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ARNOLD & PORTER

555 TWELFTH STREET, N.W.
WASHINGTON, D.C. 20004-1202
(202) 942-5000
FACSIMILE (202) 942-5999

DREW A. HARKER
(202) 942-5022

NEW YORK
DENVER
LOS ANGELES
LONDON

October 23, 1997

VIA HAND DELIVERY

Mr. Vernon A. Williams
Secretary
Surface Transportation Board
Seventh Floor
1925 K Street, N.W.
Washington, D.C. 20423-0001

D

Re: Finance Docket No. 33388,
CSX Corporation and CSX Transportation, Inc.
Norfolk Southern Corporation and Norfolk
Southern Railway Company -- Control and
Operating Leases/Agreements -- Conrail Inc.
and Consolidated Rail Corporation

Dear Secretary Williams:

Enclosed are the original and 25 copies of CSX/NS-117, Response of Applicants to Ann Arbor Railroad's Request For a Two Week Extension to File Comments, Requests For Conditions And a Responsive Application for filing in the above-referenced proceeding. Also enclosed is a 3.5" diskette containing the document in WordPerfect format.

Please date-stamp and return the enclosed copy via our messenger.

Very truly yours,

Drew A. Harker

Drew A. Harker

Counsel for CSX Corporation
and CSX Transportation, Inc.

Enclosures

cc (w/Enclosure): Service List

183067

CSX/NS-117

BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 33388

CSX CORPORATION AND CSX TRANSPORTATION, INC.,
NORFOLK SOUTHERN CORPORATION AND
NORFOLK SOUTHERN RAILWAY COMPANY
-- CONTROL AND OPERATING LEASES/AGREEMENTS --
CONRAIL INC. AND CONSOLIDATED RAIL CORPORATION

RESPONSE OF APPLICANTS TO ANN ARBOR
RAILROAD'S REQUEST FOR A TWO WEEK
EXTENSION TO FILE COMMENTS, REQUESTS
FOR CONDITIONS AND A RESPONSIVE APPLICATION

On October 21, 1997, the due date for the filing of comments, requests for conditions and responsive applications, Ann Arbor Railroad ("AA") filed a request for a two week extension of the deadline.[1] Applicants oppose the requested extension of two weeks, or of any time period, and respectfully ask that the Request be denied.

The purported basis for the two-week extension is that AA has been negotiating a settlement with the Applicants which precluded preparation of the required October 21 filing, and that a settlement remains a possibility. Request at 1-2. CSX, however, has had no substantive discussions or negotiations with

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[1] Ann Arbor's request is designated as AA-4. It will be referred to herein as the "Request."

AA about concessions in the context of the transaction.[2] While NS' negotiations with AA only recently concluded, the extent of the negotiations was no more intensive than negotiations NS had with other parties during that same time period, none of whom has requested an extension. Indeed, when AA apprised NS of its intent to seek an extension, NS informed AA that it would oppose the request. While CSX and NS have been and continue to stand ready to negotiate with any party to the proceeding, such negotiations should not be used as a pretext for avoiding a long established and important deadline.

It should be noted that both CSX and NS have been in intensive negotiations with a number of parties in the same position as AA right up to the October 21 filing date. None of these parties requested an extension.

Under the Board's procedural schedule, which has been in effect since May 22, 1997, a period of nearly five months, comments, requests for conditions and responsive applications were due on October 21 and Applicants have 55 days to file rebuttal to the scores of submissions that have been filed.[3] A

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[2] On October 22, 1997, the day after the deadline, a CSX executive, who was in Ann Arbor Michigan on other business, received a telephone call from AA's Chairman, requesting an immediate meeting on an unspecified matter. At the meeting, AA's Chairman raised AA's interest in a settlement, and CSX's executive agreed to communicate that interest to the appropriate CSX officials.

[3] At last count, Applicants have received service of 113 filings.

14-day extension significantly reduces Applicants' time to analyze and prepare responses to AA's comments, responsive application, and any supporting evidence. AA has provided the Board with no good basis why Applicants should be prejudiced in this manner.

In addition, given the time constraints, Applicants will have to make decisions immediately as to the nature and scope of their December filing, including what evidence to submit as part of their rebuttal and what discovery to conduct. If relief sought by AA overlaps or is inconsistent with relief sought by another party, this could affect Applicants with respect to either one or both requests for relief. Granting the extension sought in the Request will prejudice Applicants' ability to timely put in place their plans for preparing the most thorough and responsive rebuttal filing.

AA's commitment to respond to discovery within five days and make their witnesses available for depositions at a time and place convenient to Applicants misses the point and in no way reduces the harm to Applicants of AA's dilatory tactics. Applicants will be making critical decisions over the next two weeks about the basic scope and approach of their rebuttal filing and granting the request means that Applicants will have to do so at least partially in the dark, a result that is plainly unfair to the Applicants.

On the foregoing bases, Applicants respectfully request that the Board deny AA's request.

Respectfully submitted,

James C. Bishop, Jr.
William C. Wooldridge
James L. Howe, III
Robert J. Cooney
George A. Aspatore
Norfolk Southern Corp.
Three Commercial Place
(757)629-2838

Richard A. Allen
____
Richard A. Allen
James A. Calderwood
Andrew R. Plump
John V. Edwards
Zuckert, Scout &
Rasenberger LLP
888 Seventeenth St., N.W.
Washington, D.C. 20006-3939
(202) 298-8660

John M. Nannes
Scot B. Hutchins
Skadden, Arps, Slate,
Meagher & Flom LLP
1440 New York Avenue, N.W.
Washington, D.C. 20005-2111
(202) 371-7400

<u>Counsel for Norfolk Southern Corporation and Norfolk Southern Railway Company</u>

Timothy T. O'Toole
Constance L. Abrams
Consolidated Rail Corp.
Two Commerce Square
2001 Market Street
Philadelphia, PA 19103
(215) 209-4000

Mark G. Aron
Peter J. Schudtz
CSX Corporation
One James Center
902 East Cary Street
Richmond, VA 23129
(804) 782-1400

P. Michael Giftos
Paul R. Hitchcock
CSX Transportation, Inc.
500 Water Street
Jacksonville, FL 32202
(904) 359-3100

Drew A. Harker
____
Dennis G. Lyons
Drew A. Harker
Arnold & Porter
555 12th Street, N.W.
Washington, DC 2004
(202) 942-5000

Samuel M. Sipe, Jr.
David H. Coburn
Steptoe & Johnson, LLP
1330 Connecticut Avenue
Washington, D.C. 20036
(202) 429-3000

<u>Counsel for CSX Corporation and CSX Transportation, Inc.</u>

Paul A. Cunningham / DPN for

Paul A. Cunningham
Gerald P. Norton
Harkins Cunningham
1300 Nineteenth Street, N.W.
Suite 600
Washington, DC 20036
(202) 973-7600

Counsel for Conrail Inc. and
Consolidated Rail Corporation

Dated: October 23, 1997

CERTIFICATE OF SERVICE

I, Drew A. Harker, certify that on October 23, 1997, I have caused to be served a true and correct copy of the foregoing CSX/NS-117, Response of Applicants to Ann Arbor Railroad's Request for a Two Week Extension to File Comments, Requests for Conditions and and a Responsive Application, on all parties that have appeared in Finance Docket No. 33388, by first-class mail, postage prepaid, or by more expeditious means, as listed on the Service list.

Drew A. Harker

Drew A. Harker

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UNITED STATES OF AMERICA
DEPARTMENT OF TRANSPORTATION
SURFACE TRANSPORTATION BOARD

Finance Docket No. 33388

CSX CORPORATION AND CSX TRANSPORTATION, INC.,
NORFOLK SOUTHERN CORPORATION AND
NORFOLK SOUTHERN RAILWAY COMPANY
--CONTROL AND OPERATING LEASES/AGREEMENTS--
CONRAIL, INC. AND CONSOLIDATED RAIL CORPORATION

D

JOINT COMMENTS, EVIDENCE, AND REQUEST FOR CONDITIONS OF ATLANTIC CITY ELECTRIC COMPANY AND INDIANAPOLIS POWER & LIGHT COMPANY

"That's who the ICC's here to protect. . . . It's the shippers."
-- Mr. Philip D. Anschutz, then Chairman of the Board, Southern Pacific Transportation Company, Deposition Testimony (Feb. 16, 1996), Tr. 207, in STB Finance Docket No. 32760.

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Michael F. McBride
Brian D. O'Neill
Bruce W. Neely
Linda K. Breggin
Brenda Durham
Joseph H. Fagan
LeBoeuf, Lamb, Greene
& MacRae, L.L.P.
1875 Connecticut Avenue, N.W.
Suite 1200
Washington, D.C. 20009-5728
Phone: (202) 986-8000
Fax: (202) 986-8102

Attorneys for Atlantic City Electric Company and Indianapolis Power & Light Company

Due Date: October 21, 1997
Dated: October 21, 1997

TABLE OF CONTENTS

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UNITED STATES OF AMERICA
DEPARTMENT OF TRANSPORTATION
SURFACE TRANSPORTATION BOARD

Finance Docket No. 33388

CSX CORPORATION AND CSX TRANSPORTATION, INC., NORFOLK SOUTHERN CORPORATION AND NORFOLK SOUTHERN RAILWAY COMPANY --CONTROL AND OPERATING LEASES/AGREEMENTS-- CONRAIL, INC. AND CONSOLIDATED RAIL CORPORATION

JOINT COMMENTS, EVIDENCE, AND REQUEST FOR CONDITIONS OF ATLANTIC CITY ELECTRIC COMPANY AND INDIANAPOLIS POWER & LIGHT COMPANY

INTRODUCTION

Atlantic City Electric Company and Indianapolis Power & Light Company (jointly "ACE, et al.") hereby submit their Joint Comments concerning the application of CSX Corporation and CSX Transportation, Inc. (jointly "CSX") and Norfolk Southern Inc. and Norfolk Southern Railway Inc. (jointly, "NS") to acquire and divide among themselves the assets of Conrail Inc. and Consolidated Rail Corporation (jointly, "Conrail").[1]

[1] We use the terms "merger," or "acquisition, or "control" synonymously, unless the context requires otherwise.

transportation of coal, much of which is transported by Applicants. Their joint concern is that the acquisition of Conrail may result in rate increases for coal transportation, as well as distortions in the jurisdictional threshold in 49 U.S.C. § 10707(d)(1)(A)(Supp. 1995) of the Board's railroad rate regulation under and in the Board's determinations of railroad revenue adequacy under 49 U.S.C. § 10704(a)(1)(Supp. 1995).

In support of these comments, ACE, et al. are submitting herewith, as ACE, et al. Exhibit No. 1, the joint Verified Statement of Dr. Alfred E. Kahn, Robert Julius Thorne Professor Emeritus at Cornell, and Dr. Frederick C. Dunbar, both of whom are with the National Economic Research Association, Inc., and as ACE, et al. Exhibit No. 2, the Verified Statement of Thomas D. Crowley, President of L.E. Peabody and Associates, Inc. Documents referred to in these comments are included in ACE, et al. Exhibit No. 3.

EXECUTIVE SUMMARY

This is an unprecedented transaction involving the acquisition and division of a major Class I railroad -- Conrail -- by two other, major Class I railroads -- CSX and NS. While the transaction may offer benefits to some, it may cause harm to others, including ACE, et al.

Of greatest importance to railroad customers and to companies which depend on railroad transportation (such as coal producers), CSX and NS are paying the largest acquisition premium ever paid for a railroad -- $3.8 billion over Conrail's market value purposes and $6.7 billion over Conrail's book value.[2] Under the Board's accounting procedures, the amount CSX and NS have paid for Conrail can be translated into premiums that would, absent the Board's intervention, affect the revenue adequacy of CSX and NS and the calculation of the jurisdictional threshold:

SUMMARY OF CSX AND NS
PREMIUM PAID FOR CONRAIL
($ IN MILLIONS)

	For Revenue Adequacy Purposes	For Jurisdictional Threshold Purposes
CSX1/	$3,827	$3,248
NS2/	$5,286	$4,485
	$9,113	$7,733

1/ Based on 42% of the total premium.
2/ Based on 58% of the total premium.

Source: ACE, et al. Ex. No. 2, Crowley V.S. at 29.[3]

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[2] Unless the context specifically requires otherwise, we refer to either value as "acquisition premium."

[3] The premiums for revenue adequacy and jurisdictional costing procedures differ because of differences in the procedures for computing revenue adequacy and the jurisdictional threshold. Acquisition price is used for revenue adequacy whereas fair value is used for jurisdictional threshold purposes.

The Board has not previously ruled on whether such acquisition premiums should be used to "justify" higher rates, an increase in the jurisdictional threshold applicable to railroad rate regulation, or an increase in railroad investment base for determining revenue adequacy. Nevertheless, the Board's Uniform Rail Cost System ("URCS") would appear to allow the acquisition premium to increase the effective threshold unless the Board intervenes and takes appropriate remedial action. Also, the revenue adequacy procedures, although adopted in the context of acquisition values below book values, would appear to allow the acquisition premium paid for Conrail to affect adversely the revenue "adequacy" of CSX and NS automatically unless the Board rules otherwise.

CSX and NS have paid these substantial premiums to consummate a transaction that will increase their market power. While the Board, and before it, the Interstate Commerce Commission ("ICC"), have adopted a theory that consolidation of railroads will not increase prices to shippers because the railroads can be presumed to be maximizing profits already, the evidence obtained from the railroads themselves shows that the railroads involved in this case are not now pricing their services as this Board presumes. There are a number of obstacles to the railroads' pricing their services as the Board presumes. This transaction will remove or lessen some of these obstacles and thus will increase the surviving railroads' ability to raise prices to pay the costs of acquiring Conrail. This is of critical importance to coal shippers since a substantial portion of the delivered cost of coal is the cost attributable to railroad shipment.

