCS in-house counsel and KCS employees could not occur, severely limiting KCS's ability to air all of the evidence in this proceeding.

CONCLUSION

As currently structured, the proposed transaction is not consistent with the public interest. The proposed UP/SP merger will cause unprecedented competitive harm. To address some of this competitive harm, Applicants propose the "BNSF Agreement" relying on 4,000 miles of trackage rights. To address most, if not all, of the competitive harm, KCS proposes the "Comprehensive Solution" calling for divestiture, through sale by Applicants, of one of two parallel and duplicate lines and facilities. Among the areas that should be subject to divestiture: lines between St. Louis and Memphis, on the one hand, and Houston, on the other hand; the SP line from Houston to New Orleans; and the SP line from Houston to Brownsville via Flatonia and Victoria. Furthermore, one or more of the responsive applications filed by those parties interested in the Central Corridor should also be granted in order to alleviate the anticompetitive effects of the proposed transaction in that Corridor.

KCS believes these lines should be divested to a qualified buyer in a market driven process, subject to the approval of the Surface Transportation Board. All lines proposed for divestiture are parallel and duplicative, and some of the lines are already scheduled to be downgraded by UP/SP. By allowing a market driven process to determine which carrier is allowed to acquire parallel lines in the Houston to St. Louis Corridor, Houston to New Orleans Corridor, Houston to Brownsville Corridor, and the Central Corridor, shareholders will receive adequate compensation and all shippers on a line will gain access to an alternative carrier. Jobs will be saved rather than eliminated, and Applicants will be able to maintain the preponderance of their benefits.

Respectfully Submitted,

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Attorneys for The Kansas City Southern Railway Company

March 29, 1996

CERTIFICATE OF SERVICE

I hereby certify that a true copy of the foregoing "COMMENTS OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY AND REQUEST FOR CONDITIONS" was served this 29th day of March, 1996, by hand-delivery, facsimile, overnight delivery, or first-class mail, postage prepaid, on counsel for all known parties of record.

William A. Mullins

Attorney for The Kansas City
Southern Railway Company

Pages 128 Through 136 Not Assigned

VERIFIED STATEMENT

OF

MICHAEL R. HAVERTY

A. Background and Experience

My name is Michael R. Haverty, and I am President and Chief Executive Officer of The Kansas City Southern Railway Company ("KCS"). I began my career in railroading in 1963 as a brakeman with Missouri Pacific Railroad Company ("MoPac"). Following graduation from college, I was a transportation trainee in St. Louis, Missouri for Missouri Pacific. I continued my employment with the MoPac until 1970, serving as an assistant trainmaster at Hearne, Texas in 1968 and 1969, as a project assistant, Management Information Systems, in 1969-1970, and as Trainmaster at Chicago, Illinois in 1970. I joined Santa Fe Railway in 1970, serving first as Trainmaster at San Bernadino, California from 1970 to 1972. From 1972 to 1974 I served as Assistant Division Superintendent at Richmond, California and between 1974 and 1979 I was Division Superintendent, first for Santa Fe's Eastern Division at Emporia, Kansas and its Southern Division at Temple, Texas. In 1979, I was appointed Assistant to Vice President and in 1986 Assistant Vice President Operations in Santa Fe's headquarters at Chicago. In 1988, I was elected Santa Fe's Vice President Operations, and in 1989 I became President and Chief Operating Officer of that company.

During my tenure as Santa Fe's President, we initiated the MTQ (Managing Total Quality) program; brought back Santa Fe's renowned "warbonnet" scheme to enhance marketing programs and instill employee pride; positioned the railroad as a better potential transcontinental partner; increased freight revenues by negotiating for access to St. Louis via Gateway Western Railroad (St. Louis being a strategic rail gateway that Santa Fe had coveted for some 50 years);

implemented a cost measurement system that allowed a sharper focus and enhanced emphasis on contribution margin by business units, commodities, and rail line segments; established a new Intermodal Business Unit (IBU) to manage over $900 million of intermodal traffic which increased contribution margins on this business by 150% in one year; initiated the J.B. Hunt Transport/Santa Fe joint venture intermodal service known as Quantum in 1989 which has grown into a multi-hundred million dollar business. While President of Santa Fe, we also promoted labor agreements with the United Transportation Union (UTU) and Brotherhood of Locomotive Engineers (BLE) that reduced crew size, lengthened distance crews could operate a train, and changed pay structure. Through these agreements and other restructuring, we produced approximately $60 million in annual savings, and reduced the total work force by 20% although we did it in such a way as to minimize the hardship on our employees.

When I resigned from Santa Fe in 1991, I became a self employed executive advisor. In 1993 I formed Haverty Corp., a transportation holding company and carried on that business until I took my current employment with KCS in May of 1995.

B. <u>Purpose of Statement</u>

In this statement, I address KCS's deep concerns with the proposed UP/SP merger. These concerns are based on the unprecedented level of market power concentration that will result from the proposed parallel UP/SP consolidation if it is not properly conditioned. Part of this unprecedented market power results from the cross-over and cumulative effects of the UP/SP combination and the recently consummated merger of Burlington Northern and Santa Fe. I am also very concerned with the unprecedented trackage right/haulage right agreement in both the UP/SP and Burlington Northern Santa Fe cases, wherein those railroads engaged in a swap of more 7,000 miles of rail lines in two separate transactions in 1995 and 1996.

These serious public policy questions deserve a thorough examination by the Surface Transportation Board. The Surface Transportation Board's most important function must be to insure the preservation of the competitive foundations of the free market for transportation services in order that the efficiencies and innovation that have led to the rail industry's rebirth in the last decade and one-half continue for the benefit of the American economy and for the many shippers and employees on whose livelihood the rail industry depends.

In this regard, I want to state and emphasize KCS's willingness, from both an operational and financial perspective, to propose and implement a true market-oriented solution to these serious competitive problems. I urge the Board to adopt the "Comprehensive Solution" proposed by KCS and others by conditioning approval of this merger on divestiture of parallel lines in those corridors that will see a reduction of competition.

C. <u>The Competitive Problems</u>

Because of our concerns for the adverse competitive effects of the proposed UP/SP merger, KCS asked Dr. Curtis Grimm, Professor and Chair of Transportation, Business and Public Policy, College of Business and Management, University of Maryland at College Park, and a well recognized expert in industrial organization in the railroad industry, to examine those effects. Dr. Grimm is providing his verified statement in support of KCS's filing in this case. His findings are consistent with those he reported to me early in our consideration of the proposed merger. He found that the magnitude of the competitive implications of the UP/SP merger exceed those of any rail merger transaction reviewed by the Interstate Commerce Commission since the passage of the Staggers Act in 1980. The proposed UP/SP merger will eliminate rail competition for over $2.04 billion in annual freight traffic revenue based on 1994 ICC Waybill data. This is an amount over ten times the size of the recently approved Burlington

Northern/Santa Fe merger. Furthermore, Dr. Grimm found that the magnitude of competitive harm from the proposed UP/SP merger is significantly greater than the impact of the ill fated Santa Fe/Southern Pacific merger, a merger which was opposed by the Department of Justice and denied by the Interstate Commerce Commission because of its anti-competitive effects on the transportation market.

D. The Agreement Between UP/SP and BNSF

Since the UP/SP merger was announced, the Union Pacific and the newly consolidated Burlington Northern/Santa Fe ("BNSF") entered into an "Agreement" purporting to resolve all of the competitive problems arising from the proposed combination. Union Pacific has proposed this Agreement, which provides for limited divestiture (335 miles of track) and extensive trackage rights (approximately 4,000 miles of rail line) to BNSF, in order to mitigate what UP/SP itself recognizes as serious competitive problems.

The trackage rights granted BNSF by UP/SP are not the solution to UP/SP's unprecedented competitive problems. Based upon my years of experience as a railroad operating officer, I do not believe that extensive trackage rights are an adequate substitute for two, independent competing rail carriers, where each carrier has its own route structure and is not dependent on the other carrier to provide rail service. The Union Pacific's attempt to ameliorate the competitive problems with trackage rights of this magnitude is unprecedented.

As established by the other KCS witnesses in this case, the proposed trackage rights will preclude effective or meaningful competition because BN/SF's costs will be higher, service quality will be inferior, and many of the alternative routes are circuitous when compared to UP/SP's primary routes. The trackage rights agreement provides merely a facade of competition because BNSF, despite its stated intentions to compete vigorously, will not be able to capture enough traffic to make these routes commercially viable. This is particularly true in the Houston-Memphis-St. Louis markets.

UP/SP's deal with BN/SF as the solution to the competitive problems inherent in the proposed merger asks us to accept that all of the competitive problems will be addressed properly by these two remaining, and dominant, rail carriers in the western market. However, that Agreement must be understood in its context: UP and SP both withdrew their opposition to the BN/SF merger, early in 1995, followed shortly by the announcement that the UP and SP were going to merge. When considered as a whole, the UP/SP BNSF settlement can be seen not as a solution, but as part of the problem. The agreement allows UP/SP and BNSF together to control 100% of the rail market share in nearly all of the western two-thirds of the United States and effectively block out a third competitor.

E. Mexican Related Concerns

On August 28, 1995, Kansas City Southern Industries, Inc. ("KCSI") and Transportation Maritima Mexicana, S.A. de C.V. ("TMM"), the parent companies of KCS and TexMex, entered into a letter of intent that provides for KCSI's acquisition of a 49% interest in TexMex and for creation of a joint venture business entity in Mexico to acquire, own, and operate rail facilities and lines in that country by preserving competitive alternatives for transportation between the U.S. and Mexico. The purpose of the KCSI/TMM joint venture is to develop rail operations in Mexico and expand TMM's operations in the United States. This joint venture has a major stake in the planned privatization of rail transportation in Mexico in a way that will preserve competition for both domestic Mexican rail traffic and for international traffic between the United States and Mexico.

The proposed merger between UP and SP will have significant impact upon international rail traffic and the Mexican rail privatization process. Based upon data provided by ALK Associates, UP and SP currently control, through all gateways, over 90% of all rail traffic to and from Mexico. BNSF carries the other 10% of that traffic. After the merger and assuming no other conditions other than the BNSF agreement are imposed, the UPSP and BNSF will control 100% of the rail traffic into Mexico. This economic bottleneck is of serious concern to business interests in Texas, the principal gateway state to Mexico. The UPSP and BNSF duopoly would also preclude access by other carriers to the important and growing NAFTA trade lanes. Due to these described circumstances, KCS believes that the proposed merger will have significant consequences for rail transportation competition, both within Mexico and between the U.S. and Mexico. Competitive harm in those markets must be addressed.

F. The Comprehensive Solution

KCS strongly supported deregulation of the rail business in 1980 and considers continued deregulation vital to the health of the transportation industry and its customers. We realize continued pricing freedom as a cornerstone of deregulation cannot be justified without competition. Increased concentration of market power is inconsistent with deregulated transportation pricing. The American economy has a stake in preserving a free market for transportation, but that market requires strong and vigorous competition.

In this light, and based upon the findings of the KCS witnesses, the STB should not approve this merger unless it is conditioned upon the merging companies' being required to restore alternative competitive access to those markets that will see a reduction in competition. I urge the Surface Transportation Board to impose divestiture conditions on the Applicants by requiring those companies to divest through supervised sale of one of the two parallel and duplicative lines in corridors where the UP/SP combination will reduce competition, *e.g.*, between Houston and East St. Louis, between Houston and Memphis, between Houston and Corpus Christi and Brownsville, between Houston and New Orleans, between Houston and San Antonio and through the Central Corridor of the United States. With respect to those routes where the combination will reduce competition and where the sale of rail lines is not feasible (because UP and SP operate over one another's lines and there are no parallel and duplicative lines), divestiture should take the form of joint ownership or effective trackage/marketing rights granted to another rail carrier *e.g.*, provision for service by a third Class I railroad to the grain shippers of Central Kansas.

KCS has the financial wherewithal and is prepared to bid for and purchase those divested lines. The parent company of The Kansas City Southern Railway Company is Kansas City Southern Industries ("KCSI"). KCSI is also the parent company of various other subsidiaries, including the Janus Funds and the Berger Funds, two large mutual fund companies. Recently, KCSI completed a successful partial spin-off of its financial services company, DST, Inc. This enabled KCSI to significantly pay down its debt. As a result, KCSI is in a better position than ever to obtain financing to expand its investments, including the ability to purchase whatever lines may be divested, and whatever upgrading, building, rearranging, or developing of the underlying facilities would be necessary to efficiently operate these lines. If KCS is chosen as a successful bidder for any of the divested lines, we are prepared to provide this Board with all of the appropriate operating, financial, and environmental documentation as necessary.

KCS is pleased to see that other rail carriers have expressed a desire to purchase lines needing divestiture. KCS is prepared to cooperate fully through all available commercial means with carriers who purchase those lines to assure that divestiture results in continued competition.

Specifically, with respect to those rail carriers expressing an intent to bid on the Central Corridor lines, KCS is uniquely positioned to joint venture with those lines on Central Corridor traffic and thereby assure rail competition to those impacted regions. As such, KCS endorses the concept put forth by the "Joint Shipper Statement in Opposition to Merger Unless Conditioned as Proposed in Responsive Application of Montana Rail-Link, Inc.," the joint filing herein of the Western Shippers' Coalition, The Mountain-Plains Communities & Shippers Coalition. We will also support the application of Wisconsin Central. We will cooperate and work with any other party who desires to work with KCS to provide a comprehensive solution for the harms in the Central Corridor.

KCS is also prepared to exercise and operate over trackage/marketing rights in Kansas, Oklahoma, and Texas. In the course of the BNSF merger proceeding before the Interstate Commerce Commission, a group of grain shippers located in South Central Kansas proposed to the SP that it seek rights in that territory to replace one of the three Class I carriers (UP, BN, and Santa Fe) then serving them. The BN/SF merger would have reduced the number of Class I railroads serving these areas from three to two. As a direct result of those overtures and as part of their settlement agreement in the BN/SF case, BNSF granted SP trackage rights from Kansas City to Fort Worth with intermediate access to Hutchinson, Wichita, and Winfield, Kansas.

Of course, promptly upon obtaining trackage rights for SP that would indeed preserve three carrier competition in that region, UP and SP announced their merger plans which again will reduce the number of serving carriers to two. The very group of shippers who unavailingly sought SP's assistance have asked KCS to seek access and provide service to them as the "third Class I railroad." I have promised those shippers that KCS will seek to step into the shoes of

SP with respect to the rights it received from BNSF. We so advised the Surface Transportation Board in our January 29, 1996 filing, and I urge the Board to consider this request, especially in light of Dr. Grimm's findings as to the competitive impact of this merger on those shippers. V.S. Grimm at XXX.

G. Conclusion

The "Comprehensive Solution" calling for divestiture, through sale by Applicants, of one of two parallel and duplicate lines and facilities in those corridors where there are anticompetitive effects that are not outweighed by the efficiency gains is in the public interest. Among the areas that should be subject to divestiture include one of the two parallel lines between Houston and St. Louis, Houston and New Orleans, Houston and San Antonio, and the Central Corridor from Kansas City to San Francisco. KCS believes these lines should be divested to a qualified buyer in a market driven process, subject to the approval of the Surface Transportation Board. All lines proposed for divestiture are parallel and duplicative, and some of the lines are already scheduled to be downgraded by UP/SP.

Unlike Applicants' proposal, KCS's proposal is the true free market solution that both benefits shareholders and preserves the public interest. The Comprehensive Solution ameliorates competitive harms, retains all service benefits, and provides UP/SP the vast majority of the benefits they project for their merger. In contrast, the BNSF Agreement mitigates only some of the worst, but, nevertheless, a minority portion of competitive harms, and substitutes constrained BNSF service for unconstrained SP service and price competition.

VERIFICATION

STATE OF MISSOURI)
) ss.
COUNTY OF JACKSON)

I, Michael R. Haverty, being first duly sworn, upon my oath state that I have read the foregoing statement and the contents thereof are true and correct as stated.

MR Haverty
Michael R. Haverty

Subscribed and sworn to before me this 25th day of March, 1996.

Julie A. Robinson
Notary Public

My Commission Expires:

JULIE A. ROBINSON
Notary Public - State of Missouri
Commissioned in Jackson County
My Commission Expires May 18, 1998

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VERIFIED STATEMENT

OF

CURTIS M. GRIMM

FINANCE DOCKET NO. 32760

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

I. Introduction

My name is Curtis M. Grimm, and I am Professor and Chair of Transportation, Business and Public Policy, College of Business and Management, University of Maryland at College Park. I have been a member of this College since 1983. I received my B.A. in economics from the University of Wisconsin-Madison in 1975 and my Ph.D. in economics from the University of California-Berkeley in 1983. My Ph.D. dissertation investigated competitive impacts of railroad mergers.

My background includes extensive exposure to public policy issues regarding transportation, including Interstate Commerce Commission ("ICC") merger adjudication. I have previously been employed by the Wisconsin Department of Transportation, the ICC, and the Australian Bureau of Transport and Communication Economics, and I have provided consulting services to several other government agencies and private firms regarding transportation issues. I served as Assistant to the Chief of Intercity Transport Development, Planning Division, Wisconsin Department of Transportation on two separate occasions between 1975 and 1978, with a focus on rail policy issues such as abandonments and the creation of shortline railroads. I also worked on a consolidation involved competing bids from Burlington Northern and the Soo Line/Milwaukee Road/CNW for the Green Bay and Western Railroad, decided by the ICC in 1977.[1]

While serving as an economist at the ICC's Office of Policy Analysis from January to December 1981, my duties included analysis of competitive effects for the Union Pacific-Missouri Pacific-Western Pacific ("*UP-MP-WP*") merger.[2] During 1982, I served as a consultant for the Commission while the *UP-MP-WP* decision was being drafted and subsequently consulted for the ICC with regard to the Ex Parte No. 347 decision.[3]

I have previously participated in several ICC proceedings, including the Wisconsin Central rail merger.[4] Specifically, I provided testimony evaluating the competitive consequences of that transaction. I also submitted a statement in the instant proceeding with regard to the proposed ICC schedule. Previously, I provided a similar statement in the

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[1] *Burlington Northern, Inc.--Control Through Acquisition of Services of--Green Bay and Western RR. Co.*, Finance Docket No. 27770, 354 I.C.C. 458 (ICC decided July 8, 1977).

[2] *Union Pacific Corporation, et al.,--Control--Missouri Pacific Corporation and Missouri Pacific Railroad Co.*, Finance Docket No. 30,000, 366 I.C.C. 462 (ICC decided September 24, 1982).

[3] *Coal Rate Guidelines, Nationwide*, 1 I.C.C.2d 520 (1985), *aff'd sub nom. Consolidated Rail Corp. v. U.S.*, 812 F.2d 1444 (3d Cir. 1987).

[4] *Fox Valley & Western, Ltd. - Exemption, Acquisition and Operation - Certain Lines of Green Bay and Western Railroad Company, Fox River Valley Railroad Corporation, and The Ahnapee & Western Railway Company*, 9 I.C.C.2d 209 (1992), 272 (1993), *aff'd Fox Valley and Western v. U.S.*, 15 F.3d 641 (7th Cir. 1994).

Burlington Northern/Santa Fe merger[5] and a statement regarding the cumulative competitive impacts of the BN/SF merger and the proposed instant proceeding that was filed as part of the Petition to Reopen filed by The Kansas City Southern Railway Company in the BN/SF merger, KCS-6, *BNSF* merger proceeding. Finally, I recently participated as a witness in the dispute between Amtrak and Conrail regarding trackage rights compensation,[6] and, before the state of New York in a tax case involving Conrail.[7] On November 8, 1995, I provided testimony regarding competition issues in rail mergers to a Joint Meeting of the U.S. Senate and House of Representatives Committees on Small Business.

My research has involved deregulation, competition policy, competitive interaction and management strategy, with a strong focus on transportation. This research has resulted in over 60 publications, including articles in leading journals such as Journal of Law and Economics, Transportation Research, Transportation Journal, Logistics and Transportation Review, Academy of Management Journal, Management Science, Strategic Management Journal, and Journal of Management. More than two dozen of my publications have dealt specifically with the railroad industry, mainly on deregulation, mergers, and competition issues. I have also co-authored four monographs. Further details may be found in the attached vitae.

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[5] *Burlington Northern Inc. & Burlington Northern R.R. -- Control and Merger -- Santa Fe Pacific Corp. & Atchison, Topeka & Santa Fe Ry.*, Finance Docket No. 32549, slip op., (ICC served Mar. 7, 1995) ("*BNSF*").

[6] *National Railroad Passenger Corporation and Consolidated Rail Corporation-- Application Under Section 402(a) of the Rail Passenger Service Act for an Order Fixing Just Compensation*, Finance Docket No. 32467 (ICC served January 19, 1996).

[7] *Consolidated Rail Corporation v. State Board of Equalization and Assessment of the State of New York, et al.*, 93 Civ. 6548 and 94 Civ. 6764 (S.D.N.Y. 1994).

In formulating the analysis which follows, I have drawn from this past work and investigated the circumstances surrounding this case as follows:

- review of the relevant economic literature regarding the role of railroad competition in determining prices;
- review of testimony, data and relevant documentation produced by UP and SP;
- interviews with shippers and review of their statements;
- discussions with public officials and KCS marketing personnel;
- review of the data compilations and analyses carried out by other KCS witnesses; and
- extensive analysis of railroad traffic tapes, with the assistance of Snavely, King and Associates.

In summary, I have had extensive experience conducting and evaluating research regarding the railroad industry, direct exposure to relevant areas of railroad policy making and first-hand investigation of the facts surrounding this case upon which to base this statement. For many years I have advocated in my writings the importance of preserving and promoting railroad competition. I have long been convinced that preserving and extending the benefits of deregulation crucially hinge on adequacy of railroad competition. Accordingly, my position regarding the impacts of rail mergers that are anticompetitive, remains as stated in my 1990 Brookings co-authored monograph:

> As Alfred Kahn and others have noted of the airline industry, it is important to recognize that deregulation did not authorize the government to abdicate its antitrust responsibility and to fail to take actions to preserve competition. To the extent that mergers can enable railroads to improve service and reduce costs without concomitant anticompetitive effects, they should be encouraged.

> It is the ICC's responsibility to scrutinize carefully potential anticompetitive effects from both parallel and end-to-end mergers. In particular, a policy of continuing to discourage parallel mergers appears to be in order.

Winston, C., T. Corsi, C. Grimm and C. Evans, *The Economic Effects of Surface Freight Deregulation*, Brookings, Washington, D.C., 1990, p.54.

STATEMENT

My position in this case is clear. The effects of the proposed consolidation are anticompetitive and, as such, the UP/SP merger, as proposed, should be denied.

The competitive effects of this consolidation are of unprecedented magnitude, far greater than those of Santa Fe/Southern Pacific ("*SFSP*"),[8] which was denied by the ICC as anticompetitive. This is illustrated in Figure 1.1. BEA origin-destinations that will go from 2-to-1 independent rail alternatives are the most salient competitive harms of the UP/SP merger. Based on 1994 100% traffic tape data, the traffic revenues in these corridors are billion.[9] A similar calculation of the competitive harm from 2-to-1 reduction in independent rail alternatives was performed for *SFSP*, based on 1994 100% traffic tape data.[10] The traffic revenues for these BEA corridors were billion. Accordingly, as proposed, this merger should similarly be rejected.

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[8] *Santa Fe Southern Pacific Corporation--Control--Southern Pacific Transportation Co.*, Finance Docket No. 30400, 2 I.C.C.2d 709 (ICC served July 24, 1986).

[9] More specifically, the analysis was based on 100% traffic tapes for UP, SP, CNW, KCS, BN and SF in conjunction with the ICC Waybill Sample.

[10] To clarify, this 2-1 competitive impact of the *SFSP* merger was calculated using precisely the same methodology for UP/SP, as if it had occurred in 1994. This provides an arguably overstated estimate of the actual *SFSP* impacts, given that other rail consolidations have occurred between 1985 and 1994.

Figure 1.1

UP/SP vs. ICC Rejected SP/SF
Competitive Impact Comparison
2 - to - 1

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The remainder of the statement is organized as follows: Section I provides a backdrop for evaluation of this merger, exploring the current deregulated rail environment and previous ICC rail merger policy. Section II provides the basic approach to evaluation of competitive harms, focusing on the different types of shippers affected by the merger and the corresponding BEA-BEA market definition. Section III entails an analysis of the competitive harms acknowledged by the Applicants by way of the settlement agreement with BN. Section IV discusses the ultimate competitive impacts of this merger. Section V provides evidence regarding rail as the relevant product market. Section VII provides detailed analysis of commodities and distances of the affected traffic. Section VIII assesses competitive harms in five key corridors: Cotton Belt, San Antonio-New Orleans, Corpus Christi-Houston, Central Corridor and Kansas-Fort Worth. The final Section provides a summary and conclusion.

II. BACKGROUND AND CONTEXT FOR THE EVALUATION OF RAIL MERGERS

The context in which this merger must be evaluated is very important. The industry is very different from its form 20-30 years ago, when major parallel mergers were last approved. It has been fundamentally deregulated and revitalized such that markets are fully functional and competition is vital in the industry. It is also important to understand ICC merger policy in mergers over the past 20 years, and the role of this policy in facilitating the revitalization of the industry. Merger policy has, most importantly, discouraged parallel mergers. This preservation of competition has been vital in realizing the benefits of deregulation.

A. Revitalization of the Railroad Industry since Deregulation

This section will detail the changes in policy which have taken place in railroad regulation and the industry response to deregulation.[11] A dramatic and fundamental change has occurred in U.S. railroad policy in recent years. Prior to 1980, U.S. railroads were overwhelmingly burdened by an outmoded regulatory framework, and found themselves hampered by regulations that were causing them to lose more and more traffic, contributing to a serious deterioration of the entire railroad industry.

As a result of pressures to save the industry from bankruptcy, and coinciding with a general trend towards deregulation of U.S. industry, the Railroad Revitalization and Regulatory Reform Act (the "4-R Act") and, in particular, the Staggers Rail Act of 1980,[12] granted substantial new freedoms to the railroads, including virtually complete pricing flexibility. More specifically, railroads were provided additional freedom to set rates via new provisions on commodity exemptions, confidential contracts and maximum rate determination. ICC rate regulation now applies to only a small fraction of traffic. In addition to traffic exempt from regulation or moving via contract, the 4-R Act and Staggers Act have also provided substantial additional rate flexibility on other traffic.[13]

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[11] This section draws from Grimm, C. and G. Rogers, Liberalization of Railroad Policy in North America, Transportation Deregulation: An International Perspective, K. Button and D. Pitfield, eds., Macmillan, London, 1991.

[12] Pub.L. 96-448m 94 Stat. 1931 (Oct. 14, 1980).

[13] To successfully challenge a rate as unlawful, a shipper must essentially overcome three hurdles. First, the rate must exceed 180 percent of variable costs. Second, the ICC must determine that the railroad has no effective competition for the movement in question, *i.e.*, that it is market dominant. Third, the ICC must determine that the rate is unreasonable.

