

INTERSTATE COMMERCE COMMISSION 07/03/96

FINANCE DOCKET # 32760

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UNITED STATES OF AMERICA  
SURFACE TRANSPORTATION BOARD

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VOTING CONFERENCE

- - - - - X  
IN THE MATTER OF: :  
 :  
UNION PACIFIC CORPORATION, :  
UNION PACIFIC RAILROAD COMPANY, :  
and MISSOURI PACIFIC RAILROAD : Finance Docket  
COMPANY : No. 32760  
 :  
- 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. :  
- - - - - X

Wednesday, July 3, 1996

ICC Building  
12th & Constitution, N.W.  
Hearing Room A  
Washington, D.C.

The above-entitled matter came on for hearing,  
pursuant to notice, at 10:00 a.m.

BEFORE:

LINDA J. MORGAN, Chairman  
J. J. SIMMONS, III, Vice Chairman  
GUS A. OWEN, Commissioner

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## P-R-O-C-E-E-D-I-N-G-S

(10:00 a.m.)

CHAIRMAN MORGAN: Good morning.

Thank you for your attendance again today.

I will attempt to ensure that we are not together as long as we were on Monday.

At today's voting conference, the Board will consider the merger of the Union Pacific and the Southern Pacific Railroad systems proposed in Finance Docket No. 32760 and related dockets.

On Monday, we held oral argument in which some 35 parties presented their views on this matter.

Today, we will discuss with Board Staff the issues raised. We will consider the Staff recommendations presented and we will then vote on the recommendations.

Before proceeding with the Staff presentation, let me emphasize that our deliberations today represent another important milestone in shaping the future of the Nation's transportation network. The merger proposal before us, if approved, would have a significant effect on the efficiency of

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1 transportation service and on the economic growth and  
2 development of our country.

3 The proposed merger of UP and SP would  
4 create a single railroad system with more than 34,000  
5 miles of track operating in some 24 states and  
6 carrying a broad spectrum of commodities.

7 Our handling of this matter represents  
8 efficient and appropriate government action. Several  
9 months ago, a procedural schedule was set to conclude  
10 governmental consideration of this merger within nine  
11 months, by August 12, 1996.

12 The schedule was designed to produce a  
13 final decision as expeditiously as possible while  
14 guaranteeing all parties a full opportunity to make  
15 their case.

16 As I noted at oral argument on Monday, we  
17 have amassed a voluminous, high-quality record that  
18 thoroughly covers the sharply differing views on the  
19 many important transportation issues in this case.

20 As we are well on our way to meeting the  
21 schedule, this is indeed a good example of government  
22 at work.

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1 In terms of the Staff presentation, I  
2 propose that we adopt the following schedule:

3 The Staff will present an opening  
4 statement, addressing the applicable statutory  
5 standards and giving an overview of the issues central  
6 to this case. After that presentation, Board members  
7 may ask questions of the Staff; then the Staff will  
8 present its final recommendations. Following any  
9 questions regarding the recommendations, the Board  
10 will vote on these recommendations.

11 Upon completion of the voting process,  
12 Board members may present any closing remarks. Also,  
13 if time allows after the voting conference, the Board  
14 and its Staff will be available briefly to answer  
15 general questions from the media.

16 Mr. Konschnik, would you like to proceed  
17 with the Staff recommendations?

18 MR. KONSCHNIK: Yes. Thank you and good  
19 morning, Chairman Morgan, Vice Chairman Simmons and  
20 Commissioner Owen.

21 I have the pleasure of introducing the  
22 members of the team for this proceeding who are at the

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1 table.

2 Beginning at the end of the table to my  
3 right is Mel Clemens, Paul Graham, Harold McNulty,  
4 Elaine Kaiser, Henri Rush, Michael Redisch, Louis  
5 Mackall, Julia Farr, Paul Markoff, Jack Ventura,  
6 Walter Asmuth, Bud Ginn, and Jim Wells. Other team  
7 members, significant contributors who were not at the  
8 table, are Lee Gardner, Len Blistein, Susan Jensen,  
9 Bill Moss, Andrea Richards, Vicki Rutson, John Sado,  
10 Kevin Ellis, and Winn Frank.

11 Under the leadership of Julia Farr, this  
12 able and hard working group has devoted countless  
13 hours to bring us through development of a voluminous  
14 record and issuance of more than 40 decisions in this  
15 proceeding so far.

16 You heard oral argument two days ago. The  
17 team has prepared an overview and formulated its  
18 recommendations for your consideration today.

19 Team leader Julia Farr will begin the  
20 Staff presentation and will introduce other components  
21 of that presentation.

22 Ms. Farr?

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1 MS. FARR: Good morning, Chairman Morgan,  
2 Vice Chairman Simmons, Commissioner Owen.

3 By application filed November 30, 1995,  
4 applicants seek authorization for the common control  
5 and ultimate merger of the Union Pacific Railroad  
6 Company and Southern Pacific Rail Corporation.  
7 Applicants have also filed several related  
8 proceedings. These include a notice of exemption for  
9 settlement-related trackage rights, a petition for  
10 exemption for settlement-related line sales, five  
11 petitions for exemption for control of terminal  
12 railroads, a petition for exemption for control of  
13 three motor carriers, an application for terminal  
14 trackage rights, and authorization to abandon, or to  
15 abandon and to discontinue operations over 17 line  
16 segments.

17 Applicants have entered into settlement  
18 agreements with BN/Santa Fe, Utah Railway Company,  
19 Chemical Manufacturers Association, and several  
20 others. Applicants state that the BN/Santa Fe  
21 agreement is intended to address competitive issues  
22 raised by the merger. They have requested that the

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1 terms of this agreement be imposed as a condition to  
2 approval of the transaction. The CMA agreement  
3 provides, among other things, that the BN/Santa Fe  
4 agreement shall be subject to certain amendments. The  
5 amended settlement agreement is intended to permit  
6 BN/Santa Fe to replace the competition that will be  
7 lost when SP is absorbed into UP.

8 Comments regarding the proposed  
9 transaction have been filed by numerous parties,  
10 including elected officials, government agencies,  
11 shippers, short line railroads, and labor parties.  
12 Responsive applications and requests for imposition of  
13 conditions have been filed by railroads; shipper  
14 organizations; shippers of plastics, chemicals, grain,  
15 and coal; state and local governments and related  
16 interests; and labor parties.

17 By purchasing approximately \$1 billion  
18 worth of Southern Pacific Rail common stock, UP  
19 Acquisition Corporation initiated this transaction  
20 that, if approved, will result in the Nation's largest  
21 rail merger in geographic scope, encompassing the  
22 western two-thirds of the United States. Like the

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1 SF/SP merger that the ICC disapproved in 1986, this  
2 merger contains areas where the service provided by  
3 one of the merging carriers, UP, now overlaps with  
4 that provided by the other carrier, SP. Unlike that  
5 case, where those applicants had initially maintained  
6 that imposition of any substantial conditions aimed at  
7 mitigating competitive harm would frustrate the  
8 transaction, applicants here have offered  
9 approximately 4,000 miles of trackage rights, and will  
10 sell about 330 miles of trackage, to their competitor,  
11 BN/Santa Fe, in an attempt to redress competitive  
12 problem areas. In a nutshell, this includes trackage  
13 rights over the central corridor in the west; Houston  
14 to St. Louis and Memphis; Houston to New Orleans; and  
15 Houston to Brownsville.