In view of this, coal shippers are seeking reasonable regulatory protection and safeguards from potential rate increases that may be attributable to the acquisition, either through the acquisition premium or otherwise. No other regulated industry is allowed to use acquisition premiums to justify rate increases. Likewise, no other regulated industry is permitted to have its revenues deemed to be inadequate because of an acquisition premium. Manifestly, railroads should not be allowed to do so either.

The need for protection here is underscored by the fact that the acquisition premium is the direct result of the private negotiations among the monopolist railroads. It is not a reflection of any consultation or agreement with any railroad customer or shipper. Indeed, in the inimitable words of NS's Vice President of Strategic Planning, James W. McClellan, recovery of the acquisition premium is "a risk NS takes." McClellan Dep'n Tr. 86. And he was right. It is a risk NS (and CSX) take. But the acquisition premium is emphatically not a risk NS's or CSX's or Conrail's customers have taken or can rationally be forced to assume now. They had no part to play in paying cash for Conrail prior to Board approval of control of Conrail by CSX and NS. On the contrary, several of these commenting parties objected to the process of the Applicants' paying the acquisition premium ahead of time, but the Board allowed it while admitting that the premium would be an issue in this proceeding. Decision No. 4 (served May 2, 1997) at 3.

Therefore, ACE, et al. are opposed to the proposed transaction unless protective conditions are imposed to assure that:

(1) the acquisition Conrail does not lead to rate increases for shippers on CSX or NS adversely affected by the transaction through the loss of, or reduction in, competition;

(2) the jurisdictional threshold in 49 U.S.C. § 10707(d)(1)(A) for CSX and NS is not affected by the acquisition premium; and

(3) the determination of railroad revenue adequacy under 49 U.S.C. § 10704(a)(1) for CSX and NS is not affected by the acquisition premium.

The Board must adopt such protective conditions if it approves the proposed transaction.

ARGUMENT

I.

THE GOVERNING LEGAL STANDARD.

Under its interpretation of the governing statute, the Board is to approve the acquisition of control over a railroad if the Board finds the transaction "consistent with the public interest." 49 U.S.C. § 11324(c)(Supp. 1995). The Board must consider several factors in making such a finding. Among them, the Board must consider:

- the "effect of the proposed transaction on the adequacy of transportation to the public;"
- "the total fixed charges that result from the proposed transaction;" and
- "whether the proposed transaction would have an adverse effect on competition among rail carriers in the affected region or in the national rail system."

49 U.S.C. § 11324(b)(1), (3), and (5)(Supp. 1995). The Board also imposes conditions on an acquisition "when needed to advance the public interest." Lamoille Valley R.R. Co. v. ICC, 711 F.2d

295, 300 (D.C. Cir. 1983) (discussing 49 U.S.C. § 11324(c) when it was codified as 49 U.S.C. 11344(c)).[4]

The Board's criteria for imposing "public interest conditions" are set forth in Union Pacific -- Control -- Missouri Pacific, 366 I.C.C. 462 (1982). There, the ICC held:

> The basic consideration for determining whether a need for a public interest condition exists is whether the transaction will have anticompetitive consequences (or threaten other possible harm to the public interest). If a transaction does not pose any problems of possible harm to the public interest, then no public interest conditions should be imposed. If a transaction threatens harm to the public interest, then public interest conditions should be imposed if they are operationally feasible, ameliorate or eliminate the harm threatened by the transaction, and they are of greater benefit to the public than they are detrimental to the transaction.

Id., 366 I.C.C. at 563-64; see also Decision No. 29 (served Sept. 11, 1997) at 3.

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[4] The Board's counsel characterized the statute as "pro merger" in defending the approval of the Burlington Northern-Santa Fe merger. ACE, et al. do not agree, since that overly simplistic characterization could, if construed literally, result in one railroad in the entire United States. Rather, the statute is properly read as balancing a series of competing interests, such as competitive harms and efficiencies. Here, for some parties, such as Indianapolis Power & Light Company ("IPL"), the transaction will be especially harmful to competition and inefficient. IPL is filing supplemental comments to address its individual issues.

The instant transaction requires the attachment of "public interest conditions" to any approval of the acquisition and control of Conrail. CSX and NS have paid a huge sum for Conrail -- at least $9.895 billion. This purchase price far exceeds the market value of Conrail -- by $3.8 billion. The purchase price exceeds the net book value of Conrail by an even large amount -- $6.7 billion. For revenue adequacy purposes, the premium is larger still -- $9.113 billion -- because $2.387 billion must be added to the $6.7 billion premium to account for Conrail's accumulated depreciation and asset disposition. For jurisdictional threshold purposes, the premium will be slightly smaller, but still $7.733 billion. ACE, et al. Ex. No. 2, Crowley V.S. at 29 and Ex. No. TDC-11.

The substantial purchase price and premium paid for Conrail already have imposed substantial costs on CSX and NS and will continue to do so for years to come in the form of increased depreciation, amortization, debt expense, and debt repayment, as will be shown below. The threat presented by these substantial cost increases is that CSX and NS will raise shippers' rates to pay for these costs. CSX and NS have portrayed this transaction as one that will pay for itself through expected growth of railroad traffic and the increased efficiencies the acquisition will bring, and not through rate increases. In fact, a CSX Executive Vice President, John Q. Anderson, wrote to CSX's customers assuring them that they should not expect to pay for the acquisition through increased rates:

> Many of you have asked if we will be forced to raise prices to fund our acquisition of Conrail. In response, let me say that our plans are to grow our business aggressively and to attack a market that is 86% dominated by business moving on the highway. Improved service and efficiency available from an enhanced CSX rail system should allow us to put together price and service packages that make inroads into this market and help us meet our growth objectives. Competitive factors will also come into play as there will now be two Class I railroads vying for business in many of the markets now dominated by one carrier. <u>In short, we do not see raising prices as the path to funding this acquisition, we see efficiency and new business growth</u>.

ACE, <u>et al.</u> Ex. No. 3 (emphasis added).

But CSX and NS have not <u>committed</u>, and will not commit, to protect shippers from rate increases to pay for the acquisition of Conrail. This is a critical omission because the benefits CSX and NS need to pay for the acquisition may not be realized: CSX and NS may not be successful in making inroads into highway traffic to the extent they expect; the traffic CSX and NS gain may not generate sufficient cash flow because the traffic they expect to gain is generally relatively low-margin traffic; or the Applicants' projected efficiencies may not materialize in the time CSX and NS contemplate, if at all.[5]

ACE, et al. understand that some parties are challenging CSX's and NS's projection of benefits, which are projected to be several hundred million, or even almost a billion dollars annually, for CSX and NS combined. See Application, Vol. 1 at 19, 123-27. ACE, et al. are not doing so. But given the enormous benefits the Applicants claim, the Board can and must take affirmative steps to protect shippers from the harms that will or may occur to them from the proposed transaction. This is a fundamental regulatory responsibility. Despite the claimed benefits of the proposed transaction, many customers will remain captive to either CSX or NS or will see less competition for their business than before. Even worse, if the claimed benefits that would enable CSX and NS to pay the substantial acquisition

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[5] The post-merger experience of the merged Union Pacific/Southern Pacific (with its extraordinary service problems), the merged Union Pacific/Chicago & NorthWestern Transportation Company (which led to an unprecedented apology to shippers from UP's then-President), and the implementation difficulties faced by BN-SF following its recent merger, precludes the Board from treating the current Applicants' claims of increased efficiency and business growth as certainties, or even probabilities. The division of a Class I carrier is unprecedented and may be the most complex such transaction yet.

premium paid for Conrail do not materialize, shippers will be forced to pay higher prices as CSX and NS attempt to pay off their acquisition debt and other fixed charges resulting from the transaction; the public definitively will be harmed; and the transaction will not be consistent with the public interest.

Common sense dictates that if the plans and hopes of CSX and NS for new business and efficiencies do not materialize, then CSX and NS will have to recover the acquisition premium by passing it through to customers in the form of higher rates. There is no rational basis for inflicting this harm on shippers or the public. The Board therefore must condition this transaction to protect the public against merger-related rate increases. This is a reasonable result since it puts the risk that the benefits will not materialize where it belongs -- on the Applicants.[6]

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[6] The Federal Energy Regulatory Commission ("FERC") has recently revised its merger policy under Section 203 of the Federal Power Act, 16 U.S.C. § 824b, to avoid the pitfalls of assessing "estimates of somewhat ambiguous net merger benefits" by requiring merger applicants to "propose ratepayer protection mechanisms to assure that customers are protected if the expected benefits do not materialize." As the FERC noted, this "puts the risk that the benefits will not materialize where it belongs -- on the applicants." Order No. 592, Inquiry Concerning the Commission's Merger Policy Under the Federal Power Act: Policy Statement, III FERC Stats. & Regs. (CCH) ¶ 31,044, at 30,123 (1996).

The Board should broadly condition the transaction to ensure that CSX and NS will not impose acquisition-related increases on any customer adversely affected by the transaction. This will do no more than make binding the assurances of CSX Executive Vice President Anderson that shippers will not see increased rates as a result of the acquisition.[7]

The Board must also condition the transaction to assure that CSX and NS do not include any of the acquisition premium and associated write-up in Conrail's assets in the determination of the jurisdictional threshold under 49 U.S.C. § 10707(d)(1)(A). This is vital. It is the only measure that will ensure that the rate protection Congress adopted to establish to protect shippers against exploitation by a market-dominant carrier is not vitiated through asset acquisitions and write-ups. As a corollary to this, the Board should condition its approval on CSX and NS excluding the acquisition premium and associated write-up of Conrail's assets in calculating their revenue adequacy under 49 U.S.C. § 10704(a)(2). This too is a critical safeguard since, unless this is done, the acquisition premium CSX and NS have paid

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[7] In fact, many of the shippers who have submitted support statements with the Application may have relied on CSX's assurances in that letter to their detriment, since the purpose of that letter was to solicit their support.

would be permitted to inflate valuations which automatically would be translated into inflated return targets for subsequent revenue adequacy calculations.

These conditions are fully consistent with the criteria for imposing "public interest conditions." Union Pacific -- Control -- Missouri Pacific, 366 I.C.C. at 564. The conditions are directly related to this transaction. They do not ameliorate longstanding problems which were not created by the merger. Nor do they require CSX or NS to protect another carrier. Moreover, they do not threaten this transaction. If CSX and NS are correct that they will be able to pay for their acquisition of Conrail through growing their businesses and through efficiencies, these conditions will have no pinch. They will only pinch if the Applicants' representations concerning the benefits of the transaction are not realized. But just as is done by FERC, those projected benefits should be of no concern to the Board. They should be of concern to CSX and NS only, since they projected the benefits and they alone chose to pay what they paid for Conrail without prior approval of the acquisition.

II.

THE THREAT TO THE PUBLIC BY THE PROPOSED TRANSACTION

A. The Premium CSX and NS Have Paid for Conrail Subjects the Applicants to Substantial Increased Costs.

The total purchase price CSX and NS have agreed to pay for Conrail is $9.895 billion,[8] excluding transaction costs, which are themselves substantial.[9] This purchase price greatly exceeds the net book value of Conrail. According to the Application, as of December 31, 1995, Conrail's net book value was $3.169 billion.[10] This means that CSX and NS have paid a premium of $6.726 billion over Conrail's net book value.[11] As Witness Crowley shows, to that value must be added $2.387 billion for Conrail's accumulated depreciation that will be eliminated and adjustments for Conrail's 1995 asset disposition, for a total

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[8] This represents the purchase of 86.475 million shares of Conrail stock at $110 or $115 per share plus costs of unexercised stock options. Whitehurst Dep'n Tr. 24-25.

[9] ACE, <u>et al.</u> Ex. No. 2, Crowley V.S. at 26.

[10] Vol. 1, Ex. No. 16, Appendix C, p. 3, and Appendix G, p. 10. The net book value is the difference between Conrail's total assets and its total liabilities. It is equal to total shareholder equity.

[11] Whitehurst Dep'n Tr. 25.

acquisition premium for revenue adequacy purposes of $9.113 billion.[12]

The purchase price for Conrail also exceeds the market value of Conrail by a substantial margin. Immediately before the merger of CSX was announced in October, 1996, the market value of Conrail was $6.140 billion.[13] The $9.895 billion purchase price thus includes a premium of approximately $3.755 billion over Conrail's market valuation.

To justify the substantial premium they have paid for Conrail, CSX and NS have relied on an estimate of the "fair value" of Conrail's property and equipment of $16.243 billion.[14] This "fair value" of Conrail's properties and equipment exceeds the net book value of Conrail's property and equipment of $6.693

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[12] ACE, et al., Exh. No. 2, Crowley V.S. at 29 and Ex. No. TDC-11.

[13] On October 14, 1996, the last trading day before the merger's announcement, Conrail's stock closed at $71 per share. CSX October 16, 1996 Tender Offer (SEC Sch. 14(D)(1)), Vol. 7B, p. 24. This price is consistent with trading ranges for Conrail's stock for the prior three quarters: 1st qtr. 1996 -- $77 1/4 high and $67 5/8 low; 2nd qtr 1996 -- $73 high and $66 1/4 qtr. low; 3rd qtr. -- $74 5/8 high and $63 3/4 low. Id. The market value is computed using the 86,475,000 Conrail shares CSX and NS have purchased.

[14] Whitehurst Dep'n Tr. 29-30.

billion[15] by $9.550 billion. The effect of this enormous premium will be to add $7.733 billion to CSX's and NS's accounts for Conrail's property and equipment for jurisdictional costing purposes, on top of the gross amounts already recorded on Conrail's books, as witness Crowley shows.[16]

The write-up in Conrail's assets and the acquisition premium will impose substantial fixed charges on CSX and NS for years to come. These include:

- in additional depreciation annually to depreciate the portion of the $9.550 billion write-up in Conrail's assets allocated to specific equipment and properties.[17] This additional fixed charge will last for 45 years.[18]

- in annual amortization of the goodwill, which is the portion of the $9.550 billion write-up not yet allocated to specific equipment and properties. This fixed charge will last 40 years.[19]

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[15] Vol. 1, Ex. No. 16, Appendix C at 3; Whitehurst Dep'n Tr. 29;

[16] ACE, et al. Ex. No. 2, Crowley V.S. at 29 and Ex. No. TDC-11.