As discussed in more detail in Roberts, M.J., "Residual Railroad Rate Control: The Unmet Challenge of Deregulation," *Logistics and Transportation Review*, 23-1, (1987), the ICC initially adopted maximum coal rate guidelines in 1985[14] which introduced an approach of "constrained market pricing." These guidelines are predominantly market based, with the only long-term constraint on railroad rates being that they are not to exceed "stand-alone costs" of service.[15] Decisions in several rate cases indicate that the net effect of the post-Staggers maximum rate regulation has been to place limited restraint on the ability of railroads to raise rates. Indeed, rates have been rolled back by the ICC in only a handful of cases, for example, *Omaha Public Power District v. Burlington Northern Railroad Co.*, Finance Docket No. 38783 (Nov. 14, 1986); *Arkansas Power & Light Company, et al v. Burlington Northern Railroad Co., et al*, Finance Docket No. 36719 (May 7, 1987); and *Coal Trading Corporation, et al v. The Baltimore and Ohio Railroad Company, et al*, Finance Docket No. 38301S (Jan. 31, 1990).

Both the 4-R Act and the Staggers Act greatly liberalized the ICC criteria and procedures for rail abandonment. A 1994 ICC study revealed that the Commission now approves the vast majority of abandonment requests and that railroads are quite free to get rid of unwanted track. "In the period 1976 through 1993, the Commission received 2,228 separate abandonment proposals, covering a total of 42,114 miles of track. The commission granted 2,058 of these proposals, covering 32,214 miles; another 201 proposals (totaling

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[14] *See Ex Parte* No. 347, *Coal Rate Guidelines, Nationwide* (ICC decided May 23, 90).

[15] The stand-alone cost approach allows shippers to estimate the lowest rate at which a pothetical, efficient competitor would be adequately compensated. The shipper is allowed ncorporate both costs an' revenues of other traffic on the simulated system.

8,887 miles) were withdrawn or dismissed. In addition, 29 proposals (total 514 miles) were withdrawn because the railroad decided to sell the line instead. The Commission denied 69 proposals (totaling 2,600) miles) in that 18-year period." (p. 42) Study of Interstate Commerce Commission Regulatory Responsibilities, pursuant to Section 210(a) of the Trucking Industry Regulatory Reform Act of 1994, Interstate Commerce Commission, October 25, 1994. As of the time of the report, the ICC had only denied 31 abandonments totalling 1,095 miles since the Staggers Act.

The U.S. railroad industry has experienced a dramatic improvement in its financial condition since the Staggers Act.[16] My co-authors and I (Winston. Corsi, Grimm, and Evans; 1990) have conducted the most comprehensive study of the effects of both rail and truck deregulation, employing a counter-factual methodology.[17] In other words, rail profits, rates, revenues, costs and service levels in 1977 were compared with estimations of what values would have prevailed in 1977 had the industry been deregulated. Unlike historical comparisons of values over time, this methodology allows for control of non-deregulation impacts on railroads, such as inflation, the state of the economy, etc.

According to this study, the railroads reaped annual profit gains of $2.9 billion dollars per year (1988 dollars) from deregulation, with cost savings of over $3 billion dollars due to

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[16] As discussed above, the poor financial condition of the industry, punctuated by a number of rail bankruptcies provided the primary motivation for railroad deregulation. Indeed, by 1979, almost one-fourth of Class I rail mileage was in bankruptcy and from 1971-1980, railroad return on equity averaged less than 3 percent. MacDonald, M., "Rails Climb Back into the Ring," *Traffic Management*, December, 1993, pp. 40-41. Since the Staggers Act, not one major railroad has gone bankrupt and the financial condition of the industry has improved dramatically.

[17] Winston, Clifford, Thomas M. Corsi, Curtis M. Grimm, and Carol A. Evans, *The Economic Effects of Surface Freight Deregulation*, Brookings, Washington, D.C., 1990.

deregulation (pp. 15-41). This confirms that deregulation has resulted in substantial financial benefits to the railroads, with cost savings being the most prominent. Customers have also reaped substantial benefits from both rail and truck deregulation.

In sum, U.S. deregulation was intended to provide a greater reliance on free markets to promote railroad profitability and public benefits. Financial data and counter-factual studies support the notion that the Staggers Act has greatly contributed to a revitalization of the U.S. rail freight industry.

B. ICC Merger Policy in the post-Staggers Era

One of the essential premises underlying the deregulation of transportation, communications and other industries is that in the absence of price and entry regulation, these industries would be sufficiently competitive to generate improvements in allocative, technical and dynamic efficiency in each industry. However, competition must be preserved and promoted for this premise to be realized. As I stated in the conclusion of my article "Promoting Competition in the Railroad Industry: A Public Policy Analysis":

> The preceding analysis has demonstrated the importance of preserving and promoting competition. At stake are billions of dollars in economic benefits as well as perhaps the very success of rail regulatory reform.
>
> The implications are clear. rail intramodal competition must be encouraged in every relevant area . . . Competition should be preserved and promoted now, as undoing misguided actions will not be easy.

Grimm, C., "Promoting Competition in the Railroad Industry: A Public Policy Analysis," *Proceedings of the Transportation Research Forum*, 1984, pp. 222-227.

As discussed more fully in this article, competition has long been viewed as critical to the proper functioning of a free-market system. This view dates back at least to Adam

Smith's "The Wealth of Nations," published in 1776; the crux of Smith's *magnum opus* was that the "invisible hand" of competition ensures that pursuit of individual self-interest simultaneously promotes the public interest. Smith's insights have endured as the philosophical cornerstone of free-market economic systems.

More recently, R. M. Scherer, a leader in the field of industrial organization economics, has emphasized the importance of competition: "Competition has long been viewed as a force that leads to an optimal solution of the economic performance problem, just as monopoly has been condemned throughout recorded history for frustrating attainment of the competitive ideal." Scherer, R. M., *Industrial Market Structure and Economic Performance Chicago*, Rand-McNally, 1980, pp. 3-4.

The importance of competition in enhancing efficiency has been strongly supported by the ICC. For example, in the Norfolk Southern case, the Commission stated:

> Strong competition promotes efficiency. The thread running through our criteria governing rail consolidation proceedings is the goal of maximizing efficiency in the allocation of transportation resources. The spur of competition provides incentive for firms to minimize the cost involved in providing a given level of service, to provide good service and lower prices to customers, and to seek out innovation in all aspects of their operations. We encourage competition among railroads and between the various modes in order to maximize efficiency and consequently to obtain the best combination of price and service for the transportation consumer.[18]

Merger policy plays a vital role in the maintenance of competition. The Interstate Commerce Commission has authority regarding railroad mergers in the U.S. Modern authority dates back to the Transportation Act of 1940, which amended section 5(2) of the

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[18] *Norfolk Southern Corp.--Control--Norfolk and Western Rwy. Co. and Southern Rwy. Co.*, Finance Docket No. 29430, 366 I.C.C. 173, 216, (ICC decided March 19, 1982).

Interstate Commerce Act, which required the ICC to approve consolidations that furthered the public interest.

The 4-R and Staggers Acts, along with ICC administrative actions, encouraged end-to-end consolidations and set off a railroad merger wave. Indeed, it has been a conscious, explicit policy of the ICC to encourage end-to-end mergers but to discourage parallel mergers:

> [A]s the Commission warned over five years ago in its Merger Policy Statement, parallel mergers are not favored where there are no other competing railroads. See *Merger Policy Statement*, 363 I.C.C. 784, 791 (1981). The burden of demonstrating that such a merger is in the public interest is a heavy one, and must be borne on the shoulders of substantial evidence.

SFSP, 2 I.C.C. 2d at 833 (1986). As a result, the U.S. railroad system has gone through a major restructuring in the early 1980s, leaving three large systems dominant in the East and four major roads dominant in the West. It is critical to note that the major consolidations since Staggers have been primarily end-to-end.[19] The ICC denied the largely parallel *SFSP* proposed consolidation in the mid 1980s. Recently, the consolidation of the Burlington Northern and Santa Fe, primarily an end-to-end merger, reduced the number of dominant Western railroads to three. Figure 2.1 provides a comparison of 2-to-1 competitive impacts

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[19] See comments for 10 maps of major mergers in the 1980's and 1990's which graphically illustrate the end-to-end nature of post-Staggers mergers. The UP/MKT merger did contain parallel elements, but the parallel elements involved low traffic volume, and resulted in three or four competing railroads after the merger. However, most affected markets had three or four competing railroads after the merger. The Wisconsin Central merger also had parallel elements within Wisconsin.

Figure 2.1

UP/SP and Other Rail Mergers
Competitive Impact Comparison
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across these three mergers.[20] The comparison shows clearly that the competitive harms of the UP/SP merger dwarf those of the BN/SF consolidation.

The ICC now is at a critical juncture with regard to preserving rail competition. The proposed Union Pacific-Southern Pacific merger has unprecedented parallel effects and will result in elimination of rail competition in many Western markets. In conjunction with the BN-Santa Fe merger, where competition remains in the West, the BN-Santa Fe and UP-SP will dominate the entire West. Additionally, the ICC may well be faced with a parallel merger proposal involving the three dominant Eastern carriers and then eventually East and West railroads, potentially leaving only two major railroads in the entire U.S. Importantly, if the Commission fails to act and rail competition is further reduced, much more aggressive action will be needed in the long run to provide the needed competition for rail shippers. The Canadian model provides one such example of what this might entail.[21]

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[20] The 2-1 competitive impacts of the BN/SF merger were calculated using precisely the same methodology as for the UP/SP and *SFSP*, based on the same 1994 data. It could be argued that the 2-1 impact of the BN/SF and UP/SP mergers were partially ameliorated by various settlements and conditions. The calculations provided in Figure 2.1 do not attempt to estimate the impacts of such conditions. Of course, the extent to which the UP/SP settlement with BN/SF actually ameliorates the 2-1 competitive harm of the UP/SP merger is a sharply contested issue in this case.

[21] The 1987 National Transportation Act included several provisions to increase rail intramodal competition, in particular for shippers captive to a single railroad. Most importantly, the Canadian interswitching legislation promotes such competitive access in a more vigorous manner than U.S. reciprocal switching legislation. Such access is provided to shippers primarily within an urban area through rates set by government fiat. Dating back to 1908, interswitching was required within distances of four miles. In other words, assume a coal mine has physical access to only one railroad (Railroad A), but is located within four miles of a second railroad (Railroad B). The coal mine can arrange to ship its coal with Railroad B, with Railroad A required to move the coal from the mine to the junction with Railroad B at prescribed rates. The 1987 legislation extended this to 30 kilometers and also provided the National Transportation Agency to set compensatory rates for such interswitching, to be adjusted annually. Shippers outside this limit who compete with

(continued...)

We now turn to an analysis of the competitive effects of the instant transaction. Many shippers will be faced with a significant reduction of competition, and subsequent sections of this statement will provide details of these impacts.

III. THE BASIC APPROACH TO THIS MERGER AND DEFINITION OF THE RELEVANT GEOGRAPHIC MARKET

We note at the outset two aspects of competitive analysis provided by the Applicants with which we take issue. First, as long enunciated by the ICC, there is a difference between an impact on a competitor and an impact on competition.[22] *Rio Grande Industries, Inc., -- Purchase and Trackage Rights -- Chicago, Missouri & Western Railway Company and Line Between St. Louis, MO, and Chicago, IL*, 5 I.C.C. 2d 952, 1989 ICC LEXIS 284 at *33 (1989) ("In contrast, a showing of expected substantial harm to a particular competitor as result of a transaction is not equivalent to a showing of harm to competition"); *Blackstone Capital Partners L.P. -- Control Exemption -- CNW Corporation and Chicago and North Western Transportation Company*, 5 I.C.C.2d 1015, 1019-20 (1989) (harm to a particular carrier is not equivalent to harm to competition). Indeed, Applicants' Witness Barber echoed strong support for this notion in his deposition:

Q. What about revenue diversion from Kansas City Southern?

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[21](...continued)
shippers within the 30 kilometers limit can apply to be deemed within the limit. According to the National Transport Agency of Canada (1992), Canadian National and Canadian Pacific currently interswitch between 130,000 and 140,000 cars annually, with half that volume outside the previous four mile limit. According to the National Transportation Act Review Commission (1992), the percentage of shippers having access to two or more railroads has increased from 54 to 80 percent because of the extension of the interswitching limit.

[22] A negative impact on a competitor may raise a legitimate essential services issues.

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A. Well, as a result of increased competition, there will be -- can be expected to be some diversion from KCS . . . . I've noted that in my testimony, but that has not anything to do with competitive harm. The emphasis in the law is the effect on competition with the emphasis upon the last three letters, i-o-n. And as I see it competition here is strengthened, not impaired . . .

* * * *

Q. What about the effect on the carrier that may be losing revenue . . . You don't see it as a harm to competition?

A. No, not under the conditions that I've described here. The two-to-one points are covered, I see no reduction in competition in other areas or in routes, and competition, therefore, is not harmed. I've also as I indicate in here noted that other railroads in my judgment, even if they might lose some revenue, and some might, that they're not entitled to any protection against some imagined harm to competition which doesn't exist . . . .

* * * *

Q. There is a harm to KCS, is there not?

A. I don't know what you mean by the word harm.

Q. An effect.

A. Well, but again it's an effect as a result of strengthened competition and of no impairment to competition. All that you're telling me is that a competitor as a result of strengthened competition, unimpaired competition, may lose some revenue. But that is not harm in a competitive economy and it's not harm within the thrust of consolidation, competitive concerns.

(Barber Deposition at 45-47).

While these statements were made with regard to a competitor weakened by a merger, they hold in equal force with regard to a competitor strengthened by a merger. Much of the Applicants' case entails arguments that UP will be strengthened by the merger, and that the merger is thereby "pro-competitive." Many witnesses, including this one, raise serious questions with regard to both the degree to which UP and SP need strengthening as competitors and the degree to which this merger provides such strengthening. Given Mr.

Barber's statement, it is curious that Applicants are now claiming that the STB should approve this transaction in order to save SP from financial weakness and in doing so strengthen UP. Regardless of how the STB ultimately comes down on these issues, the impact on the Applicants, as competitors, has no more of a legitimate role in the analysis of the consolidation's impact on competition than does the impact on competitors.

Second, we would caution against an assessment of competitive harms based on "popularity" indicators, such as the number of shipper statements filed in support of this transaction shippers. I would urge, instead, an analysis based on a careful examination of the data. In particular, the STB must recognize the disincentive for shippers to come forth in merger cases, even if they believed that anticompetitive effects might result. In this era of close relationships between shippers and carriers, a shipper risks alienating a railroad by publicly opposing a rail merger. A shipper in such an instance must weigh the negative effects of speaking out (loss of leverage, disruption of working relationships, and possible retaliation[23]) against the positive effects of speaking in favor of the consolidation. Shippers may face significant harms from the transaction, but still judge from a self-interested perspective that the benefits of speaking out in favor are greater than the consequences. There is a strong incentive to come out in support of a merger; a shipper may gain explicitly or implicitly by cooperation with the railroad which serves it. In any event, the effects on

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[23] This concern is not theoretical. In a March 4, 1996 letter to ALJ Jerome Nelson expressing concern over disclosing shipper contracts with the U.S. Department of Justice,the DOJ pointed out that: "[m]any individuals contacted by the Department in connection with this proceeding have expressed concern about the confidentiality of their communications with us, and some have stated that they feared retaliation for discussing their concerns about the proposed transactions with the Department." (Vol. III, Highly Confidential Appendix, pp.1067-69.)

competition should not be judged by the numbers game, *i.e.*, "I have more shipper statements than you, therefore, I win."

In particular, it should be recognized that there is a strong disincentive for shippers to come forth against a merger of companies if they will in the future be captive to the merged company. Because of the shipper- and movement-specific way that rail rates are set, leverage in negotiations is critical. A shipper who candidly explains why truck and source competition would be inadequate defenses for it against a rail monopolist risks -- indeed invites -- higher rates if the merger is ultimately approved without conditions. Otherwise stated, shippers who do complain should be taken as representative beyond their numbers. In summary, we must examine the shipper statements very carefully, with an eye towards the asymmetrical incentives which exist to participate for and against the merger. In many respects, the traffic data, the empirical evidence from shippers, and the findings of the economic literature, are more probative than shipper statements in support of the merger.

A. A Topology of 2-to-1 Shippers

In addressing competitive effects in this merger, a starting point is that there is no one ideal, perfect way to do so. We can get useful information on competitive harms from many different approaches, perspectives and data sources which, when combined, allows judgment as to the magnitude of impacts. We can use aggregations of data of different types, combined with shipper testimony, theory, statistical analyses, and the like.

It is useful to construct a topology of shippers affected by the consolidation. We will examine competitive impacts with a starting point of BEA-BEA market definition, utilizing longstanding precedents of the ICC and DOJ. Such an approach includes, appropriately, shippers who are impacted beyond the narrow definition of competitive harms by Applicants.

In order to understand why the use of the BEA is the appropriate starting point for defining the relevant geographic market, it is useful to examine the numerous ways in which shippers within a BEA benefit from having UP and SP serve that BEA.

Type 1 – "2-to-1" shippers according to Applicants' definition where there is a corresponding reduction in competitive alternatives.

Applicants negotiated an agreement with the BNSF in order to provide BNSF access to those geographic points that would see a reduction, absent the agreement, from two carriers (UP and SP) down to one carrier (the merged UPSP). The key word used by Applicants for determining what shippers received access to BNSF is the word "points." In other words, the definition of the appropriate "geographic market" used by Applicants for purposes of determining what shippers are "2 to 1 shippers" focused only on those shippers located at a point which prior to the merger were physically served only by UP and SP. See App. Vol. II, V.S. Peterson at 14-20; App. Vol. I, V.S. Rebensdorf at 296-298.

All of the "2 to 1" shippers, as defined by Applicants, involved shippers at points who were physically served by UP and SP and no other carrier. For the vast majority of these shippers, they were exclusively served by either UP or SP, but were open to the other Applicant carrier, and only the other Applicant carrier, via reciprocal switching. Very few such shippers had direct access to both UP and SP. See App. Vol. II, V.S. Peterson at 72.[24]

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[24] Applicants also considered a shipper located on a shortline a "2 to 1" shipper if the shortline was able to connect with both UP and SP and no other railroad. V.S. Rebensdorf at 297. But see Comments and Request for conditions of Yolo Shortline Railroad Company (while we share trackage rights in UP's West Sacramento railyard with SP, . . . UP does not permit interchange directly with SP. . .. UP has carefully arranged that our traffic will be interchanged solely with UP, . . . coupled with the hostile relationship between SP and UP, this has impeded our ability to arrange and provide our customers economic transportation (continued...)

Figure 3.1 illustrates a 2-to-1 shipper according to the definition provided by the Applicants. Industrial Site #1 would be a 2-to-1 shipper according to this definition; the shipper is served by both UP and SP, either with a physical connection or through reciprocal switching. These 2-to-1 shippers, as defined by the Applicants, are indeed one important class of affected shippers.

It is useful to carefully analyze the Applicants' *de facto* assessment of competitive harms, which we will do in more detail in the subsequent section. However, Applicants have acknowledged that 2-to-1 shippers, as defined by them, represent slightly more than $1 Billion in annual revenues. App. Vol. I, at 20; V.S. Peterson at 15. To resolve these admitted harms, Applicants have proposed an extensive set of trackage rights be granted to BNSF.

Type 2 -- Shippers who have physical access to either UP or SP, but are located in proximity to the other.

Referring to Figure 3.2, Industrial Site #2 is served by only UP, but SP is located in the vicinity. According to the Applicants, Site #2 is not a 2-to-1 shipper and would not suffer any competitive harms from the consolidation. However, there are many ways a shipper in the position of Industrial Site #2 could gain value from the presence of an

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[24](...continued)
for numerous shipments) March 22, 1996. In addition, if there were an actual build-out project begun, as opposed to a theoretical or threatened build-out, Applicants considered the shipper a 2 to 1 shipper. Under Applicants limited definition, only two locations fit the build-out criteria so as to justify access to BNSF, Baytown and Mont Belvieu. Yet, discovery has exposed that internally, prior to the merger, UP considered several other points to be potential build in opportunities (*See*, Peterson Deposition, p. 83-84;

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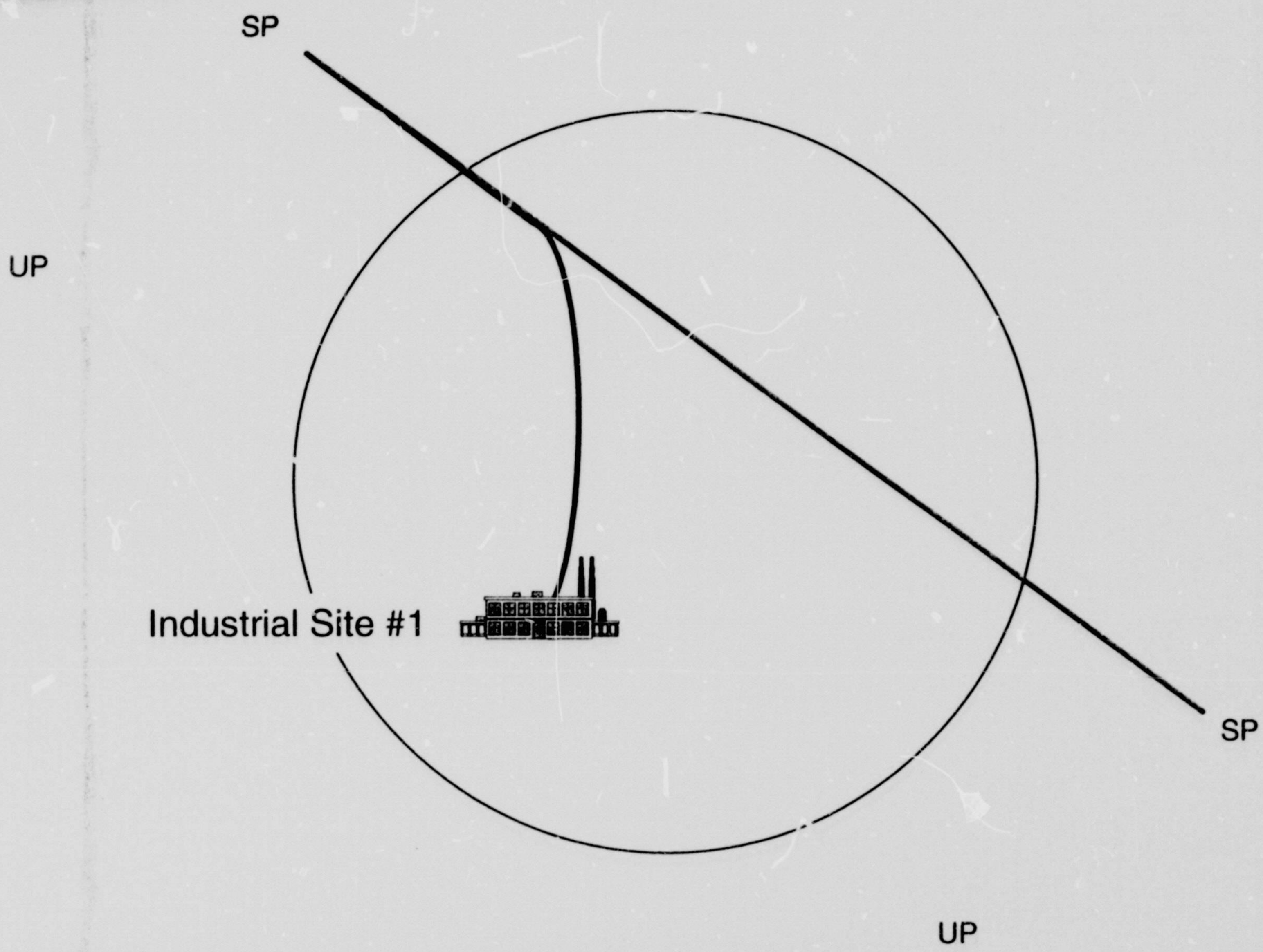
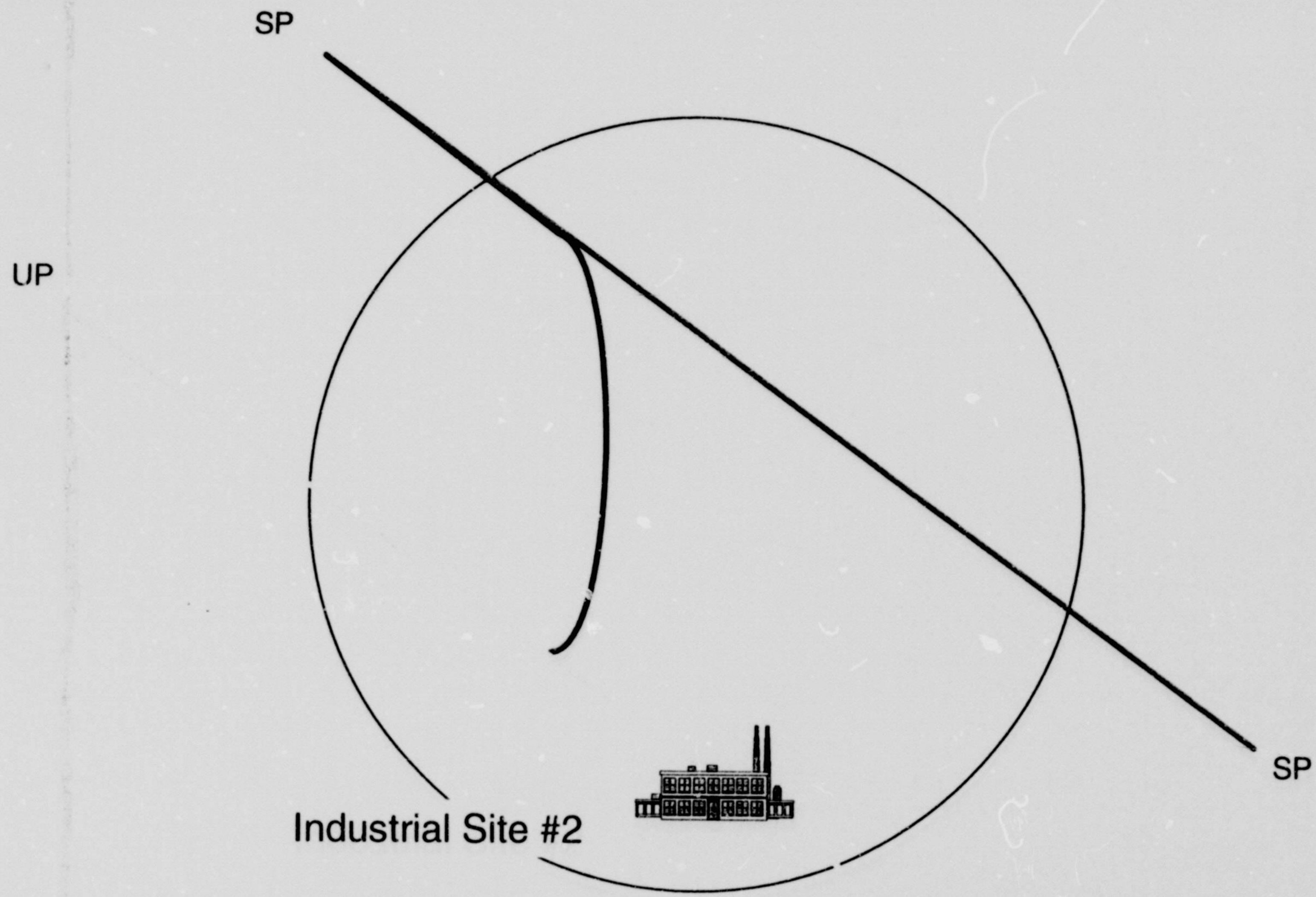