16 The statutory provisions that apply to  
17 this proceeding are codified under the law in effect  
18 prior to the ICC Termination Act at 49 U.S.C.  
19 11341-51, and these relate to functions retained under  
20 the Board's jurisdiction pursuant to new 49 U.S.C.  
21 11323-27. The statute clearly states that the "single  
22 and essential standard of approval" is that the Board

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1 find the transaction "to be consistent with the public  
2 interest." To determine the public interest, the  
3 Board must balance the benefits of the merger against  
4 any competitive harm that cannot be mitigated by  
5 conditions.

6 This statutory mandate, which requires the  
7 Board to balance efficiency gains against competitive  
8 harm, sharply contrasts with the approach to mergers  
9 historically taken by DOJ and FTC. The policies  
10 embodied in the antitrust laws provide guidance, but  
11 are not determinative. Because of the Board's broad  
12 conditioning power and continuing oversight, it is  
13 possible for the Board to approve transactions with  
14 conditions that the antitrust enforcement agencies  
15 would either disapprove or approve only following  
16 substantial divestiture.

17 The clear trend since 1980 has been that,  
18 when railroads have reduced their costs through  
19 mergers or otherwise, those savings have largely been  
20 passed on to their shippers in terms of lower rates  
21 and improved service. Rail rates have decreased  
22 remarkably since 1980, despite the fact that most

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1 shippers are served by a single rail carrier. Because  
2 of the several major mergers since that time, and due  
3 to the formation of Conrail as the single carrier in  
4 the Northeast, large regions of the country are now  
5 served by a single major rail carrier or by two such  
6 carriers. Even with this structure, rail competition  
7 has thrived, and shippers have continued to enjoy  
8 increasingly lower rates.

9 Despite significant parallel aspects, the  
10 proposed merger will be in large part pro-competitive,  
11 stimulating price and service competition in markets  
12 served by the merged carriers. The efficiency savings  
13 of the proposed merger will be very substantial, and  
14 UP/SP customers will benefit from tremendous service  
15 improvements brought about by shorter routes, extended  
16 single-line service, enhanced equipment supply, better  
17 service reliability, and new operating efficiencies.  
18 Shippers now served by SP, whose service is threatened  
19 by that carrier's decline, would be assured of quality  
20 service by UP/SP or BN/Santa Fe.

21 Some of the key issues that the team has  
22 examined include whether the public interest is harmed

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1 by the fact that there would be only two major Class  
2 I railroads, rather than three, serving the western  
3 half of the country; whether shippers suffer a  
4 significant loss of geographic or source competition  
5 due to the loss of SP as an independent carrier;  
6 whether shippers at points that go from three to two  
7 directly serving railroads suffer a substantial loss  
8 of competition as a result of losing their SP option;  
9 whether the settlement agreement really allows  
10 BN/Santa Fe to serve all shippers whose direct access  
11 to rail service has gone from two railroads to one;  
12 whether competition is lost by shippers that now have  
13 only a direct connection with either UP or SP, but who  
14 benefit from having the other railroad nearby to  
15 provide the potential for transloading, build-ins, or  
16 build-outs; and whether any other party has offered a  
17 solution that better serves the public interest.

18 After analyzing the record and hearing the  
19 parties' oral arguments presented on July 1, the team  
20 believes that the proposed merger, subject to certain  
21 mitigating conditions that we are recommending, will  
22 be in the public interest, and that any competitive

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1 harms will be heavily outweighed by the positive  
2 effects and benefits of the merger. We believe that  
3 many of these benefits will be passed through to  
4 shippers in terms of lower rates and better service.  
5 Discounting applicants' projected \$76 million in net  
6 traffic diversions and applicants' projected receipt  
7 of \$47.2 million in net trackage rights fees from  
8 BN/Santa Fe, the team has assessed that applicants  
9 will achieve quantifiable cost savings alone of  
10 approximately \$627 million per year.

11 Our findings as to the major issues we  
12 examined are as follows:

13 With respect to the reduction from three  
14 to two major railroads in the West, we note that  
15 protestants have claimed that the merger will create  
16 a rail transportation duopoly, leading to tacit  
17 collusion and higher prices. But as DOT explains,  
18 "the competitive outcome of duopoly is indeterminate.  
19 In principle, competition can lead to a wide range of  
20 outcomes from prices that maximize the joint profits  
21 of the duopolists to a competitive equilibrium."  
22 Experience with rail mergers since 1980 indicates that

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1 the problems feared by protestants here have not  
2 occurred. After carefully examining this issue, the  
3 team finds that rivalry, not tacit collusion, is the  
4 likely outcome of this merger.

5 With respect to source and geographic  
6 competition, the team finds that the merger will not  
7 diminish source competition in the market areas  
8 addressed by protestants, specifically plastics and  
9 chemical products moving out of the Gulf area, and  
10 coal moving out of the SP-served Uinta Basin and  
11 UP-served Powder River Basin and Hanna Basin.

12 With respect to shippers at points that go  
13 from three to two directly serving railroads, we find  
14 that most of their traffic is made up of commodities  
15 that enjoy vigorous motor carrier competition, and  
16 find that corrective action in 3-to-2 markets is not  
17 required.

18 With respect to shippers at points that go  
19 from two to one directly serving railroad, we note  
20 that applicants have designated as 2-to-1 points,  
21 those plants with access to both UP and SP, either  
22 directly or through reciprocal switching, and have

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1 granted BN/Santa Fe access to those plants via  
2 trackage rights, as a replacement for SP. Applicants  
3 have also have granted overhead trackage rights to  
4 BN/Santa Fe over 2-to-1 corridors, where only UP and  
5 SP offer competitive alternatives, and have granted  
6 authority to BN/Santa Fe to serve shippers at 2-to-1  
7 points. We agree with DOT and DOJ that applicants  
8 have not gone far enough in addressing adverse  
9 competitive effects, and we will recommend additional  
10 mitigating conditions to ensure that BN/Santa Fe will  
11 be an effective replacement for SP at these 2-to-1  
12 points and that the competition lost by shippers that  
13 now have only a direct connection with either UP or  
14 SP, but who benefit from having the other carrier  
15 nearby to provide the potential for transloading,  
16 build-ins, or build-outs will have those competitive  
17 options preserved.

18 Several protestants, including NIT League,  
19 Society of Plastics, KCS, Conrail, DOJ, and DOT have  
20 expressed concerns regarding alleged problems with the  
21 trackage rights agreement. We have carefully reviewed  
22 each of the allegations. We find that the trackage

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1 rights agreement, to a large extent, enables BN/Santa  
2 Fe to replace the competitive service that is lost  
3 when SP is absorbed into UP. Applicants, in their  
4 settlement agreement with CMA and in additional  
5 concessions that they made in their rebuttal  
6 statement, have addressed many, if not all, of the  
7 particular problems raised by protestants. These  
8 concessions have substantially improved the original  
9 agreement, and have removed many problems that might  
10 otherwise have hindered the effectiveness of the  
11 trackage rights.