[17] ACE, et al. Ex. No. 2, Crowley V.S., Ex. No. TDC-14.

[18] Whitehurst Dep'n Tr. 41-43.

[19] ACE, et al. Ex. No. 2, Crowley V.S. at 26; Wolf Dep'n Tr. 34, 39.

- in annual interest during the "Normal Year" on the billion in acquisition debt incurred to finance the acquisition of Conrail.[20]

In addition to these substantial fixed charges, CSX must repay the billion in acquisition debt it has incurred, and NS must repay the billion in acquisition debt it has incurred.[21] In the first three years after the acquisition, CSX will pay off in acquisition debt

while NS will repay in acquisition debt.[22] After paying these substantial sums, CSX and NS still will have in acquisition debt to repay.[23] In the "Normal Year" following the transaction, both CSX and NS will use all their residual cash flow to repay the acquisition debt. In that year alone, CSX and NS estimate their combined residual cash flow to be per year.[24]

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[20] ACE, <u>et al.</u> Ex. No. 2, Crowley V.S. at 26.

[21] <u>Id</u>.

[22] <u>Id</u>.

[23] CSX's outstanding debt at the beginning of the "Normal Year" is estimated to be . . NS's outstanding acquisition debt at the beginning of the "Normal Year" is estimated to be . .

[24] ACE, <u>et al.</u> Ex. No. 2, Crowley V.S. at 26.

The effect of these substantial fixed charges, plus others not mentioned, is predictable. CSX and NS expect to suffer net losses as a result of the acquisition in the first two years following the transaction and expect to increase net income by only $86 million in the "Normal Year" following the transaction.[25]

The acquisition premium, the associated asset write-up, and the increased depreciation expense resulting from the write-up will also increase variable costs (because investment is included in the URCS definition of variable costs). As Mr. Crowley shows, this increase produces an increase in CSX's and NS's variable costs of transporting a ton of coal by and percent, respectively.[26]

B. CSX and NS Have the Motive, the Will and the Ability to Raise Rates to Pay for the Acquisition.

The increase in variable costs for CSX and NS that will result from the acquisition may be offset if everything works out as CSX and NS plan and all the benefits they project in increased traffic and increased efficiencies materialize. But their plans

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[25] Id.

[26] ACE, et al. Ex. No. 2, Crowley V.S. at 33 and Ex. Nos. 12 and 13.

may not work out as anticipated, and CSX and NS will then face higher variable costs. This is what is of concern to ACE, et al. and other shippers -- that CSX and NS will then seek to cover their increased variable costs by raising shipper rates.

The shippers' concerns are altogether warranted by two fundamental facts -- CSX and NS have the motive and the will to increase rates as much as possible and they have the clear ability to do so unless the Board provides some regulatory protection.

1. CSX and NS Have the Motive and the Will to Raise Rates.

As has been shown, the acquisition will increase NS's (and CSX's) variable costs.

if the market allows. CSX

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[27]

Coal Marketing Vice President Sharp and NS Coal Marketing Vice President Fox admit that their jobs can be characterized as charging coal shippers the highest rates that can be charged without losing their business. Sharp Deposition Tr. 43-44; Fox Deposition Tr. 99-100, 118.

. Of course, it is not surprising that the Applicants would strive to maximize their profits, which the Board assumes for purposes of this proceeding. Decision No. 17 (served July 31, 1997), at 3. This makes it all the more important that constraints are placed on their ability to pass on to shippers the cost of the extraordinary premium paid for Conrail.

2. CSX and NS Have the Ability to Raise Rates.

In prior merger cases, the Board and the ICC have adopted or followed a theory that concludes that sole-served shippers are not at risk from mergers. Burlington Northern Inc., et al., Finance Docket No. 32549, Decision No. 38 (Aug. 16, 1995) ("Burlington Northern"), aff'd sub nom. Western Resources, Inc. v. Surface Transp. Bd., 109 F.3d 782 (D.C. Cir. 1997) ("Western Resources"); Chicago, Milwaukee, St. Paul and Pacific Railroad Co., et al., 2 I.C.C.2d 161, 234, (1984), 2 I.C.C.2d 427 (1985); Union Pacific, et al., 366 I.C.C. at 538. The theory holds that:

> there is only one monopoly profit to be gained from the sale of an end-product or service (here the transportation of coal for use at an electric generating plant).

Western Resources, 109 F.3d at 787 (citing 3 Areeda & Turner, Antitrust Law ¶ 725b, at 199 (1978)).

In prior orders in this proceeding, the Board has asserted that ACE, et al. were challenging this theory:

> [ACE, et al.] are asserting, in essence, that Conrail has some as yet unexercised market power that either CSX or NS will exercise if we allow them to acquire Conrail's lines. They are, in essence, challenging a basic priniciple of economics, that firms will generally attempt to maximize their profits. "This is a basic premise the ICC and the Board have long applied, with court approval, when viewing competitive issues in assessing mergers: if carriers have additional market power, they will use it."

Decision No. 42 (served Oct. 3, 1997), at 8 (quoting Decision No. 17 (served Aug. 1, 1997), at 3). This is simply incorrect. ACE, et al., as well as Drs. Kahn and Dunbar and Mr. Crowley accept the theory. But they recoginze it for what it is -- a theory only, not a fact -- so that the market power of the surviving railroads may be able to increase prices.

This is entirely consistent with prior precedent. The ICC and the Board have both made clear that the theory gives rise only to a presumption that can be rebutted. Burlington Northern, slip op. at 71 (quoting Union Pacific, et al., 4 I.C.C.2d 409, 476 (1988). Chicago, Milwaukee, St. Paul and Pacific Railroad Co., et al., 2 I.C.C.2d at 455. The Court in Western Resources also made clear that whether the merger of two carriers will harm sole-served shippers depends on the theory being "both correct and applicable. . . ." 109 F.3d at 787 (emphasis added). ACE, et al. do not believe the theory is being followed consistently in the real world, and the evidence presented by Drs. Kahn and Dunbar and Mr. Crowley, which was obtained from Conrail, CSX, and NS, shows that it is not.

There are number of reasons the theory is not being followed in the real world. As Drs. Kahn and Dunbar show, the theory requires several extremely demanding assumptions to be valid. Among the required assumptions are:

- There is no actual or potential alternative to the existing bottleneck, the entry or availability of which might be affected by the vertical integration or merger under consideration;
- The bottleneck carrier has perfect information about the demand function of the shipper;
- The bottleneck carrier has perfect information about the cost functions of competing carriers;
- There is no uncertainty about future costs and prices;
- Different carriers have identical beliefs about the nature of any regulatory constraints; and

- Revenue-sharing agreements do not preclude the bottleneck carrier from realizing the profit-maximizing monopoly profit.[28]

But shippers are certainly reluctant to reveal their demand functions to the carrier, so the bottleneck carrier is unlikely to know the shipper's demand function perfectly. A witness for CSX recognized that, for the railroads to capture the economic rents to a monopolized destination, they needed "perfect knowledge," but acknowledged that the "the knowledge that the railroads have of coal markets is limited."[29] Carriers are also unlikely to share their cost structures with other carriers, so the bottleneck carrier is unlikely to know the origin carrier's cost structure perfectly.

Different carriers are likely to have different views of regulatory contraints, and the bottleneck carrier is certain not to have perfect foresight about future prices and costs. The railroad industry has a history of dividing revenue from interline movements. This historical practice undoubtedly continues because, with so few railroads remaining, each railroad

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[28] ACE, et al. Ex. No. 1, Kahn/Dunbar V.S. at 7-8.

[29] ACE, et al. Ex. No. 3, Sansom Dep'n Tr. at 113 and 172; see also,

is likely to find itself in the position of being a bottleneck carrier on one route and dependent on a bottleneck carrier on another. This creates a situation where the carriers are likely to continue to divide revenue for fear of retaliation on another route. Such fear is a fact of life, as NS Witness McClellan testified:

> Q. And is NS going to have any ownership interest in the Hawthorne Yard?
>
> A. No.
>
> Q. And how is it that you could be so confident that Norfolk Southern will have adequate capacity for traffic in and out of the Hawthorne Yard?
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> Q. Because we have -- the agreement says that we will have adequate capacity. And I believe that we could, if there's a disagreement, make a case that they were trying to squeeze us there.
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> And, furthermore, the nature of this transaction, there are are a number of places where CSX will be relying on NS and vice versa. So . . . there's pressure on both sides. <u>Let me be blunt about it. We have some places where, if they're not reasonable in Indianapolis, we can be somewhat unreasonable with them. And that's the way it works.</u>

McClellan Dep'n Tr. 129 (emphasis added).

In view of the rigorous assumptions necessary to support the theory, Drs. Kahn and Dunbar conclude that the assumptions "are not likely to be met in practice with sufficient uniformity to justify a presumption that the theory applies validly to every transaction".[31]

To determine whether this acquisition will harm shippers, Mr. Crowley and Drs. Kahn and Dunbar analyzed data from the Costed Waybill Samples for Conrail, CSX and NS for 1988 through 1995[32] and certain documents from the marketing files the

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[31] ACE, et al. Ex. No. 1, Kahn/Dunbar V.S. at 10.

[32] The Administrative Law Judge ("ALJ") ordered the Applicants to provide to counsel for ACE, et al. their traffic tapes for coal movements to the generating plants owned by ACE, et al. for 1995 through mid-1997 and for the two years before and two years after the last merger affecting each Applicant. Decision No. 11 (served July 18, 1997). The Board upheld the ALJ, despite the sworn affidavits of Drs. Kahn and Dunbar and Mr. Crowley that data the ALJ ordered be produced was too limited to test reliably whether the Applicants were following the Board's theory. Decision No. 17 (served Aug. 1, 1997). As Witness (continued...)

Applicants produced in discovery and tested whether the evidence supported the predictions of the theory. One such prediction is that the merger of an origin carrier and a monopolist destination carrier will not cause prices to rise because the destination carrier is already extracting the full monopoly profit. The only merger involving the Applicants for which sufficient data is available is Conrail's acquisition of Monongehela Railway Company ("MGA") that was approved in 1991.

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[32](...continued)
Crowley testifies, the traffic tape data was too limited to test, over time, the railroads' ratesetting for destinations captive to one railroad. ACE, et al. Ex. No. 2, Crowley V.S. at 8. Consistent with the suggestion of NS's counsel at the July 16, 1997 Discovery Conference, ACE, et al. then turned to the Board's Costed Waybill Sample for data, which are only available through 1995 and provide variable costs, a necessary factor, only since 1988. Since the actual revenues are masked, ACE, et al., sought the masking factors to have as accurate a picture of the railroad's ratesetting practices as possible. While the ALJ ordered the Applicants to produce the masking factors for the same routes as he had ordered for the traffic tapes, the Board reversed. Decision No. 42 (served Oct. 3, 1997). Mr. Crowley derived his own masking factors using the actual revenues from the traffic tapes for 1995. Thus, the evidence ACE, et al. is presenting is the most accurate evidence the Board has allowed ACE, et al. to have.

. Drs. Kahn and Dunbar also tested the data using a regression analysis.

Another prediction of the theory is that the carrier's contribution on a single-line service to a monopolistic destination will be the same as the contribution on the destination segment of an interline movement.

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This evidence is directly contrary to the predictions of the Board's theory. But it is consistent with the railroad's expections. For example, the then Chairman of Union Pacific admitted in his deposition in the Union Pacific/Southern Pacific merger proceeding, Finance Docket No. 32760 (Tr. 148) that a sole destination carrier cannot reap all of the profit from the interline movement:

> Q. In other words, you think that, if a shipper is served by a single carrier at destination but another carrier might be involved at origin, that the destination carrier cannot extract all of the profit from the move?
>
> A. No way.

The Applicants in this proceeding have had the same experience.

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Another prediction of the theory is that origin competition should not reduce prices to the shipper at a monopolized destination.

In sum, the evidence, which was produced by the Applicants themselves, shows that the Board's theory has not been followed

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consistently by the Applicants. As Dr. Kahn and Dunbar succintly state:

> We have examined four hypotheses implied by the one-lump theory. None is supported by the available empirical evidence. Taken together, the weight of this empirical evidence is overwhelming. It is simply not true that bottleneck carriers typically extract all the monopoly profit from a coal shipment; nor is it the case that a reduction in origin competition has no effect on the prices paid by shippers.[41]

This means that the railroads surviving after this transaction will have the ability to increase prices. Shippers are thus at risk for rate increases as the Coal Marketing Vice Presidents of CSX and NS do their jobs of charging coal shippers the highest rates that can be charged without losing their business so that CSX and NS can recover the increased costs this acquisition imposes on them. The shippers thus require protection from the Board, and the Board's own precedents, discussed supra, require that it be granted.

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[41] Id.

III.

THE ABILITY OF NS AND CSX TO RAISE RATES BECAUSE OF THE INCREASED MARKET POWER THEY WILL OBTAIN IF THE TRANSACTION IS APPROVED REQUIRES THE BOARD TO ADOPT REMEDIES TO PROTECT SHIPPERS.

The evidence shows that all coal shippers in the service territories of the Applicants are at risk of having their rates for rail transportation increased as a result of this acquisition. These increases could result from reductions in competition, either at origin or at destination, and thus increases in market power, and by increases in the variable costs CSX and NS must cover on every transaction (because return on investment is included in the definition of "variable costs" in URCS). The acquisition premium and associated asset write-ups will also cause distortions in regulated rate levels if the acquistion premiums are included in the calculations of the jurisdictional threshold and revenue adequacy. As discussed more fully throughout this Section, these threats of harm to the public require the Board to adopt conditions to protect the public. The necessary conditions do no more than hold the Applicants to their statements -- that NS has taken the risk of recovering the acquisition costs and that CSX does not see paying for the acquistion through rate increases but through increased competition and efficiencies.

A. The Acquisition Premium and Associated Write-up in Assets Must Be Excluded From The Determination of the Jurisdictional Threshold Applicable to the Board's Rate Authority.