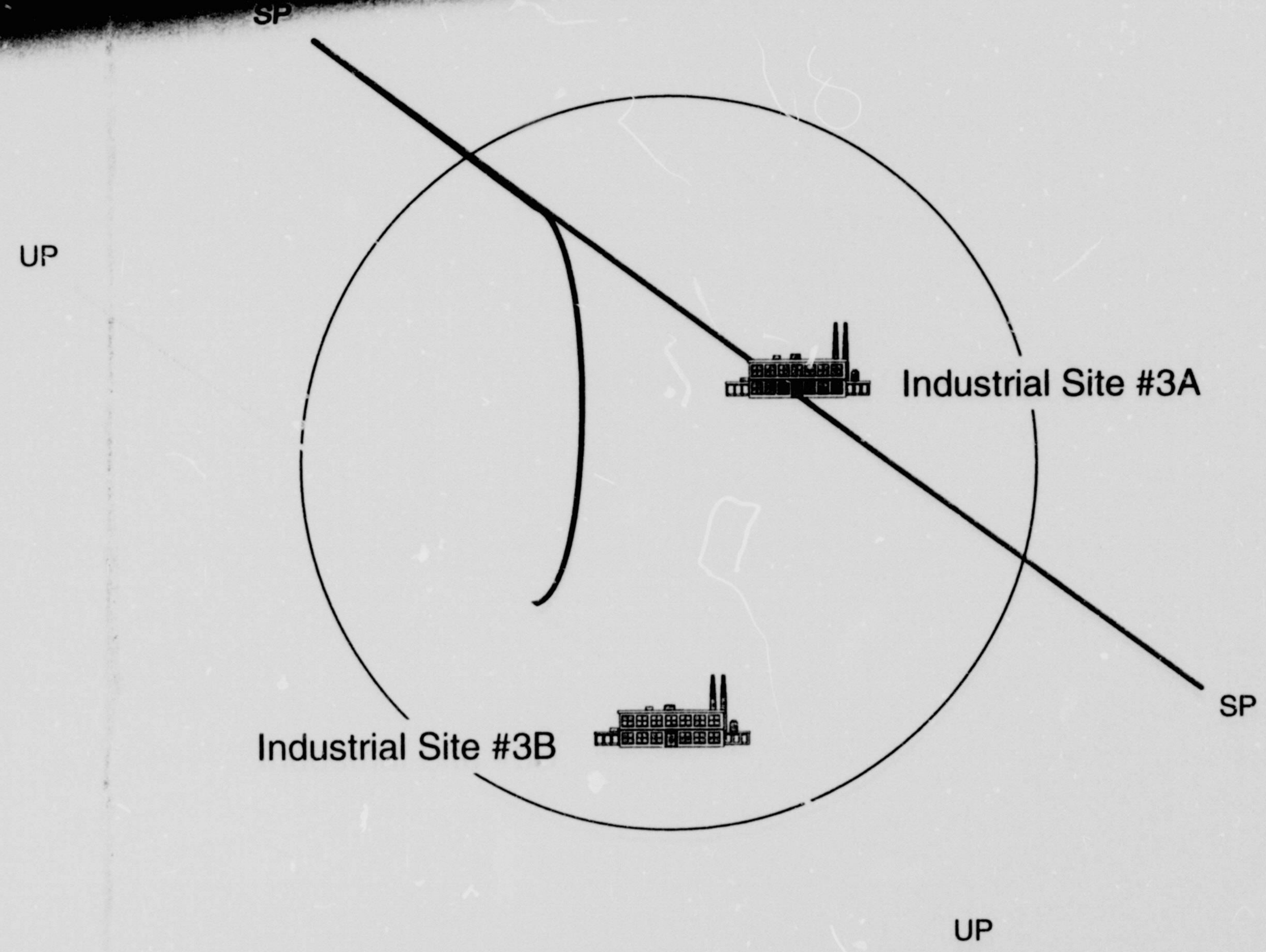
UP-SP Defined 2-to-1 Shipper



Shipper has physical access to only one applicant but is in proximity to the other.

independent UP and SP. This shipper benefits from UP/SP competition in at least the following ways:

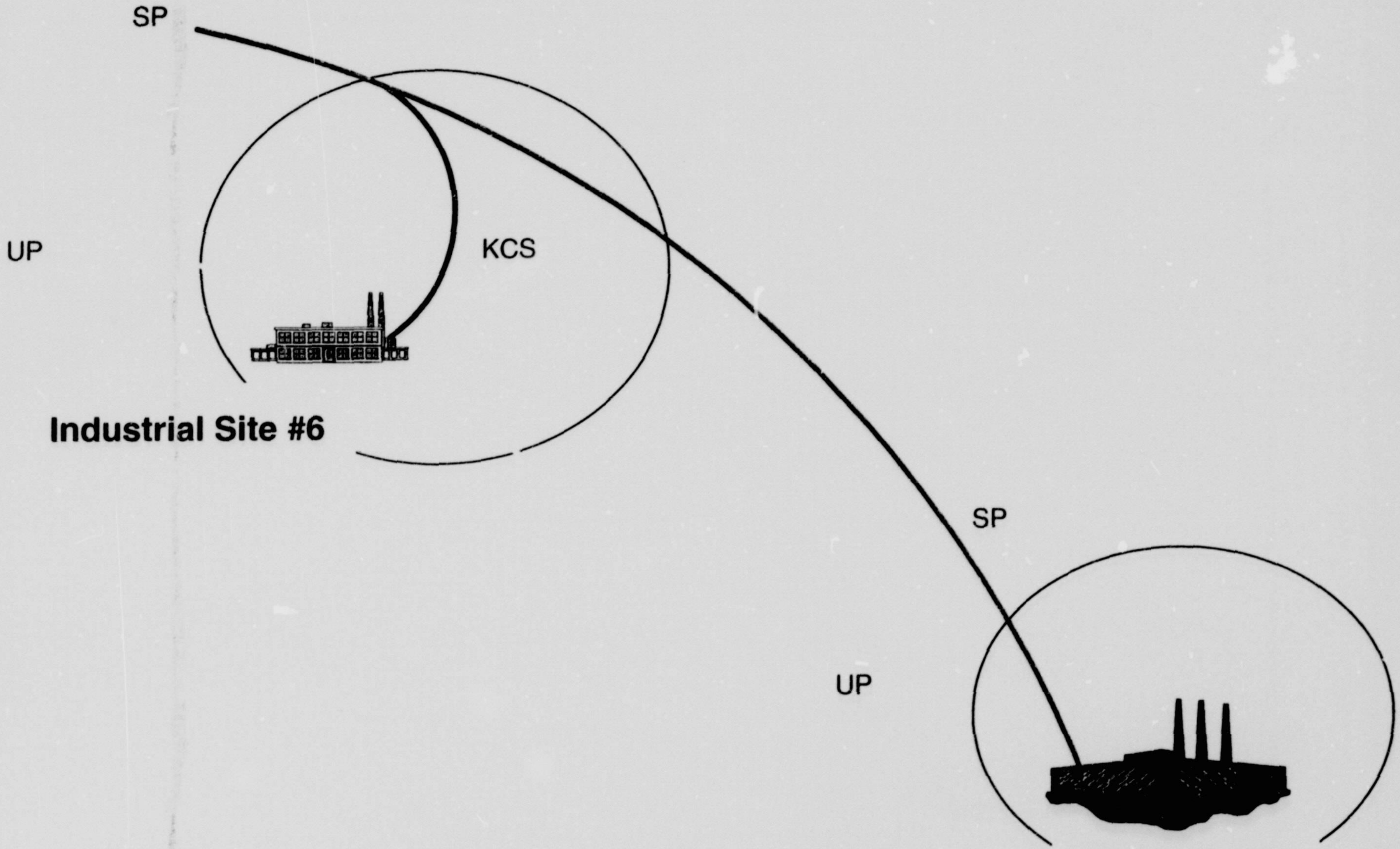
- Industrial Site #2 can transload by truck to SP, or threaten (tacitly or explicitly) to do so and use this threat to gain a reduced contract rate. The Applicants, especially Witness Petersen, describe in detail rail competition of this nature with regard to soda ash. App., Vol. I, V.S. Peterson at 249-253.
- Industrial Site #2 can shorthaul UP, or threaten to do so and use this threat to gain a reduced contract rate. This may involve ICC action to limit the rate charged by UP in such an instance.
- Industrial Site #2 can build out a spur line to connect with SP, or threaten (tacitly or explicitly) to do so and use this threat to gain a reduced contract rate. A variant of this occurs when plant expansion are required to handle increasing volumes.
- Industrial Site #2 can relocate plant/facility to SP's line upon receiving a more favorable contract rate, or threaten to do so, and use this threat to gain a reduced contract rate.
- Industrial Site #3 has "captive" plants located on both railroads, as depicted in Figure 3.3. Relative production levels across the two plants are determined in part by rail rates to each plant. Thus, UP and SP will compete with regard to this shipper's traffic.
- Industrial Site #4 competes in the product market with Industrial Site #5, as depicted in Figure 3.4. This product market competition will result in "upstream" competition between UP and SP.



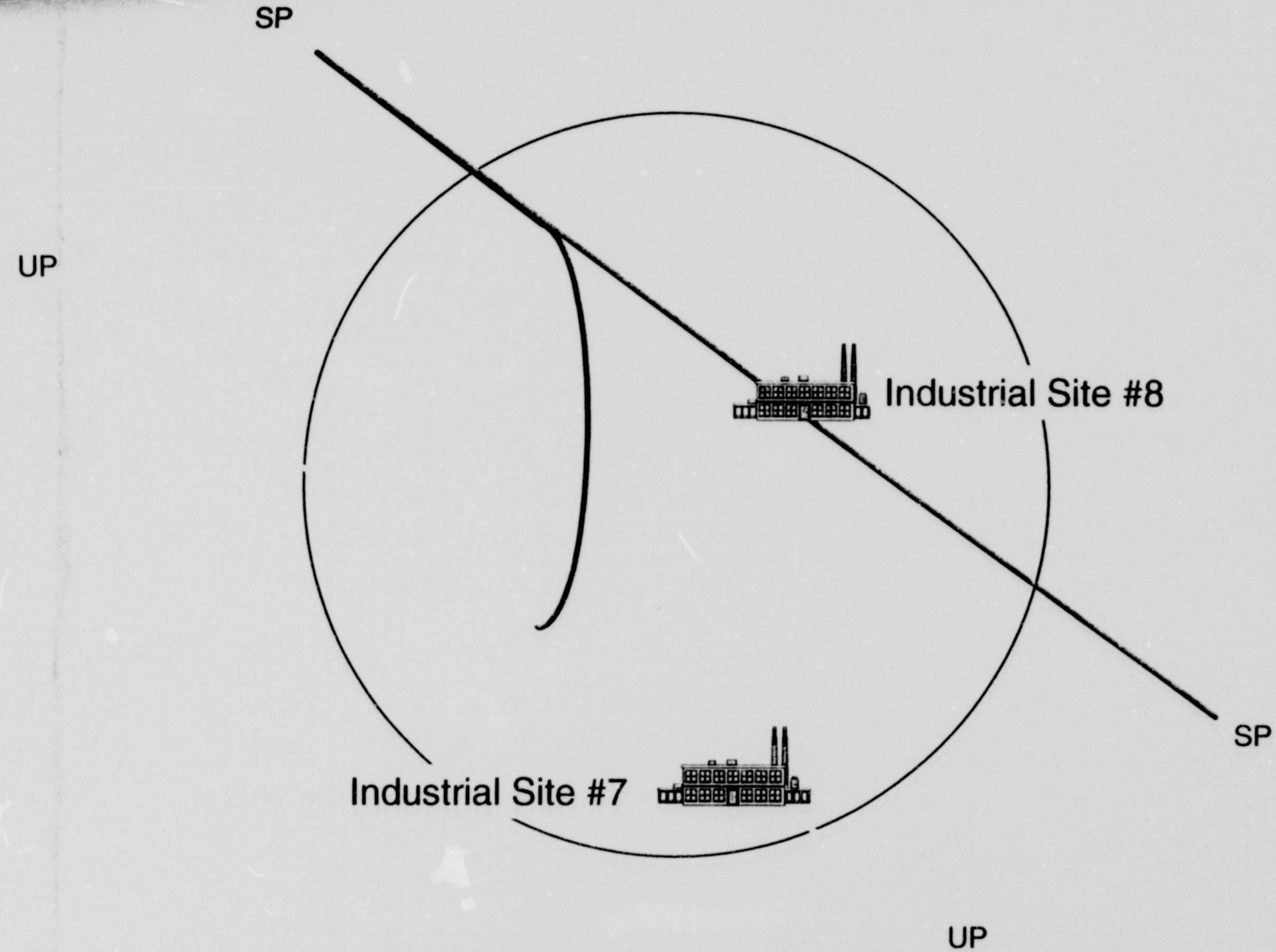
Shipper has captive plants on both UP and SP lines.

Shippers served by different railroads competing in same product market.

Figure



Shipper not considered 2-to-1 by applicants.



Shipper benefits from ex ante site location competition.

- Industrial Site #6 is served by both UP and KCS, but has a UP single-line and KCS-SP interline routing option. See Figure 3.5. The merger eliminates this shipper's independent alternatives, but such a shipper is not counted as a "2-to-1" shipper by Applicants.
- Following a UP/SP merger, a shipper wishes to locate a plant in the area. With reference to Figure 3.6, the shipper faces a choice between Industrial Site #7 and Industrial Site #8. Prior to the merger, the shipper would have received the benefits from UP and SP ex ante site location competition; the choice of a site would not be finalized until a long-term contract with one of the railroads was locked in.
- Shippers, especially large shippers with multiple plant locations served by several railroads, can use the concept of "package bidding" where these shippers will put out for bid their entire rail transportation needs for a certain period of time and then select one carrier to provide those needs. Where UP and SP currently compete in such package bidding situations, this competition will be lost as a result of the merger.

Two notes are in order. First, we are not implying that every shipper can benefit from every one of the types of competition as indicated above, or that such competition is always as strong as UP/SP's with regard to Industrial Site #1, in Figure 3.1. However, as is established through discovery, depositions, and the verified statements of Mr. Shade May, Mr. William Ploth, Mr. Lynn Turner, and Ms. Patteye Simpson submitted with this filing, it is very common for railroads to compete in the manner described above.[25] A large numbers of shippers will lose this competition as a result of the merger, and because such shippers are not benefiting from direct UP/SP competition at 2 to 1 points, as defined by Applicants, these shippers will not receive access to BNSF under the trackage rights agreement.

Second, to the extent that Applicants have included some shippers currently transloading, or actually committed to build-out, in their definition of 2-to-1 shippers so as to qualify for BN access, this fails to address the competitive impact on many other shippers who benefit from the threat (explicit or implicit) of transloading or building out or who may be able to pursue this option in the future.[26]

Because such forms of competition are important in determining whether the relevant geographic market should be points or broader geographic markets, I will discuss each form of competition and provide specific examples where UP and SP shippers are benefiting from these forms of competition.[27] As a result, such UP and SP shippers will lose these options

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[25] The evidence on which I relied in conducting my analysis and which was obtained through discovery is contained within the Highly Confidential Appendix filed by KCS in this proceeding.

[26] One such company, Escalation, Inc. runs an annual shipper seminar where part of the program is to introduce shippers to such strategies. *See* Verified Statement of Mr. Shade May, Vice-President, Escalation, Inc.

[27] As I explain later, I chose to use BEA to BEA pairs as the relevant geographic market. This approach has broad support in both Commission decisions and the academic literature. *SFSP*, 2 I.C.C. 2d at 768 ("[T]he following BEA data conclusively show applicants' dominance of the Southern Corridor for traffic moving to and from the Los Angeles BEA"). Indeed, UP itself, in the *SFSP* case, also used rail market shares between specific BEA areas to establish that a merger of the Santa Fe with the Southern Pacific would be anticompetitive. *SFSP*, 2 I.C.C. 2d at 767, 769-770. Support and validation of the use of BEA's as a unit of measure is also found in a study performed for BN/SF by the

(continued...)

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after the merger, and because the BNSF trackage rights agreement only covers certain 2-to-1 points, such shippers will not have access to BNSF, let alone a third carrier, following the merger.

1. Industrial Site #2 can transload by truck to SP, or threaten (tacitly or explicitly) to do so, and use this threat to gain a reduced contract rate.

Many shippers may be exclusively served by either UP or SP but nonetheless have the other carrier nearby. In such situations, a shipper can threaten to transload from its plant, which is "captive" to one carrier, to the competing carrier nearby. By transloading, I mean the ability for that "captive" shipper to truck its product from its plant location (located on the UP in the Figure) and then reload that product for rail shipment on the competing carrier, in this instance, SP. Such "transloading" is effective even for bulk commodities that depend upon rail movements for long-distance travel because the truck portion of the move is usually confined within the BEA and is not used for BEA to BEA moves.

Applicants themselves recognize that shippers benefit from the ability of a shipper to transload from UP to SP, or vice versa. The Application is replete with such transloading references.

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[27](...continued)

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The evidentiary record is also replete with such transloading examples. HC37-400032

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Despite acknowledging that such transloading occurs between UP and SP shippers, Applicants did not specifically include such shippers as 2 to 1 points.[28] Instead, at those 2 to 1 points that are currently directly served by UP and SP only (either because there is a

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[28] Rebensdorf Deposition at 442.

Q. Now, would such a shipper, if one existed hypothetically because you don't have personal knowledge of it, be covered by the agreement or not be covered by the agreement?
A. A shipper who --
Q. Who is served directly only by either UP or SP but which has the capability to truck. Other than the soda ash shipper that you testified about, would that shipper hypothetically be covered by the agreement with BN/SF?
A. No.

Witness Barber, however, appears to dispute this and testifies that the settlement covers this precise example. Barber Deposition at 71-72.

physical connection to the industrial site or the industrial site is open to reciprocal switching), and thus giving BNSF access, Applicants claim that BNSF can put in (i.e., invest in) transload facilities at those points to serve new shippers. (Peterson Deposition at 222). Thus, only after making an investment in transloading facilities, will BNSF be able to provide a competitive option to shippers who previously had an option from UP or SP. (Peterson Deposition at 222).

Other than this narrow statement by Mr. Peterson and the irreconcilable Statements of Rebensdorf and Barber, there is no analysis to back up this claim. Thus, for example, in Figure 3.2, as there is no 2 to 1 point shipper as defined by Applicants, there is no shipper who received access to BNSF. Accordingly, those shippers in the position of Industrial Site #2 who transloaded, or could transload, to the SP line will lose the ability to do so after the merger.[29] Curiously, Applicants rely on such examples of transloading to establish the point that extensive competition will exist after the merger to restrain UPSP's prices, but when it comes to determining whether such UP and SP shippers will be competitively harmed, such as Industrial Site #2 shippers, 2 to 1 transloading shippers received no protection.

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[29] *See* Peterson Deposition at 935-936

> We have a Sierra Pacific lumber mill at say Quincy, California. And they can currently truck 50 miles over [to] the SP main line. Quincy is exclusively served by SP. The point that they would truck to on the SP would be exclusively served by SP. I don't think we would think that it's fair to make either of those two points a two-to-one point.

2. Industrial Site #2 can short haul UP, or threaten to do so and use this threat to gain a reduced contract rate. This may involve ICC action to limit the rate charged by UP in such an instance.

Chemical shippers in the Houston market area served by one carrier often use this ability to move carload traffic on local mileage scale rates to the agent of another local carrier and then rebill that shipment on a new "Bill of Lading" to competitively served destinations using the second carrier's lower rate. The threat of this process serves as a competitive tool to keep the rates of the exclusively served carrier at competitive levels. V.S. Simpson and Turner at 95-96; HC20-200004

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As another specific example of this process, Hoechst Celanese (HC) was "captive" to the SP at its Bayport, TX High Density Polyethylene (HDPE) plant which produced approximately 350 million pounds of HDPE per year. Upon the renewal date of the existing contract a new contract was offered by SP which:

- substantially increased the rate by reducing the car allowance:
- required an increase in the volume requirement from a percentage of freight shipped by rail to a percentage of production; and,
- eliminated HC's option to use the Illinois Central Railroad as a bridge carrier for east bound freight via Chicago, IL.

HC responded by utilizing a local rate to move cars from its plant to the BN yard in the Houston area and re-routing the majority of the traffic onto the BN, thereby short hauling SP. As a result, SP:

i. terminated a separate contract with HC governing local service and offered a new contract at double the existing rates. The local service contract was relied upon to service in-state customers;

ii. increased HC's rates again by cancelling the switching allowance contract which provided an allowance to HC for providing its own in-plant switching; and

iii. restricted its local joint tariff rates in an attempt to prevent HC from moving its freight on the BN, or at least to recoup a substantial part of its long-haul revenues from the local move.

HC responded by installing a bulk trucking operation and delivering the product to the BN by truck where it was transloaded into railcars, again short hauling SP. It is interesting that having another carrier 26 miles away was not recognized by SP as competition until HC went to great means to make it happen. *See* V.S. Shaderick May at 10[illegible]07.

This example again shows that many shippers served by only one carrier have the ability to bring a nearby competing railroad into play when the situation warrants. The proximity of another railroad affects rates. Should the UP/SP merger be approved, the ability to short haul from UP to SP and vice versa will be lost to many current and future shippers.

3. Industrial Site #2 can build out a spur line to connect with SP, or threaten (tacitly or explicitly) to do so and use this threat to gain a reduced contract rate.

The Commission has a well established policy of imposing some form of a condition on a proposed merger in order to prevent competitive harm caused by the merger of two railroads where one of those railroads served a plant and the shipper had a build-in option to the other railroad. *BNSF*, slip op. at 68, 98. In Applicants' opinion, there were only 2 such 2 to 1 points that qualified for access by BNSF, Baytown and Mont Belvieu, Texas (and that involved UP building in to SP served shippers. Applicants admit the existence of other build-out options, but claim they did not consider such other locations as 2 to 1 points, (Peterson Deposition at 325-327),

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UP and SP are not appropriate arbiters to decide what build-in or build-out situations should be given access to another carrier. Nonetheless, the evidence, at least to the extent it has been provided, establishes there are many more situations that should qualify as build-in, build-out points and buttresses my opinion that Applicants market definition is too narrow.

REDACTED This study is contained in the Vol. III, Highly Confidential Appendix, pp.24-34. While UP claims that only two projects were deemed worthy, Mont Belvieu and Baytown, *see* March 8 Letter from Arvid E. Roach to Alan E. Lubel, Vol. III, Highly Confidential Appendix, 24.1-24.4, the evidence indicates

HC13-000785-000790. There is also evidence of other potential build-in situations. HC42-000087-000088

HC48-001053 REDACTED

HC41-006620

(MP)).

Along this line, and somewhat disingenuously, Witness Barber testified all that is required is an "imminent possibility" of a build-in, that not "one shovel of dirt" had to be moved, that no application to the Commission had to be filed, that the possibility of a build-in" could have an effect on rates was all that was required for that shipper, like those at Mont Belview, to be considered at 2-to-1 shipper. (Barber deposition at 64-68)

This evidence of a wide number of build-out situations and the Commission's policy of providing conditions for build-in and build-out situations confirms my opinion that the BEA should be the proper geographic market. To choose a narrower definition, such as a point, ignores completely the ability of shippers to build-in or build-out or to threaten such build-ins and build-outs.

> 4. Industrial Site #2, Figure 3.2, can relocate plant/facility to SP's line upon receiving a more favorable contract rate, or threaten to do so, and use this threat to gain a reduced contract rate.

Obviously, the ability to relocate your plant or facility from the UP line to the SP line is an expensive means of achieving competitive rail rates. Regardless, the evidence establishes that shippers do in fact use this threat in their rate negotiations. HC09-019685

HC49-000315

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HC39-301687-301688; HC39-302153-302155

If UP and SP merge, a shipper located on the UP who was able to leverage its rail rates downward as a result of the ability to relocate its plants to the SP line will lose this form of indirect UP and SP competition. Once again, the best way to capture this form of competition is to use a BEA as the proper geographic market.

5. Industrial Site #3 has "captive" plants located on both railroads, as depicted in Figure 3.3. Relative production levels across the two plants are determined in part by rail rates to each plant. Thus, UP and SP will compete with regard to this shipper's traffic.

For example, one of the chemical shippers in Louisiana has separate plant facilities on the rail lines of both UP and SP. The shipper's facilities are separated geographically by 15 miles. Even though the shippers' plants were not served directly by both UP and SP, this shipper nonetheless enjoyed competitive rate levels from both UP and SP because of its ability to shift and reschedule production between its manufacturing facilities, depending upon each carrier's recognition of these competitive factors. V.S. Simpson and Turner, at 96.

Evidence gathered in discovery also confirms this as a legitimate form of competition. HC37-400027

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; HC48-000282

To avoid producing shipper files (which Applicants claimed would be to burdensome) Applicants stipulated to the following:

> Shippers on a line of one railroad often seek improved service or lower rates based on the fact that another railroad provides an alternative means of transportation or represents an alternative carrier for the shipper. Such service and price competition occurs with respect to shippers served by both SP and UP, and even instances where such shippers have multiple plant locations that may or may not have physical access to both UP and SP. Such service and price competition occurs with respect to many commodities and most major transportation corridors, including corridors where UP and SP have parallel lines.

Stipulation to KCS Interrogatory No. 22, Discovery Conference, January 28, 1996.

As a slight variation of this form of competition, a shipper who may be exclusively served by SP at one location but nonetheless has a plant at another location which has access to both UP and SP will be able to request a lower rate at its exclusively served location to match the rate at the location that has two carrier direct competition. For example, in at least one case, a plastic producer has a plant at Mt. Belvieu, Texas exclusively served by SP and another plant at Baytown, Texas served by both UP and SP which produced the same commodity. SP would package rate offers, considering tonnages from both facilities and propose rebate allowances from its exclusively served location when annual volume from the location served by UP and SP reached predetermined annual volume levels. This tactic insured participation from the jointly served location, sometimes to the exclusion of UP. V.S. Simpson and Turner at 98.

Despite the discovery evidence and this stipulation, because neither of the shipper's plants had actual direct UP and SP competition, as defined by Applicants, Applicants would not consider such plants as 2 to 1 points, although it is clear that such shippers do benefit from UP and SP competition within the same BEA.