12 But, even though applicants have met many  
13 of their critics' objections, we find that there are  
14 remaining areas that still need to be addressed. As  
15 DOJ and DOT correctly point out, the BN/Santa Fe  
16 trackage rights only permit it to serve certain  
17 specified points, those at which a shipper goes from  
18 two to one directly serving carrier. The merger would  
19 still reduce competition where a shipper at what  
20 applicants call a "1-to-1" point had a competitive  
21 option of building out or building in to either SP or  
22 UP to put pressure on the single carrier serving it.

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1 Similarly, where a shipper served only by UP or SP  
2 could have transloaded shipments to the other carrier,  
3 that option would not be replaced by the settlement  
4 agreement. W. believe that maintaining these options  
5 is important to shippers who use them as leverage in  
6 their negotiations with carriers.

7 To address these competitive problems, as  
8 well as concerns about whether BN/Santa Fe will have  
9 sufficient traffic to compete effectively, we are  
10 recommending five broad-based conditions to expand the  
11 CMA agreement and augment the BN/Santa Fe trackage  
12 rights:

13 First, we recommend that the "new  
14 facility" provision of the CMA agreement be extended  
15 to require applicants to permit BN/Santa Fe to serve  
16 any new facility at any point on any SP or UP segment  
17 over which it has been granted trackage rights.

18 Second, we recommend that the term "new  
19 facility" include new transload facilities, and that  
20 applicants make available all points on their lines  
21 over which BN/Santa Fe receives trackage rights to  
22 transload facilities, wherever BN/Santa Fe or some

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1 third party chooses to establish them.

2 Third, we recommend that Applicants extend  
3 the build-out and build-in provision contained in the  
4 CMA agreement to all shippers with physically feasible  
5 connections; that applicants remove the time  
6 limitation contained in the provision; and that  
7 parties be given the right to resolve any technical  
8 disputes relating to this provision in either an  
9 arbitration proceeding or an administrative proceeding  
10 at the Board.

11 Fourth, we recommend extending Article 3  
12 of the CMA agreement to require Applicants to make  
13 immediately available to BN/Santa Fe at least 50  
14 percent of the volume under contract at 2-to-1 points  
15 on all of the BN/Santa Fe trackage rights corridors  
16 not limited to just Texas and Louisiana.

17 Fifth, we recommend that the Board adopt  
18 the five-year oversight that Applicants consented to  
19 in the CMA agreement. We also recommend that the  
20 Board impose a common carrier obligation on BN/Santa  
21 Fe to provide service to the shippers to which it has  
22 been given access under the settlement agreement, and

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1 require BN/Santa Fe to submit on October 1, 1996, a  
2 progress report and operating plan, and to submit  
3 further progress reports quarterly thereafter as to  
4 its progress in implementing its service obligations.  
5 We further recommend that the Board make clear that  
6 failure to conduct trackage rights over certain  
7 corridors could result in the termination of BN/Santa  
8 Fe's trackage rights by giving them to another carrier  
9 or by divestiture of the relevant line segments.

10 With these conditions, we find that  
11 BN/Santa Fe will be an effective replacement for SP at  
12 these 2-to-1 and 1-to-1 points, and that BN/Santa Fe's  
13 operations should have sufficient density to permit  
14 effective competition. Although various protestants  
15 have argued that the compensation terms and other  
16 conditions of the trackage rights arrangement may not  
17 allow BN/Santa Fe to replace the competition that will  
18 be lost when SP is absorbed into UP, the team has  
19 determined that those arguments are without merit.  
20 Under the CMA agreement and their concessions,  
21 applicants have given BN/Santa Fe the option to pay  
22 compensation under a formula similar to what was

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1 established in the SSW compensation case, only more  
2 favorable to BN/Santa Fe. In addition, applicants  
3 have agreed to a dispatching protocol to protect  
4 BN/Santa Fe's service and operations, and have agreed  
5 in their recent Second Supplemental Agreement to  
6 reduce SP's high reciprocal switching charges from  
7 \$495 per car to \$130 per car at all BN/Santa Fe-served  
8 points to assure that shippers who reach BN/Santa Fe  
9 by reciprocal switching will have meaningful access.

10 Some opponents contend that trackage  
11 rights are simply not enough, and that divestiture is  
12 required. The team, in its analysis, has determined  
13 that ordering divestiture of any of the major  
14 components of SP that have been sought by the various  
15 parties would be a substantial overreach and would  
16 destroy important efficiency benefits of the merger.  
17 Particularly, the team finds that giving another  
18 carrier direct access to this traffic would  
19 unnecessarily affect a great deal of traffic not  
20 harmed by the merger.

21 Divestiture is promoted by DOJ and others  
22 as a solution that does not require the setting of

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1     trackage rights compensation or oversight to ensure  
2     that it works. Unlike DOJ, the Board does have  
3     continuing oversight. Although divestiture may have  
4     a surface appeal, it also entails substantial  
5     regulatory intervention in supervising the divestiture  
6     and it would likely lead to serious additional  
7     problems here. Moreover, the Board, as acknowledged  
8     by applicants, has the authority under its oversight  
9     condition to order divestiture should the Board find  
10    such action necessary in the public interest during  
11    the oversight period.

12             In addition to these general conditions,  
13    we will recommend mitigating conditions to ameliorate  
14    specific competitive harms in the Texas-to-Mexico  
15    corridor and in the Central Corridor.

16             We are recommending that the Board grant  
17    trackage rights to the Texas-Mexican Railway Company  
18    between Robstown and Corpus Christi to Houston, and on  
19    to Beaumont, restricted to the movement of freight on  
20    Tex Mex's Laredo-Robstown-Corpus Christi line. We  
21    believe that such trackage rights are required to  
22    ensure the continuation of an effective competitive

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1 alternative to the UP routing to the border crossing  
2 at Laredo and to ensure the continued provision of  
3 essential services to shippers located on the Tex Mex  
4 line.

5 Also, we are recommending that the Board  
6 grant applicants' request to discontinue service over  
7 the Tennessee Pass Line in Colorado, but deny their  
8 abandonment request until it is demonstrated that  
9 overhead traffic can be rerouted successfully. We  
10 further recommend that the Board retain specific  
11 authority to require applicants to reroute overhead  
12 traffic over the Tennessee Pass Line should unforeseen  
13 operational problems on the Moffat Tunnel Line lead to  
14 significant shipper harm.

15 Further, we recommend that certain  
16 individual requests for relief be granted, which  
17 attorney Paul Markoff will be addressing in his  
18 presentation.

19 Because the Board does not impose  
20 conditions "to ameliorate long-standing problems which  
21 were not created by the merger," nor impose conditions  
22 that "are in no way related either directly or

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1 indirectly to the involved merger," the team  
2 recommends that all other requested relief be denied.

3 In conclusion, the team finds that the  
4 merger benefits outweigh any competitive harms of the  
5 transaction, and the conditions we are recommending  
6 will effectively mitigate the competitive harms of the  
7 merger, while preserving its benefits.