The governing statute provides that the Board does not have jurisdiction over rates where the railroad does not have market dominance over the transportation to which the rate applies. 49 U.S.C. § 10707(b) (Supp. 1995). A finding that the rate results in a revenue-variable cost percentage less than 180 percent is determinative that the railroad does not have market dominance. 49 U.S.C. § 10707(d)(1)(A). The revenue-variable cost percentage of 180 percent is thus effectively the threshold of the Board's jurisdiction over rail rates, and constitutes a rate "floor" for captive traffic.

If the Board finds that the railroad has market dominance, the Board may then find the rate unjust and unreasonable if the rate exceeds a "reasonable maximum." CSX coal witness Sansom conceded that the revenue-variable cost percentage of 180 percent is effectively the "reasonable maximum" and thus, the regulatory constraint on the market-dominant railroad's rates:

> Q. I'm now going to ask you to assume that there is regulatory jurisdiction over the bottleneck portion serving the destination, okay?

A.   Where we have inelastic demand.

* * *

Q.   I'm sorry, elastic demand. We're going to get to inelastic demand in a minute. Regulatory jurisdiction, multiple origins serving the same interchange from different carriers. Should the shipper be able to extract some of the benefits of origin competition?

A.   Yes.

Q.   Now, answer the same question if it's inelastic demand?

A.   No.

Q.   And why not?

A.   Because I think the -- subject to regulatory constraints, the delivering carrier would acquire those savings.

Q.   Okay. If the regulatory constraints are the same in both circumstances, whether the demand is elastic or inelastic, would your answers have still been the same?

* * *

MS. TAYLOR: Do you know what he means by that, Dr. Sansom?

THE WITNESS: No.

BY MR. MCBRIDE:

Q.   I thought you earlier testified or you threw in a phrase subject to regulatory limits. Do you remember saying that?

A.   Yes.

Q. That's what I'm referring to. I don't mean to use a different word if you want to use limits. Do you understand what the regulatory limits are when the STB asserts jurisdiction?

A. Yes.

Q. What do you understand them to be?

A. Well, I think it would be the market dominance test, which we're assuming exclusive market dominance here?

Q. Yes.

A. And then the 1.8 times regulatory constraint on the rates, 180 percent of variable costs.

Q. 180 percent of variable costs.

A. Right.

Q. Which is your shorthand assumption for what happens when you do a stand-alone cost analysis; is that correct?

A. Yes.

Q. Because you understand that in most circumstances, in the SAC cases, the shipper has been able to get a rate prescribed at the 180 percent level?

A. Yes.

Sansom Dep'n Tr. 117-120; see also Goode Dep'n Tr. 61. Thus, for most coal shippers, 180 percent of variable costs is, effectively, the rate floor as well as the rate ceiling.

In establishing this regulatory regime through the "4-R Act" and the Staggers Rail Act on rates only where the shipper is subject to a market-dominant carrier, Congress's intent was unmistakable. It wanted to allow "a rail carrier to establish any rate for transportation unless a carrier has market dominance, in which case the rate must be just and reasonable." H.R. Rep. 96-1430, 96th Cong., 2nd Sess. 88 (1980), reprinted in 1980 U.S.C.C.A.N. 4110, 4120 (emphasis added). In other words, Congress decided to "retain the protection of ICC rate regulation in areas in which no effective competition existed." Western Coal Traffic League v. United States, 719 F.2d 772, 778 (5th Cir. 1983) (en banc), cert. denied, 466 U.S. 953 (1984).

Of course, the whole purpose of retaining this regime of maximum rate protection is to inhibit the market-dominant carrier from exploiting its market power. This purpose would be eviscerated if the Board allowed the acquisition premium and the associated write-up in Conrail's assets to affect the calculation of variable cost for purposes of calculating the jurisdictional threshold and thus, effectively, the rate floor for captive traffic.

This increase can be enormous -- $7.733 billion as Witness Crowley shows.[42] Including this premium and associated asset

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[42] ACE, et al. Ex. No. 2, Crowley V.S. at 29 and Ex. No. TDC-11. This amount reflects the difference between the Applicants' estimate of the fair value of Conrail's property and equipment, which is $16.243 billion as noted above, and the gross book value of Conrail's property and equipment, which Witness Crowley shows is $8.510 billion. ACE, et al. Ex. No. 2, Crowley (continued...)

write-up in the calculation will increase the jurisdictional threshold and therefore the rate floor for a typical coal movement on CSX from per ton without the premium to per ton with the premium.[43] The new effective threshold is for CSX and percent of variable costs NS.[44]

If the Board permitted these increases, the Board would be permitting the carriers to do indirectly what the statute is designed to prevent it from doing directly -- charge a rate in excess of the "reasonable maximum," or defined by Congress in setting the jurisdictional threshold at 180 percent. As Drs. Kahn and Dunbar note, this would be a "mockery" of the captive shipper protections of the Staggers Rail Act.[45] A hypothetical highlights the simple, but fundamental principle, at issue.

Assume Mr. Smith owns a water company. There is only one water company in town, and the town therefore has passed an ordinance requiring water rates not to exceed a "reasonable maximum." The "reasonable maximum" rate provides Mr. Smith with an income of $50,000 a year. Since there is only one water

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[42](...continued) V.S., Ex. No. TDC-11.

[43] ACE, et al. Ex. No. 2, Crowley V.S. at 33 and Ex. No. TDC-12.

[44] ACE, et al., Ex. No. 2, Crowley V.S. at 33 n.29.

[45] ACE, et al., Ex. No. 1, Kahn/Dunbar V.S. at 20.

company, Mr. Smith could increase water rates and earn $100,000 a year, but the ordinance will not let Mr. Smith increase the rate above the "reasonable maximum" level.

Suppose, however, the town allows a buyer of Mr. Smith's water company to raise his rates to a level that gives him a fair return on the amount he invested in the company. A prospective buyer realizes that the water company can produce twice as much income as it does for Mr. Smith. So he will pay a price that capitalizes the income the company can generate. This enables Mr. Smith to appropriate the income that the town seeks to deny by establishing a "reasonable maximum" rate level that he makes available to the buyer. Mr. Smith sells the company and the buyer promptly raises the rates to generate the $100,000 in income.

Two things have happened here. First, Mr. Smith has appropriated the economic benefits of his strong bargaining position in the water market. He has done indirectly what the town prevented him from doing directly. The second is that the consumers of water are now paying the market-clearing price from which the town sought to shield them by establishing a "reasonable maximum" limit on rates. The shield turns out to be no shield at all. The limits are formal, not real.

The same would be true of the Board's regulation of the rates of market-dominant carriers if the Board were to allow any part of the acquisition premium CSX and NS have paid for Conrail and the associated write-up of Conrail's assets to affect the calculation of the variable costs for purposes of determining the jurisdictional threshold. The Board would be permitting CSX and NS to raise their rates and those of Conrail's customers above the previous "reasonable maximum."

Such an outcome is wholly inconsistent with the statute. Congress chose to maintain maximum rate regulation where the carrier is market-dominant to protect shippers from the carriers' economic power. It has long been a principle of maximum rate regulation, universally recognized, that acquisition-related asset write-ups are not allowed to affect the investment base.[46] It if were otherwise, "all that need be done to raise rates and obtain greater income would be to have one company buy utility properties from another company at a higher price than original cost and in this very simple way . . . increase the cost of service to customers." United Gas Pipe Line Co., 25 F.P.C. 26, 64 (1961), rev'd on other grounds sub nom., Willmut Gas & Oil Co. v. FPC, 299 F.2d 111 (D.C. Cir. 1962).

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[46] ACE, et al., Ex. No. 1, Kahn/Dunbar V.S. at 17.

This is but one example where a write-up in assets has been excluded from the investment base by the Federal Power Commission and its successor, the FERC, under the Natural Gas Act, 15 U.S.C. § 717, et seq., and Federal Power Act, 16 U.S.C. § 825, et seq.[47] The Federal Communications Commission also excludes acquisition write-ups from the investment base under the Cable Act of 1992:

> We continue to believe that the prices paid for cable systems, especially during the period when those systems possessed market power, are not a reliable or reasonable basis for ratemaking, and that their use is not required or supported by public utility practice, the purposes of the Cable Act of 1992, or the Constitution. It appears certain that those prices often include some expectation of supra-competitive profits that the market power of cable systems operating in a less than fully competitive environment could expect to generate.
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> * * *
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> Traditionally, such excess acquisition costs have been partly or wholly excluded from the rate base of regulated concerns, because these costs are seen as inappropriate costs for ratepayers to bear. This is because these costs typically benefit the seller, not the ratepayer; they do not contribute to the plant supporting regulated service.

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[47] See also, e.g., Northwestern Elec. Co. v. FPC, 321 U.S. 119 (1944); Transcontinental Gas Pipe Line Corp. v. FERC, 652 F.2d 179 (D.C. Cir. 1981); Montana Power Co. v. FERC, 599 F.2d 295 (9th Cir. 1979); Carolina Power & Light Co. v. FPC, 433 F.2d 158 (4th Cir. 1970); California Oregon Power Co. v. FPC, 150 F.2d 25 (9th Cir. 1945), cert. denied, 326 U.S. 781 (1946); Pacific Power & Light Co. v. FPC, 141 F.2d 602 (9th Cir. 1944).

* * *

> We believe that disallowing acquisition costs, to the extent they include capitalized supra-competitive profits, is consistent with, if not indeed compelled by, the theory and purposes of the Cable Act of 1992. The Act does not instruct us to consider acquisition costs or the prices individual shareholders paid for cable companies before the adoption of the Act. The language and legislative history of the Cable Act of 1992 demonstrate a primary concern with preventing the undue market power of cable operators subject to neither regulation nor effective competition from setting supra-competitive rates. Allowance of the acquisition price of cable systems as part of the costs of service would present a substantial probability, in our view, of passing on to customers costs that reflect neither the costs of providing service nor the costs that would be incurred under competition.

In Re Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992, Report and Order and Further Notice of Proposed Rulemaking, 9 FCC Rcd 4527, 4578-80 (1994)(footnote omitted).

Significantly, the Board's predecessor historically disallowed acquisition costs from the investment base. For example, in Ex Parte 271, Net Investment -- Railroad Rate Base & Rate of Return, 345 I.C.C. 1494 (1976), the ICC acknowledged that "[t]he governing principle underlying [transportation] property accounts is that transportation property shall be recorded for ratemaking purposes according to original cost." Id., 345 ICC at

1519 (emphasis added). Original cost excludes any acquisition write-up in the assets. When the ICC attempted to give just partial recognition (in the context of oil pipeline regulation) to an acquisition write-up in determining the depreciation component of the maximum rate (which is one way the acquisition premium would affect the calculation of the revenue-variable cost percentage), the Court of Appeals declared the result "irrational":

> The final irrationality is that the deprec[iable] basis used . . . allows depreciation charges, and thus the rates, to change dramatically from one day to the next -- so long as a purchase of the assets intercedes -- even though the cost of the carriers' public service has not actually changed.

Farmers Union Cent. Exchange v. FERC, 584 F.2d 408, 420 (D.C. Cir. 1978) cert. denied, 439 U.S. 995 (1978).[48] On remand, the agency held that the "purchase price is not entitled to any recognition at all for any ratemaking purpose." Williams Pipe Line Co., 21 F.E.R.C. ¶ 61,260, at 61,636 (1982). The Court of Appeals resoundingly affirmed this aspect of the decision:

> FERC soundly held that the use of purchase price instead of original cost in rate base calculations would engender an undue incentive to trade pipeline assets at a high

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[48] The respondent was the FERC because the Department of Energy Organization Act had transferred responsibility for regulating oil pipelines from the Interstate Commerce Commission to the FERC. The order under review was issued by the ICC.

> price, which, under a purchase price regime, would increase allowable rates.

Farmers Union Cent. Exchange v. FERC, 734 F.2d 1486, 1527 (D.C. Cir. 1984), cert. denied, 469 U.S. 1034 (1984).

Using URCS, the Board's formula for determining the jurisdictional threshold would include investment in plant and equipment as a "variable cost," thus enabling NS and CSX to recover the acquisition premium. ACE, et al. Ex. No. 2, Crowley V.S. at 27. But as NS Vice President McClellan testified, the recovery of the acquisition premium is "a risk NS takes." McClellan Dep'n Tr. 86. And he is right -- it is a risk NS (and CSX) have taken. It is emphatically not a risk their customers, and Conrail's customers, have taken.

To avoid yet another "irrational" result, the Board must not allow the write-up in Conrail's assets to be included in the calculation of variable costs of either CSX or NS for purposes of calculating the jurisdictional threshold. ACE, et al. Ex. No. 1, Kahn/Dunbar V.S. at 20. This can be accomplished, as Mr. Crowley explains, by directing CSX and NS to record their portion of Conrail's historical gross book value and accumulated depreciation as it was reported to the Board before the acquisition. The difference between the appraised value and historical book value should be recorded in CSX's and NS's

Account 80-- Other Elements of Investment.[49] By placing the premium in Account 80, the unit costs of CSX and NS developed in URCE will not be affected by the acquisition premium.

B. The Acquisition Premium and Associated Asset Write-ups Should not Be Allowed to Affect Determinations of Revenue Adequacy for CSX or NS.

The Board should also condition its approval of the transaction on CSX and NS excluding all acquisition-related costs and asset write-ups from their calculations of revenue adequacy under 49 U.S.C. §10704(a). ACE, et al. recognize that in Ex Parte No. 483, 6 I.C.C.2d 933, 940-42 (1990), aff'd sub nom. Association of America Railroads v. ICC, 978 F.2d 737 (D.C. Cir. 1992), the ICC adopted the use of acquisition costs for purposes of computing the investment base in revenue-adequacy determinations. But that decision is not binding in all circumstances. It was adopted in the context of acquisitions at prices below book value. Moreover, the ICC stated that it would not "accept the sale price of rail assets as a substitute for old book values in every case. Our decision will be driven by what is the most accurate and reasonable valuation in each particular case." 6 I.C.C.2d at 941.