> 6. Industrial Site #4 competes in the product market with Industrial Site #5, as depicted in Figure 3.4. This product market competition will result in "upstream" competition between UP and SP.[30]

This phenomenon is confirmed by the discovery evidence that was produced. HC50-100521

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HC08-001063

001186

[30] I do not argue that such product competition will be a perfect substitute for service by two railroads, or that competition in the product markets will result in perfect competition between the two railroads.

, HC40-001875 HC41-

003674-003677

HC45-001747

HC48-000282

HC08-001044 **REDACTED**

HC40-003655

HC09-018058

Whether such competition is properly called "product market" competition, or from the receivers' perspective, "source" competition, such forms of competition will serve to constrain UP's and SP's rates before the merger, but after the merger, such shippers will no longer have this ability to "play such UP shippers off against the SP shippers" and vice-a-versa.

> 7. Industrial Site #6 is served by both UP and KCS, but has a UP single-line and KCS-SP interline routing option. See Figure 3.5. The merger eliminates this shipper's independent alternatives, but such a shipper is not counted as a "2-to-1" shipper by Applicants.

For example, Montel Plastics's plant located at West Lake Charles has access to SP and KCS. Currently, Montel ships its product from its West Lake Charles plant to New Orleans. It has two independent rail routings prior to the merger: (1) it can ship either KCS to DeQuincy, LA where KCS interchanges the traffic with UP, which takes the traffic to New Orleans; or (2) it can ship the traffic SP single-line from the plant to New Orleans. After the merger, because UP and SP will be merged, there will no longer be two independent rail route alternatives, as UPSP would be in either movement and would thus serve as a "bottleneck" carrier. *See* MP-1, the filing of Montel Plastics for a complete discussion of Montel's competitive situation.

International Paper ("IP") also has three plants similar to the Montel Plastics situation. IP's plants at Bayou Pierre, LA, Texarkana, TX, and Pineville, LA, are all served, either directly or via reciprocal switching, by both KCS and UP. For all three of these plants, KCS interchanges the traffic with SP in order to provide an independent rail route alternative to the UP single-line route. Obviously, after the merger, as with Montel, UPSP will be in either movement and would thus serve as a "bottleneck" carrier. For a detailed discussion of IP's competitive situation, *See* IP's Comments filed on March 29, 1996.

Applicants did not consider plants, such as the Montel Plastics' Lake Charles Plant and the IP plants, as a "2 to 1 point" because of the presence of KCS. However, it is clear that after the merger, KCS alone does not now have, and will not have, absent the imposition of a condition, the ability to provide a second independent routing option for these plants.

> 8. Following a UP/SP merger, a shipper wishes to locate a plant in the area. With reference to Figure 3.6, it faces a choice between Industrial Site #7 and Industrial Site #8. Prior to the merger, the shipper would have benefitted from UP/SP ex ante site location competition; the choice of a site would not be finalized until a long-term contract with one of the railroads was locked in.

While this is a similar form of indirect UP and SP competition as was discussed with reference to Figures 3.2 or 3.3, this analysis assumes that such a shipper may not have any of its current facilities served by either UP or SP but is looking for an industrial site for a new plant facility. Such a shipper does benefit by the fact that UP and SP are in the same

EA. *See* HC08-002624

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HC39-400577-400580

HC41-006620 **REDACTED**

The merger will reduce these competitive options.

9. Shippers, especially large shippers with multiple plant locations served by several railroads, can use the concept of "package bidding" where these shippers will put out for bid their entire rail transportation needs for a certain period of time and then select one carrier to provide those needs. Where UP and SP currently compete in such package bidding situations, this competition will be lost as a result of the merger.

In reviewing the evidence, it became clear that many shippers, especially large shippers with multiple plant locations, are able to use the leverage of potential large volumes of traffic that would go to one carrier in order to obtain lower rail rates, even at exclusively served plants. This is, in effect, the same thing as the standard economic theory of "volume discounting." HC37-400029-400031

HC08-004299

HC42-000018-000019

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HC-39-300949-300951

HC-40-003051

HC42-000050, HC42-000194, HC42-000262,

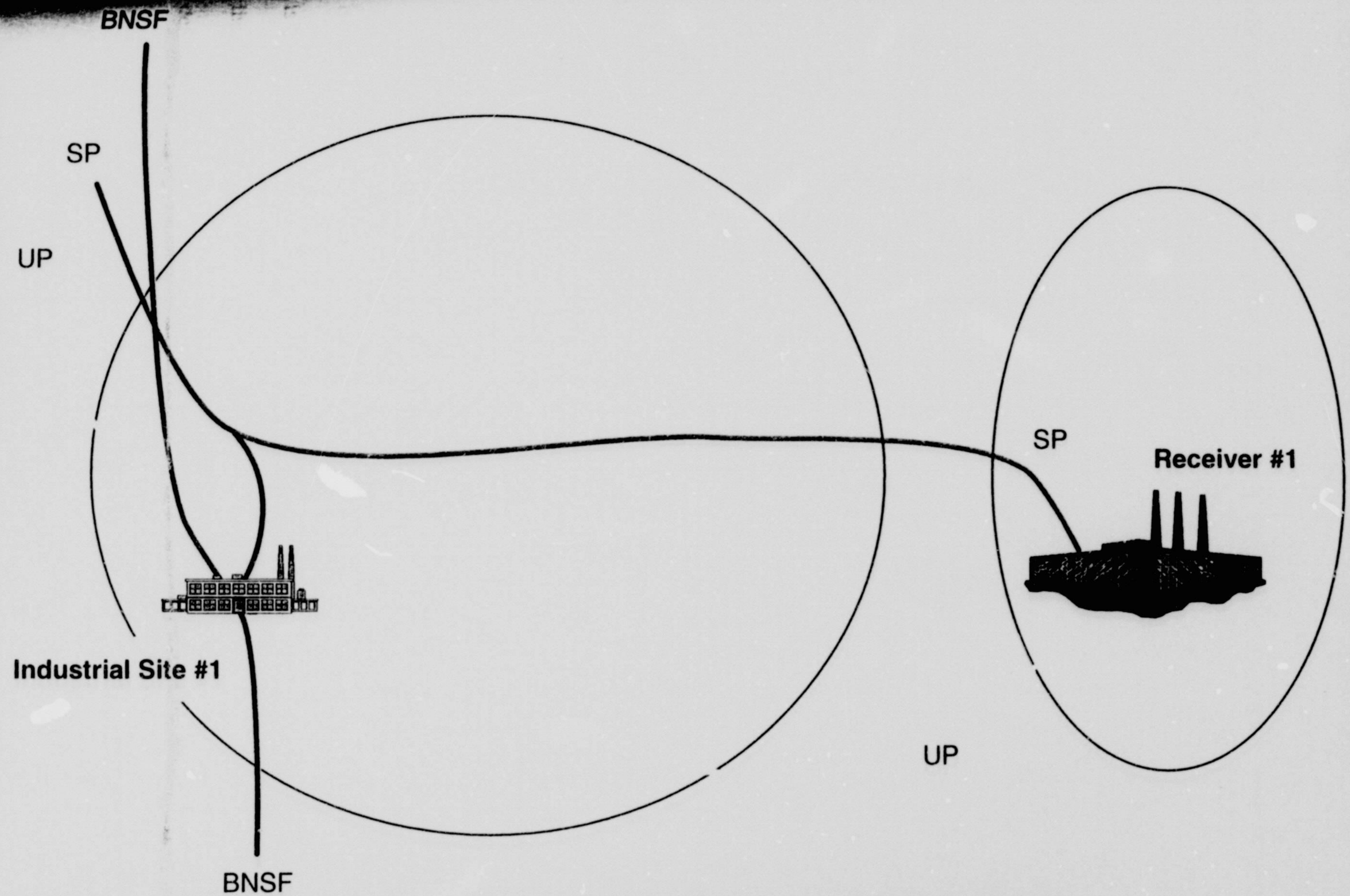
HC42-to-100120, HC42-to-100127

HC39-301687 (Location of distribution center depends upon best package deal offered by UP to compete with SP); HC39-400577-400580 (CN's letter to UP requesting assistance to develop bid for Dow Chemical traffic); HC37-400013-400016 (UP needs to put together a comprehensive bid package to keep SP from bidding); HC37-400036-400042 (Discussion of package bids between UP and SP for DuPont's business). It is clear that these shippers will lose the ability to get competitive package bids from UP and SP after the merger and will instead have to find different alternatives.

Type 3 -- Shippers who have physical access to both UP and SP (and two independent alternatives involving UP and SP to destination) with access to a third railroad at origin or destination which does not serve the entire market from origin to destination.

Figure 3.7 provides an example. UP and SP serve both origin and destination. BN serves the origin but not the destination. Such a shipper wishing to move goods from origin to destination has only two options, UP or SP. We classify such a shipper as a "2-to-1" shipper, to denote the number of origin-destination options. Although product/geographic competition from the BN alternative is useful in some cases, it is not in any way a substitute for direct origin-destination competition. In some instances this shipper may also be able to ship to another (substitute) location *via* BN. This may provide relief from monopoly pricing in the origin-destination market, but if, for example, a buyer of the product was located at the destination, it would not be a factor. Similarly, someone receiving goods in the origin city from the destination city could potentially receive from an alternative origin served by BN.

Indeed, such source competition may be effective for some shippers in limited situations. However, as I have argued in previous ICC testimony, the theory under which source competition provides an effective limitation on the ability of a monopoly railroad to raise rates rests on a number of strong assumptions. If there is a degree of product differentiation, or products coming from the current origins are closer in location, or capacity constraints exist on production at alternative sites, these factors will create an umbrella under which rail rates can be raised. Indeed, if firms are currently drawing



Shipper has physical access to UP and SP at origin and destination, along with access to BNSF at origin.

products from a given origin, there is a presumption that this is the lowest-cost alternative or in some other sense the optimal choice.

Thus, the main limitations of source competition in providing a strong competitive substitute are differences in distance and characteristics of alternative sources. In other words, a receiver's option to purchase goods from an alternative source located a greater distance away than the current source, even in the absence of switching costs, would still allow a rate increase reflecting the transportation differential of the two sources. Similarly, a receiver's option to purchase from an alternative source goods that were not a perfect substitute for goods from the current source would still allow a rate increase reflecting the relative preferences for the differentiated products. However, source competition from two locations within the same BEA would ensure that the distances of the two sources from destination were comparable and may well also give rise to products that are undifferentiated (e.g., agricultural products grown in the same region could well have comparable characteristics). Thus our BEA-BEA primary market definition, which includes source competition from sources within the same BEA, but excludes such competition from disparate BEA's, though necessarily oversimplified, is based upon a reasonable assumption.

B. The BEA to BEA Analysis Is The Proper Market Definition

As I have discussed in testimony in previous ICC merger cases, the critical threshold issue in conducting a rigorous evaluation of the competitive consequences of this transaction is the definition of the relevant markets. Although the Commission is not required to utilize the Department of Justice and Federal Trade Commission's horizontal merger guidelines for defining relevant markets, this methodology provides a clear and powerful market definition tool and can be usefully applied here. Accordingly, boundaries for markets can be established as follows:

> Specifically, the Agency (DOJ or FTC) will begin with each product (narrowly defined) produced or sold by each merging firm and ask what would happen if a hypothetical monopolist of that product imposed at least a 'small but significant and nontransitory' increase in price, but the terms of sale of all other products remained constant. If, in response to the price increase, the reduction in sales of the product would be large enough that a hypothetical monopolist would not find it profitable to impose such an increase in price, then the Agency will add to the product group the product that is the next-best substitute for the merging firm's product.

Department of Justice and Federal Trade Commission Horizontal Merger Guidelines April 2, 1992, Section 1.11.

To apply these standards to the transaction under consideration here, it must first be understood that a railroad's "products" consist of the transportation of commodities between specific origin-destination pairs. A railroad is truly a multiproduct firm, in that each origin-destination and type of commodity shipped can properly be regarded as a unique product. If we begin with such a correctly-defined product of the merging firm -- we must then ask, in the words of the merger guidelines, whether in response to a hypothetical price increase, "the reduction in sales would be large enough that a hypothetical monopolist would not find it profitable to impose such an increase in price." As to numerous commodities and shippers, there is clear evidence that a hypothetical rail monopolist could profitably increase prices.

As discussed above, even if some shippers in a broader market could apply the same competitive factors they relied upon prior to the merger to keep UP and SP rates competitive in order to keep a merged UPSP's rates competitive, this does not help in rendering a price increase by a monopoly railroad unprofitable. The key is that a monopoly railroad(s) can selectively raise prices to specific shippers in accordance with the availability to the particular shipper, for particular movements, of source, product or intermodal competition.

Clearly, it is beyond the realm of possibility in this case to analyze in detail the circumstances of each and every one of thousands of shippers in order to determine if such shipper could utilize the various forms of competition in order to protect itself from a rate increase. However, we will in a subsequent section provide a detailed breakdown of shippers according to commodities shipped and mileages. Again, the critical point is the fact that while there may be some shippers who will be able to readily shift to truck or other alternatives if UPSP try to raise their rates too high, there are numerous shippers who cannot readily shift to truck or other alternatives in the face of rail rate increases. While the mere presence of the other forms of competitive factors may eventually place a "cap" on such rail rate increases by the merged UPSP for such shippers, absent two independent rail routings, such shippers will undoubtedly be subject to significant rate increases.

The examination of types of shippers impacted by a loss of competition, as discussed in the previous section, supports a definition of rail markets as narrowly defined origin-destination pairs using BEA's. As noted previously, the Commission has consistently supported this definition of markets, and has rejected other market definitions. A BEA-BEA market definition also follows that of the Justice Department in the SP/SF case, in particular that of Witness Pittman in his testimony and academic writings related to that case[31], defining markets as flows between origin and destination BEA's.

[31] R.W. Pittman, "Railroads and Competition: The Santa Fe/Southern Pacific Merger Proposal," *The Journal of Industrial Economics*, 1990.

Another issue in defining rail markets is the complexity that many long-haul movements entail coordination by more than one carrier. It is common for connecting carriers to submit a single competitive bid for the entire movement. Therefore, competition is greatly enhanced when the alternative, fully-independent routings are available. If one firm participates on all routings, competition can be greatly hampered. The Commission has clearly stated that independence of routings is critical:

> Competition between railroads generally requires the presence of two or more independent routes, that is, routes having no carriers in common. When a single carrier is a necessary participant in all available routes, *i.e.*, a bottleneck carrier, it can usually control the overall rate sufficiently to preclude effective competition.

Consolidated Papers, Inc., et al v. Chicago and North Western Transportation Co., et al, 7 I.C.C. 2d 330, 338 (1991).

Accordingly, I focused my primary attention on instances where the proposed consolidation will reduce the number of independent railroad routings, especially from 2-to-1 or from 3-to-2. The Commission's notion of independent routes set forth above can be illustrated in the table below.

MEMPHIS TO SAN ANTONIO	
CURRENT RAIL ROUTES	**MARKET SHARE FOR THAT ROUTE**
SP DIRECT	17%
UP DIRECT	31%
BN - UP	4%
CSXT - UP	26%
NS - SP	22%

There are five rail routings in the Memphis to San Antonio market, but only two independent routes. Either UP or SP becomes a bottleneck carrier for each of the five routes, leaving two independent competing routes pre-merger. After the merger only one independent route remains, as UP/SP participates in each of the routes. Thus this BEA pair constitutes a 2-to-1 market.

Finally, I based my information regarding the available routings in a market on the actual flow of traffic in a given BEA-BEA pair, as given by the 1994 100 percent traffic tapes of UP, SP, CN&W, KCS and BN/SF along with ICC waybill data. I eliminated from consideration routes which handled three carloads or less for the year, as well as routes with excessive circuity.[32] This procedure is similar to the elimination of routes with excessive circuity employed by Applicant Witness Petersen.[33]

There are, however, specific differences between our market definition and the Applicants. Basically, the Applicants only include in their market definition shippers served by solely UP and SP. As discussed in the previous section, this definition does not take into account many shippers harmed by the consolidation as given in the above topology. Applicants' definition is sharply at odds with past ICC decisions and analysis, and sharply at odds with Applicants' own discussion of rail competition between UP and BN.[34]

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[32] 200% applied to routes less than 250 miles; 180% to those less than 1,000 miles; 170% to those less than 2,000 miles; and 160% for those greater than 2,000 miles.

[33] One alternative procedure would be to determine routings based on physical routings available, regardless of circuity or actual traffic. Given that the 100 percent traffic tapes are employed extensively, and all commodities are considered, the three carload minimum is not very restrictive. The Appendix includes all traffic flowing between BEA pairs, should the Commission wish to investigate this issue further.

[34] When discussing the scope of post-merger rail competition between UP and BN, the (continued...)

Applicants in railroad merger proceedings have historically used an "accordion theory" to reconcile conflicting claims over merger benefits and competitive consequences. When attempting to minimize the reduction in competition between the Applicants, Applicants tend to define the relevant market for assessing antitrust claims very narrowly. Here, the accordion compresses the relevant market very narrowly, such as rail service to a particular plant. If two railroads do not both serve that same shipper with direct service, they are deemed not to compete.

The accordion expands, however, when the task is to demonstrate the continued strength of competition from sources other than the merged carriers or to stress the need of the merged carriers (particularly the alleged weak partner) for merger benefits to compete with other railroads or other modes of transportation. There the relevant market for analysis of competition is defined to be all the rail service in a BEA, a state, throughout the Western United States, or throughout the entire country -- including all other modes of transportation or even railroads in other countries, such as CN, CP, and the Mexican railroads. With careful use of the "accordion," UP and SP can be made to appear to compete with everyone but each other.

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[34](...continued)
applicants' market definition is broadened to include instances where shippers do not have actual access to both carriers (draw from Petersen statement). Dr. William Tye calls this the accordion theory of competition--when arguing UP and SP are competitors only at 2 to 1 points, the accordion is compressed, but when arguing that there will be plenty of competition after the merger, the accordion is expanded. See March 29, 1996 filing of the Texas Railroad Commission, V.S. Tye. (William B. Tye, *The UP/SP Merger: An Assessment of the Impacts on the State of Texas*, March 1996.). The discussion here draws from his statement.

C. In Conclusion, The BEA As A Relevant Geographic Market Is Appropriate

It is clear that shippers benefit from UP and SP competition in all of the ways above described.[35] Applicants narrow definition of UP and SP competition as occurring only at 2 to 1 points is simply that---too narrow to adequately reflect the numerous ways shippers benefit from UP and SP competition. In this important respect, our market definition is harmonious in assessing rail competition consistently and in accordance with standard practice. Indeed, it should be noted that there are salient instances where the Applicant has defined a shipper as 2-to-1, but where the shipper is not categorized as a 2-to-1 shipper in our analysis. For example, with reference to Figure 5.1, this shipper is served by only SP and UP, but BN is in the BEA and also serves the destination. We would categorize this shipper as a 3-to-2. Similarly, referring to Figure 4.2, a shipper who is served by UP and SP as Industrial Site #2 who hands off to a monopoly carrier at the destination is considered a 2-to-1 shipper by the Applicants, but is considered by us as a 1-1.[36]

IV. APPLICANTS THEMSELVES ACKNOWLEDGE THAT THE PROPOSED TRANSACTION WOULD HAVE SUBSTANTIAL ANTICOMPETITIVE EFFECTS

A useful starting point in assessing competitive impacts is provided by the Applicants, not with their hollow discussion of competition within the application, but with their

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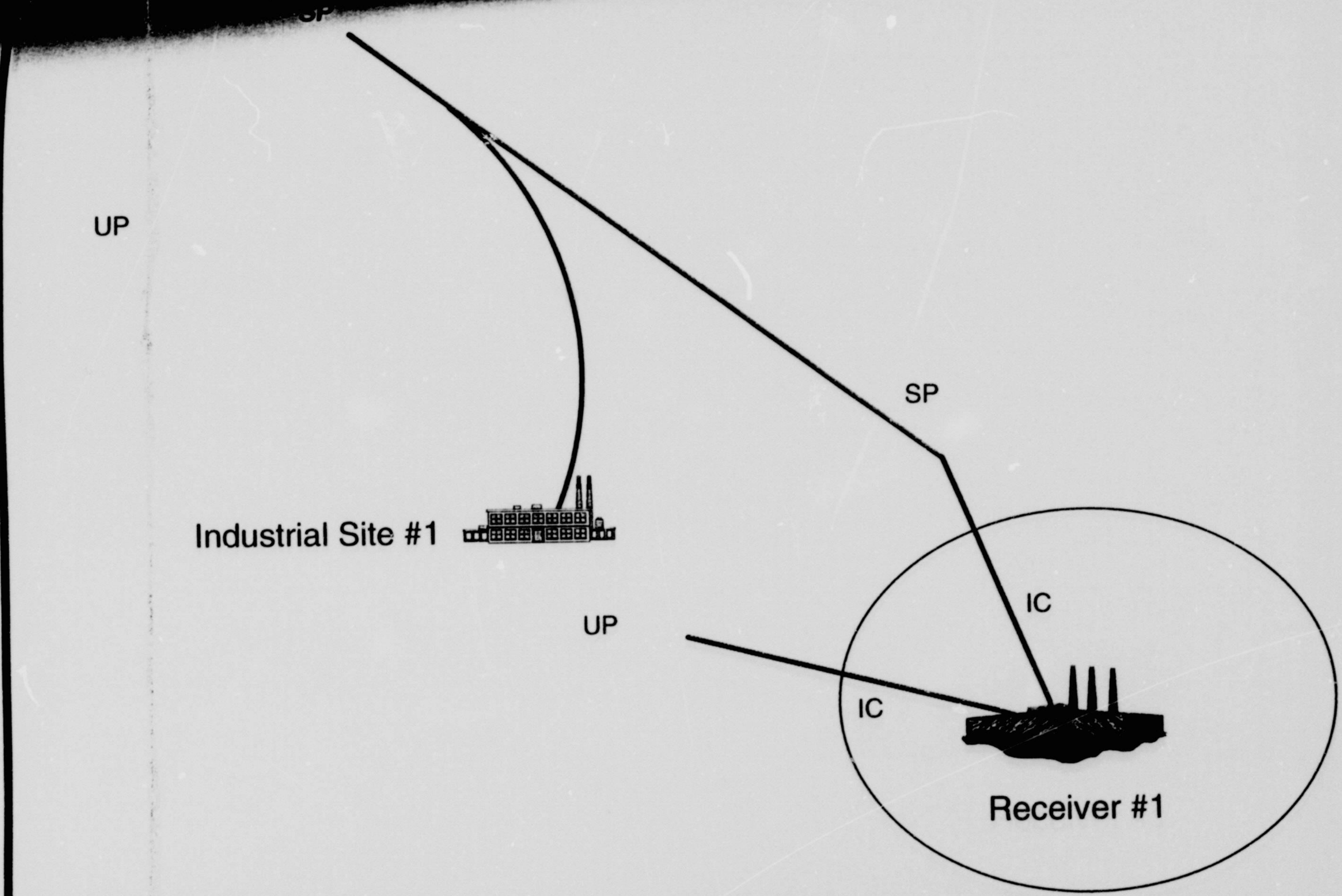
[35] For further evidence of UP and SP competing head-to-head for shipper's business, see the evidence filed in Vol. III, Highly Confidential Appendix, pp. 1043-66, "Direct UP and SP Competition." This evidence is difficult to categorize but nonetheless shows the extensive competition that currently occurs between UP and SP.

[36] We would also expect a competitive impact associated with a reduction in interline competition, but do not include such impacts in our primary analysis.



UP and SP provide interline competition, handing off to monopoly railroad at destination.

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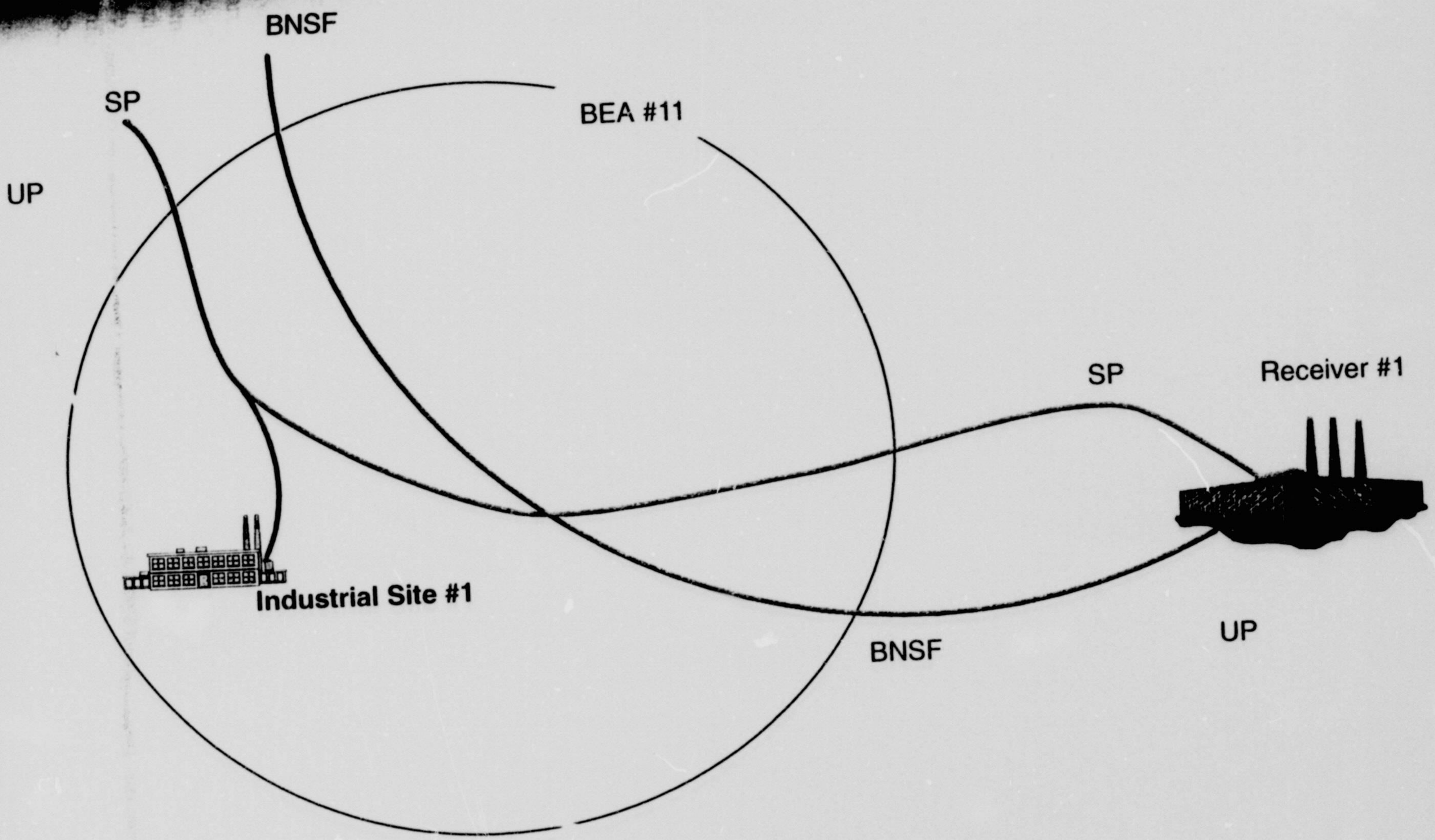

3-to-2 Shipper

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assessment of competitive harms as indicated by the settlement with BN/SF. Indeed, actions speak much louder than words in this regard.