8 Attorney Paul Markoff is prepared to  
9 present the team's full recommendations regarding the  
10 proposed transaction and conditions being sought,  
11 unless the Board first would like for the team to  
12 address any questions at this time.

13 CHAIRMAN MORGAN: Thank you.

14 Let's spend a few minutes on the benefits  
15 as the Staff sees them. As I understand your  
16 presentation, you have concluded that there are clear  
17 benefits associated with this, both quantifiable and  
18 non-quantifiable.

19 Would you like to summarize again for us  
20 what those benefits are?

21 MS. FARR: I would like to have Louis  
22 Mackall and Mike Redisch speak to that.

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1 MR. REDISCH: The applicants have  
2 suggested that this merger would lead to \$750 million  
3 of what they refer to as quantifiable public benefits.  
4 You would include labor savings within a lot of other  
5 operational efficiencies that would be brought about  
6 as the carriers make the best of these two route  
7 systems, mixing and matching.

8 We have assessed those, and determined  
9 that all but two claimed quantifiable benefits are --  
10 should truly be counted as public interest benefits of  
11 this merger.

12 The two that we have looked at a little  
13 differently are the \$76 million in net merger benefits  
14 the applicants have claimed. Even here this is a  
15 merger that will lead shippers to better routings to  
16 shift close to a billion dollars worth of traffic  
17 flows by 500 million to the applicants and perhaps  
18 another 500 million to the Burlington Northern system.

19 Applicants had suggested that a way to  
20 gauge the public benefit with those traffic shifts,  
21 which are not shifts due to new market power but are  
22 shifts due to better service and more efficient

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1 routing, would be to look at the net revenue gains  
2 from those shifts.

3 We have not counted those as quantifiable  
4 public benefits, but we discussed later how we believe  
5 that this merger would generate a very significant  
6 amount of what we call unquantifiable or  
7 non-quantifiable benefits. These would be included in  
8 them.

9 Simply, we have rejected applicants' claim  
10 that a segment of the trackage rights proceeds from  
11 the Burlington Northern/Santa Fe should be included as  
12 benefits. On this record, there are only two major  
13 parties that dispute the benefit claims from  
14 applicants. Most of the voluminous record is aimed at  
15 dealing with competitiveness.

16 The KCS witnesses have presented their own  
17 restatements of the applicants' claims. They would  
18 assert the benefits are in the order of over \$400  
19 million rather than the \$630 million that we believe  
20 are accurate. Applicants have shown that KCS savings  
21 have significant errors in them and we have  
22 disregarded those.

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1           The Department of Justice has hired its  
2           own witness and he has said that the quantifiable  
3           benefits in this merger could be as little as \$73  
4           million. The Department of Justice stands alone in  
5           actually disputing the public benefits here.

6           CHAIRMAN MORGAN: So we have \$73 million  
7           from the Justice Department, \$400 minimum from KCS?

8           MR. REDISCH: And \$630 million or so from  
9           your Staff, and \$750 million from the applicants  
10          themselves.

11          CHAIRMAN MORGAN: The quantifiable  
12          benefits in the BN/Santa Fe merger, they are how much?

13          MR. REDISCH: As projected by the BN/Santa  
14          Fe, they were \$560 million. But since that time, Mr.  
15          Craiston has announced at a gathering that they have  
16          found an additional \$400 million worth of efficiency  
17          gains as they put their two railroads together.

18          This was not viewed with skepticism by  
19          Wall Street. This was viewed as a good news to BN  
20          stockholders. Shares went up \$6 that day. At oral  
21          argument, the attorney for the BN/SF suggested that  
22          not all of these were purely merger-related, but she

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1 went on to explain that they resulted from combined  
2 management having the ability to apply best practices  
3 from each railroad to the new operation.

4 I must say, it was surprising to us,  
5 because the very expert witness that the Department of  
6 Justice had hired to assess the dispute, the  
7 applicants' benefits in this current proceeding, had  
8 testified in the BN/Santa Fe case there would be  
9 virtually no public benefit from that merger.

10 We had rejected his arguments then and the  
11 facts subsequently show us right and him wrong. So it  
12 was surprising to have to see this very same fellow be  
13 brought on as an outside expert witness by the  
14 Department to do an impartial assessment of the  
15 benefits.

16 CHAIRMAN MORGAN: Let's move on then to  
17 the non-quantifiable benefits.

18 MR. REDISCH: Indeed.

19 CHAIRMAN MORGAN: We have 600 and some odd  
20 million the Staff has suggested in non-quantifiable  
21 benefits.

22 VICE CHAIRMAN SIMMONS: Madam Chairwoman,

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1 I would like to ask some questions.

2 You have given us the details of these  
3 benefits, including efficiencies that the applicants  
4 will achieve.

5 Do you believe that BN/Santa Fe will  
6 realize any gains in efficiencies as a result of their  
7 trackage rights? If so, I would like for you to  
8 identify them.

9 MR. REDISCH: Certainly. This will give  
10 -- if you look at a route map, which we have done very  
11 carefully, of the existing BN/Santa Fe system and the  
12 trackage rights that they will gain that we are  
13 proposing that you will impose here, you will see that  
14 it is a very good venture. It gives them a useful  
15 route to use in the central corridor; gives them  
16 access to New Orleans; provides for them two new  
17 single line routings in the I-5 corridor in  
18 California. It will provide significant benefits to  
19 BN/Santa Fe and to its shippers.

20 VICE CHAIRMAN SIMMONS: Okay.

21 COMMISSIONER OWEN: I would like to  
22 compliment Staff on their analysis. I think you hit

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1 the mark far more accurately. Sad to say, the Justice  
2 Department seems to have missed it again.

3 Thank you.

4 CHAIRMAN MORGAN: If I might move back to  
5 non-quantifiable benefits?

6 MR. REDISCH: Yes.

7 Very briefly, they would be the more  
8 efficient routes and the new single-line service that  
9 this merger will provide to shippers, both on the  
10 UP/SP and the Santa Fe.

11 It will also lead to increased capacity in  
12 capital investment by Union Pacific and what we  
13 consider to be a non-quantifiable benefit. I will let  
14 Mr. Ginn speak to this briefly. It will lead to a  
15 significant improvement to the current declining level  
16 of SP service and provide what we believe to be a  
17 viable long-run solution to the problem that SP has  
18 become.

19 MR. GINN: The SP, to put it in simple  
20 terms, you have got what I would call past is  
21 prologue. You have a railroad here that traditionally  
22 has had a very, very high operating ratio; a high-cost

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1 railroad. It has not been able to generate through  
2 operations sufficient cash flow to cover its capital  
3 needs in the past.

4 With this merger, it will have excess  
5 capital that has heretofore been unavailable. Here  
6 I'm talking about the \$1.3 billion in capital that's  
7 going to be directed towards various and sundry  
8 investments that will serve to improve rail service.  
9 Here we are talking about tunnels in the Sierra; the  
10 construction of double track; passing tracks;  
11 terminals.