Here, there is no credible basis for assuming that the valuation CSX and NS have placed on Conrail's property and

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[49] ACE, et al. Ex. No. 2, Crowley V.S. at 39.

equipment to justify the purchase price is accurate. That valuation reflects a write-up in the net book value of well over 100 percent, from $3.169 billion to $9.895 billion. No explanation is provided in the Application as to why Conrail's assets are worth so much more in the hands of CSX and NS. Surely, this does not reflect inflation. Nor can it reflect the market's valuation. The market valued Conrail at a level only slightly below the net book value of Conrail's property and equipment ($6.140 billion market value versus a net book value of Conrail's property and equipment of $6.693 billion). Nor can the Board credit CSX's and NS's $16.243 billion valuation of Conrail's property and equipment as reasonable

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Moreover, in accepting the use of acquisition costs, the ICC noted that it would not recognize an acquisition cost where the

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[50] The Witnesses sponsoring the pro forma financial statement and who relied on the $16.243 billion valuation of Conrail in preparing their Verified Statements were not involved in the preparation of this estimate and were not even certain who prepared it. Whitehurst Dep'n Tr. 30-31, 34; Wolf Dep'n Tr. 23. The estimate, which is included as an exhibit to Mr. Crowley's Verified Statement (ACE, et al. Ex. No. 2, Crowley V.S. Ex. No. 10)

. Applicants claim still to be valuing Conrail's assets, which seems odd since they have already paid for Conrail. Applicants' counsel have agreed that, if the final report is the basis for any part of their rebuttal, ACE, et al.'s counsel will be provided with the report when Applicants' counsel receive it.

acquisition price had been "held down primarily as a result of governmental action or policy." Id. But the same principle should apply when the purchase price has been inflated by governmental action or policy.

The fundamental reason other regulatory agencies have not included the premium in determining rates is that doing so "would engender an undue incentive to trade . . . assets at a high price, which, under a purchase price regime, would increase allowable rates." Farmers Union Cent. Exch. v. FERC, 734 F.2d at 1527. The ICC's and Board's policy of using acquisition costs appears to have had precisely the effect the Court of Appeals, and every other regulatory agency, feared. Since 1990 there has been an increasing number of acquisitions in the railroad industry with ever greater acquisition premiums. But none have been nearly as large as that paid for Conrail; the instant transaction is only the latest and largest. The Board should disregard the acquisition premium and associated write-up in Conrail's assets, just as it would disregard write-downs of assets caused by governmental action.

In Ex Parte No. 483, the ICC sought to avoid the established rule against including asset write-ups in the investment base by claiming that, unlike the rates of most utilities, most rail rates are not subject to maximum rate regulation. 6 I.C.C. 2d at

941. But the fact is that the revenue-adequacy determinations are, as a statutory matter, only used in determining whether a rate under challenge exceeds a reasonable maximum. Moreover, the calculation of revenue adequacy is (or ought to be) based on rate of return on net book value -- the classic means of determining a maximum rate for a regulated entity in other regulated industries. See Ex Parte No. 393 (Sub-No. 1), supra. Thus, the Board cannot avoid the "fatal circularity" in its method that was exposed long ago by the Supreme Court in FPC v. Hope Natural Gas Co., 320 U.S. 591, 601 (1944):

> The heart of the matter is that rates cannot be made to depend upon "fair value" when the value of the going enterprise depends on earnings under whatever rates may be anticipated.

ACE, et al. Ex. No. 1, Kahn/Dunbar V.S. at 17. If the Board allowed acquisition asset write-ups to be included in the investment bases of CSX and NS, the Board would permit Conrail's assets to be transferred at prices inflated above the net original cost and then would allow those inflated valuations automatically to be translated into correspondingly inflated return targets for subsequent revenue adequacy calculations. This would permit an easy evasion of the Board's regulatory mandates and would perpetuate railroad claims of revenue inadequacy. Id.

This would clearly be true here. If the acquisition premium were included in the calculation, NS, which was revenue-adequate before the acquistion, with a cost of capital above the Board's 1996 cost of capital rate (13 percent versus 11.9 percent), would become revenue-inadquate simply because of the acquisition, with a cost of capital below the 1996 cost of capital rate (percent versus 11.9 percent). CSX, which was revenue-inadequate in 1996 before the acquisition would become dramatically more so after the acquisition (8.9 percent before versus percent after).[51]

Thus, both the <u>numerator</u> (the return) and the <u>denominator</u> (the investment) elements of the revenue adequacy calculation will be distorted by the acquisition premium paid for Conrail unless the Board prevents that result. To avoid inaccuracies and the "fatal circularity" described by Drs. Kahn and Dunbar, the Board must do so. Mr. Crowley shows that this can be done by identifying Conrail's net railway operating income and net investment base at pre-acquisition or existing book levels. The amounts should be divided between CSX and NS on the basis of the percentage of Conrail they acquire (42 and 58 percent, respectively) and would be taken into account in determining their revenue adequacy. The premium CSX and NS have paid for

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[51] ACE, <u>et al.</u> Ex. No. 2, Crowley V.S. at 34-35.

Conrail would be recorded in Account 80--Other Elements of Investment and would not be allowed to affect revenue adequacy determinations. As Witness Crowley shows, this procedure maintains the status quo for the revenue adequacy of CSX and NS.[52]

C. Coal Shippers Currently Benefitting From Competition at Origin or Destination Which Will Be Reduced or Eliminated by the Proposed Transaction Are Entitled to Protection From the Board.

Drs. Kahn and Dunbar and Mr. Crowley have demonstrated convincingly that coal shippers benefit from origin competition, contrary to the presumptions applied in prior rail mergers and acquisitions. Despite these presumptions, the ICC and the Board have conceded in the past that they are rebuttable, and thus ACE, et al.'s evidence entitles ACE and IPL (and any other coal shipper who makes an affirmative request for such relief in this proceeding) to appropriate relief. Drs. Kahn and Dunbar would also provide such relief to coal shippers whose destination competition is reduced or eliminated, as would the Board under its established precedents. Drs. Kahn and Dunbar explain that there are only three appropriate remedies to protect shippers from the loss of such competition -- equal access for CSX and NS to all such shippers at their destinations for the receipt of

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[52] ACE, et al. Ex. No. 2, Crowley V.S. at 36-37.

coal, acceptance of rate jurisdiction over the "bottleneck" segment of any such movement of coal, or a rate cap with adjustments for cost changes using the Rail Cost Adjustment Factor (Adjusted) for some period of time (most likely for five years or longer). Their preference is for equal access because it is structural and does not require regulation. Their second and third choices for the appropriate remedy would be in the order listed. Because "Congress did not intend rail shippers to be deprived of protection from mergers that threaten to weaken the competition the [Staggers Rail] Act was intended to unleash," ACE, et al. Ex. No. 1, Kahn/Dunbar V.S. at 23, the Board must adopt one of these remedies from the proposed transaction. The equal access remedy is preferable because it would best carry out the intent of Congress; it would minimize the need for regulation; and it most closely corresponds to the structure of the remedies the Applicants themselves devised to ensure competition where they thought it appropriate.

CONCLUSION

The Board should not approve the proposed transaction unless it adopts protective conditions that:

(1) Provide Atlantic City Electric Company, Indianapolis Power & Light Company,[53] and any other coal shipper making an affirmative request for such relief in this proceeding effective equal access for NS and CSX at their destinations for the receipt of coal. If the Board is disinclined to adopt this remedy it should in the alternative require NS and CSX to accept "bottleneck rate" jurisdiction for these shippers. Finally, if the Board is disinclined to adopt either of these two remedies, the Board must impose a rate cap with adjustments for cost changes using the Rail Cost Adjustment Factor (Adjusted) for ACE and IPL for at least five years, with the Board leaving open the possibility of extending the cap if circumstances warrant;

(2) Prevent the acquisition premium paid for Conrail from affecting the jurisdictional threshold under 49 U.S.C. § 10707(d)(1)(A); and

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[53] IP&L is filing supplemental Comments addressing Company-specific issues. Those Comments propose additional protective conditions or other appropriate relief.

(3) Prevent the acquisition premium from affecting the calculation of railroad revenue adequacy under 49 U.S.C. § 10704(a)(1).

Respectfully submitted,

Michael F. McBride

Bruce W. Neely

Michael F. McBride
Brian D. O'Neill
Bruce W. Neely
Linda K. Breggin
Brenda Durham
Joseph H. Fagan
LeBoeuf, Lamb, Greene & MacRae, L.L.P.
1875 Connecticut Avenue, N.W.
Suite 1200
Washington, D.C. 20009-5728
Phone: (202) 986-8000
Fax: (202) 986-8102

Attorneys for Atlantic City Electric Company and Indianapolis Power & Light Company

Dated: October 21, 1997

EXHIBIT 1

ACE, et al. Exhibit No. 1

BEFORE THE
SURFACE TRANSPORTATION BOARD

FINANCE DOCKET NO. 33388

State of New York	)	
	)	ss. (for Dr. Kahn)
County of Tompkins	)	

State of New York	)	
	)	ss. (for Dr. Dunbar)
County of New York	)	

**VERIFIED STATEMENT OF ALFRED E. KAHN
AND FREDERICK C. DUNBAR**

My name is Alfred E. Kahn. I am the Robert Julius Thorne Professor of Political Economy, Emeritus, Cornell University and Special Consultant with National Economic Research Associates, Inc. (NERA). I have been Chairman of the New York State Public Service Commission and of the Civil Aeronautics Board; and in my capacity as Advisor to President Carter on Inflation, I participated actively in the successful efforts of his Administration to deregulate both the trucking industry and the railroads. I am the author of the two-volume *The Economics of Regulation*, reprinted in 1988 by MIT Press, and have written and testified extensively in the area of direct economic regulation and deregulation, and particularly of the telecommunications, electric power, railroad and airline industries. I have also been a member of the Attorney General's National Committee to Study the Antitrust Laws (1954-56) and the National Commission on Antitrust Laws and Procedures (1978-80); I am the co-author of *Fair Competition, The Law and Economics of Antitrust Policy* and have published numerous articles in that area. I attach a copy of my full resume as Appendix B.

My name is Frederick C. Dunbar. I am Senior Vice President of NERA. Among other areas, I specialize in transportation and antitrust economics. I have testified frequently before the Interstate Commerce Commission (ICC), the predecessor agency to the STB, on the conceptual and practical issues involved in the regulation of transportation rates. This testimony has included Verified Statements in the proceedings in which the ICC adopted SAC as the appropriate cost test for maximum rate reasonableness in coal shipping rate cases.[1] I have authored several professional publications in transportation economics. Prior to joining NERA, I was an economics professor teaching courses in mathematical economics, statistics and economic regulation. I am currently an adjunct professor at Fordham Law School where I teach antitrust economics. My curriculum vitae, which is attached as Appendix C, provides an overview of this experience.

NERA was established in 1961 and now employs about 300 people in 11 offices worldwide. The senior staff at NERA consists largely of former economics professors who now provide research and analysis. Over the past two decades, NERA has gained a special competence in antitrust, transportation and resource economics.

I. Introduction and Summary

We have been asked by several of the clients represented by Mr. Michael F. McBride to analyze whether the acquisition of Conrail assets by CSX and Norfolk Southern will leave captive shippers less protected than before from monopoly pricing by the railroads. In particular, we have been asked to consider two specific questions:

- whether the possibility that captive shippers may be subject to higher rates or poorer service after the merger is precluded by the phenomenon purportedly described by the "one-lump" theory—which necessitates our examining whether the theory accurately describes railroad pricing behavior; and

- whether the large acquisition premium paid by CSX and Norfolk Southern for Conrail's assets could itself lead to an increase in the rates charged by those

[1] "Using a Dynamic Discounted Cash Flow Analysis to Calculate Stand Alone Costs," Dunbar, Frederick C. and Petersen, R., *Journal of the Transportation Research Forum* (1990).

successor companies over certain of Conrail's former routes and/or reflect an anticipated weakening of competition flowing from the merger, from which shippers deserve protection.

We have also been asked to suggest remedies to the potentially harmful effects described above that are consistent with sound economic principles and the promotion of competition. In addition, we have been asked by the same clients and by Consumers Energy to analyze the effect of the acquisition on the jurisdictional threshold for captive shipper protection and the calculation of railroad revenue adequacy.

II. THE "ONE LUMP" THEORY

A. Relevance of the One-Lump Theory to the Transaction

The "one-lump" theory simply states that when one supplier has a monopoly of any input essential to a production process, it will capture all the monopoly rents that are available, subject to regulatory restraints, if any. A corollary is that suppliers elsewhere in the chain will make zero economic profit. This is a standard result in the economics of industrial organization, usually formulated in terms of vertical integration:

> Consider an admittedly extreme example. A monopolist supplier sells to a perfectly competitive industry. Assume the monopolist extends its monopoly downstream, acquiring the competitive industry through a series of vertical mergers. Does this monopolization at a second level result in any additional efficiency losses....[T]he answers to all these questions are negative.[2]

This theory is often credited to Aaron Director and its most thorough-going explication in the antitrust context to Robert H. Bork.[3]

In the railroad context, the theory applies to any situation in which a shipper uses a rail route (or several routes) at least one link of which is a bottleneck. (Often, the bottleneck carrier serves the receiver at the destination, but, in principle, it may reside anywhere else—at an origin

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[2] W.K. Viscusi, J.M. Vernon and J.E. Harrington, *Economics of Regulation and Antitrust*, D. C. Heath and Company, 1992 (First Edition), p. 229.

[3] R. Bork, *The Antitrust Paradox*, New York: Basic Books (1978), pp. 224-231.

or a bridge link, for example.) It follows from the theory that a railroad merger among carriers participating in a shipment already dependent on a bottleneck carrier will not result in increased rates, because the shippers would already have been charged the maximum price that a rational, profit-maximizing monopolist would charge.