The deal struck by the Applicants with BN/SF is a clear acknowledgement of competitive harms to the class of 2-to-1 shippers receiving access. Several points are critical in analyzing this settlement. The process as described by the Applicants is noteworthy. First, UP analyzed the competitive problems of the merger and formulated a settlement plan based on what Applicants considered the most salient problems: shippers served by both, and only both, UP and SP (Refer again to Figure 3.1 for an example). This plan then served as the basis for negotiations with BN/SF and other railroads. UP drove the process, based on acknowledged competitive problems which they felt needed to be addressed.[37] And clearly, UP and its attorneys were quite aware of the long-standing ICC policy not to impose remedies beyond harms of the merger; thus, an argument that an agreement was struck going beyond the harms of the merger is not in any way credible.

Also noteworthy is the detailed shipper list which drove the negotiations. UP identified individual shippers who would receive access. Access was not determined by

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[37] As discussed in more detail elsewhere, notwithstanding Applicants attempts to suppress the truth about the negotiations, there is strong evidence that the Agreement was a "package deal" conceived by UP/SP.

Mr. Ice, BN/SF's lead negotiator, admitted that going into the negotiation he was given a "map" indicating the rights offered by UP/SP. (Ice Dep., p. 177.) Of course, parties were not allowed to question Mr. Ice on what give and take took place in the negotiations concerning the routes in the map. Mr. Rollin Bredenberg of BN/SF, who attended an internal meeting with Mr. Ice and others to discuss the UP/SP offer, came away with the "working assumption" that the offer to BN/SF was a "package deal." (Bredenberg Dep., p. 68) A Call Report of a subsequent telephone conversation with Mr. Bredenberg confirms that BN/SF was given an all or nothing, take it or leave it preposition. (Bredenberg Dep., Exhibit 1).

corridor, or region. In fact, the traffic tapes supplied to KCS through discovery last fall listed 2-to-1 shippers as defined by Applicants.

The shippers served only by SP and UP are indeed impacted by the merger and we need to carefully quantify and assess the impacts as acknowledged.[38] Thus, the scope of the admitted competitive harms is of great interest. Based on the 1994 UP/SP 100% traffic tapes and the list of shippers characterized by the Applicants as 2-to-1, we estimate the traffic from their 2-to-1 shippers to be $1.1 billion, half a billion of which overlaps KCS defined 2-to-1s. In other words, the BNSF trackage rights agreement provides access to only about one-fourth of the KCS defined 2-to-1s. This acknowledged competitive harm from UP/SP, which as we will demonstrate, significantly understates the actual competitive impact, is comparable to our BEA-BEA based estimate of 2-to-1 harm in the *SFSP* merger, as illustrated in Figure 4.1. As Figure 4.1 demonstrates, even if the Commission accepted Applicants' 2-to-1 definition, the anticompetitive effects of this transaction are far greater than an equivalent assessment of competitive harms for *SFSP*, which was denied as anticompetitive. This merger, as proposed, should similarly be rejected.

Indeed, a close examination of the settlement reveals important information about the Applicants' assessment of competitive harms and the broad scope of competitive impacts. Applicants acknowledged that elimination of rail competition constituted a competitive harm of the merger necessitating redress *via* access **regardless of the commodity being shipped.** See Table 7.1. Applicants could have alternatively chosen to delimit the set of shippers

[38] We, of course, also need to subject to careful scrutiny the proposed solution to these acknowledged competitive harms, serious questions about which are raised in a number of statements. We also wish to make clear that the shippers acknowledged to be impacted are in no way the only customers harmed by the consolidation.

Figure 4.1

Competitive Impact Comparison
UP/SP vs. SP/SF Merger

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Source: 1994 100% traffic tapes and ICC Waybill Sample for KCS defined 2-to-1's.
UP/SP 100% traffic tapes for UP/SP defined 2-to-1's.
UP/SP's 2-to-1 definition for the SP/SF merger was calculated using the ratio of UP/SP defined 2-to-1's vs. the KCS defined 2-to-1's and then applying that ratio to the SP/SF.

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Table 7.1

UP/SP Defined 2 - to - 1's by STCC
Originations and Terminations

STCC	Commodity Name	Revenue Total ($ Millions)

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requiring access. This is strong evidence of rail transportation as the relevant market in this case, an admission that a reduction of rail competition is significant, regardless of the commodity. We will address this point in more detail in Section VI.

Moreover, Applicants acknowledged that elimination of rail competition constituted a competitive harm of the merger **even where another railroad held a monopoly bottleneck over a portion of the route, *i.e.*, UP and SP provided interline competition**. Figure 4.2 illustrates an instance where a shipper is served by UP and SP, but hands off to a railroad with a monopoly at the destination. This shipper faces a reduction in interline competition, but no reduction in the number of independent alternatives. An example of such a shipper in the UP 2-to-1 list is a movement of chemicals from Baytown, Texas to Pocatello, Idaho. The shipper has competition between UP and SP at the origin, but only UP serves Pocatello.

The existence of such traffic in Applicants' *de facto* competitive analysis provides powerful evidence that interline competition reduction constitutes a serious competitive harm.[39] Again, it was well within the capabilities of the Applicants to delimit the set of shippers receiving access, to exclude shippers served at the origin or destination by UP and SP, but for whom the merger does not reduce the number of independent alternatives. It is an acknowledgement by Applicants that the competitive harms from this merger extend well

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[39] The importance of interline competition was a contested issue in the BN/SF case, with a number of shippers supporting the argument, and Commissioner McDonald acknowledging the legitimacy of these arguments in a separate expression. My 1992 Journal of Law and Economics article, cited in the BN/SF case, supports the competitive impact of a reduction in interline competition. Grimm, C., C. Winston and C. Evans, "Foreclosure of Railroad Markets: A test of Chicago Leverage Theory." Journal of Law and Economics, Vol. XXXV, October 1992, pp. 295-310.

beyond the 3-to-2 and 2-to-1 shippers who are the subject of our primary competitive analysis.

V. THE COMPETITIVE IMPACTS OF THIS TRANSACTION ARE UNPRECEDENTED AND FAR GREATER THAN ACKNOWLEDGED BY APPLICANTS.

In this section, using the topology of affected shippers and determining the independent rail routings between BEA's, I was able to determine all of the corridors where shippers' alternative independent rail routings will drop from 2-to-1 and from 3-to-2. The complete 100% traffic analysis detailing all of the corridors and relevant market shares for each independent route in the 2-to-1, 3-to-2, 4-to-3 and 5-to-4 categories is included in Vol. III, Highly Confidential Appendix, pp. 99-333, submitted in this filing. The commodity breakdown for these corridors and the average route miles for these commodities is contained in Table 7.2 for KCS defined 2-to-1's and Table 7.3 for KCS defined 3-to-2's, and discussed in Section VII. The complete traffic tape analysis from which these tables were drawn is also included in the Highly Confidential Appendix.

A. The 2 to 1 impacts of the consolidation are profound

As noted, Applicants have acknowledged that there will be severe competitive impacts in markets where rail competition will be eliminated, the 2-to-1 markets. Their *de facto* competitive analysis concludes that there will be competitive harm for 2-to-1 shippers across a broad range of commodities and includes examples where there is no loss of independent alternatives. With regard to the 2-to-1's, the main points at issue are the magnitude of the 2-to-1 shippers and the efficacy of their proposed solution to the 2-to-1 problem. Referring to Figure 5.2, the total 2-to-1 impact using the BEA-BEA definition as previously discussed is

Table 7.2

KCS Defined 2-to-1's by STCC and Mileage

STCC	Commodity	2100 +	2100 - 1800	1800 - 1500	1500 - 1200	1200 - 900	900 - 600	600 - 300	300 - 1	Indeterminate	Total
0	Undetermined STCC numbers										
1	Farm products										
8	Forest products										
9	Fresh fish or other marine products										
10	Metallic ores										
11	Coal										
13	Crude petroleum, natural gas or gaso										
14	Nonmetallic minerals										
19	Ordnance or accessories										
20	Food or kindred products										
21	Tobacco products										
22	Textile mill products										
23	Apparel or other finished textile										
24	Lumber or wood products										
25	Furniture or fixtures										
26	Pulp,paper or allied products										
27	Printed matter										
28	Chemicals or allied products										
29	Petroleum or coal products										
30	Rubber or miscellaneous plastics										
31	Leather or leather products										
32	Clay,concrete,glass or stone products										
33	Primary metal products,including										
34	Fabricated metal products										
35	Machinery										
36	Electrical machinery,equipment or										
37	Transportation equipment										
38	Instruments,photographic goods,optical										
39	Miscellaneous products of manufacturing										
40	Waste or scrap materials not identified										
41	Miscellaneous freight shipments										
42	Containers,carriers or devices,shipping,										
43	Mail,express or other contract traffic										
44	Freight forwarder traffic										
45	Shipper association or similar traffic										
46	Miscellaneous mixed shipments										
47	Small packaged freight shipments										
48	Unknown STCC										
49	Hazardous materials or hazardous										
50	Bulk commodities										
	Grand Total										

REDACTED

Table 7.3

KCS Defined 3-to-2's by STCC and Mileage

STCC	Commodity	2100 +	2100 - 1800	1800 - 1500	1500 - 1200	1200 - 900	900 - 600	600 - 300	300 - 1	Indeterminate	Total
0	Undetermined STCC numbers										
1	Farm products										
8	Forest products										
9	Fresh fish or other marine products										
10	Metallic ores										
11	Coal										
13	Crude petroleum, natural gas or gasoline										
14	Nonmetallic minerals										
19	Ordnance or accessories										
20	Food or kindred products										
21	Tobacco products										
22	Textile mill products										
23	Apparel or other finished textile										
24	Lumber or wood products										
25	Furniture or fixtures										
26	Pulp,paper or allied products										
27	Printed matter										
28	Chemicals or allied products										
29	Petroleum or coal products										
30	Rubber or miscellaneous plastics										
31	Leather or leather products										
32	Clay,concrete,glass or stone products										
33	Primary metal products,including										
34	Fabricated metal products										
35	Machinery										
36	Electrical machinery,equipment or										
37	Transportation equipment										
38	Instruments,photographic goods,optical										
39	Miscellaneous products of manufacturing										
40	Waste or scrap materials not identified										
41	Miscellaneous freight shipments										
42	Containers,carriers or devices,shipping,										
43	Mail,express or other contract traffic										
44	Freight forwarder traffic										
45	Shipper association or similar traffic										
46	Miscellaneous mixed shipments										
47	Small packaged freight shipments										
48	Unknown STCC										
49	Hazardous materials or hazardous										
50	Bulk commodities										
	Grand Total										

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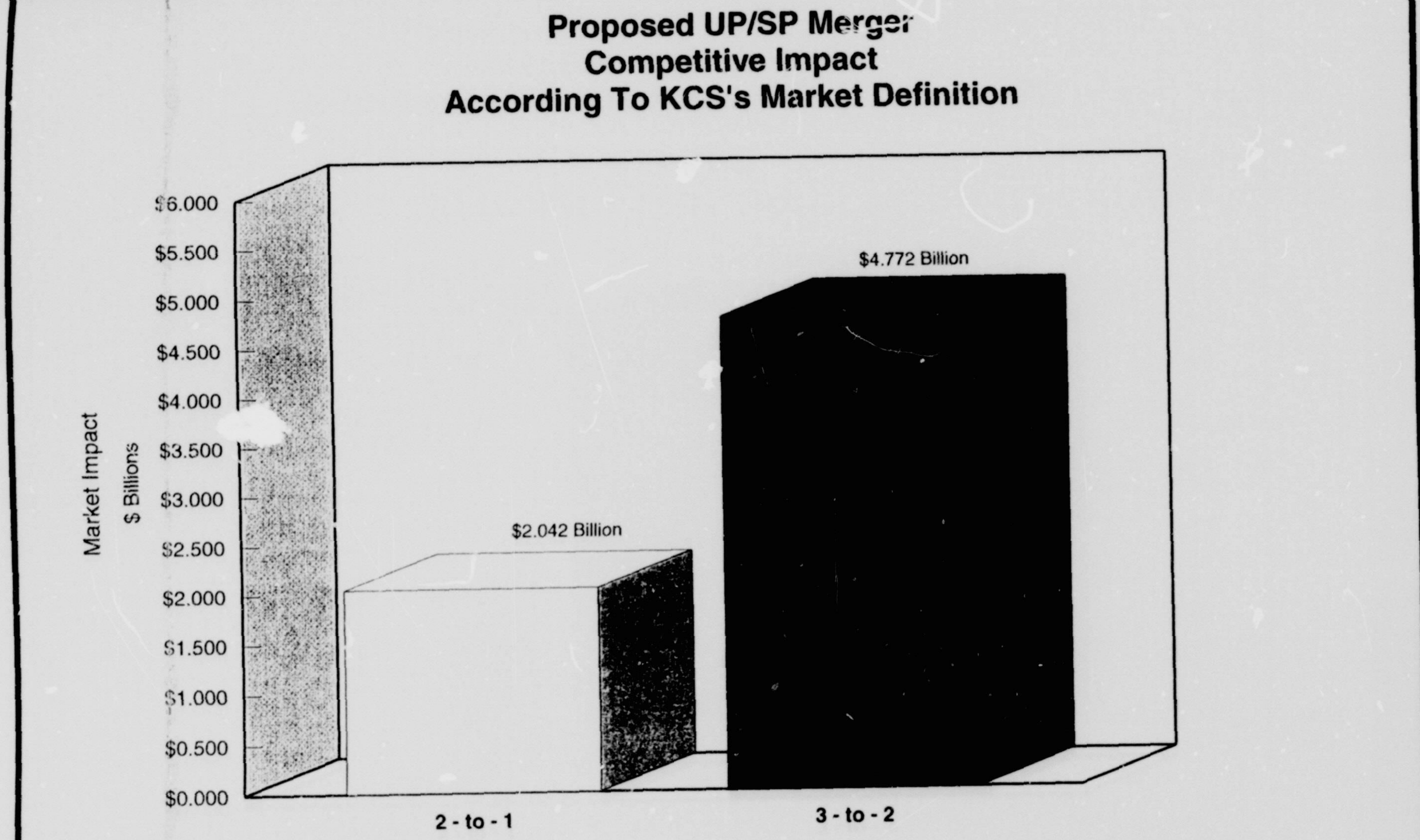
Figure 5.2



Source: 1994 ICC Waybill Sample.

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Proposed UP/SP Merger
Competitive Impact
According To KCS's Market Definition

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$2.04 billion. The complete list of market pairs and routing information for 2-to-1 markets is provided in Appendix 1.

Applicants' definition certainly understates the 2-to-1 problems. Whether the Board accepts their definition, which includes slightly over $1 Billion of 2-to-1's, or accepts our definition, which shows an impact of $2.04 billion, the magnitude of the competitive problems is this case far surpass any other rail merger in history. Even if the Board accepts Applicants' definition (which it should not) the Board, to approve this merger, must be convinced that the BNSF trackage rights agreement resolves those problems. As various other witnesses in this case establish, the BNSF agreement does not resolve those problems and this merger should not be approved as proposed.

B. The 3-to-2 impacts of the consolidation are profound.

In this section, we explore in detail the 3-to-2 impacts of the consolidation, based again on the same BEA-BEA market definition as discussed above. The complete list of market pairs and routing information for 3-to-2 markets is provided in Appendix 2, while comparable data for 4-to-3 and 5-to-4 markets are provided in Appendices 3 and 4 respectively. Referring again to Figure 5.2, the total traffic in 3-to-2 markets for 1994 totalled billion. **REDACTED**

Figure 6.1 provides information regarding the combined share of UP/SP across the 3-to-2 markets. Many 3-to-2 markets have a character quite similar to the 2-to-1 markets, in that they are dominated by UP and SP. Appendix 3 provides full information regarding this breakdown.

It is clear from this profile of 3-to-2 markets that the facts are sharply at odds with the characterization of UP, SP, and BN competition provided by the Applicants, who would

Figure 6.1

3-to-2 Routes Where UP/SP
Controls 70% or More of the Total Market

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have us believe that BN is omnipotent and omnipresent, while UP struggles to compete and SP is non-existent. On the contrary, there are many, many markets in which UP and SP are number one and two competitors, and thus provide the main competition for shippers, with BN much less effective. Also, SP has a strong market share in many markets. Whatever its financial position, SP is clearly a significant and effective competitor in many rail markets. We explore these themes in more detail below.

Although Applicants have acknowledged a problem when competitors are reduced from 2-to-1, they argue that there will be no anticompetitive impact in 3-to-2 markets. This assertion rests on four main arguments. First, collusion is difficult in the railroad industry. Second, there are many instances of effective competition between two railroads. Third, while in general three railroads may compete more vigorously than two, in this instance stronger competition would be provided by BN and a merged UP/SP than between the current behemoth BN, the overmatched UP, and the competitively invisible SP. Fourth, the Applicants argue that the econometric evidence on 3-to-2 impacts has no validity. Let us explore these arguments in turn.

C. While Tacit Collusion in the Railroad Industry Is, in General, Difficult, the UP/BN Duopoly Poses Special Concerns

As I have discussed in previous testimony before the ICC, the individual, private negotiation of rates, with proposed rates not generally available to the other competitor, means that very effective competition can and does take place between two rail carriers. Absent unique circumstances, tacit collusion between two independent rail competitors may indeed be difficult in the railroad industry. This is, of course, why elimination of rail competition in the 2-to-1 instances raises such profound concerns. Nonetheless, there is strong evidence that tacit collusion is more difficult with three rather than two carriers. In any event, there are unique circumstances present with regard to the competition between BN and UP/SP which raise special concerns about coordinated behavior.

In general, with additional firms coordination or tacit collusion becomes more difficult, as a greater number of firms increases the probabilities that the firms will have different notions about what price levels will maximize profits. As more firms are added, the number of two-way communication channels over which coordination must occur increases exponentially.[40] For example, with two firms there is only one communication channel, with three firms there are two channels, with four firms there are six channels, and with five firms there are ten. The presence of five firms results in a situation in which ten times as many communication channels need to be maintained, with a break-down in any one of these most likely destroying coordination efforts for the entire industry.[41] Therefore, as the number of competitors in an industry increases, the intensity of rivalry will tend to also increase. The competitors will achieve mutual forbearance and tacit collusion will become more difficult.[42]

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[40] O.E. Williamson, "A Dynamic Theory of Interfirm Behavior, *Quarterly Journal of Economics*, 1965, 79, 579-607.

[41] The increasing difficulties of coordination with more firms are analyzed more formally by D.K. Osborne, "Cartel Problems," *American Economic Review*, 1976, 66, 835-844.

[42] The effect of the number of competitors affects intensity of rivalry has also been found in the author's study of competitive interaction in the U.S. airline industry. In time periods with fewer competitors rivalry declines; with more competitors rivalry increases. Further support as to how the number of competitors affects rivalry is drawn from the authors' action-based study in the brewing, long distance telecommunications and personal computer industries. Drawing from a sample of new product introductions and responses from 1975-1990, we found that rivalry was stronger where the number of competitors was larger. Specifically, response time became quicker, radically decreased, and the degree of threat became greater as the number of competitors increased. Smith, K., C. Grimm and M.

(continued...)

This point was documented quite clearly by KCS Witness White and, in fact, was stated very clearly by Applicant's Witness Willig (Ordover and Willig, 1983):

> The view that a reduction in the number of firms facilitates coordinated use of assets among the incumbent firms is a rock upon which much of industrial economics has been built. Consistent with this view is the economic theory underlying the Guidelines: that the main evil of horizontal mergers is their potential of facilitating oligopolistic cooperation, leading to elevated prices and resource misallocation.

Ordover, J. and R. Willig, "The 1982 Department of Justice Merger Guidelines: An Economic Assessment, 71 Cal. L. Rev. 535, 552 (1983).

Indeed, there are particular factors present here which raise particular concerns about conscious parallelism. The fact that each of the dominant Western systems extended a significant package of trackage rights to the other in their respective mergers indicates a cooperation between the two that may well extend to their interaction in the marketplace.[43] Going forward, the trackage rights whereby each would operate over the other's system is akin to a joint production venture, which allows significant exchange of information and facilitation of tacit collusion. The two systems will overlap in many markets; such extensive multi-market contact has also been shown to reduce the level of competition.[44]

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[42](...continued)
Gannon, The Dynamics of Competitive Strategy, Sage Publishing, Newbury Park, CA, 1992. Schomburg, A., C. Grimm and K. Smith, "Avoiding New Product Warfare: The Role of Industry Structure," Advances in Strategic Management, P. Shrivastava, A. Huff and J. Dutton, eds, JAI Press, Vol. 10B, 1994, pp. 145-173.

[43] The preponderance of the trackage rights in BN/SF were given to Southern Pacific.

[44] V.S. Grimm, KCS-3, Exhibit A.

There is indeed a high degree of overlap in the territories served by BN/SF and UP/SP. Indeed, even a cursory look at a map of the U.S. railroad system reveals both the extent to which the two systems overlap and the extent to which they dominant rail transportation in the Western U.S. Figure 8.1 provides a closer examination of the degree to which the BN/SF and UP/SP systems would dominate rail transportation over a large region of the country. Based on Class 1 railroad originations by BEA, BNSF and UP/SP will have fully 100 percent market share across the west.

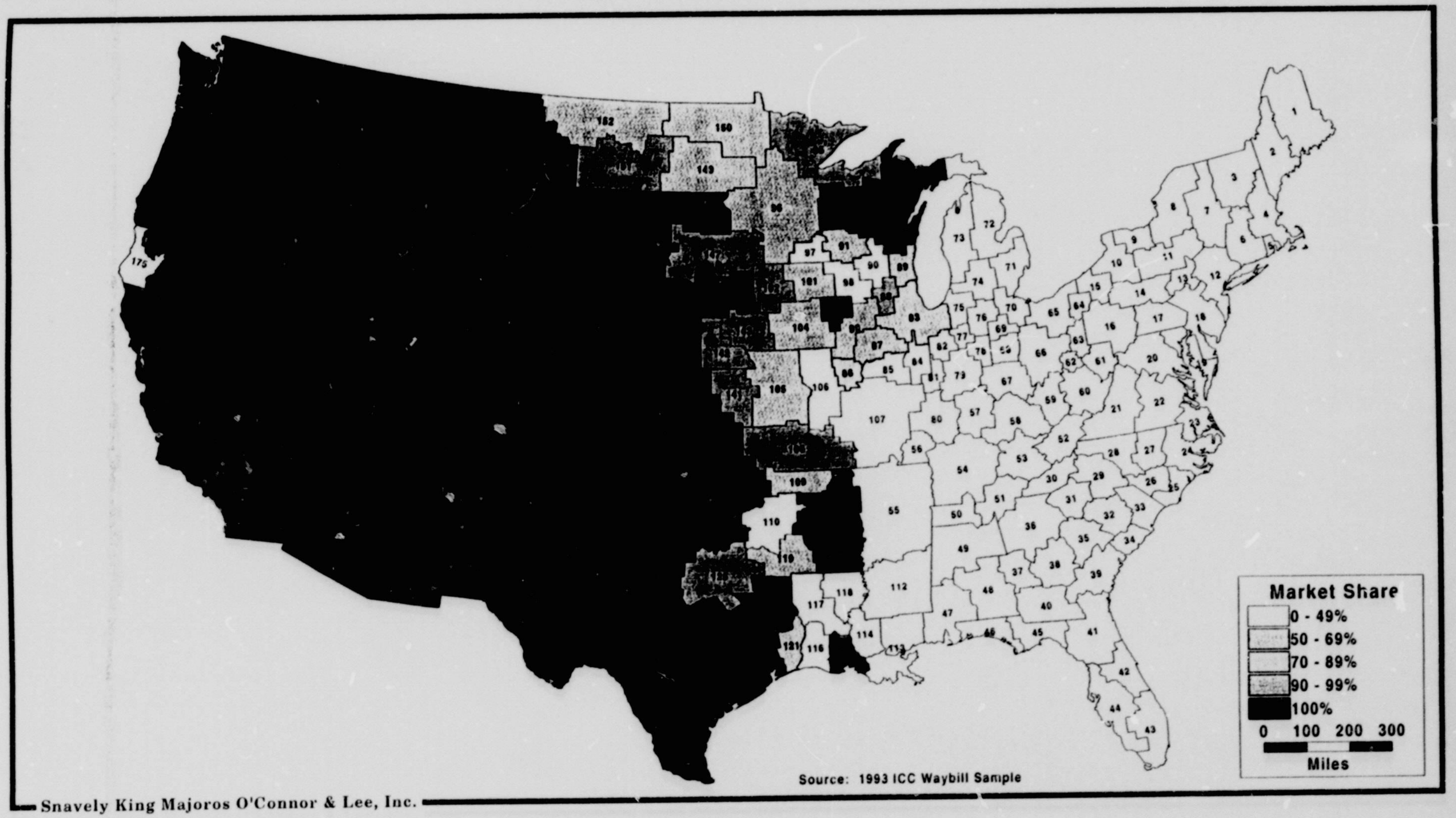
Clearly, there will be no rail competition whatsoever for many shippers and rail markets within the West. Where rail competition remains, it will be largely limited to the UP/SP and BN/SF multimarket duopoly. There is ample evidence that such an outcome would clearly be anticompetitive.[45]

D. Stronger Rivalry Will Prevail with Three Rather Than Two Carriers

First, there are indeed instances in the railroad industry where two railroads provide effective competition. That is not at issue. However, this fact does not negate that there will be a significant competitive harm from this consolidation with regard to 3-to-2 shippers. While two firms in any industry will in most instances compete with each other, rivalry will generally be more vigorous when a third firm is present with customers receiving more options, better service and lower prices. With more firms, the chances are greater that any one maverick firm will set off a fierce competitive skirmish. Accordingly, when a third rival eliminated from a market, prices increase and service quality is diminished. This is the ndamental principle of industrial economics to which Ordover and Willig referred in the

[45] Indeed, DOJ horizontal merger guidelines recognize substantial c mpetitive effects n the number of firms in a relevant market is reduced to two.

Combined Market Share of UP-SP and BN-SF Railroads



Map of Business Economic Areas

Market Share Basis:
Carloads Originated by Class I Railroads

December 12, 1995

above quote. Ordover, J. and R. Willig, 71 Cal. L. Rev. at 552. KCS Witness White discusses this point in detail in his statement.

The Applicants assert that these fundamental principles of economics do not hold in this instance, that rivalry between BN and a combined UP/SP will be more vigorous than the current rivalry between BN, UP and SP. We expose the fallacy in this argument next.