12 So from a financial point of view, the  
13 merger is certainly going to be beneficial to the  
14 Southern Pacific.

15 It is going to be part of a more efficient  
16 system, a system that has superior earning power,  
17 borrowing power. And that is -- when that is  
18 considered, you have a franchise here that is going to  
19 be well taken care of.

20 CHAIRMAN MORGAN: One of the things that  
21 came up in the oral argument was that we don't really  
22 need to worry right now about this, about SP's

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1 financial condition. There's also a discussion in the  
2 record about the fact that this has been SP's  
3 situation now for a while.

4 Why is it more an issue now than it might  
5 have been previously?

6 Obviously, you have done some assessment  
7 of that. Would you give me your assessment?

8 MR. GINN: There are a couple of things  
9 here. First, the SP has been basically subsidized in  
10 the last several years through real estate sales. Now  
11 since October of 1988, they have realized almost \$2  
12 billion in cash proceeds from the sale of real estate.  
13 We are talking here about transit corridor sales,  
14 talking about the sale of commercial real estate.

15 Now that stockpile has got to deplete. I  
16 mean, it is finite.

17 In 1995, I believe the real estate sales  
18 accounted for about \$50 million in proceeds. But it  
19 took over 400 transactions to produce that amount of  
20 gain.

21 The DOJ would have us believe that the  
22 future of this railroad standing alone is going to be

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1 essentially that of its experience in 1994. 1994 was  
2 a very good year. It was a good year for most of the  
3 railroads.

4 In 1994, however, the SP benefited from a  
5 very large sale of real estate, the Alameda corridor  
6 sale. That was \$245 million. That accounted for  
7 about half their net income that year.

8 They also did some cost cutting that they  
9 thought would be effective in combination with some  
10 other strategic groups that were made to achieve  
11 revenue growth, only to find they overextended  
12 themselves in their cost cutting.

13 So what has happened is that in 1995, you  
14 did not have that same type of profitable experience.

15 We certainly did not have that as we  
16 proceed into 1996.

17 To give you an example, in 1996, the SP  
18 generated about \$28 million in operating income. It  
19 had a net income deficit of \$4 million. The UP and  
20 the DNSF in combination generated well over \$400  
21 million in operating income.

22 So standing alone, this railroad is going

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1 to have a very difficult time in the future generating  
2 cash flow that it needs to maintain a viable,  
3 competitive plant investment that will serve its  
4 consumers well, its shippers well, result in revenue  
5 growth, and also the other thing that you want in  
6 order to bring down your operating ratio, and that is  
7 more efficient plant with the associated cost  
8 reductions that go with it.

9 That's not going to happen on a  
10 stand-alone basis. With the merger, it will happen,  
11 though, because the SP will be part of a much larger,  
12 more efficient system and there will be synergies we  
13 talked about.

14 CHAIRMAN MORGAN: Do you, in your  
15 analysis, do you then agree that with what we have  
16 heard from the SP, which is that if they have to  
17 continue to stand alone, that they will begin to  
18 reduce their system over time in order to accommodate  
19 the financial situation that they are in?

20 MR. GINN: I think they are going to have  
21 to. They are responsible to the captive suppliers.  
22 Here I am talking about the stockholders. You don't

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1 just keep throwing money at a business venture that  
2 produces very meager returns. This is what you have.  
3 We have a railroad here that is a high-cost railroad,  
4 a high operating ratio railroad that is producing  
5 inadequate rates of return; and money is not going to  
6 flow to that -- continue to flow to that type of  
7 investment.

8 I don't think that it would be advisable  
9 in the future to keep selling real estate to the  
10 extent that they can -- and I don't even know if they  
11 continue to sell a lot more real estate, because I  
12 don't know how much real estate they have left. But  
13 to take that real estate and invest those proceeds in  
14 something that is returning a 2 percent return, that's  
15 what I think the SP's rate of return would be in 1995,  
16 based on preliminary figures that I have seen, it just  
17 doesn't make sense.

18 VICE CHAIRMAN SIMMONS: Don't you agree  
19 that SP's shippers are -- I guess with what you have  
20 said, not only are SP's shippers threatened with poor  
21 service, but its thousands of employees risk losing  
22 their jobs?

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1 I think it is important to say right here  
2 that this is why the SP employees themselves support  
3 this merger. They work on the railroad and they know  
4 its problems.

5 Do you agree?

6 MR. GINN: Yes, I agree with that,  
7 Commissioner.

8 COMMISSIONER OWEN: Along that line there,  
9 would you agree then that your analysis kind of  
10 coincides with the applicants', and that of the  
11 analysis of the employees of the railroads in their  
12 own mind and with that of the Attorney General Dan  
13 Lungren of California where he says basically the same  
14 thing you are saying?

15 MR. GINN: Certainly, yes.

16 COMMISSIONER OWEN: And the Justice  
17 Department analysis will stand alone by itself?

18 MR. GINN: That's correct. I do not share  
19 the views of the staff of the Justice Department.

20 COMMISSIONER OWEN: Based upon this, if  
21 the merger were to go ahead and you had the \$1.3  
22 billion to put into the infrastructure, the

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1 interchanges, building the yards, doing all of this,  
2 building the corridor, whatever else is involved, that  
3 many jobs would be created, shippers will be -- their  
4 opportunities will be enhanced considerably? The  
5 employees will have a much better opportunity to  
6 maintain a long-time employment relationship with a  
7 stronger railroad?

8 MR. GINN: Definitely. Correct, sir.

9 COMMISSIONER OWEN: Thank you.

10 CHAIRMAN MORGAN: One other question on  
11 benefits.

12 The issue was raised in the record  
13 regarding being able to achieve these benefits short  
14 of this merger.

15 How have you analyzed that?

16 MR. MACKALL: I will take that, if I  
17 could.

18 CHAIRMAN MORGAN: Yes.

19 MR. MACKALL: Justice has arranged that  
20 the burden of proof is on the applicants to show that  
21 the applicants could not achieve any of the merger  
22 benefits by any means short of the merger. Really the

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1 applicants have met the burden of proof here. They  
2 have come in with very specific documented evidence,  
3 conservative evidence about an actual operating plan  
4 and about actual savings and operating costs. They  
5 will need fewer employees. The trains will run over  
6 fewer miles. These are very specific things.

7 Justice has come in with a statement that  
8 basically is based on theories. The witness for  
9 Justice basically said that he hadn't read the  
10 operating plan that was prepared by the applicants.

11 If you read the whole statement that he  
12 submits, it is pretty clear that the operating plan is  
13 not part of his statement. He doesn't predicate any  
14 of his criticisms on any of the details of it.  
15 Rather, he has some arguments that we should assume  
16 that all of these things can be done voluntarily. We  
17 think that clearly applicants have met their burden of  
18 proof here and that Justice has not rebutted these  
19 claims.

20 I will let Michael speak more to the  
21 particulars, if you want to get into them, as to why  
22 the theories are incorrect. I think it is a matter of

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1 evidence they have met the burden.

2 CHAIRMAN MORGAN: Of course, I guess the  
3 bigger issue is also whether we try to second-guess  
4 the industry in terms of how they feel they can best  
5 achieve efficiencies and benefits.