The validity of the one-lump theory is at issue in this proceeding, since it is clear that the transaction will reduce competition on some portion of a number of the routes used by coal shippers, another portion of which was already controlled by a single carrier. In particular, there are a number of routes used by coal shippers dependent on a bottleneck carrier at destination but not at origin.

The transaction at issue will reduce the number of choices among carriers on these freight movements. According to the one-lump theory, however, this will have no adverse effect on the coal shippers, since despite the existence of competition on part of the several affected routes, they would already be paying the bottleneck carrier the profit-maximizing monopoly price for the total carriage—that is, the maximum price that a rational, profit-maximizing monopolist with sole control over the whole route would have charged.

There is a widespread belief among coal shippers and receivers, however, that in practice competition tends to reduce the prices that they pay overall, even if there is a bottleneck elsewhere on the route. In such an instance as described, they believe, Conrail does not charge as high a price as it would if it confronted no competition at all along any of the segments of the route; and after the merger, therefore, with some of that competition eliminated, Norfolk Southern and/or CSX are likely to increase their rates for coal shipments—despite the prediction of the one-lump theory.

B. The STB View

Before proceeding to our appraisal of the one-lump theory, it is necessary to correct a number of misconceptions that appear to have crept into the STB's understanding of ACE, et al.'s arguments in this case. The STB's current view of those arguments appears to be well set out in its Decision Number 42 in this case,[4] as follows:

> the proposition that movants seek to prove with the unmasked revenues is highly questionable. Movants are asserting, in essence, that Conrail has some as yet unexercised market power that either CSX or NS will exercise if we allow them to acquire Conrail's lines. They are, in essence, challenging a basic principle of economics, that firms will generally attempt to maximize their profits.

We submit, respectfully, that this statement both mischaracterizes the ACE, et al. position and is inconsistent also with generally accepted principles and practice in empirical economics and with the state of the art in the economics of industrial organization.

The first problem is its elevation of theory over practice. There is an old joke about the theoretical economist who, upon being informed that the facts do not support his theory, declares, "So much the worse for the facts." The STB appears to be guilty of the same myopia. Most theoretical economists working in this field today would emphasize the need to examine the empirical evidence in a given situation before coming to any such general conclusions. As the leading advanced text on the theory of industrial organization, written by a prominent economic theorist, puts it:

> even a theorist should regret the very high ratio of theory to evidence in a field in which theoretical models are often lacking in generality and in which practical implications are so crucial.[5]

The second misconception in the STB's statement is its explicit premise that any rejection of the one-lump theory in this case can be based *only* on the belief that Conrail is not exploiting market power that it already possesses and that CSX or NS *will* do so after the takeover. This is simply not so. We are seeking to determine, rather, whether the takeover of Conrail's lines by CSX and NS will *increase* market power. Our main theoretical point is that *even within the profit-maximization framework*, there are a number of situations in which a reduction in origin competition on a route with a destination bottleneck would lead to an increase in prices. If, for example, origin competition constrains prices even in the presence of

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[4] STB Decision Number 42, STB Finance Docket No. 33388, Decided October 3, 1997.

[5] J. Tirole, *The Theory of Industrial Organization*, Cambridge: MIT Press (1994), p. 3.

a destination bottleneck, then a reduction in that competition will increase the market power of the surviving destination carrier. (See, for example, our numerical example in Appendix A.) Our empirical work attempts to test that hypothesis. The search is not, therefore, for evidence of market power that Conrail is not currently exploiting but for market power that does not exist at present but would be created by the merger.[6]

C. Theoretical Discussion

There is no dispute that the one-lump theory can be derived from some set of specific highly abstract assumptions (just as, given a certain set of carefully chosen assumptions, it can be shown that legally prescribed minimum wages increase employment or that an increase in prices produces an increase in demand—propositions that most practicing economists believe are usually false in the real world). Nor do we deny that the theory can provide useful guidance to public policy, provided it is not taken as an immutable law and exempted from critical appraisal on the basis of the specific facts in each situation. What we deny is that the one-lump theory is in any sense either generally valid for vertical mergers in practice, or accepted as the last word in the economic theory of vertical integration. It is easy to construct equally—indeed more—plausible economic models in which it will not hold, and in which the reduction in competition on part of a rail route will indeed result in a socially undesirable increase in prices. In such models, this result occurs because of different and probably more realistic behavioral assumptions.[7]

A recent, detailed review of the literature on this subject by the author of the leading graduate textbook on industrial organization, Jean Tirole (with Oliver Hart), describes it as follows:

Some commentators have argued that a purely vertical merger will not affect a

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[6] We point out also, although this is not the main thrust of our argument, that much modern industrial organization economics—for example the extensive and well-recognized principal-agent literature—does not assume profit-maximization by firms. See *ibid.*, pp. 34-51, for an extensive discussion of the profit-maximization *hypothesis* (our italics) and the circumstances in which it may or may not be plausible.

[7] See, for example, M. Salinger, "Vertical Mergers and Market Foreclosure," 103 *Quarterly J. of Econ.* 345 (1988); J. Ordover, G. Saloner, and S. C. Salop, "Equilibrium Vertical Foreclosure," 80 *Amer. Econ. Rev.* 127 (1990).

> firm's monopoly power.... Other commentators have responded by developing models in which vertical integration can lead to the foreclosure of competition in upstream or downstream markets.... Thus at this stage the debate about the conditions under which vertical mergers are anticompetitive is far from settled.[8]

Tirole and Hart proceed to dismiss the more extreme claims of the proponents of the one-lump theory in no uncertain terms:

> It is sometimes claimed that in this case [the upstream monopolist] would never have an incentive to merge with a downstream firm..because [it] is already a monopolist in the upstream market. (For example, as Posner and Easterbrook [1981, p.70] have written: 'there is only one monopoly profit to be made in a chain of production.') This claim is false....

There is also a considerable literature on the issue of vertical foreclosure specifically in the railroad industry. Again, this literature fails to support the view that vertical foreclosure can never raise competitive problems.[9] Rather, it concludes that the competitive effects of vertical mergers are likely to depend on the precise cost structures, relative bargaining positions and nature of the contracts between the merging railroads and their customers.

Our conclusion is consistent with that of the aforementioned literature—namely, that the circumstances in which the pure one-lump theory is likely to hold represent an "extreme example."[10] Our review of the literature suggests that among the required assumptions necessary for the one-lump theory to hold are that:

- there is no actual or potential alternative to the existing bottleneck, the entry or availability of which might be affected by the vertical integration or merger under consideration;

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[8] O. Hart and J. Tirole, "Vertical Integration and Market Foreclosure," *Brookings Papers on Economic Activity: Microeconomics 205* (1990). Professor Tirole is also the author of the standard advanced text on industrial organization, *Theory of Industrial Organization*, which contains a similar, though less extensive, discussion of vertical foreclosure issues.

[9] See, for example, C. Grimm and R. Harris, "Vertical Foreclosure in the Rail Freight Industry: Economic Analysis and Policy Prescriptions," *ICC Practitioners Journal* 508-531 (1983); W. Tye, "Post-Merger Denials of Competitive Access and Trackage Rights in the Rail Industry," *Transportation Practitioners Journal* 413; C. Grimm, C. Evans and C. Winston, "Foreclosure of Railroad Markets: a Test of Chicago Leverage Theory," *Journal of Law and Economics* 35 (1992).

- the bottleneck carrier has perfect information about the demand function of the shipper;

- the bottleneck carrier has perfect information about the cost functions of competing carriers;

- there is no uncertainty about future costs and prices;

- different carriers have identical beliefs about the relevant regulatory constraints, and

- revenue-sharing agreements do not preclude the bottleneck carrier from realizing the profit-maximizing monopoly profit.

In the real world, these conditions are unlikely to be fully satisfied.

Before proceeding to the critical part of our analysis—the statistical testing of the predictions that flow from these assumptions—we cannot refrain from pointing out how implausible they are. For example, it is a commonplace observation that bottleneck monopolists cannot possibly possess perfect information about either shippers' present demand functions or competitors' costs or, even more so, about their future course—information that is automatically disclosed by a competitive market. The more competitors there are, the more likely the market results will be dictated by the one with the strongest expectations of demand elasticity, for example, or the applicable regulatory restraints.

In particular, the first assumption is implausible. Monopoly power is not unvarying over time, and bottleneck segments are not free of the threat of competitive challenge, particularly by competitors already operating on vertically adjacent routes. One of us pointed out the importance of this fact as long ago as 1959:

> Were market position and power fixed and immutable quanta, vertical integration could do no harm and might do only good. It could not of

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[10] See note 2, above.

STB FD 33388 10-21-97 D 182968 2/5

> itself enhance horizontal market power; and by causing complementary functions to be performed at cost, it might induce even monopolists to lower prices. In fact, however, market positions are subject constantly to encroachment and market power to erosion in a dynamic economy. Every business in the real world, therefore, must devote a good deal of attention to securing itself against the inroads of competition. Vertical integration is one important and familiar way of trying to do this. Like others of the tactics companies use to protect or extend their market positions, it may be a competitive phenomenon, productive of social benefit. But it may also be a method of forestalling potential competitive or countervailing pressures.[11]

Consider the following example. Suppose that two carriers compete over most of a route but one of them has a bottleneck monopoly for some part of it, and that the second carrier could construct the remaining portion of the route, bypassing the bottleneck portion if the charges of the integrated competitor were high enough. In this case, economic theory predicts—contrary to the pure one-lump theory—that the bottleneck carrier would not be able to extract all the potential monopoly profits on the whole route because, if it tried to do so, the competing carrier would find it profitable to construct the remaining portion. The monopoly power of the bottleneck carrier would be at least partially constrained.[12] It would still appear to have a bottleneck monopoly because the competing carrier would not actually construct the additional portion: the merely implied threat of such construction would constrain prices.

In these circumstances, a vertical merger of the bottleneck carrier and its potential competitor could eliminate the competitive threat to its bottleneck monopoly. It will now, by virtue of that vertical merger, be able to charge the full monopoly price, since the credible threat to construct an alternative would be eliminated. So in this case, the merger would increase the effective monopoly power and would increase prices and reduce welfare, contrary to the predictions of the simple one-lump theory. This is because the one-lump theory assumes that the degree of monopoly power conveyed by control of the bottleneck facility is given and not subject to enhancement or reinforcement against challenge by a vertical merger of its possessor

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[11] M.G. deChazeau and A. E. Kahn, *Integration and Competition in the Petroleum Industry*, Petroleum Monograph Series, Volume 3 (Yale University Press, 1959). Reprinted in 1971, p. 48.

[12] A market that appears to be a monopoly but where prices are in fact constrained by the threat of entry, is known as a contestable market. See W.J. Baumol, J.C. Panzer and R.D. Willig, *Contestable Markets and the Theory of Industry Structure*, New York: Harcourt Brace Jovanovitch, 1982.

and a potential challenger. Because of the importance of this case, we present an arithmetic example demonstrating rigorously that in this situation a merger will lead to an increase in prices, assuming profit-maximizing behavior on the part of all firms both before and after. (See Appendix A)

Since we proceed to test the predictions of the one-lump theory against the empirical evidence, we refrain from explicating in a priori terms the unlikelihood of their being met in practice with sufficient uniformity to justify a presumption that the theory applies validly to every transaction. What matters is whether they are sufficiently close to being valid to ensure that prices after the merger will behave more or less as the pure one-lump theory predicts – that is, that they will not change to the disadvantage of shippers. We observe, however, that there already has been an empirical study that attempted to test whether the existence of potential interline competition reduces prices and increases welfare.[13] It concluded that "the effect of interline carriers on the welfare difference is substantial and statistically reliable, thus refuting the applicability of the Chicago [one-lump] hypothesis" and concluded "our results also support recent theoretical contributions [which we have described above] that one cannot a priori assume away potential vertical or tied-sales foreclosure harms".

D. Statistical Analysis

The one-lump theory provides a number of testable hypotheses:

- a merger that reduces or eliminates origin competition on certain routes should not tend to increase prices on those routes relative to other routes;
- on routes where there is a bottleneck at the destination but potential interline competition at origin, the bottleneck carrier should make the same "profit" regardless of whether it handles traffic for the whole route or for only the

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[13] C. Grimm, C. Evans and C. Winston, Foreclosure of Railroad Markets: A Test of Chicago Leverage Theory, Journal of Law and Economics, vol. 35 (1992).

bottleneck portion; [14]

- on such routes, the competitive origin carrier should make zero profit;

- the existence or extent of origin competition should not tend to reduce prices for local service;

The first hypothesis was tested by Thomas D. Crowley.[15] These data show that after Conrail's purchase of the Monongahela Railroad (MGA), the average rate per ton for Conrail terminating traffic from former MGA origins , while the average rate per ton on other Conrail terminating traffic .

We emphasize that this single observation represents averages, respectively, of and data points, and that this was the only recent eastern U.S. merger for which we have adequate information. We also examined these data using regression analysis. We used only data on those routes where coal was shipped both in 1991 and 1995. We regressed the change in the rate on an indicator variable for routes affected by the merger and the change in the tons shipped (weighing observations by tons shipped).

The results of these regressions are shown in Table 1:

[14] The conception of "profit" has little meaning, in its usual sense, when applied to single products provided in common by a multi-product firm. We use "profit" here in the sense of the differences between revenues and variable costs of particular units of traffic or business, representing the contribution that those units make toward recovering fixed and common costs of the firm and therefore toward its total profit. That is the contribution that a profit-maximizing firm would seek to maximize from the several components of its output or sales.

[15] Verified Statement of Thomas D. Crowley, October 21, 1997, pp. 13-15

	Regression 1	Regression 2
Dependent Variable	Change in Rate Per Ton	Change in Rate Per Ton
Merger Indicator Variable		
Change in Tons Shipped		
Constant		

This is perhaps as pure an experiment as could be conceived of the underlying question at issue in this proceeding: is a merger that reduces origin competition likely to lead to an increase in the rates paid by coal shippers?