E. The Nature of Competition Between SP, UP and BN

Let us next turn to the specifics of a reduction from three carriers to two in the context of competition between SP, UP and BN. The Applicants would have us believe that SP is an insignificant and ineffective competitor, that UP cannot compete against BN without the addition of SP, and that BN is the omnipotent "king of the hill" in this three-way rivalry, such that competition would be stronger with UP/SP vs. BN than with the current three competitors. The Applicants' logic for this argument, not to mention their factual basis, is seriously flawed.

First, let us examine in detail the nature of competition between these three railroads. Referring again to Figure 6.1, which portrays the combined market share of SP and UP in the 3-to-2 markets, we find that indeed UP and SP dominate in many markets. There are many markets where UP and SP are clearly the most effective competitors. The obverse is that on the same routes BN is far from dominant. The data underlying Figure 6.1 also reveals that SP has a strong presence in many markets. Indeed, SP participates in 50% or more of the movements for over $1 billion of the 3-to-2 traffic.

Moreover, the importance of SP in stimulating rivalry in the Western rail market goes well beyond its market share. Robert Crandall, CEO of American Airlines, has complained that the financially weak airlines have been the ones initiating price wars and otherwise stimulating rivalry.[46] Michael Porter (1985) also makes this point, distinguishing "good" competitors from "bad" competitors, from the perspective of other firms in the industry. A firm which is unhappy with its current financial position is an attribute of a "bad" competitor, one that may well stimulate a good deal of rivalry.[47] Financial weakness does not diminish a competitor's role in stimulating rivalry, it increases its role. Moreover, a company which does not have as high of product and service quality competes more so on price, again increasing its effect on the stimulation of rivalry.

The role of SP as a strong rival, often on the price dimension, is supported by a wealth of evidence in this case. For example, there is cogent documentation of this in the DOD data discussed by KCS witness Ploth, in that SP is consistently the most aggressive competitor vis-a-via UP and BN.

Other examples are present that support the notion of SP as an aggressive competitor. "In contrast, despite higher production costs SP-served coal producers in the Green River and Uinta basins have increased production in recent years."[48] "Another reason for the growth in production and shipments of D&RGW coals has been the aggressive stance of the SP in moving these coals east."[49]

"The SP's market share of new and changing utility markets for western bituminous coal has increased from seven percent to 64 percent since 1989, at the expense of the UP's

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[46] *See, e.g.*, Donoghue, J.A., Editorial, Air Transport World, July 1992, p. 5.

[47] Porter, M. Competitive Advantage, New York, Free Press, 1985.

[48] Mark T. Morey. "Railroad Consolidation in the West - Implications for the Coal Market," *A Fieldston and Coal Transportation Report*, November, 1995, p. 18.

[49] Morey, p. 6.

market share which has declined from 93 to 18 percent."[50] [W]e are persuaded that the SP's aggressive pricing strategies have been more successful in securing new markets for Western Bituminous coal than have been those of the UP."[51]

F. Econometric evidence supports concern from both 2-to-1s and 3-to-2s

First, we address the "evidence" provided by Applicants that 3-to-2's are not a problem, because in a few instances selected by Applicants rates have gone down over time where competitors have been reduced. First, details regarding the competitive circumstances faced by individual shippers in these markets are not provided, so that we cannot discern the extent to which independent competitive alternatives in origin-destination markets actually did decline. More importantly, even to the extent rates may have declined over time along with the number of competitors, the argument clearly confuses correlation with causality. As indicated by the Applicants themselves, rates in general have declined in the railroad industry, due to cost savings and productivity increases brought about by the increased competition under Staggers. Applicants fail to control for such impacts with their anecdotal evidence. A cross-sectional econometric study would more properly analyze the impacts of a change in competition in a given market, assessing the degree of competition across markets at a given point in time, thereby holding constant factors driving costs and prices which vary over time.

In my writings and previous submissions to the Commission, I have expressed many times my views as to the importance of intramodal rail competition in the post-Staggers

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[50] Resource Data International, Inc. "Western Bituminous Coal Industry: Analysis of Coal & Transportation Markets," November, 1995. p. 2.

[51] Resource Data, p. 17.

railroad industry. There are a number of studies which have shown the value of intramodal rail competition in lowering rates and improving shipper welfare. Taken together, these studies provide abundant support for a structural antitrust approach as applied to rail mergers. The studies indicate that to the extent a given merger will result in increased rail concentration in relevant markets, rail rates would be expected to rise and shipper welfare would fall. These studies also provide strong support for the definition of markets as rail competitors in specific origin/destination pairs.

Rail competition was shown to be important even while pre-Staggers regulation was still present. A study I conducted, published in 1985, gathered 1977 data on rail rates and degree of rail competition in 110 rail markets, as defined by specific origin-destination pairs. The study found a significant relationship between rates and rail competition at origin and destination, with added competition causing lower rates.[52]

Two studies by MacDonald have used post-Staggers data to investigate the impact of rail competition on rates. The former study uses 1983 data regarding shipments of corn, soybeans, and wheat; regressions are performed to ascertain the relationship between rates and rail competition. MacDonald concludes: "The analysis shows an important, statistically significant effect of concentration on prices in an industry with high barriers to entry and large capital commitments." A second study draws on data from 1981-1985 regarding grain shipments. It concludes: "Competition among railroads has a statistically significant, fairly

[52] Grimm, C., "Horizontal Competitive Effects in Railroad Mergers," in T. Keeler, ed., *Research in Transportation Economics*, Vol. 2, 1985, pp. 27-53.

strong effect on rates. More competitors, as measured by RRCOMP, are associated with lower rates."[53]

Additionally, a Brookings Institute study in which I participated[54] supported the importance of railroad competition in reducing rail rates. Using 1985 data drawn over a large number of origin-destination pairs, the authors found price-cost margins were significantly lower in markets with a greater degree of railroad competition. This work was extended in a subsequent article[55], providing further support for the importance of rail competition.

Finally, Professor Levin of Yale has provided insights through simulations on the social benefits of increasing competition in concentrated rail markets. He has shown that, given various assumptions concerning demand elasticity and revenue/variable cost ratios, the social benefit of adding a second, equal-sized competitor to a monopoly market ranges from 6.8 percent to 18.9 percent of the revenues in that market. Adding a third railroad in a two-firm market yields social benefits of from 2.4 percent to 6.6 percent of revenues. This suggests that reduction of the number of competing railroads in a market from two to one has a particularly negative effect.[56]

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[53] MacDonald, James M., "Competition and Rail Rates for the Shipment of Corn, Soybeans, and Wheat," *Rand Journal of Economics* Vol. 18, 1987; and MacDonald, James M., "Railroad Deregulation, Innovation, and Competition: Effects of the Staggers Act on Grain Transportation," *Journal of Law and Economics* Vol. 32, April 1989, pp. 63-95.

[54] Winston, C., T. Corsi, C. Grimm and C. Evans, *The Economic Effects of Surface Freight Deregulation*, Brookings, Washington, D.C., 1990.

[55] Grimm, C., C. Winston, and C. Evans, "Foreclosure of Railroad Markets: A Test Of Chicago Leverage Theory," *Journal of Law and Economics*, Vol. XXXV, October 1992, pp. 295-310.

[56] Levin, Richard, "Railroad Rates, Profitability, and Welfare under Deregulation," *Bell Journal of Economics*, Vol. 12, Spring 1981, pp. 1-26.

Applicants' Witness Willig has criticized these studies with regard to validity of data and inadequate control variables. It should be emphasized, however that all of these studies were published in highly reputable academic journals or as monographs and went through refereeing procedures designed to address just the types of issues raised by Willig. For us to believe his criticisms, one would have to believe that the refereeing process failed in each of these six instances. Also, it is important to note the publication of these studies in journals, as opposed to preparation and presentation in a particular case.

Particularly relevant to this consolidation are two studies by MacDonald[57], which have used post-Staggers data to investigate the impact of rail competition on rates for agricultural commodities. One study uses 1983 data for shipments of corn, soybeans and wheat, with regressions being performed to ascertain the relationship between rates and rail competition. A second study draws on data from 1981-1985 regarding grain shipments. MacDonald has provided a statement in this case thoroughly and completely rebutting the criticisms offered by Willig. Witness White also addresses the validity of this literature in his statement.

I will not repeat at length the points raised in MacDonald's and White's statements, but will offer a few additional comments regarding Willig's criticisms of my own studies. Two points are in order regarding my 1985 study, which showed a significant relationship between rail competition and rates. First, the results indicated strong three-two impacts:

> It appears that competitive effects of mergers are much more serious when initial concentrations are between .4500 and .6500.

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[57] McDonald, James M., "Competition and Rail Rates for the Shipment of Corn, Soybeans, and Wheat," *Rand Journal of Economics*, Vol. 18, 1987; and McDonald, James M., "Railroad Deregulation, Innovation, and Competition: Effects of the Staggers Act on Grain Transportation," *Journal of Law and Economics*, Vol. 32, April 1989, pp. 63-95.

> Referring again to Table 3, transformations of markets with three firms, not equally sized, to two firms appear to produce the greatest harm.[58]

Second, Willig dismisses this study because it draws on data from 1977, prior to the Staggers Act. As discussed in more detail in that paper, railroads did have important mechanisms to compete prior to Staggers, in particular the quoting of commodity rates "so precisely in terms of commodity and origin-destination that they apply in practice to individual customers". Grimm, C., "Horizontal Competitive Effects in Railroad Mergers," in Keeler, Research in Transportation Economics, Vol. 2, p. 28. Of course, Staggers provided the railroads with many new mechanisms by which to compete. However, it is highly significant that although these mechanisms to compete were not readily available in 1977, rail intramodal competition nonetheless had a significant influence on rates. The test using 1977 data (prior to the widespread introduction of contracts) thus provides a conservative test of the impact of competition today and remains relevant, particularly as it has been corroborated by a number of studies using post-Staggers data.

Willig also criticizes my studies using post-Staggers data which is referenced in both Winston, C., T. Corsi, C. Grimm and C. Evans, *The Economic Effects of Surface Freight Deregulation*, Brookings, Washington, D.C., 1990 and Grimm, C., C. Winston, and C. Evans, "Foreclosure of Railroad Markets: A Test Of Chicago Leverage Theory," *Journal of Law and Economics*, Vol. XXXV, October 1992, pp. 295-310, and found that price-cost margins were significantly lower in markets with a greater degree of railroad competition. First of all, the rate data for the study was obtained by my co-author, Cliff Winston, directly

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[58] Grimm, C., "Horizontal Competitive Effects in Railroad Mergers," in T. Keeler, ed., *Research in Transportation Economics* Vol. 2, 1985, p. 41.

from a number of railroads -- not from the ICC waybill sample. Second, there is no basis for Willig's assertion that the statistically significant effects on rates "may also be largely driven by cases where there is one single-line carrier." V.S. Willig at 572. Although the average number of single-line carriers per market is small, there is sufficient variation in this variable to obtain a statistically precise estimate. I would also note that the sample contains additional independent alternatives arising from interline options (1992:302) and, accordingly this variable, the number of independent routings, was included within the equation. The estimated coefficient for this variable was negative and significant, that is, as the number of independent routings increases, price/cost margins[59] decrease.

In summary, the prevailing econometric evidence provides incontrovertible evidence from a large number of published studies regarding impacts not just with 2-to-1 markets, but also from 3-to-2s. Finally, the DOD data analyzed in the statement of witnesses Nunn and Ploth provides further corroboration regarding the competitive impacts of eliminating SP from the market.

G. Barriers to entry

A final issue is to what extent lost competition from the merger might be restored through new entry. In this regard, the structure of the railroad industry is such that there are substantial barriers to entry, particularly because of the costs of constructing a new line.[60] Keeler describes rail structure as follows:

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[59] The dependent variable is a more complex price/cost equivalent. Full details are provided in 1992:308-9.

[60] While construction of spur lines in feasible, construction of a new line connecting major BEA pairs is another matter entirely.

In short, Baumol and the others have documented that, with very easy entry and exit, a natural monopoly has almost all the attractive characteristics of a competitive market, eliminating the need for regulation. They appropriately call such a natural monopoly a 'contestable' natural monopoly.

VI. RAIL IS THE APPROPRIATE PRODUCT MARKET

In my academic writings and previous ICC testimony, I have consistently argued that rail is the appropriate product market, and that we should reject a market definition that includes other modes within the product market. In determining whether or not a shipper received access to BNSF, Applicants did not consider the type of commodity shipped or the distance the commodity was shipped to the receiver. All 2-to-1 shippers, as defined by Applicants, received BNSF access whether or not the commodity in question may also be easily transported by truck, barge, or air. In other words, Applicants have accepted the notion that the relevant product market was the transportation of products by rail, *i.e.*, reduction of intramodal competition.[61]

Focusing on whether or not there is a reduction in intramodal competition, *i.e.*, competition between rail carriers, is entirely consistent with Commission precedent. *SFSP*, 2 I.C.C. 2d 709, 758 (1986)("[T]he relevant product market here is railroad freight transportation. Equally as clear is the necessity . . . for this Commission to assure the continuation of adequate levels of rail intramodal competition."); *BNSF*, slip op. at 59 ("We rest this conclusion primarily upon continued intramodal competition."). *See also* the *UP/MP/WP* case basing the decision largely on econometric estimates of low cross-elasticity

[61] It would be fundamentally unfair to apply a different standard of what constitutes the relevant product market to KCS while at the same time imposing Applicants' proposed conditions which rely on a completely different definition of the relevant product market.

of demand between rail and truck;[62] and *Chicago, Milwaukee, St. Paul, and Pacific Railroad Company-Reorganization-Acquisition by Grand Trunk Corporation*, 2 I.C.C.2d 161, 224-225 (1984)("*MILW-GTW*")(defining the relevant product market as the transportation of freight by rail).

While the Commission has examined whether or not freight transportation by other modes should be included in the same product market as rail freight transportation for the purpose of determining the competitive effects of a proposed transaction,[63] the focus of most, if not all, prior merger cases has been the reduction of transportation in the intramodal market. Even in the *UP/MKT* proceeding, where the Commission did consider intermodal and intramodal transportation in defining the relevant product market, the Commission's ultimate conclusion rested on the continued presence of intramodal competition as an effective constraint on rates.[64] Accordingly, in defining the relevant product market, focusing primarily on intramodal competition is appropriate. The Commission has supported

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[62] *Union Pacific Corporation, Pacific Rail System, Inc. and Union Pacific Railroad Company -- Control -- Missouri Pacific Corporation and Missouri Pacific Railroad Company, Finance Docket No. 30,000*, 366 I.C.C. 459, Appendix E, at 673 (1982) ("*UP\MP\WP*").

[63] *Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company -- Control -- Missouri-Kansas-Texas Railroad Company*, 4 I.C.C.2d 409 (1988) ("*UP/MKT*").

[64] "We conclude that, post-merger, ample transportation competition will remain throughout the MKT service territory. We rest this conclusion primarily upon continued intramodal competition." *Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company -- Control -- Missouri-Kansas-Texas Railroad Company, et al.* 4 I.C.C.2d 409 (1988) ("*UP/MKT*").

this position in important rail merger cases by rejecting efforts to include motor carrier and barge in its definition of relevant markets.

Although truck competition can supplement inadequate intramodal competition for some products and markets, it is not an effective substitute for rail to rail competition. The relative costs of truck and rail, and thus the extent to which motor carriers are competitive with rail in a particular market, depend on the commodity being transported and the distance between origin and destination.[65] For longer distances and for movements of bulk products, rail usually has a significant cost advantage. The nature of products, volume and commercial value are factors present that would tend to limit intermodal applications. Furthermore, given that railroads set prices to a large degree individually on a movement-by-movement basis, the fact that some shippers may have truck or source alternatives to a monopoly rail firm for some movements does not help other shippers -- or even those same shippers, for their movements where no competitive alternatives exist.

As will be discussed in more detail below, other modes cannot provide an adequate counterbalance for the diminution of rail competition in the proposed transaction.

VII. TRUCKS WILL NOT PROVIDE AN EFFECTIVE ALTERNATE MODE OF TRANSPORTATION FOR MOST OF THE COMMODITIES INVOLVED IN THE 2-TO-1 AND 3-TO-2 MARKETS

A careful assessment of the record confirms that truck competition is not as pervasive as UP suggests and does not provide a discipline on rail rates for the vast majority of all

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[65] Keeler, Theodore, *Railroads, Freight and Public Policy*, Brookings, Washington, D.C., 1983; *accord* "In evaluating the effect of the consolidation on long-haul movements of bulk commodities, the focus may be on retaining effective intramodal competition." 49 CFR 1180.1(c)(2)(i).

origin-destination and commodity markets), rail transportation alone must still stand as the relevant market.

Water transportation is of relevance to only a small fraction of the traffic at issue. Most points in the area served by the merging carriers are not on navigable waterways; moreover, even for those that are, the other end of the move is seldom also served by a connecting waterway. Where water is a viable option, it is generally already the mode of choice, and even then, rail competition generally remains important to such shippers in that the water option is not at all times available. Similarly, as discussed previously, source competition may be effective for some shippers in limited situations, but this must be rejected as a competitive panacea.

Evidence regarding the limitations of truck competition in providing a competitive substitute for rail has been examined in previous ICC rail merger proceedings and documented in previous Commission decisions. Additional evidence that there will be competitive impacts across a very broad range of commodities/distances, including those where truck competition is present, is provided by the DOD data. There, while truck was an active bidder for many of the movements, the bids submitted by truck were frequently higher than rail and significantly so. (*See, e.g.*, V.S. Ploth at 34-37.) If truck was a successful alternate for rail, as Applicants claim, one would expect those shipments would be already moving by truck. Any elimination of the independent routings is bound to raise prices, at least to the lowest truck competitive price. Clearly we can anticipate a competitive impact with the elimination of rail competition, even where truck is a viable option. For

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[68](...continued)
Norfolk and Western Railway Company and Baltimore and Ohio Railroad Company -- Control --Detroit, Toledo and Ironton Railroad Company, 360 I.C.C. 498, 517 (1979)

other shipments, truck is not an alternative at all. Where this situation is present, we can expect an even stronger competitive impact.

Another very strong argument for rail as the relevant product market is the ICC's decision in *SFSP*, a merger with commodity mix and extensive long-haul markets very similar to the instant merger. The Commission stated the following:

> We have defined the appropriate product market as rail transportation. Much Southern Corridor traffic, in particular, requires movement by rail rather then by other transportation modes. Distances over which Southern Corridor movements would travel are generally well over 1,000 miles, making trucks ineffective competitors for most commodities. . . . Chemicals, assembled automobiles, food products, iron and steel, and cotton are heavily represented in Southern Corridor movements, and shippers of those commodities have also explained why, economically, those movements must be by rail. The record is replete with evidence of the inability of shippers to depend on modes other than rail for significant movements of many important commodities.

SFSP, 2 I.C.C.2d at 775 (1986).

In summary, a detailed examination of the effectiveness of truck competition is warranted. In a case on a much smaller scale, such as the Wisconsin Central merger in which I participated, it is feasible to analyze the effectiveness of truck competition with regard to individual shippers. In the instant proceeding (as in *SFSP*), with many thousands of shippers suffering a loss of rail competition, that approach on a comprehensive basis is out of the question. However, we develop a detailed portrait of commodities and distances of 2-to-1 and 3-to-2 shippers. This is the procedure followed by the ICC and DOJ in the *SFSP* merger.

A. The Applicants' *de facto* competitive analysis: a commodity profile

As we have discussed above, UP's agreement with BN constitutes Applicants' *de facto* competitive analysis. It is highly significant that Applicants acknowledged that elimination of rail competition constituted a competitive harm of the merger necessitating redress *via* access **regardless of the commodity being shipped and the length of haul of the shipment.** By limiting BNSF access to 2-to-1 points where the commodities transported are easily transported by truck or rail, Applicants could have narrowed the set of shippers requiring access, but, instead, Applicants granted access to BNSF at 2-to-1 points regardless of the commodity shipped. This constitutes strong evidence of rail transportation as the relevant market in this case, and is an admission that a reduction of rail competition is significant, regardless of the commodity. From information provided by the Applicants on these shippers, in conjunction with the 1994 traffic tapes, a profile of Applicants' stance on which commodities require continuing rail competition emerges. A breakdown of commodities/distances of Applicants' shippers receiving BN access under the settlement agreement is provided in Table 7.1.

The Applicants' de facto competitive analysis includes the following commodities with greater than $1 million of 1994 revenues: ordnance, apparel, furniture, rubber or plastics, fabricated metal, machinery, electrical machinery, miscellaneous freight, returned empty container, mail and express traffic and small packaged freight shipments; and the following commodities with greater than $10 million of 1994 revenues: farm products, metallic ores, coal, crude petroleum, nonmetallic minerals, food, lumber, pulp or paper, chemicals, petroleum products, concrete and stone, primary metal, transportation equipment, waste or scrap, freight forwarder traffic and miscellaneous mixed shipments.

B. The Commodity/Distance Profile for 2-to-1 and 3-to-2 Shippers

To further the role of truck in ameliorating the full competitive impacts of the merger, it is useful to examine specific data on the commodities/distances of 2-to-1 and 3-to-2 traffic according to our market definition. Table 7.2 and 7.3 provide a breakdown of commodity totals and lengths of hauls for the 2-to-1 and 3-to-2 traffic respectively; full details are provided in Appendices 5, 6, 7 and 8. A portrait of the affected shippers suggests that some of the traffic now handled by Applicants could be shifted to truck to avoid a rate increase; however, for the greatest portion of that traffic, truck is not an option at a cost that would prevent rail carriers from exacting significant rail rate increases. For 2-to-1 shippers, over three-fourths of the revenues are derived from shipments over 600 miles. Almost one-half of revenues have haul lengths greater than 1200 miles. Chemicals and coal are the two most prevalent commodities. For 3-to-2 shippers, over $2 billion of revenues are derived from movements of greater than 2100 miles. We will highlight some important findings from this table, by commodity, and provide additional evidence regarding the conditions under which truck can substitute for rail in Exhibit 1.

VIII. AN EXAMINATION OF COMPETITIVE IMPACTS IN FIVE SALIENT CORRIDORS FURTHERS OUR UNDERSTANDING OF THE CONSOLIDATION'S IMPACT.

In this section we turn to an analysis of competitive impacts in five corridors: Cotton Belt Corridor, San Antonio - New Orleans, Houston - Brownsville, Central Corridor, and Kansas - Fort Worth. In each instance we provide additional data regarding commodities as well as summary information regarding competitive effects for each BEA pair traversing the corridor. More complete information regarding competitive impacts of any BEA pair can be found in Appendices 1, 2 and 3.

Cotton Belt Corridor

Table 9.1 and Appendix 9 provide information regarding this corridor, which has a total of million of combined 2-to-1 and 3-to-2 traffic. The heart of the corridor is the Houston - St.Louis market, a 3-to-2 BEA pair with UP and SP together controlling 88% of carloads and 86% of revenues. Dallas - St. Louis is another 3-to-2 market within this corridor where UP and SP are quite dominant, with control of 98% of carloads and 96% of revenues. There are also a number of important 2-to-1 markets comprising this corridor including Little Rock - Shreveport, Houston - Little Rock, Little Rock - Houston, Chicago - Little Rock, Kansas City - Brownsville - McAllen, Texas, Little Rock - St. Louis, and Chicago - Tyler - Longview, Texas.

The dominant commodity, by far, within this corridor is chemicals, comprising 43% of the combined 2-to-1 and 3-to-2 traffic. Percentages for other commodities within the corridor can be found by referring to Table 9.1.

San Antonio - New Orleans

Table 9.2 and Appendix 9 provide information regarding this corridor, which has a total of $241 million of combined 2-to-1 and 3-to-2 traffic. Of this total, $198 million is 2-to-1 traffic, with the most important markets being San Antonio - Houston, Baton Rouge - Houston, Austin - Houston, Houston - New Orleans, New Orleans - Houston, Houston - San Antonio and Houston - Baton Rouge. Non-metallic minerals and chemicals are the two dominant commodities in this corridor, with Table 9.2 providing further details.

Cotton Belt Corridor

Commodity Distribution by STCC2

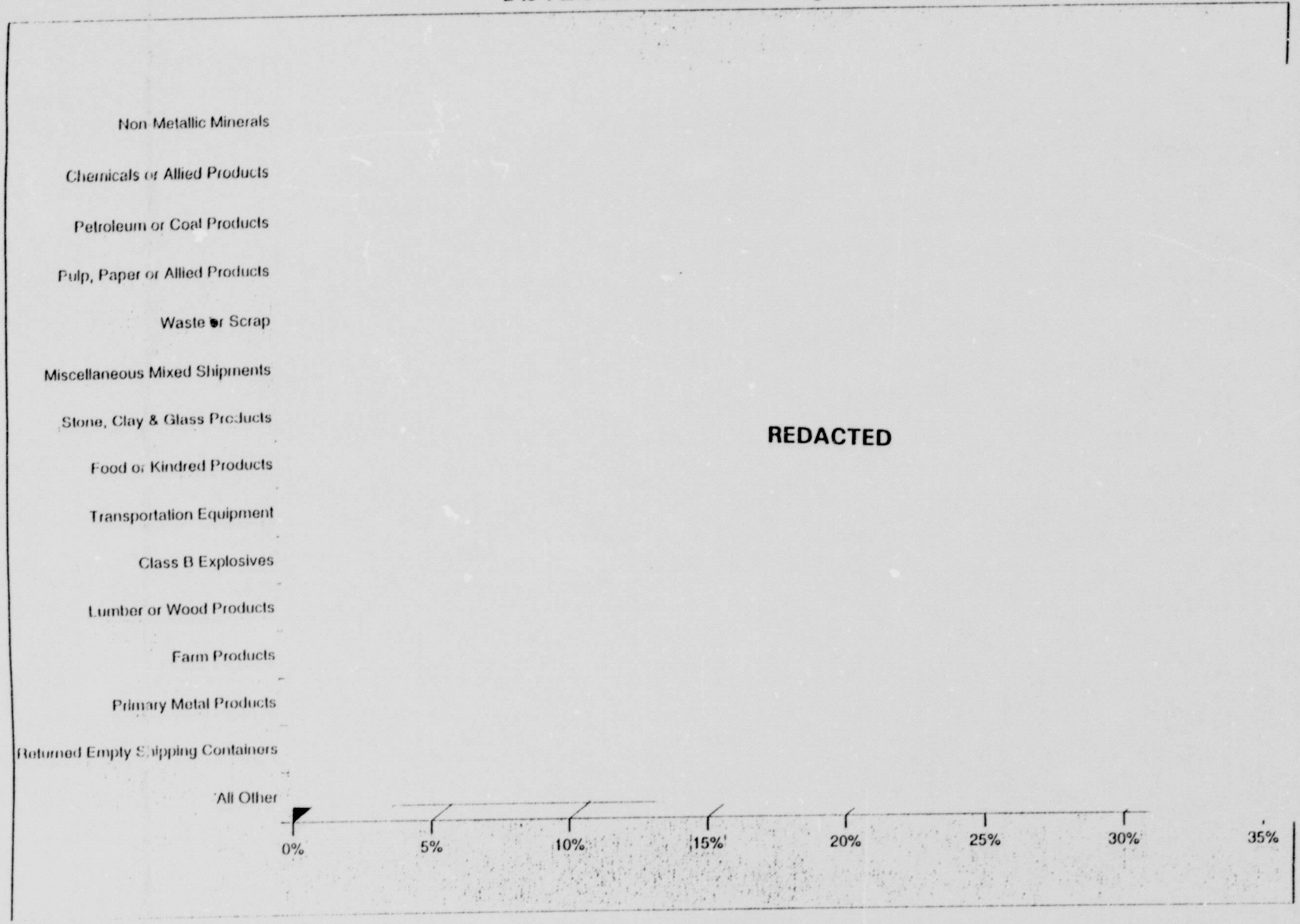
2- to - 1's and 3- to -2's

STCC No.
28
29
24
20
46
37
14
01
33
26
32
10
40
49
42
51

REDACTED

Highly confidential: Filed pursuant to protective order issued in Finance Docket No. 32760

Table 9.2
San Antonio, TX to New Orleans, LA Corridor - Revenue Distribution by Commodity
2-to-1 and 3-to-2 Traffic UP/SP Merger



San Antonio, TX to New Orleans, LA Corridor

Commodity Distribution by STCC2

2- to - 1's and 3- to -2's

STCC No.	Description	Total 2-to-1 Revenue	Total 3-to-2 Revenue	Combined Total Revenue	Total Revenue Percent
14	Non-Metallic Minerals				
28	Chemicals or Allied Products				
29	Petroleum or Coal Products				
26	Pulp, Paper or Allied Products				
40	Waste or Scrap				
46	Miscellaneous Mixed Shipments				
32	Stone, Clay & Glass Products				
20	Food or Kindred Products				
37	Transportation Equipment				
49	Class B Explosives				
24	Lumber or Wood Products				
01	Farm Products				
33	Primary Metal Products				
42	Returned Empty Shipping Containers				
52	All Other				
	TOTAL				

REDACTED

Houston - Brownsville

Table 9.3 and Appendix 9 provide information regarding this corridor, which has a total of $110 million of 2-to-1 traffic. Corpus Christi - Houston, Houston - Corpus Christi, Houston - Brownsville, Kansas City - Brownsville, Lincoln, Nebraska - Brownsville, and Omaha, Nebraska - Brownsville are among the BEA pair with the most 2-to-1 traffic. Farm products and chemicals are the dominant commodity. Table 9.3 provides a full commodity breakdown.