6 MR. MACKALL: Our statute really gives the  
7 initiative to the carriers to come in with proposals  
8 to achieve public interest benefits. We are supposed  
9 to examine them and decide whether those proposals are  
10 in the public interest. That's what we have done here  
11 basically.

12 COMMISSIONER OWEN: How do you respond to  
13 Justice's point that trackage rights are not relevant  
14 and meaningful in this case?

15 MR. REDISCH: Yes. That really relates  
16 less to the public benefits than to the competitive  
17 harm that the trackage rights here are meant to  
18 address.

19 There is a large amount on the record  
20 about how effective trackage rights can be. Up front,  
21 of course, you have to realize that the competition we  
22 are aiming to preserve here, the competition that

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1 would be lost when SP is absorbed into the Union  
2 Pacific Rail system, is to a significant extent  
3 competition offered by SP today through trackage  
4 rights, through the trackage rights that were granted  
5 in the Union Pacific/Missouri Pacific/Western Pacific  
6 merger in 1982 that permits the Southern Pacific  
7 system to reach from Pueblo, Colorado to St. Louis,  
8 and also on trackage rights the SP operates over in  
9 the Gulf area. Much of the competition we are  
10 attempting to preserve is trackage rights space.

11 The Commission has had a lot of history  
12 using trackage rights as a means of remedying  
13 competitive harm in merger proceedings. All the  
14 parties here have agreed that trackage rights can be  
15 an effective remedy. The issue in this case is  
16 whether the unprecedented nature of these particular  
17 trackage rights, the mileage at stake and the like,  
18 somehow makes this case so unique that past precedent  
19 is inapplicable. We have determined that that is not  
20 so.

21 In fact, if you look at, rather than the  
22 cold trackage rights, the individual corridors you are

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1 addressing, in the central corridor, the SP has its  
2 own track through Pueblo, Colorado and then operates  
3 over trackage rights in the eastern half of the  
4 corridor. After this merger, it will be just the  
5 opposite, if you follow our recommendation. They will  
6 have its own track running east from Denver and  
7 operate on trackage rights west of Denver. While the  
8 geography will be flip-flopped, the percentage of the  
9 corridor operated on trackage rights will remain the  
10 same.

11 In other areas, if you look at line  
12 segments rather than at the total package, you will  
13 find each line segment over which it is being asked to  
14 replace SP's presence is similar to a line segment  
15 over which we imposed trackage rights in the past.

16 There are a lot of corollary matters  
17 associated with these particular trackage rights.  
18 They relate to whether there will be enough traffic  
19 available for the Burlington Northern to effectively  
20 compete.

21 They relate to whether the Burlington  
22 Northern, which will evolve into one of the only two

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1 remaining railroads operating in the west, whether its  
2 role is proper as the trackage rights carrier.

3 They relate to the compensation.

4 But to answer your initial question,  
5 trackage rights have been and can be effective as a  
6 remedy for merger-related competitive harms.

7 We will speak at some length perhaps later  
8 about whether these particular trackage rights here  
9 are the right remedy for this situation and why the  
10 Staff believes that they are.

11 CHAIRMAN MORGAN: Is there evidence on the  
12 record, specific evidence of harm as it relates to  
13 trackage rights?

14 We have had a lot of discussion on the  
15 record about the concept of landlord-tenant, why  
16 trackage rights aren't a good competitive alternative.  
17 But in terms of actual harm, obviously we have  
18 trackage rights throughout the country, the BN/Santa  
19 Fe merger had trackage rights associated with it as a  
20 competitive fix.

21 What is the Staff's analysis of the record  
22 in terms of specific --

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1 VICE CHAIRMAN SIMMONS: If I may, I think  
2 the Chairman is actually asking you about any  
3 operational difficulties of the dissemination.

4 Have we had any history of that in our  
5 assignment of trackage rights?

6 MR. REDISCH: We certainly have, Vice  
7 Chairman Simmons. I think that during your tenure  
8 here, there has been an active and ongoing debate  
9 between the southern rail system over the trackage  
10 rights in the central corridor. There has been a  
11 debate over compensation and a debate over  
12 discrimination; but while that debate had been going  
13 on, shippers in that corridor have continued to  
14 receive competitive service from the Union Pacific and  
15 Southern Pacific systems while this Commission has sat  
16 as the arbiter of that debate.

17 VICE CHAIRMAN SIMMONS: Very good.

18 CHAIRMAN MORGAN: Then there is no  
19 evidence regarding the BN/Santa Fe trackage rights  
20 arrangement not having worked, related to the BN/Santa  
21 Fe merger?

22 MR. REDISCH: That's correct. There have

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1       been allegations that it began slowly, but there has  
2       been no evidence presented that the trackage rights  
3       that the Board imposed in that merger have been  
4       ineffective in preserving the competition that  
5       otherwise would have been lost.

6               CHAIRMAN MORGAN: You mentioned trackage  
7       rights compensation. This is probably a good time to  
8       discuss that, because there is a significant amount of  
9       discussion in the record about the right level and the  
10      right formula as it relates to trackage rights  
11      compensation.

12             Now the Staff is not recommending adopting  
13      any of the alternative approaches suggested by DOT,  
14      DOJ, and other parties. Could you explain why that  
15      is?

16             MR. REDISCH: Yes. There have been two  
17      quite different approaches suggested by the parties.  
18      The shipper parties have generally been in favor of a  
19      lower compensation fee. The government parties that  
20      have spoken to this, the Department of Justice at some  
21      length and the Department of Transportation on brief,  
22      have not really discussed the level of the fee itself.

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# **CORRECTION**

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INCORRECTLY.....



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1 They would defer to us on the appropriateness of the  
2 level, but they seem to have no problem with the level  
3 of compensation that applicants have agreed to with  
4 Burlington Northern.

5 But these government parties are proposing  
6 that the structure of the fee be changed into a fixed  
7 component, an up-front payment by the Burlington  
8 Northern system, and a lower usage payment.

9 We find no merit in either of these  
10 proposals.

11 As to the level of compensation, what we  
12 are talking about here is some form of payment that  
13 will place the Burlington Northern system in a  
14 position to offer the level of competition that is  
15 currently offered by the Southern Pacific system.

16 The payment, 3.0 mills, so actively and  
17 disputed and discussed in the record, but that  
18 apparently played little role in our oral argument on  
19 Monday, many shipper witnesses have suggested that as  
20 they have in the Burlington Northern merger that the  
21 tenant only need repay the landlord for the immediate  
22 or variable or attributable costs that the tenant

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1 imposes on the landlord.

2 The Commission has always held that the  
3 landlords could not exist if their tenant simply paid  
4 them for the out-of-pocket costs without also helping  
5 to defray the capital costs involved in the track  
6 structure.

7 We held that in BN/Santa Fe and we hold  
8 that here.

9 The shippers then attempt to apply the  
10 method that the Commission uses when parties in merger  
11 cases, one the landlord and one the tenant, when those  
12 parties cannot come to agreement. That standard is  
13 called SSW compensation.