In order to provide additional evidence on the empirical validity of the one-lump theory, we also tested the other three hypotheses described above, using data on a sample of 166 routes. The original source of these is the STB's Costed Waybill Sample, and they were provided to us by L.E. Peabody and Associates.[16] Data examined included the tons hauled in each year from 1988 to 1995 on local and interline service and revenues earned and the variable cost incurred (a) by the bottleneck carrier where it was the only carrier and (b) by both carriers on interline hauls.

We tested the second and third hypotheses by examining average contributions, defined as revenues minus variable costs, for the bottleneck carrier in cases where it had the entire haul and where it was an interline haul. We also looked at the average contribution for the

[16] See "Verified Statement of Thomas D. Crowley," October 21, 1997, pp. 8-12, for more detail.

competitive origin carrier. To ensure comparability, we looked only at routes and years where there was both single-line and interline traffic. From a sample of observations (where an observation is a route and a year), we found the following (with the standard errors of the estimates in parentheses):

Average Contribution for Bottleneck Carrier on Single-Line Haul	
Average Contribution for Bottleneck Carrier on Double-Line Haul	
Average Contribution for Competitive Origin Carrier	

Next, we tested the fourth hypothesis by analyzing the dependence of the prices paid by shippers in the presence or absence of origin competition, using regression analysis. We constructed two variables for prices paid by the shipper: the first was simply the average price per ton; the second was the average contribution paid by the shipper per ton over variable costs.[18] We also constructed two variables designed to serve as proxies for the degree of origin competition. The first was the proportion of tons shipped in a given year that was carried on interline (two-line) rather than single-line hauls. The second was an indicator variable that took

[17] Very similar results were obtained when we used regression analysis to control for tons hauled.

[18] We used price and contribution per ton rather than per ton-mile, since it is the price per ton that the shipper cares about (and presumably the price or contribution per ton the carrier cares about) rather than the number of miles over which the shipment travels. Of course, both revenues and variable costs will vary systematically with distance; but this does not bias our estimates because the cross-sectional time series regression analysis allows different effects on prices on different routes.

the value 1 if a significant proportion of coal shipped (more than 1,000 tons and more than 10 percent of total) was shipped on interline hauls. The reason for constructing these two different indicator variables was that it is not necessarily clear whether, if origin competition does indeed depress prices, that effect will occur simply because of its *existence* (in which case the indicator variable would be the relevant one) or whether the depressing effect will be greater the greater the *proportion* of shipments carried by the competitive (non-bottleneck) carrier (which would show up in the proportion variable).

We regressed both dependent variables, price and margin, on each origin competition variable separately. This exercise yielded a total of four separate regressions. Since we are using cross-sectional time series data, an estimation approach that allows for unobserved differences between the different routes is required. The form of the model to be estimated is therefore:

$$y[i,t] = a + B^{*}x[i,t] + u[i] + e[i,t]$$

We used a generalized least squares random-effects estimator in each case; the alternative fixed effects estimator produced results qualitatively similar, but showing a greater depressing effect of origin competition on prices.[19] The results are shown in Table 2:

	Reg 1.	Reg 2.	Reg 3	Reg 4.
Dependent Variable	Price	Price	Margin	Margin
Origin Competition (Indicator)				
Origin Competition (Proportion)				
Constant				

[19] Very similar results were obtained using tons hauled as an additional explanatory variable.

The salient points that emerge are the following:

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We have examined four hypotheses implied by the one-lump theory. None is supported by the available empirical evidence. Taken together, the weight of this empirical evidence is overwhelming. It is simply not true that bottleneck carriers typically extract all the monopoly profit from a coal shipment; nor is it the case that a reduction in origin competition has no effect on the prices paid by shippers.

III. THE ACQUISITION PREMIUM

The second issue we were asked to analyze was whether the large "acquisition premium" paid by CSX and Norfolk Southern for Conrail's assets is likely itself to itself lead to an increase in the rates charged by CSX and Norfolk Southern over certain of Conrail's former routes and the economic consequences of any such increase. We consider this effect from three different perspectives:

- the effect of the acquisition premium on the book value of the assets currently held by Conrail and the consequent effect on the rates carriers are permitted to charge on movements where rates are currently constrained by regulatory ceilings;
- the effect on the revenue adequacy of CSX and Norfolk Southern;
- its implications for the competitive effects of the acquisition.

A. Effect of the Acquisition Premium on Regulated Rates

The transaction will increase the book value of Conrail's assets from its present $8,510 million. For the purposes of the transaction, CSX and Norfolk Southern have appraised them at $16,243 million as of this writing, and it is to be presumed that it is at this level that CSX and Norfolk Southern will seek to value Conrail's assets in their accounts. This has been the practice in recent railroad mergers: the last two major railroad ones which have completed their accounting—BN/SF and UP/CNW—used appraised value in adjusting the property accounts of the acquired railroads.[20]

This revaluation will have the effect of increasing the rates that CSX and Norfolk Southern are permitted to charge on certain routes that are subject to regulatory constraints, because the Variable Cost definition for the purpose of calculating the so-called "jurisdictional threshold" of a rail movement is affected by the appraised value of a railroad's assets.

Such an increase would be wholly unjustified on economic or traditional regulatory grounds or, indeed, in terms of the intent of the Staggers Act, which prescribed that threshold. As a matter of both economic and regulatory principle, market values simply cannot be allowed to affect regulated prices, since that would involve the fatal circularity recognized by the

[20] See "Verified Statement of Thomas D. Crowley," October 21, 1997, pp. 23-24.

Supreme Court 50 years ago: if a company is allowed to earn a "reasonable" return on whatever price it pays for an asset, that will in turn determine the price it is willing to pay, up to the present discounted value of the future stream of unconstrained monopoly profits. Instead of regulated price being determined by cost, independently determined, the cost will itself be determined by price and, in turn, "justify" whatever price maximizes profits. No sensible system of regulation can allow such an outcome.

As a direct consequence of this principle, whenever and wherever the net book value of a company's stock or assets serves as the basis for determining its permissible rates or return for regulatory purposes, it is axiomatic that those book values must be based on the original cost of the assets. To incorporate market-value-based write-ups in the rate base to which the allowable rate of return is applied in determining a regulated company's revenue requirements or entitlements—which in turn determine its allowable prices—is to introduce a fatal circularity into the process. As the Supreme Court aptly put it:

> The heart of the matter is that rates cannot be made to depend on 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated.[21]

Precisely the same reasoning applies to the net book value that serves as the investment base in these calculations of the jurisdictional threshold would eviscerate the regulatory process if it were the asset prices *at which they were subsequently valued* in or as the result of asset transfers, mergers or acquisitions. It would permit easy evasion of regulation: the assets could be transferred at prices or valuations inflated above net original cost and those inflated valuations would then automatically be translated into correspondingly inflated threshold values. The effect would be to exempt many rail rates from any regulatory restraints.

B. Effect of the Acquisition Premium on Revenue Adequacy

A similar problem arises with respect to the calculation of revenue adequacy for CSX and Norfolk Southern after the transaction. Currently, the net book value of Conrail's assets for

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[21] FPC v. Hope Natural Gas Co., 320 U.S. 591, 601 (1944)

revenue adequacy purposes is $6, 474 million. The result of the transaction will be to increase net investment for revenue adequacy purposes by some $9,113 million.[22]

Just as in the case of the threshold price to captive shippers, it would be simply wrong to allow CSX and Norfolk Southern's judgment about the market value of Conrail's assets to influence calculations of their revenue adequacy. It would introduce the same circularity into the regulatory determinations of whatever constraints are subject to the revenue adequacy test, and allow railroads to manipulate those constraints at the expense of their customers.

Unfortunately, this is precisely what has occurred as a result of previous mergers, acquisitions, consolidations and reorganizations: the asset reevaluations entailed by them have simply have found their way into the book values on the basis of which assessments of revenue adequacy and rate ceilings have been made—in a self-justifying upward spiral.

C. Implications of the Acquisition Premium for the Effects of the Acquisition of Shippers

Finally, the premium incorporated in the acquisition price paid by CSX and Norfolk Southern *over the market value* of Conrail's assets (as distinguished from its net book value, which has been the subject of our preceding discussion) has significant implications for the competitive effects of the merger. That premium clearly represents the incremental net cashflows expected by Norfolk Southern and CSX as a consequence of the acquisition.

As of Octobter 14, 1996, the last trading day before CSX made its original offer for Conrail, the market value of Conrail's shares was about $6,140 million. Eventually, the total cost to Norfolk Southern and CSX was $9,895 million. The difference of some $3,755 million reflects the incremental net revenues that the management of Norfolk Southern and CSX thought they could secure by taking over the Conrail assets.

There are several possible sources of those additional net revenues:

- increased efficiencies in the operation of the Conrail assets;

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[22] See "Verified Statement of Thomas D. Crowley", October 21, 1997, p. 29.

- increased efficiencies resulting from the joint operation of the Conrail assets with the assets of the acquiring carriers;

- increased monopoly power resulting from reductions in competition.

We are not in a position to assess the relative contributions of these three possible benefits to the acquiring party to the overall premium paid for the Conrail assets and are not in a position to make a recommendation about whether the benefits outweigh the possible injury to customers of the railroads and the consuming public. But we believe the acquisition will increase monopoly power; and the Board must therefore assume, as it consistently does, that CSX and NS will exercise all of the market power available to them to raise shippers' rates.

IV. Possible Remedies

Having demonstrated, both theoretically and empirically, that the elimination of competition on originating routes is highly likely to result in higher rates to shippers hitherto benefiting from that competition, despite their dependence both ore and after on single destination carrier, and that the acquisition premium paid for Conrail will in fact raise the threshold for application of the captive shippers cause and the revenue adequacy threshold for whatever regulatory intervention may be effected by such determinations, we submit that we have established an irrefutable case for preventing those harmful consequences if the merger is to be permitted to go into effect.

As a general proposition our preference as economists would be for structural rather than regulatory remedies aimed at preserving access of competitive carriers and shippers to one another as a more consistent with the national policy of leaving the disciplining of the transportation industries to unregulated competition rather than additional regulation. At the same time, since the Staggers Act itself provided for continuing regulatory protections in situations in which competition is inadequate, clearly the first remedy must be to ensure that those continuing statutorily-prescribed protections are not weakened by the merger. We then proceed to consider other remedies—with a preference for structural—the basis for which we have already provided in our theoretical and empirical analyses.

A. The Acquisition Premium Must Not Affect Regulated Rates or Revenue Adequacy Calculations Competitive Access Should Be Permitted Wherever Possible

Our preceding discussion of these possible consequences of the premium that NS and CSX paid for Conrail above its net book value would, if uncorrected, raise the barriers to application of the safeguards in the Staggers Act itself—including whatever the effect would be of reclassifying the acquiring railroads as revenue—inadequate. Clearly, it would make a mockery of captive shipper and revenue adequacy provisions if companies could circumvent them merely by combining or acquiring another's assets at prices above the levels that previously provided the basis for the threshold for captive shipper protection or revenue adequacy of the railroads in question. Further discussion of this obvious remedy seems to us superfluous.

B. To Preserve Competitive Access

The potentially anticompetitive effects of the merger and injury to shippers exposed by our preceding analysis are not confined to shippers and shipments qualifying under the pertinent statutory and regulatory provisions for captive shippers protection. Where that injury is the consequence of a merger or acquisition subject to regulatory approval or disapproval, sound regulatory policy, statutory construction and antitrust theory and practice all not only permit but—if the acquisition itself is to be approved—dictate the imposition of safeguards applicable to all situations in which shippers are likely to suffer from the consequent reduction in competition, and not merely in situations in which they qualify formally as captive shippers.

Our analysis suggests that some form of remedy is required for all destinations that will be served henceforth by either or both of the acquiring carriers, NS and CSX, where competition, actual or potential, is eliminated or lessened at either origin or destination as a result of the acquisition of Conrail.[23] Examples of such instances are discussed by Mr.

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[23] We have not discussed separately the loss of, or reduction in ,destination competition because, as we understand it, there is no dispute by anyone (including the Board and the Applicants) that so-called "2-1" shippers (i.e., those shippers losing a destination carrier) are entitled to protection. We have not determined which destinations are in this category but are aware that Indianapolis Power & Light Company claims its Stout Plant is so affected and Applicants' witness Hart has stated that there are a number of other such "2-1" points resulting from the transaction.

Crowley.

As we have already observed, policies of both deregulation and competition give rise to a preference, to which we subscribe, for automatic, structural remedies rather than additional regulatory prescriptions. In conformance with this preference, we propose the following:

1. Extension of the "shared asset area" provision of the merger agreement

As we understand it, the acquisition agreement between CSX and NS has provided for a jointly-owned independent operator to provide destination carriage in three areas—in northern Jersey, southern New Jersey and Philadelphia, and around Detroit—in which the operator would handle all traffic in and out of those areas and is under obligation to provide equal access to both partners, thereby enabling them to compete with one another for all traffic in and out of those areas, using the facilities of the joint access operator. Such an arrangement will provide an opportunity for both the acquiring carriers to compete for business hitherto served by a destination monopolist and, in a sense more importantly, it gives shippers in those areas the opportunity to bargain with each of them separately in order to obtain the best possible terms. Such arrangements could be extended to other areas (for example, Indianapolis).

In recommending this, we endorse the concept of equal access for CSX and NS but are not wedded to any particular arrangements they plan for their "shared asset areas" or "joint access areas," such as the MGA. The Applicants, having endorsed the concept of equal access in various regions of their own choosing, are not in a position to argue that the same concept should not be extended to other areas adversely affected by the acquisition. This is particularly so because we are advised that there were no objective criteria used to determine which areas would have equal access.

2. Extension of the right of shippers to seek captive shipper protection in the charges for bottleneck routes

The logic of this provision is clear: having demonstrated that the presence of origin competition (whether from the same originating point or a separate, competing originating point) does provide protection to shippers, and having demonstrated that elimination of that competition exposes shippers to higher rates, we suggest that additional protection may in some circumstances best be provided by permitting shippers to seek captive shipper protection for the previous, separate bottleneck segment alone.[24] This is particularly likely to be the case on destinations previously served by a Conrail monopoly, where now NS and CSX compete for the originating traffic (e.g. from differing origins). A Conrail destination monopoly might have been indifferent about whether CSX or NS obtained the originating business but in the new circumstances either NS or CSX would have inherited the destination monopoly and might succeed, by exploiting that power, in either diverting traffic originating with its competitor or weaken the ability of shippers to play those two competitors off against one another.