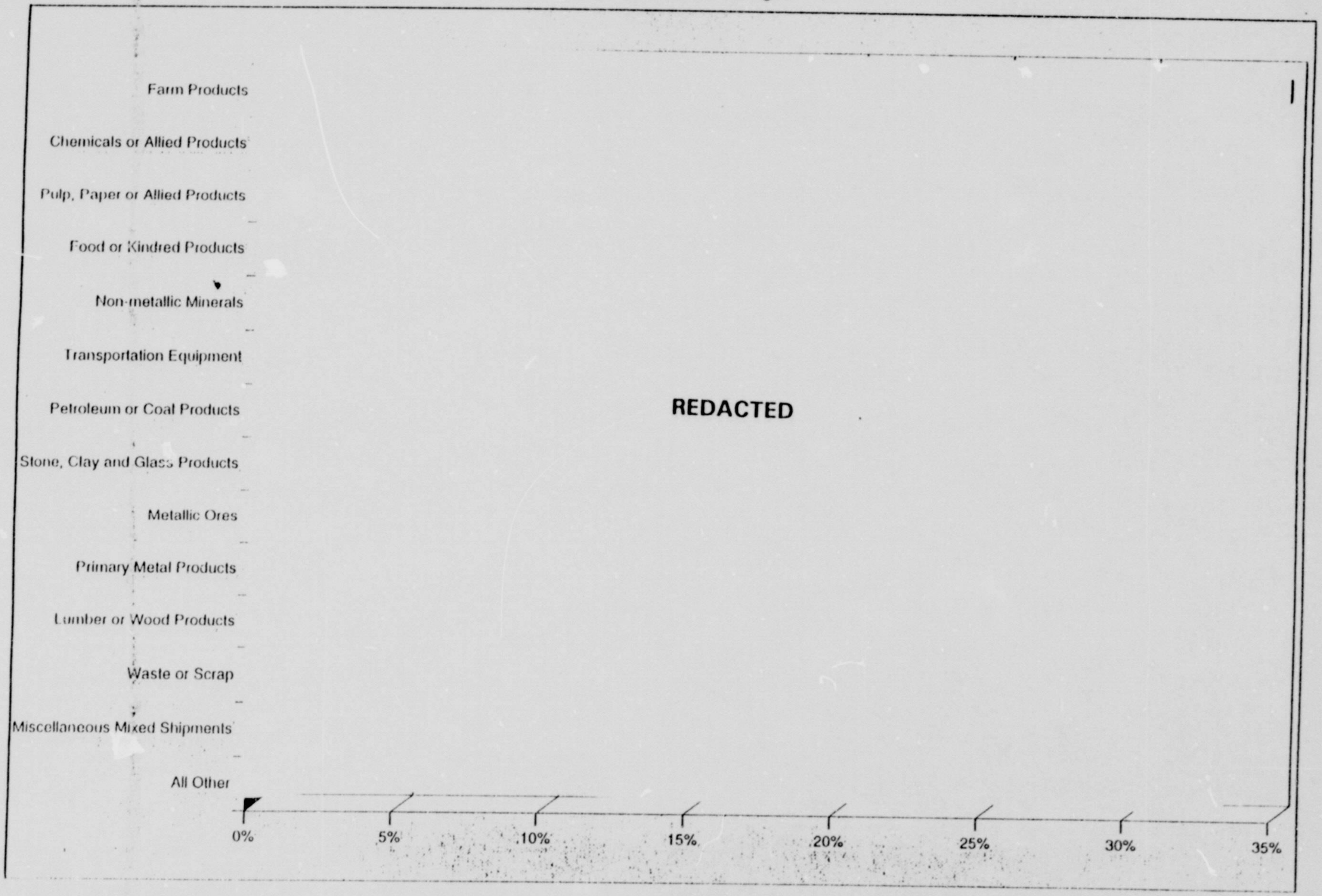
Central Corridor

Table 9.4 and Appendix 9 provide information regarding this corridor, which has a total of $1.220 billion of combined 2-to-1 and 3-to-2 traffic. These consist in part of major 3-to-2 markets, such as San Francisco - Chicago, Salt Lake City - Chicago, Chicago - Salt Lake City, Detroit - San Francisco, San Francisco - New York, Chicago - Stockton - Modesto, CA, and Chicago - San Francisco. There are also significant 2-to-1 impacts in markets such as Duluth - Salt Lake City, San Francisco - Salt Lake City, Salt Lake City - San Francisco, and Salt Lake City - Stockton. The top commodities, as listed in Table 9.4, are miscellaneous mixed shipments, transportation equipment, food products and chemicals.

Kansas - Fort Worth

The UP-SP merger reduces competition over this line segment from 3-to-2 independent competing routes, as indicated in the accompany diagram. Following the BNSF merger, 3 carriers serve this market. They are UP (over ex-MKT lines), BNSF, and SP (over trackage rights granted in SP's settlement agreement with BNSF in the BN/SF merger). 1994 data does not reflect the relatively recent SP entrance into this market. The main focus

Ta[illegible].3
Houston, TX to Brownsville, TX Corridor - Revenue Distribution by Commodity
2-to-1 Traffic UP/SP Merger



Highly confidential: Filed pursuant to protective order issued in Finance Docket No. 32760

Table 9.3

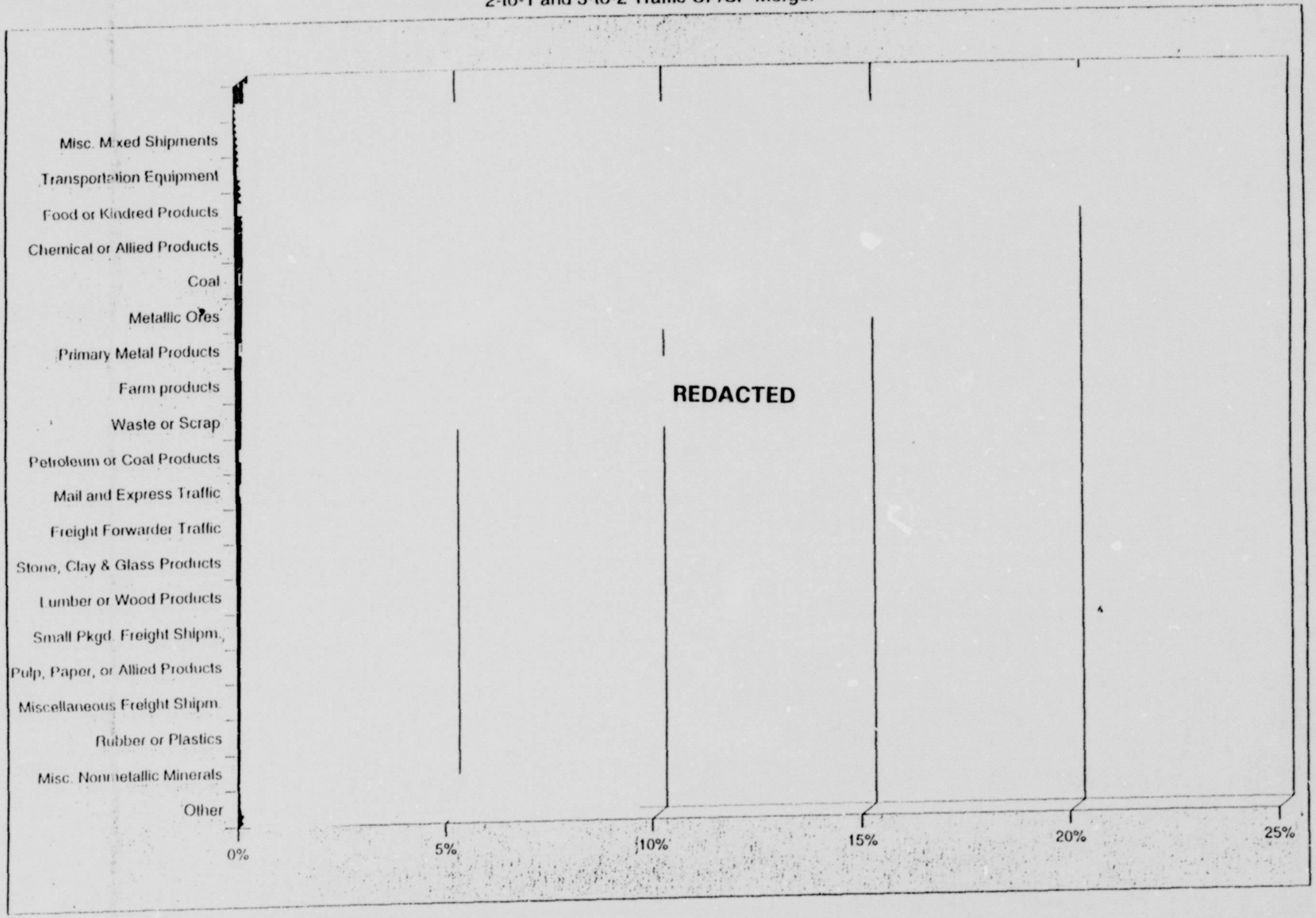
Houston, TX to Brownsville, TX Corridor

Commodity Distribution by STCC2

2- to - 1's

STCC No.	Description	Total Revenue	Total Revenue Percent
01	Farm Products		
28	Chemicals or Allied Products		
26	Pulp, Paper or Allied Products		
20	Food or Kindred Products		
14	Non-metallic Minerals		
37	Transportation Equipment		
29	Petroleum or Coal Products	REDACTED	
32	Stone, Clay and Glass Products		
10	Metallic Ores		
33	Primary Metal Products		
24	Lumber or Wood Products		
40	Waste or Scrap		
46	Miscellaneous Mixed Shipments		
51	All Other		
	TOTAL		

T[illegible]9.4
Central Corridor - Revenue Distribution by Commodity
2-to-1 and 3-to-2 Traffic UP/SP Merger



Highly confidential: Filed pursuant to protective order issued in Finance Docket No. 32760

Table 9.4

Central Corridor

Commodity Distribution by STCC2

2- to - 1's and 3- to -2's

STCC No.	Description	Total 2-to-1 Revenue	Total 3-to-2 Revenue	Combined Total Revenue	Total Revenue Percent
46	Misc. Mixed Shipments				
37	Transportation Equipment				
20	Food or Kindred Products				
28	Chemical or Allied Products				
11	Coal				
10	Metallic Ores				
33	Primary Metal Products				
01	Farm products				
40	Waste or Scrap				
29	Petroleum or Coal Products				
43	Mail and Express Traffic				
44	Freight Forwarder Traffic				
32	Stone, Clay & Glass Products				
24	Lumber or Wood Products				
47	Small Pkgd. Freight Shipm.				
26	Pulp, Paper, or Allied Products				
41	Miscellaneous Freight Shipm.				
30	Rubber or Plastics				
14	Misc. Nonmetallic Minerals				
51	Other				
	TOTAL				

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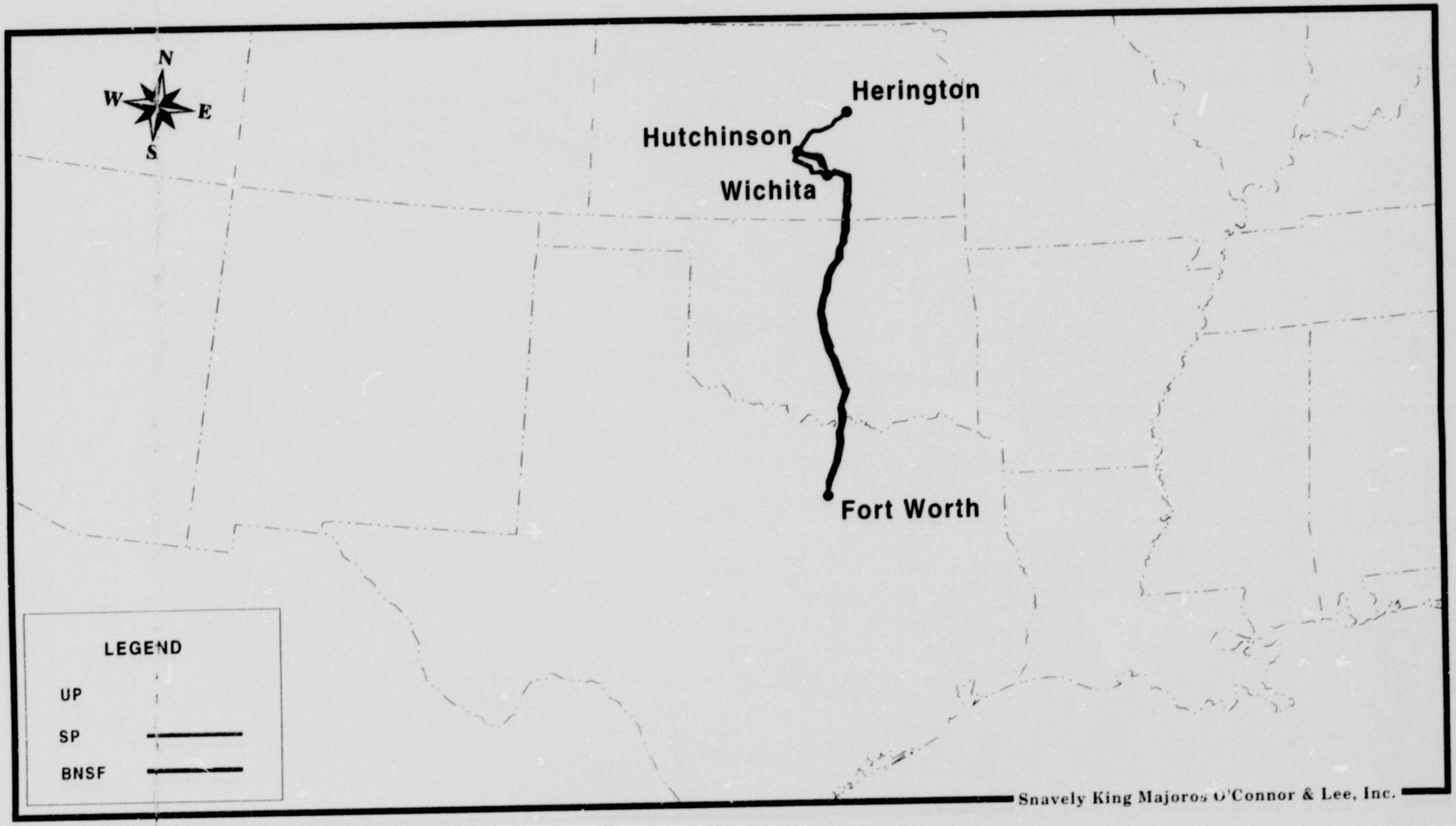
Central Kansas Grain Producers
Kansas to Texas and the Gulf



March 25, 1996

here is on grain and a coalition of Kansas grain shippers has expressed concern regarding the competitive impact in this market.

In the BNSF proceeding USDA expressed concern that intermodal competition is limited already in the Upper and Lower Plains wheat markets and that further reductions in competition "could adversely affect U.S. wheat shippers and producers. USDA is also concerned that intramodal competition will be drastically reduced in a number of rail dependent wheat production areas." Comments of the United States Department of Agriculture filed in *Burlington Northern Inc. and Burlington Northern RR. Co. -- Control and Merger -- Santa Fe Corporation and the Atchison, Topeka and Santa Fe Ry. Co.*, Finance Docket No. 32549. While USDA did not oppose the BNSF merger, they did ask the Commission to "make every effort to assure that an adequate level of competition is maintained in those markets and on those routes where competition will likely suffer as a result of the merger. In these instances, the Commission should consider appropriate trackage rights and operating concessions that will preserve or even increase the benefits of competition." Id.

CONCLUSION

This parallel merger is clearly anticompetitive unless strongly conditioned. Rail competition is of great importance to many shippers in this area; loss of this competition would result in higher rates for these shippers.

Consistent with the DOJ/FTC merger guidelines, the proper market definition in the case is rail transportation in narrowly defined origin-destination markets. Clearly the markets in question in this consolidation are highly concentrated by DOJ or any other standard and will significantly increase in concentration as rail competitors are reduced from three to two and two to one. We have quantified the most salient effects and those most readily quantifiable, 2-to-1 and 3-to-2. Many other shippers face a horizontal competitive effect, for example 4-3, or the reduction of interline options, which we have also discussed. Many other competitive effects are possible, other than those described above.

By any reasonable assessment, this merger has unprecedented competitive harm and should, as proposed, be denied.

VERIFICATION

Personally appeared the undersigned Curtis Grimm, PhD., who under oath states that the information contained in the foregoing Verified Statement is true and correct.

Curtis Grimm

Curtis Grimm, PhD.

Sworn to and subscribed before me this 26 day of March, 1996.

Kathleen M. Lauth

Notary Public

My Commission Expires: 8/1/97

EXHIBIT 1

STCC 01 - FARM PRODUCTS REDACTED

For farm products, million of STCC01 revenue are from shipments on 2-to-1 routes and million are from shipments on 3-to-2 routes. Most of these movements are of sub-group 0100000-0119999 -- field crops, raw cotton, grain, oil kernels, seeds etc. STCC01 2-to-1 traffic is generally within the 900-1500 mile range and consists primarily of sub-group 0100000-0119999 commodities. This sub-group accounts for $ million of total revenues.

The 3-to-2 traffic is generally between 600-1200 miles, and is mostly comprised of commodities in sub-group 0100000-0119999. This sub-group accounts for million of total revenues. Most of the STCC0120000-0119999 traffic is transported over 2100 miles.

Grain is an important commodity within this group, and it is well established that rail has a significant advantage over truck for movements of grain beyond those of a short distance. As noted in a recent USDA report; "Railroads remain the predominant mode of grain transportation in the United States." [1] This has been well documented in previous ICC decisions, for example, *SFSP*; "Trucks are generally regarded as effective competitors for grain movements for distances of 250 miles or less, while movements of 500 miles or more are clearly rail dominant."[2]

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[1] J.D. Norton, P.J.Bertels, and F.K. Buxton, "Transportation of U.S. Grains A Modal Share Analysis," *Agricultural Marketing Service, U.S. Department of Agriculture*, July, 1992, p. 5.

[2] *SFSP*, 2 I.C.C. 2d at 791 (1986); *UP/MKT*, 4 I.C.C. 2d at 442 (1988); *see also*, ICC Finance Docket 30800 Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company - Control - Missouri- Kansas-Texas Railroad Company, et al, p. 442.

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Pittman (1990) offered the following assessment:

Grain (1131 barley, 1132 corn, 1136 sorghum, 1137 wheat, 1144 soybeans) Trucks are competitive with rail for moves up to 250-500 miles.[3]

STCC 10 - METALLIC ORES

For metallic ores, $ million of STCC10 revenues are 2-to-1's and $ million are 3-to-2's. The 2-to-1's are dominated by commodities in the sub-group 1000000-1019999 -- iron, copper, lead, zinc ores. The 3-to-2's are dominated by commodities in sub-group 1040000-1059999 -- gold or silver ores.

Most 2-to-1 traffic is in the 1500-1800 reflecting over half the carloads in the 1000000-1019999 sub-group (iron, copper, lead and zinc) and 66 percent of the sub-group revenues.

The 3-to-2's are dominated by traffic in the 300-600 mileage block reflecting 58 percent of the revenues in this sub-group, 1040000-1059999. This sub-group accounts for $ million or 92 percent of total revenues. Metallic ores were included in the list of commodities singled out by the ICC in its SFSP decision.

STCC 11 - COAL

For coal shipments, $ million of STCC11 revenues are 2-to-1's and million are 3-to-2's. Both 2-to-1's and 3-to-2's are dominated by commodities in the sub-group 1120000-1139999 -- bituminous coal or lignite.

Most 2-to-1 traffic are over distances of 300 miles with the sub-group traffic accounting for almost all traffic and revenues. The sub-group accounts for 314 thousand

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[3] R.W. Pittman, "Railroads and Competition: The Santa Fe/Southern Pacific Merger Proposal," *The Journal of Industrial Economics*, 39 (1) (1990): 25-46.

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carloads and $ million or 99.9 percent of total revenues. The 3-to-2's are dominated by traffic over 900 miles with the sub-group traffic accounting for almost all traffic and revenues. The sub-group accounts for 30 thousand carloads and $ million or percent of total revenues.

Movements of coal are clearly rail dependent. Rail transportation controls about two-thirds of the coal traffic in the United States.[4] Competition from other transportration modes, particularly truck carriers, are cost effective only for distances under 300 miles.[5]

According to Morey:

> Unlike coal production in the East and Midwest, where significant tonnages can move to market by non-rail modes (truck and barge), western coal production is heavily dependent upon rail. And if the UP/SP merger goes through, the transportation of coal from all western mines will be basically controlled by only two railroads.
>
> . . .
>
> To coal consumers, there is the strong possibility that rates will rise due to the smaller number of carriers doing business. Two large railroads should be in a stronger position to exert pressure on rates than five different carriers of various sizes, especially in those instances where a customer is captive to one carrier.[6]

STCC 14 - NONMETALLIC MINERALS

For nonmetallic minerals $ million of STCC14 revenues are 2-to-1's and $ million are 3-to-2's. The 2-to-1's are dominated by commodities in the sub-group 1420000-

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[4] Facts about Coal, 1995 National Mining Association, Washington, D. C.

[5] Coal Data: A Reference, Energy Information Administration, November 1991, p. 18.

[6] Mark T. Morey. "Railroad Consolidation in the West - Implications for the Coal Market", *A Fieldston and Coal Transportation Report*, November, 1995, p. 5-6.

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1439999 -- crushed or broken stone. The most of the 3-to-2's are commodities in the 1420000-1479999 sub-groups -- gravel or sand, clay, ceramic, chemicals or fertilizer minerals.

The 2-to-1 traffic in the dominant sub-group accounts for 125,818 carloads or 79 percent of the total traffic, and $ million or 64 percent of total revenues. The 3-to-2 traffic in the dominant sub-groups accounts for 84,762 carloads or 93 percent of the total traffic, and $ million or 85 percent of total revenues. In the *UP-MKT* decision, the Commission made clear the limited basis upon which truck could compete for such bulk products:

> Truck transport is prohibitively expensive for the long haul; crushed stone is a high-bulk, heavy loading commodity, for which motor carriers are effective only for distances of less than 75 to 100 miles.[7]

UP-MKT, 4 I.C.C.2d at 464-465 (1988).

STCC 19 - ORDNANCE OR ACCESSORIES

For these commodities, $ million of STCC19 revenues are 2-to-1's and $1.6 million are 3-to-2's. Both the 2-to-1's and the 3-to-2's are dominated by commodities in the sub-group 1920000-1939999 -- ammunition, guided missiles, combat vehicles.

The 2-to-1 traffic in the dominant sub-group accounts for 1370 carloads or 95 percent of the total traffic, and $ million or 94 percent of total revenues. The 3-to-2 traffic in the dominant sub-group accounts for 342 carloads or 76 percent of the total traffic, and $ million or 84 percent of total revenues. Most traffic for both 2-to-1's and 3-to-2's are long

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[7] ICC Finance Docket 30800, Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company - Control - Missouri-Kansas-Texas Railroad Company, Et Al, p. 464-5.

haul, over 2,100 miles. The competitive impact of reduced rail competition for this commodity is well-documented in the statement of KCS witness Ploth.

STCC 20 - FOOD OR KINDRED PRODUCTS

For food products, $157.2 million of STCC20 revenues are 2-to-1's and $ million are 3-to-2's. Both the 2-to-1's and 3-to-2's are dominated by commodities in the 2040000-2059999 and 2080000-2099999 sub-groups -- grain mill products, prepared feeds, fish, poultry, milled rice, beverages, wines, nuts, vegetables, etc.

Most 2-to-1 traffic is over 600 miles while most of the 3-to-2 traffic is over 1200 miles. The 2-to-1 traffic in the dominant sub-groups accounts for 68,893 car loads or 77 percent of the total traffic, and $ million or 76 percent of total revenues. The 3-to-2 traffic in the dominant sub-groups accounts for 194118 carloads or 70 percent of the total traffic, and $ million or 71 percent of total revenues. The majority of the 3-to-2 traffic and revenues are in the 2080000-2099999 sub-groups.