14 It has three components to it. The  
15 biggest debate is over this return element. When the  
16 shipper parties have attempted to calculate a rental  
17 fee based on this standard, they have misapplied it  
18 and they have misapplied it because, under this  
19 standard, under the capitalized earnings approach, you  
20 need to have a dollar figure to represent the  
21 landlord's capital that will earn a return.

22 In the SSW case, the Union Pacific had

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1 purchased the Missouri Pacific. There was a  
2 transaction price to be used. Here the Union Pacific  
3 is purchasing the Southern Pacific, so there is a  
4 transactions price only for the Southern Pacific, even  
5 though a significant amount of the trackage rights  
6 will move over Union Pacific lines, almost as many  
7 lines of the Union Pacific as the Southern Pacific.

8 Staff believes that it is inappropriate to  
9 use a purchase price for the SP to figure out a rate  
10 base for the Union Pacific's track. The Union Pacific  
11 is not a single track, low service railroad, the way  
12 the SP is. The Union Pacific track is better  
13 maintained and has higher value.

14 Nonetheless, what the Applicants have  
15 shown is even if you were to apply our standard or  
16 SSW's standard using the SP transaction price, one  
17 that would favor shippers in this case rather than the  
18 Applicants, that the trackage rights compensation  
19 level you would arrive at is much higher than what the  
20 Burlington Northern has negotiated with the  
21 applicants. It would be 3.84 mills instead of 3.0  
22 mills.

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1           What the applicants have said and what we  
2           have verified is that the trackage rights compensation  
3           that they have agreed to with Burlington Northern is,  
4           one, less than the compensation that was agreed to in  
5           the Burlington Northern case last summer and, two, is  
6           considerably less than the compensation that we would  
7           impose if the parties weren't able to reach agreement  
8           themselves.

9           CHAIRMAN MORGAN: The formula we would use  
10          if this issue came before us has been upheld in court?  
11          The SSW formula has been upheld?

12          MR. MACKALL: That's correct.

13          MR. REDISCH: As a practical matter,  
14          people got caught up in the trackage rights matter  
15          without understanding what a limited role it plays in  
16          railroad pricing decisions. Compensation only relates  
17          to under-the-wheel costs.

18          In this particular proceeding, there is  
19          evidence that the western railroads under-the-wheeled  
20          variable costs represent only 17 percent of their  
21          total variable costs. That means that for the  
22          Southern Pacific rail system, if its variable costs

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1     were a dollar, these under-the-wheeled variable costs,  
2     it would have would be 17 cents.

3             The Burlington Northern trackage rights  
4     fees are higher than the SP's under-the-wheeled  
5     variable costs. That's because there is no fixed  
6     component. If the SP's costs were a dollar, their  
7     variable costs, and their under-the-wheel variable  
8     costs were 17 cents, the comparable figures for the  
9     Burlington Northern operating under its trackage  
10    rights would be 28 cents for trackage rights  
11    compensation and \$1.11 for its total variable costs.

12            So if nothing else were different under  
13    the compensation arrangement that applicants and BN  
14    had agreed to, the BN's variable costs would be \$1.11  
15    and the SP's variable costs would be a dollar. The  
16    shippers who are able to take advantage of those very  
17    low markups over variable costs all favor this merger.

18            The shippers who would be able to get  
19    railroads to offer them a markup of only 5, 10, or 15  
20    percent, the intermodal shippers who are at risk here,  
21    they face markups of 50, or 40, or 30, or 60 percent.  
22    Railroads have to, on average, price 38 to 40 percent

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1 above their variable costs to earn a competitive  
2 return. So we don't see this as an impediment.

3 Further, what I said was, all other things  
4 being equal, the SP would have this advantage if it  
5 was paying more than SP's costs. But all other things  
6 are not equal. Because above the whole, the  
7 Burlington Northern has a very efficient railroad and  
8 the Southern Pacific is not.

9 So what that means is if you were to  
10 compare the variable costs of the Burlington Northern  
11 and the variable costs of the Southern Pacific, the  
12 railroad that it is replacing, when the Burlington  
13 Northern operates as a trackage rights tenant, its  
14 variable costs will, in fact, be lower than the  
15 Southern Pacific.

16 The Justice Department has suggested that  
17 somehow this would mean that we are imposing a test on  
18 the Burlington Northern because of its above-the-wheel  
19 efficiencies. This is an odd phrase to use for a  
20 compensation arrangement that has been mutually agreed  
21 to by the applicants and Burlington Northern and  
22 offered to us for our approval. I would hardly call

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1 that a tax on Burlington Northern's efficiency.

2 CHAIRMAN MORGAN: So that what it sounds  
3 like then with respect to trackage rights  
4 compensation, that the amount that is being paid is  
5 lower than what we would impose were it before us,  
6 number one?

7 MR. REDISCH: Yes.

8 CHAIRMAN MORGAN: Number two, the ultimate  
9 rates that are being paid by the shippers along this  
10 route might even be a little lower as a result of the  
11 trackage rights compensation figure and BN's cost  
12 structure?

13 MR. REDISCH: Yes.

14 CHAIRMAN MORGAN: I would turn for a  
15 minute to competition. The position that the Staff is  
16 taking on and the analysis of the competitive harm  
17 here in looking at the 3-to-2 markets, my  
18 understanding is that you are agreeing with the  
19 Department of Transportation that the 3-to-2 markets  
20 do not represent harm that we need to address as part  
21 of this merger approval; is that correct?

22 MS. FARR: Yes, Chairman Morgan.

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1 CHAIRMAN MORGAN: Why is that?

2 MS. FARR: I would like to have Jack  
3 Ventura and Michael Redisch address this.

4 MR. REDISCH: I'll begin. Jack can fill  
5 in.

6 There is really no way for applicants in  
7 their agreement to offer a third railroad because  
8 Burlington Northern is the only one around. It is  
9 filling in as the second railroad.

10 So what you have to decide, if you like  
11 the proposal put forward by applicants, is that the  
12 Burlington Northern will do as a replacement and that  
13 there will be little harm in moving from three  
14 railroads to two in the West.

15 The first hurdle you have to deal with --  
16 and I will let Jack talk to this, if he would like --  
17 is over the broader issue of duopoly in the West.  
18 That is, as we broadly move -- there are two different  
19 sets of arguments the parties have raised about the  
20 3-to-2 points that are so actively discussed in the  
21 record.

22 First, when they look at individual points

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1 or movements, they assess a slew of rate studies,  
2 empirical rate studies that attempt to show what  
3 happens, how much higher prices shippers pay when they  
4 have two railroads to choose from instead of three.

5 But in discussing the broader issue of  
6 what is likely to happen in the West, they refer to a  
7 different non-empirical set of cost studies.

8 I will let Jack discuss those now.

9 MR. VENTURA: Well, you have duopoly, and  
10 you have collusion. They are not the same thing.  
11 Basically duopoly is a simple matter of there being  
12 two railroads or two firms in the market in general.

13 Collusion may or may not happen. It is  
14 more likely to happen if you have two, or three, or  
15 four, but it doesn't necessarily happen. It depends  
16 upon the structure and the conditions under which the  
17 firms are operating.