STCC 24 - LUMBER OR WOOD PRODUCTS

For lumber or wood products, $ million of STCC24 revenues are 2-to-1's and $ million are 3-to-2's. In its decision in *UP/MP/WP*, the ICC stated that "DOT notes that in the U.S. Department of Commerce, 1977 Census of Transportation, Commodity Transportation Survey (1981): (1) for lumber and wood products except furniture (STCC

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Code 24), 80 percent of the tonnage moving 1,000 to 1,499 miles and 87 percent of the tonnage moving over 1,500 miles moves by rail."[8]

Pittman assessed this commodity as follows:

> Lumber products (24114 pulpwood logs, 24115 pulpwood chips, 24211 lumber, 24321 plywood, 24996 particle board) Logs and chips are low value commodities for which intermodal competition is effective for shortest of distances; higher value manufactured commodities can see effective competition for moderate distances only.[9]

STCC 26 - PULP OR PAPER PRODUCTS

For pulp or paper products, $ million of STCC26 revenues are 2-to-1's and $ million are 3-to-2's. Both the 2-to-1's and 3-to-2's are dominated by commodities in the 2620000-2639999 sub-group -- paper, newsprint, wrapping paper, fiberboard, etc.

Most 2-to-1 traffic is over distances in the 900-1200 mileage block, and 3-to-2 traffic is over 2100 miles. The 2-to-1 traffic in the dominant sub-group accounts for 64,953 carloads or 83 percent of the total traffic and $139.2 million or 80 percent of total revenues.

The 3-to-2 traffic in the dominant sub-group accounts for 60,664 carloads or 78% percent of the total traffic $ million or 83 percent of total revenues.

In the *UP/MP/WP* decision the ICC stated that "DOT notes that in the U.S. Department of Commerce, 1977 Census of Transportation, Commodity Transportation

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[8] ICC Finance Docket 30000, Union Pacific Corporation, Pacific Rail System Inc., and Union Pacific Railroad Company - Control - Missouri Pacific Corporation and Missouri Pacific Railroad Company, p. 677-678; *UP/MP/WP*, 366 I.C.C. at 677-678 (1982).

[9] R.W. Pittman, "Railroads and Competition: The Santa Fe/Southern Pacific Merger Proposal," *The Journal of Industrial Economics*, 39 (1) (1990), pp. 32-34.

Survey (1981): . . . (2) for paper and allied products (TCC Code 26) 75 percent of the tonnage moving over 500 miles moves by rail."[10]

STCC 28 - CHEMICALS

For chemical traffic, $ million of STCC28 revenues are 2-to-1's and $834.7 million are 3-to-2's. The 2-to-1's are dominated by commodities in the 2800000-2819999 sub-group -- industrial chemicals such as potassium and sodium alkalies, crude coal products, dyes, etc. The 3-to-2's are dominated by commodities in the 2800000-2839999 sub-group; including commodities such as plastic materials and drugs.

Most 2-to-1 traffic is over distances in the 900-1200 mileage block, and most of the 3-to-2 traffic is over 1200 miles. The 2-to-1 traffic in the dominant sub-group accounts for 101,894 carloads or 69 percent of the total traffic and $ million or 68 percent of total revenues. The two dominant 3-to-2 sub-groups account for 256,417 carloads or 81 percent of the total traffic, and $ million or 88 percent of total revenues.

In its *UP/MP/WP* decision, the ICC states that "DOT notes that in the U.S. Department of Commerce, 1977 Census of Transportation, Commodity Transportation Survey (1981): . . . (3) for chemicals and allied products (STCC Code 28), 78 percent of the tonnage moving over 500 miles moves by rail." *UP/MP/WP*, 366 I.C.C. at 677-678 (1982).

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[10] ICC Finance Docket 30000 Union Pacific Corporation, Pacific Rail System, Inc., and Union Pacific Railroad Company - Control - Missouri Pacific Corporation and Missouri Pacific Railroad Company, p. 677-678; *UP/MP/WP*, 2 I.C.C. 2d at 677-678 (1982).

Oum further determined the distance ranges for effective intermodal competition, with chemicals in a category of "Up to 500 miles." [11]

STCC 29 - PETROLEUM OR COAL PRODUCTS

For these products, $ million of STCC29 revenues are 2-to-1's and $154.5 million are 3-to-2's. Both the 2-to-1's and the 3-to-2's are dominated by commodities in the 2900000-2919999 sub-group -- gasoline, jet fuel, kerosene, asphalt, tars, liquefied gas, etc.

Most 2-to-1 traffic is over distances in the 300-600 mileage block, and the 3-to-2 traffic is over all mileage blocks. The 2-to-1 traffic in the dominant sub-group accounts for 25,237 carloads or 68 percent of the total traffic and $ million or 69 percent of total revenues. The dominant 3-to-2 sub-group accounts for 57,817 carloads or 81 percent of the total traffic, and $ million or 87 percent of total revenues.

According to Oum, distance ranges for effective intermodal competition are as follows for these commodity groups:

CFTM66 (Fuel oil, except gasoline) up to 400 miles;

CFTM69 (Other refined petroleum products) 300-1500 miles; and

CFTM78 (Nonmetallic basic products) 200-1200 miles.[12]

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[11] T. H. Oum, "A Cross Sectional Study of Freight Transport Demand and Rail-Truck Competition in Canada," *The Bell Journal of Economics*, 10 (1979), pp. 479-80.

[12] T. H. Oum, "A Cross Sectional Study of Freight Transport Demand and Rail-Truck Competition in Canada," *The Bell Journal of Economics*, 10 (1979); pp. 479-80.

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STCC 32 - CLAY, CONCRETE, GLASS OR STONE

For these commodities, $ million of STCC32 revenues are 2-to-1's and $ million are 3-to-2's. The 2-to-1's are dominated by commodities in sub-groups 3220000-3239999 and 3280000-3289999 -- glass containers, bottles, lighting glassware, cut stone, slate, or talc. The 3-to-2's are dominated by commodities in sub-group 3280000-3299999 -- stone and stone products.

Most 2-to-1 traffic is over the 300-1200 mileage block and most 3-to-2 traffic is over 2100 miles. The 2-to-1 traffic in the dominant sub-groups account for 37,900 carloads or 80 percent of the total traffic, and $ million or 84 percent of the total revenues.

The dominant 3-to-2 sub-group accounts for 16,168 carloads or 41 percent of the total carloads and $ million or 48 percent of the total revenues. In addition, the sub-group 3220000-3230000 (glass containers and products) accounts for 10,370 carloads and $ million in total revenues.

STCC 33 - PRIMARY METAL PRODUCTS

For primary metal products $ million of STCC33 revenues are 2-to-1's and $ million are 3-to-2's. Both the 2-to-1's are dominated by commodities in sub-group 3300000-3319999 -- steel works, blast furnaces, iron and steel products, ferroalloys, wire, etc.

Most 2-to-1 traffic is in the 900-1200 mileage block and most 3-to-2 traffic is over 2100 miles. The 2-to-1 traffic in the dominant sub-groups account for 30,268 carloads or 81 percent of the total traffic, and $ million or 79 percent of the total revenues. The dominant 3-to-2 sub-group accounts for 86,327 carloads or 81 percent of the total carloads, and $172.2 million or 83 percent of the total revenues. Iron and steel was mentioned above in the list of commodities singled out by the ICC in *SFSP*.

STCC 37 - TRANSPORTATION EQUIPMENT

For transportation equipment, $ million of STCC37 revenues are 2-to-1's and million are 3-to-2's. Both the 2-to-1's and 3-to-2's are dominated by the sub-group 3700000-3719999 -- motor vehicles, parts and accessories, truck trailers etc.

Most 2-to-1 are transported over distances in the 1500-1800 mileage block and most 3-to-2 traffic is transported over 2100 miles. The 2-to-1 traffic in the dominant sub-group accounts for 69,614 carloads or 90 percent of the total traffic, and $ million or 94 percent of the total revenues.

The 3-to-2 traffic in the dominant sub-group accounts for 293,017 carloads or 96 percent of the total carloads, and $ million or 98 percent of the total revenues.

In its *UP/MP/WP* decision, the ICC stated that "DOT notes that in the U.S. Department of Commerce, 1977 Census of Transportation, Commodity Transportation Survey (1981): . . . (4) for transportation equipment (§ TCC Code 37), 82 percent of the tonnage moving over 500 miles moves by rail." *UP/MP/WP*, 366 I.C.C. at 677-678 (1982). In addition, the following assessment is relevant:

Pittman discussed this commodity as follows; "High value manufactured commodities for which motor carriers can compete with rails for distances up to 1000 miles. Strongly branded nature of these commodities renders source competition particularly ineffectual in protecting shippers from rail price increases."[13]

STCC 40 - WASTE OR SCRAP

For waste and scrap, $ million of STCC40 revenues are 2-to-1's and $ 2.7 million are 3-to-2's. Both the 2-to-1's and 3-to-2's are dominated by the sub-group 4020000-4039999 -- waste or scrap for metal, textiles, paper, wood, chemicals, rubber or plastics, stone, clay, leather, etc.

Most 2-to-1's and 3-to-2's are transported over 300 miles. The 2-to-1 traffic in the dominant sub-group accounts for 56,538 carloads or 96 percent of the total traffic, and $72.6 million or 94 percent of the total revenues.

The 3-to-2 traffic in the dominant sub-group accounts for almost all traffic and revenues -- 41,238 carloads or 99.8 percent of the total carloads, and $52.5 million or 99.6 percent of the total revenues.

STCC 46 - MISCELLANEOUS MIXED SHIPMENTS

For miscellaneous, $ million of STCC46 revenues are 2-to-1's and $ are 3-to-2's. Both the 2-to-1's and 3-to-2's are dominated by the sub-group 4600000-4619999 -- freight rate shipments.

Most 2-to-1's are transported over distances in the 900-1200 mileage block. Most 3-to-2's are transported over 2100 miles. The 2-to-1 traffic in the dominant sub-group

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[13] R.W. Pittman, "Railroads and Competition: The Santa Fe/Southern Pacific Merger Proposal," *The Journal of Industrial Economics*, 39 (1) (1990), pp. 25-46.

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accounts for 153,504 carloads or 91 percent of the total traffic, and $ or 89.3 percent of the total revenues.

The 3-to-2 traffic in the dominant sub-group accounts for almost all traffic and revenues -- 2.0 million carloads or 95 percent of the total carloads, and $ or 94 percent of the total revenues.

Intermodal has been a growth area for railroads and is expected to continue to be in the future.

> Intermodal transportation has seized 18 percent of the U.S. market for freight moving more than 500 miles and will have 25 percent by 1997, according to a survey of shippers.
> . . .
> While the survey showed that intermodal performance lags trucking in short-haul markets, intermodal enjoys an advantage for long-haul freight, the survey reported. The survey also showed that intermodal users and non-users indicate they expect intermodal performance relative to truck transportation to continue to improve during the next three years.

Mercer Management Consulting, "Intermodal has 18 percent of long-haul market in U.S." *American Shipper*, April, 1995, p. 93. In the late 80's/early 90's more common-carriage capacity on highly competitive routes motivated carriers to offer lower rates, but on less competitive routes oligopolies or even monopolies developed, mostly along modal lines, increasing shippers' transportation costs.[14]

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[14] Gerhardt Muller, *Intermodal Freight Transportation*, Intermodal Association of North America and Eno Transportation Foundation, Inc., 3rd Edition, 1995.

Pittman described the competitive situation as follows; "Motor carries can compete for some within-CA moves and LA-Houston moves, but generally merged RR would be able to raise prices."[15]

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[15] R.W. Pittman, "Railroads and Competition: The Santa Fe/Southern Pacific Merger proposal," *The Journal of Industrial Economics*. 39 (1) (1990), pp. 25-46.

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RAILROADS AND COMPETITION: THE SANTA FE/ SOUTHERN PACIFIC MERGER PROPOSAL*

RUSSELL W. PITTMAN

The Merger Guidelines of the US Department of Justice provide the framework for a detailed analysis of the competitive implications of the proposed merger of the Santa Fe and Southern Pacific railroads. Although the gross welfare loss from the merger is found to be large—in the range of $40–230 million per year—the transfers from shippers to the railroads are much larger. Thus an overall welfare calculus requires not only an accurate estimate of the efficiencies resulting from the merger but also a judgment as to the welfare relevance of wealth transfers.

"In the case of railways ... no one can desire to see the enormous waste of capital and land (not to speak of increased nuisance) involved in the construction of a second railway to connect the same places already united by an existing one ..."

John Stuart Mill [1848, vol. 2, p. 142]

"One of the most interesting and difficult applications of the theory of monopolies is to the question whether the public interest is best served by the allotment of a distinct basin to each great railway, and excluding competition there. ... It must be admitted that, other things being equal, the 'monopoly revenue price' fixed by a railway will be lowered by every increase in the demand for its services.... But, human nature being what it is, experience has shown that the breaking of a monopoly by the opening out of a competing line accelerates, rather than retards the discovery by the older line that it can afford to carry traffic at lower rates."

Alfred Marshall [1920, V, XIV, 5]

I. INTRODUCTION

IN SEPTEMBER of 1983, the Santa Fe (ATSF) and Southern Pacific (SP) railroads announced their long-rumored, long-negotiated plan to merge. The proposed merger would have created a third large railroad in the western United States and would have followed close on the heels of the mergers

*My thanks to Cindy Alexander, Tim Brennan, Mary Fitzpatrick, Ken Heyer, Sheldon Kimmel, Knox Lovell, Henry McFarland, and Bert Smiley for helpful comments on an earlier draft and to Rob French for excellent research assistance. Remaining errors are my own. I appeared as an expert witness for the Justice Department before the Interstate Commerce Commission in the Santa Fe/Southern Pacific merger proceedings. However, the opinions expressed are not necessarily those of the Department.

which created the other two: the 1980 consolidation of the Burlington Northern (BN) system with the acquisition of the St. Louis–San Francisco Railway, and the 1983 acquisition by the Union Pacific (UP) system of the Western Pacific and Missouri Pacific railroads.

However, unlike the BN and UP mergers, which combined railroads with primarily connecting, or "end-to-end", relationships, the merger of the ATSF and SP would have been primarily a parallel combination: the two roads provide the only rail service along the "southern corridor" between southern California, through Arizona and New Mexico, to Texas and the Gulf ports, and they are two of only three rail carriers between California and the Midwest.

For this reason, the Antitrust Division of the Justice Department announced in October of 1985 its opposition to the merger. Although approval of railroad merger applications by the Interstate Commerce Commission (ICC) had in recent years been "nearly automatic" (Lee, *et al.* [1987]), in July of 1986 the Commission stunned the railroad industry by turning down the merger application on a four-to-one vote. A proposal to reopen the proceeding lost by the same vote in July of 1987.

What made this proposed merger so anticompetitive that the ICC was forced to deny it? In this paper, I use the framework provided by the US Department of Justice Merger Guidelines [1984] and more recent data than were available at the time of the ICC proceeding to analyze the competitive implications of the ATSF/SP merger. I find that a serious loss of competition would likely have followed from the merger (a result also found by Shepherd [1988]), resulting in large gross deadweight losses and much larger transfers from shippers to the merging railroads. Under six of eight sets of parameters used, the efficiencies resulting from the merger outweigh the gross deadweight losses; however, under six of eight sets of parameters the transfers far outweigh the efficiencies, and under all eight sets the sum of the gross deadweight losses and the transfers outweighs the efficiencies. Thus a welfare evaluation of the merger requires a judgment as to the appropriate weight to be given to wealth transferring activities (including a prediction as to their efficiency implications).

II. THE COMPETITIVE FRAMEWORK: DEFINING MARKETS[1]

A merger is anticompetitive if it results in a significant increase in market power. But what is a market? What firms are in a market? And how is power in a market to be measured?

[1] This and the following section of the paper are based upon my testimony in a more recent railroad-merger proceeding: the proposed purchase by the UP of the Missouri-Kansas-Texas railroad (Pittman [1987]).

The Department of Justice Merger Guidelines define a market as

> a product or group of products and a geographic area in which it is sold such that a hypothetical, profit-maximizing firm ... that was the only present and future seller of those products in that area would impose a "small but significant and nontransitory" increase in price above prevailing or likely future levels.[2]

The most important determinant of whether a particular product and location constitute a market is the ease with which customers currently in the proposed market may switch their purchases to other products or other locations. If consumers can switch with little difficulty, then a hypothetical monopolist would not raise price, and the product/location combination does not constitute a market.

In applying this definition, one begins with each product produced by each merging firm and asks whether a hypothetical single seller of this product would have the ability to impose successfully a "small but significant and nontransitory" increase in price above the prevailing level. If such a price increase seems likely to be sustainable, then this product constitutes a market. If such a price increase seems unlikely to be sustainable because of the movement of buyers to other products, then we add the next-best substitute product to the product group and ask the price-increase question again. Progressively less close substitutes are added until the question is answered in the affirmative, at which point the product or group of products is accepted for analysis as a market.

In the analysis of a merger proposal by two railroads with largely parallel routes, the logical starting point for defining a market is the carriage of a particular commodity (call it X) from one point (call it origin A) to a second point (call it destination B) by the merging railroads.[3] In some instances, the merging railroads may be the only firms in that market. In other instances, there are additional railroad carriers capable of carrying the same commodity X between the same two points A and B at price and service terms comparable to those offered by the merging railroads, and these must be included in the market as well.

Further, in at least two situations the product group must be expanded beyond the carriage by rail of X from A to B. These situations are the following:

(1) "intermodal competition": when nonrail transportation modes can economically carry X from A to B; and
(2) "source competition": when rail or nonrail transportation modes can

[2] Department of Justice Merger Guidelines at 2.0.
[3] If the merger proposal under consideration concerns two railroads with purely an end-to-end relationship, then no such markets would be served by both firms. This does not mean that no loss of competition is possible from such a merger, however. This is because markets may also consist of the carriage of commodity X from and/or to common point A by the merging railroads.

economically carry X from A (to anywhere else) and rail or nonrail modes can economically carry X to B (from anywhere else).[4]

Intermodal competition refers to the ability of shippers to substitute another mode of transportation for rail in the shipment of X from A to B. The alternative mode in question is usually motor carrier and is almost always either motor carrier or water carrier. (For certain products it may be an oil, gas, or coal-slurry pipeline.) Motor carriers offer important service advantages over rail carriers, and in many cases they are close substitutes for rail transportation. However, there are certain commodities and certain conditions for which motor carriers are at a significant disadvantage relative to rail and so may not be in the market—most importantly, when the distance between A and B is great, when the volume of X shipments is large, and when the value of X relative to its weight is small.[5] Water transportation is sometimes a better substitute for rail than is motor transportation, especially for bulk products travelling long distances, but its substitutability is obviously limited to only certain geographic locations.[6]

If trucks or barges are close substitutes for rail in the hauling of a particular commodity, then trucks or barges must be included in the market with rail, and the cost and entry conditions relevant to trucks or barges must be considered in the analysis of the degree of market power possessed by rail carriers following a merger.

Source competition refers to the ability of shippers faced with supercompetitive rail prices in the shipment of X from A to respond by sending their commodity to alternative destination C, and the corresponding ability of customers at B to buy their commodity from alternative origin D. Source competition is a very good competitive alternative for some shippers and customers, but it is a very poor one for others. As Richard Levin testified in the ATSF/SP merger deliberations, source competition

> tends to be effective when sources of supply are numerous, when cost conditions of alternative sources of supply are homogeneous, when transport costs from alternative sources are similar, when the delivered products are close substitutes, and when the share of transport costs in the delivered price of the product is high.[7]

[4] A third situation of potential importance is called "product competition": when other carriers, using whatever mode, can economically carry a different commodity Y to B, where Y is a close substitute for X. I did not find this an important consideration in evaluating this merger, so I do not discuss it further here.

[5] See, for example, Oum [1979]; Friedlaender and Spady [1981]; Levin [1981]; and Winston [1985].

[6] See, for example, Kneafsey [1975, pp. 63–64]; Liba [1982]; and Hauser and Grove [1986].

[7] Levin [1984, p. 5]. The first, third, and fourth of these factors probably require no explanation. Cost conditions are important for the following reason. Suppose that two origins, S and T, currently supply a destination at the same price level, but that T is operating much closer to its capacity constraint—i.e. it is on or near a steeper portion of its supply curve. Then an attempt by carriers (or shippers) at S to raise price could not be undermined by output expansion

Source competition tends not to be effective in constraining market power for the carriage of commodities that are strongly differentiated by brand name, because maintenance of the goodwill stock of the brand name may require service to particular locations. A railroad facing no competition on a particular origin-destination pair can take advantage of this requirement and expropriate the available quasi-rents.

If the commodity in question is one for which source competition may in principle be effective, one must examine the possibility of this competition at both the origin and the destination of the origin-destination move being analyzed. Only if there is effective source competition at both the origin and the destination can such competition generally mitigate effectively the market power of carriers serving the origin-destination pair.

The reasoning is as follows. An origin-destination monopolist is really a monopolist *intermediary* between the seller at the origin and the customer at the destination. If only the seller or only the customer has competitive alternatives, then the other remains at the mercy of the monopolist. A monopoly railroad at the destination can raise the delivered price paid by the customer, forcing it to climb up its demand curve to a less desirable point; correspondingly, a monopsony railroad at the origin can lower the effective price received by the seller, forcing it to climb down its supply curve to a less desirable point. As long as the relevant demand and supply curves are less than perfectly elastic, there is both a wealth transfer to the railroad and a deadweight welfare loss to society.[8]

III. THE COMPETITIVE FRAMEWORK: MEASURING MARKET POWER

Once one is satisfied that a product-location pair constitutes a market, what factors dictate whether a merger of two firms in the market would create or enhance market power?

Let us define market power as "the ability of one or more firms profitably to maintain prices above competitive levels for a significant period of time."[9] If the only two firms in a market merge to form a monopoly, they would possess such power by definition, since that is precisely the criterion by which

at T, and source competition would be ineffective. The share of transport cost in the value of the delivered commodity is important because the higher this share, the more sensitive purchasers will be to an increase in the cost and the more likely they will be to switch to other sources (a point made originally by Marshall [1920, V, VI, 2] and qualified by Hicks [1932, p. 242]. For a recent discussion of the continuing controversy, see Peirson [1988]).

[8] For an early discussion, see Clark [1910]. As Warren-Boulton [1978, p. 52] points out, such a monopoly may in fact yield no welfare loss if the buyer(s) and seller(s) are able to agree on the profit-maximizing quantity and restrict the dimension of their bargaining to price. This outcome is easiest to imagine in a bilateral monopoly configuration, but it could occur when a monopoly faces a small number of buyers or a monopsony faces a small number of sellers.

[9] Department of Justice Merger Guidelines at 1.0.

we have defined a market in the first place. If two of a small number of firms in a market merge to form an even smaller number, their ability to achieve supercompetitive pricing would likely be enhanced significantly, assuming that entry by other firms into the market is not easy.[10]

If a particular location/commodity pair market includes motor or water carriers in addition to rail carriers, we can conclude with some confidence that a merger of two rail carriers would not cause a significant increase in market power, because truck and barge capital are sufficiently mobile that any attempt by rail carriers to raise prices or reduce service quality would result in a significant loss of rail market share and profit.[11] The same reasoning would apply if motor and/or water carriers could provide source competition at both the origin and the destination.

If a particular location/commodity pair market consists only of rail carriers, then the merger of two of these carriers will certainly result in some loss of competition. The degree to which competition is lost could conceivably depend on the market shares of the merging railroads, but I have seen no empirical test of this. What it seems more clearly to depend on is the number of rail carriers remaining in the market following the merger: Levin [1981a, b], Grimm [1985], and MacDonald [1987, 1989] all find significant increases in rail rates resulting from a move from three carriers to two, while Levin [1981a, b], Atkinson and Kerkvliet [1986], and MacDonald [1987, 1989] all find significant rate increases resulting from a move from two carriers to one. I have seen no empirical demonstration of a competitive loss resulting from a move from four carriers to three.

For this reason, I will focus in this paper on markets in which the proposed merger of the ATSF and SP would result in a reduction in the number of competitors from three to two or from two to one. Concluding from the empirical literature just cited that such a reduction constitutes a significant reduction in the strength of *intra*modal competition, I will then examine whether the markets in question include motor or water carriers or significant source competition at both origin and destination. In markets which do not include such factors, I conclude that the merger would be anticompetitive.

IV. TWO MEASUREMENT ISSUES

Two measurement issues need to be addressed before we proceed to a competitive analysis of the ATSF/SP merger. First, which rail firms are to be

[10] Stigler [1964] argues from a model of collusion that "the incentive to cut prices ... increases rapidly with the number of sellers." Orr and MacAvoy [1965] reach a similar theoretical conclusion. The same theoretical result is shown in a noncollusive oligopoly setting by Waterson [1984] and in an auction setting by Froeb [1988]. Empirical support for this position in a variety of industry settings may be found in Weiss [1984, 1989], Brannman, *et al.* [1987], and Brown and Warren-Boulton [1988].

[11] See Baumol [1984], emphasizing motor carriers, MacDonald [1987], emphasizing water carriers, and MacDonald [1989], discussing both.

included in a particular market? Second, how large is the geographic area of an origin or destination included in a market?

It would be possible to investigate rail markets and include only those firms currently carrying a particular commodity between the particular origin-destination pair as "in the market." However, if another railroad is currently carrying freight of any kind between the origin and destination in question, even if it is not carrying the commodity in question between the two locations, a reasonable (rebuttable) presumption would seem to be that that railroad could easily carry the commodity in question, therefore has an effect on rates, therefore belongs in the market. Once we make that presumption we can ask whether, for example, it is only a contract between the shipper and the first railroad that keeps the second railroad from participating at a particular time, or whether there is something about the configuration of the second railroad—perhaps a circular route or poorly-maintained track requiring low speeds or lack of direct service to certain plants—which hampers its ability to serve the particular shippers at issue. Thus in counting the number of railroads in a particular commodity/location market I include all railroads currently serving that origin-destination pair, regardless of whether they currently carry the particular commodity.[12]

The question of the geographic scope of origins and destinations does not yield an answer that can be applied uniformly for all products and locations. While many shippers have immediate access to two or more rail carriers at their plant or mine sites—through either direct service, trackage rights, or reciprocal switching arrangements—even those who do not may be able to substitute among rail carriers if they can move their product by truck to a rail carrier serving nearby points. The degree to which this is economically feasible depends upon the characteristics of the commodity—especially upon its value per ton—and upon the distance to the nearest alternative railroad, but the practice appears to be widespread.[13] My judgment is that for nearly all commodities and locations, all railroads serving a particular county need to be included among the competitive options facing shippers, and that for most commodities and locations the net must be cast even wider, to groupings of counties such as the Commerce Department's Business Economic Areas

[12] This methodological decision does not, in principle, bias the analysis either in favor of or against a merger, since the consequence is to include both nonmerging and merging railroads as potential competitors for shippers whom they do not currently serve. For example, while this rule would cause us to consider benign a market currently split 50/50 between the ATSF and SP but capable (by our definition) of being served by the UP, BN, and Kansas City Southern (KCS), it would also cause us to consider troublesome a market currently split 50/50 between the ATSF and UP but capable of being served by the SP.

[13] I have encountered instances of this practice in the following two-digit Standard Transportation Commodity Code industries: 01, farm products; 11, coal; 14, nonmetallic minerals; 20, food and kindred products; 24, lumber and wood products; 26, pulp, paper, and allied products; 28, chemicals and allied products; 32, clay, concrete, glass, and stone; 33, primary metal products; 34, fabricated metal products; 37, transportation equipment; and 40, waste and scrap materials.