18 We believe DOT has it right, that there  
19 are -- there's a lot of studies in this record, but  
20 that on balance, they are inconclusive and the reason  
21 they are inconclusive is that a lot of holes were shot  
22 through some of those saying that there would be

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1 substantial increases going from 3 to 2.

2 You have to expect that; but the railroad  
3 industry is not exactly identical to other industries.  
4 There are important differences. I think the  
5 networked structure, the networked characteristics of  
6 railroads plays a major role in what the ultimate  
7 impact will be.

8 Now it is true that when firms meet each  
9 other in many markets, there are more opportunities to  
10 facilitate collusion as a general principle and there  
11 will be a quantum leap, if you want, in the number of  
12 markets in which BN, SF, and UP will meet. However  
13 that same network structure, characteristic of this  
14 industry, works the other way because, as you increase  
15 in scale, you get economies from doing so.

16 By putting the effort into penetrating  
17 more markets, you lower your costs, and it becomes  
18 more profitable to enter those markets. So we would  
19 expect that that would make a big difference in  
20 BN/Santa Fe going after traffic, that because there  
21 are more markets, greater scale, more scale  
22 opportunity, that they will have more incentive to

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1 enter those markets.

2 So we don't feel that collusion will be a  
3 problem given all the conditions that we are  
4 recommending to expand BN/Santa Fe's opportunities to  
5 penetrate these markets.

6 CHAIRMAN MORGAN: So because you are going  
7 from 3 to 2, you do not automatically assume that  
8 there is collusive activity going on in the  
9 marketplace that must be addressed?

10 MR. VENTURA: That's quite correct.

11 There are things, as the applicants point  
12 out very well, that make it very, very difficult to  
13 collude in this market. So much of the trade is in  
14 contracts; and these contracts are secret, and there  
15 are many features of rail operations that -- of the  
16 service being provided that can vary, and you can't  
17 tell which way a competitor is going under a contract,  
18 what kind of specific features it is offering that go  
19 with the particular set of rates, which itself are  
20 secret.

21 So there are opportunities for railroads  
22 to be rivals against each other without being caught;

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1 and that works against collusion, as well.

2 There are a lot of, as we say, pricing  
3 studies of the -- based on general research and so on  
4 that were updated in the record; and a lot of them  
5 don't speak to duopoly -- I mean collusion, but what  
6 happens in general when you go from 3 to 2 railroads.

7 Here we don't take so much issue with the  
8 main studies that were done, for example, the McDonald  
9 study that was done. If you analyze what happens in  
10 the gray market when you go from 3 to 2, you will have  
11 some degree of increase; but then, is that increase  
12 applicable to this vast majority of 3-to-2 traffic  
13 that is involved, that is being said to be effective?  
14 We find no, most of this traffic is intermodal, the  
15 bulk of it, and locomotive.

16 The parties in this record representing  
17 those commodities aren't in favor -- you aren't  
18 basically in favor. You aren't going to be in favor  
19 unless you come out ahead on this merger, that your  
20 rates are not going to go up.

21 We put aside the impact that will be  
22 negative on them. That leaves a much smaller base

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1 that could be possibly harmed. Then we find that the  
2 increase that they are saying doesn't necessarily  
3 apply to that lower base because of the -- as we have  
4 all been talking, about the SP not being as efficient  
5 a competitor, a constrained competitor. We don't  
6 think we have that kind of an increased effect on the  
7 balance.

8 So on the balance, if there are to be  
9 3-to-2 impacts, we say a small fraction of what the  
10 opponents say it will be.

11 CHAIRMAN MORGAN: Let me move to the  
12 Justice Department study regarding competitive harm  
13 which we spent a little time on in the oral argument.

14 They have done a study which essentially  
15 says there will be \$800 million in competitive harm.

16 MR. REDISCH: Yes.

17 CHAIRMAN MORGAN: That is divided up into  
18 about \$260 million in 2-to-1 markets and \$540 markets  
19 in 3-to-2 markets?

20 MR. REDISCH: Maybe 300 and 500 million.  
21 You trusted a lawyer to do your arithmetic for you.

22 CHAIRMAN MORGAN: No comment.

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1 (Laughter.)

2 CHAIRMAN MORGAN: Let's spend a minute or  
3 two on the 2-to-1 traffic.

4 MR. REDISCH: Yes.

5 CHAIRMAN MORGAN: The \$300 million that  
6 the Justice Department has concluded would be -- would  
7 represent competitive harm in that market.

8 Now the other day when I asked the Justice  
9 Department about this, I indicated that the way I read  
10 it, they were not taking into account any kind of  
11 competitive alternatives such as Santa Fe trackage  
12 rights in coming up with \$260 million or \$300 million;  
13 is that right?

14 MR. REDISCH: Yes. As you will remember,  
15 the gentleman from Justice said, indeed, that was so.  
16 They had not taken any account of the 4,000 miles of  
17 trackage rights involved in the settlement agreement  
18 in deriving that number.

19 CHAIRMAN MORGAN: Let's talk about the  
20 other number for a minute, the \$600 million number.

21 MR. REDISCH: Yes.

22 CHAIRMAN MORGAN: That represents 3-to-2

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1 markets and some of that, as I understand it, covers  
2 intermodal automotive, truck competitive track. Is  
3 that the way you read the study?

4 MR. REDISCH: Oh, very much so. There are  
5 debates about just what 3-to-2 market you are talking  
6 about. Each party has their own slight variation on  
7 a definition of a 3-to-2 or a 2-to-1 market and they  
8 have different estimates. I think the applicants say  
9 there's \$2.1 billion of 3-to-2 traffic. The Justice  
10 Department has a higher number. Kansas City Southern  
11 has an higher number.

12 Justice is looking at their figures of the  
13 \$4.75 billion in 3-to-2 traffic they were talking  
14 about, half of it was intermodal. Another 20 percent  
15 was automotive. Justice applied a percentage rate  
16 increase derived from a flawed study, one that would  
17 overestimate rate increases on traffic any way and  
18 took that overestimate and applied it to traffic that  
19 receives a significant amount of truck competition to  
20 begin with in large part because Justice also believes  
21 that trucks can't compete with railroads for  
22 automotive or intermodal movements when the distance

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1 is over 500 miles.

2 Now the Department of Transportation  
3 testified exactly the opposite. They said for  
4 distances up to 730 miles, it is not that trucks can't  
5 compete with railroads, it is that railroads can't  
6 compete with trucks. You don't see any or hardly any  
7 intermodal movements that are 5- or 6- or 700 miles.  
8 It is all going by truck. Beyond that point,  
9 railroads begin to gain market share. For the very  
10 long movements, railroads tend to dominate.

11 Justice ignored all of that and included  
12 \$2.4 billion of intermodal traffic as a 3-to-2 point  
13 and blindly multiplied that by 10.9 percent which is  
14 their overestimate of how much rates rise when you  
15 would go from three railroads to two.

16 CHAIRMAN MORGAN: So then the number \$800  
17 million has a \$300 million component in it of 2-to-1  
18 traffic which does not account for some sort of  
19 competitive presence coming in to fix whatever harm  
20 there is?

21 MR. REDISCH: Doesn't account at all.  
22 That is correct.

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