The reasons that this remedy is appropriate, if the equal access remedy is not adopted, are several. First, of course, if destination competition is lost, it is obvious that there may be a need for regulation to replace the lost competition. Second, the mere obligation to quote a separate rate for the bottleneck segment would make it possible for shippers to invoke and achieve the benefits of competition on the non-bottleneck segment, which competition our data shows the shippers had. Third, the Staggers Rail Act designed a regulatory system that relied on competition to the maximum extent possible to restrain prices. Under this scenario, regulation should not be necessary except where the bottleneck carrier fails to act in accordance with the regulatory constraints that the Board agrees merits its assertion of regulatory jurisdiction over the rate for the bottleneck segment.

We see extension of the shared assets provision and reversal of the bottleneck decision as alternative remedies, with the first, structural one preferable to the second.

3. A Rate Cap With Adjustment for Cost Changes

If the Board refuses to adopt either of our preferred remedies, it may not fail altogether to protect shippers from loss of competition. If a shipper is not permitted either a structural remedy or potential regulatory remedy, either of which should restore lost competition, the only remaining remedy that we can devise would be for the Board, as a condition for approval of the transaction, to impose a cap on rates for shippers in jeopardy from the potential loss of

[24] Clearly, this recommendation would apply also in those instances in which destination competition is eliminated or reduced.

competition, subject to the Board's Rail Cost Adjustment Factor (Adjusted) for some period of time. At a minimum, we suggest this period should be five years, with the Board leaving open the possibility of extending the cap if circumstances warrant.

CONCLUSION

Because virtually everyone pays electric rates that directly incorporate the cost of rail transportation of coal, the Board must recognize that it must provide meaningful protection for shippers exposed to jeopardy from the limitation on competition that may flow from the acquisition of Conrail. Having been involved in the debate that led to the passage of the Staggers Rail Act of 1980, we emphatically believe that Congress did not intend rail shippers to be deprived of protection against mergers that threaten to weaken the competition the Act was intended to unleash.

VERIFICATION

I, Alfred E. Kahn, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement. Executed this 17 day of October, 1997.

Alfred E. Kahn

Alfred E. Kahn

VERIFICATION

I, Frederick C. Dunbar, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement. Executed this 17 day of October, 1997.

Frederick C. Dunbar

Frederick C. Dunbar

APPENDIX A

Consider the following situation. A route runs from A to C, via B. B to C is currently a bottleneck. There are two competitive routes from A to B. Carrier 1 owns one of the AB routes, and the BC bottleneck, while Carrier 2 owns the BC route. This is the classic "one-lump" situation. Now suppose the variable cost of a shipment is as follows: A to B, on Carrier 1, $10; A to B, on Carrier 2, $10: B to C, on Carrier 1, $5. Let us also suppose the shipper's willingness to pay for one shipment is $20. The situation can be represented like this:

Carrier 2

$10

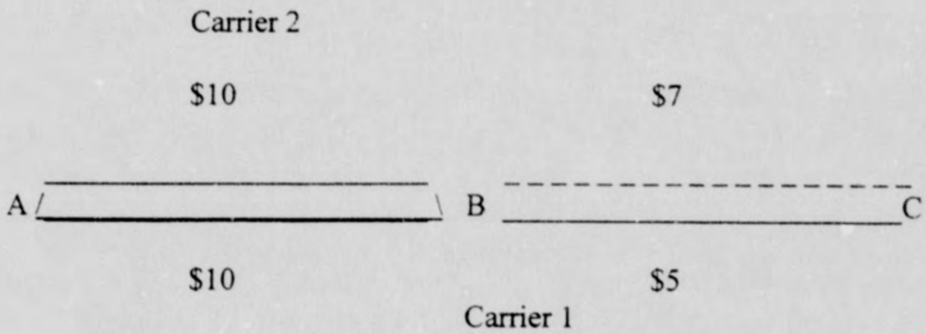
A / \ B C

$10 $5

Carrier 1

The classic one-lump theory makes three predictions: that Carrier 1 should offer to make the shipment for $20, or very slightly less, extracting all the monopoly profit ($5)[1]; that Carrier 1 should be indifferent as to whether the shipment from A to B travels on its line or Carrier 2's line, but that if it does go on Carrier 2's line then Carrier 2's revenue share should be $10, or very slightly more, with all the monopoly profit still going to Carrier 1; and that a merger between Carrier 2 and Carrier 1 will have no effect.

Suppose, however, that it is possible to construct a new route from B to C, and that such a route would have a long-run variable cost of $7. This situation can be represented like this:



In these circumstances, it is clearly not an equilibrium outcome for Carrier 1 to charge $20, because in that event it would be profitable for Carrier 2 to construct the new route from B to C and to undercut its price. Nor is the "competitive" price of $15 an equilibrium, since at that price there would be no incentive to build the new route. The only equilibrium is for Carrier 1 to charge $17, just enough to deter entry on the BC route. The route still *looks* like a bottleneck, since the new BC route is never constructed; but its *potential* existence is enough to constrain prices.

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[1] See note 14 in the main text for a discussion of this definition of "profit".

Now suppose Carriers 1 and 2 merge, and that the cost of constructing a new AB route would be 15.

Potential Entrant

$15 $7

A / \ B C

$10 $5

Carrier 1+2

In these circumstances, the merged carrier can put prices up to $20 without fear of entry, since a new carrier that built the entire ABC route would have a long-run variable cost of $22. Nor would it be economic for a carrier to construct simply the BC portion of the route, since it would in this case be excluded from the market by the bottleneck over the AB portion.

The point of this example is to show that it is perfectly feasible, and entirely consistent with conventional economic theory, for a profit-maximizing carrier which controls the bottleneck portion of a route not to possess the market power necessary to charge the full monopoly price; that this can continue indefinitely even if no actual competition is ever observed over the bottleneck portion; and that in cases a merger which reduced origin competition could indeed lead to a reduction in competition and an increase in prices and market power over the entire route.

APPENDIX B

ALFRED E. KAHN

BUSINESS ADDRESS:

308 North Cayuga Street
Ithaca, New York 14850
Tel: (607) 277-3007
Fax: (607) 277-1581

Professor Kahn is the Robert Julius Thorne Professor of Political Economy, Emeritus, at Cornell University and a Special Consultant to NERA.

He has been Chairman of the New York Public Service Commission; Chairman of the Civil Aeronautics Board; and Advisor to the President (Carter) on Inflation and Chairman of the Council on Wage and Price Stability.

Professor Kahn received his Bachelor's and Master's degrees from New York University and a Doctorate in Economics from Yale University. Following service in the Army, he served as Chairman of the Department of Economics at Ripon College, Wisconsin. He moved to the Department of Economics at Cornell University, where he remained until he took leave to assume the Chairmanship of the New York Public Service Commission. During his tenure at Cornell, Professor Kahn served as Chairman of the Department of Economics, member of the Board of Trustees of the University and Dean of the College of Arts and Sciences.

Throughout his career, Professor Kahn has served on a variety of public and private boards and commissions including: the Attorney General's National Committee to Study the Antitrust Laws; the senior staff of the President's Council of Economic Advisors; the Economic Advisory Council of American Telephone & Telegraph Company; the National Academy of Sciences Advisory Review Committee on Sulfur Dioxide Emissions; the Environmental Advisory Committee of the Federal Energy Administration; the Public Advisory Board of the Electric Power Research Institute; the Board of Directors of the New York State Energy Research and Development Authority; the Executive Committee of the National Association of Regulatory Utility Commissioners; the National Commission for Review of Antitrust Laws and Procedures; the New York State Council on Fiscal and Economic Priorities; the Governor of New York's Fact-Finding Panel on Long Island Lighting Company's Nuclear Power Plant at Shoreham, L.I.; the Governor of New York's Advisory Committee on Public Power for Long Island; the National Governing Board of Common Cause; and, in 1990, as Chairman of the International Institute for Applied Systems Analysis Advisory Committee on Price Reform and Competition in the USSR.
He has also served as a court-appointed expert in State of New York v. Kraft General Foods, Inc., et al., U.S. Disctrict Court, S.D.N.Y.; Advisor to New York Governor Carey on

Telecommunications Policy; and as a consultant to the Attorneys General of New York, Pennsylvania and Illinois, the Ford Foundation, the National Commission on Food Marketing, Federal Trade Commission, Antitrust Division of the Department of Justice, the U.S. Department of Agriculture and the City of Denver on charging and financing of Stapleton Airport.

He has received L.L.D. honorary degrees from Colby College, Ripon College, Northwestern University, the University of Massachusetts and Colgate University, and an honorary D.H.L. from the State University of New York, Albany; he also received the Distinguished Transportation Research Award of the Transportation Board Forum, The Alumni Achievement Award of New York University, the award of the American Economic Association's Transportation and Public Utilities Group for Outstanding Contributions to Scholarship, The Henry Edward Salzberg Honorary Award from Syracuse University for Outstanding Achievement in the Field of Transportation, and the Burton Gordon Feldman Award for Distinguished Public Service from Brandeis University; and was elected to membership in the American Academy of Arts and Sciences and Vice President of the American Economic Association. He is a regular commentator on PBS's "The Nightly Business Report."

He has testified before many U.S. Senate and House Committees, the Federal Power Commission, the Federal Energy Regulatory Commission and numerous state regulatory bodies.

Professor Kahn's publications include *Great Britain in the World Economy; Fair Competition: The Law and Economics of Antitrust Policy* (co-authored); *Integration and Competition in the Petroleum Industry* (co-authored); and *The Economics of Regulation*. He has written numerous articles which have appeared in *The American Economic Review, The Quarterly Journal of Economics, The Journal of Political Economy, Harvard Law Review, Yale Journal on Regulation, Yale Law Journal, Fortune, The Antitrust Bulletir* and *The Economist*, among others.

EDUCATION:

YALE UNIVERSITY
Ph.D., Economics, 1942

UNIVERSITY OF MISSOURI
Graduate Study, 1937-1938

NEW YORK UNIVERSITY
M.A., Economics, 1937
A.B. (summa cum laude), Economics, 1936

EMPLOYMENT:

1961-1974	NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.
1980-	Special Consultant
	CORNELL UNIVERSITY
1947-1989	Assistant Professor; Associate Professor; Robert Julius Thorne Professor of Economics; Robert Julius Thorne Professor of Political Economy, Emeritus, 1989-; Chairman, Department of Economics; Dean, College of Arts and Sciences; on leave 1974-80.
	NEW YORK UNIVERSITY SCHOOL OF LAW
Spring 1989	Visiting Meyer Professor of Law
	UNITED STATES GOVERNMENT
1978-1980	Advisor on Inflation to President Carter
1978-1980	Chairman, Council on Wage and Price Stability
1977-1978	Chairman, Civil Aeronautics Board
1955-1957	Senior Staff, Council of Economic Advisors to the President
1943	U.S. Army, Private
1943	War Production Board
1942	Associate Economist, International Economics Unit, Bureau of Foreign and Domestic Commerce, Department of Commerce
1941-1942	Associate Economist, Antitrust Division, U.S. Department of Justice
	NEW YORK STATE PUBLIC SERVICE COMMISSION
1974-1977	Chairman
	BROOKINGS INSTITUTION
1940, 1950-1951	Staff Economist
	RIPON COLLEGE
1945-1947	Assistant Professor, Chairman, Department of Economics
	TWENTIETH CENTURY FUND

1944-1945	Research Economist
	COMMISSION ON PALESTINE SURVEYS
1943-1944	Economist
	UNIVERSITY OF MISSOURI
1937-1938	Teaching Assistant

CONSULTANCIES AND PROFESSIONAL ACTIVITIES:

1994-	American Airlines on code-sharing
1994-	Antitrust Division, U.S. Department of Justice, on the application of Ameritech for waivers of the interexchange restrictions in the AT&T Modified Final Judgment
1993-1994	Court-appointed expert in State of New York v. Kraft General Foods, Inc., et al., U.S. District Court, S.D.N.Y.
1992	New Zealand Telecom on the progress of competition in New Zealand telecommunications
1992	Rochester Telephone Company on corporate restructuring and deregulation
1992	Russian Government on economic reform
1991	British Mercury on terms of competition with British Telecom
1989	City of Denver on charging and financing of Stapleton Airport
1988-1990	Attorneys General, New York and Pennsylvania, on airline mergers
1985	Attorney General, State of Illinois, on Illinois Bell rates
1981-1984	City of Long Beach, California, the Coca-Cola Company and American Airlines on antitrust litigation
1981-	Economic commentary, Nightly Business Report (PBS)
1980-1982	Advisor to Governor Carey on Telecommunications Policy
1968	Ford Foundation
1966	National Commission on Food Marketing
1965,1974	Federal Trade Commission
1963-1964	Antitrust Division, Department of Justice
1960-1961	U.S. Department of Agriculture
1957-1961	Boni Watkins, Jason & Co.

See also the list of testimony below.

MEMBERSHIPS:

1992-	Member, New York State Telecommunications Exchange
1992-93	Member, Ohio Blue Ribbon Panel on Telecommunications Regulation
1991-	Board of Editors, *Review of Industrial Organization*
1990-92	Chairman, International Institute for Applied Systems Analysis Advisory Committee on Price Reform and Competition in the USSR
1986	Governor Cuomo's Advisory Panel on public power for Long Island

1983-89	Governor Cuomo's Fact-finding Panel on Long Island Lighting Company's Nuclear Power Plant at Shoreham, L.I.
1983-90	New York State Council on Fiscal and Economic Priorities
1982-	*The American Heritage Dictionary* Usage Panel
1982-1985	Governing Board, Common Cause
1980-1986	Director, New York Airlines
1978-1979	National Commission for the Review of Antitrust Laws and Procedures
1975-1977	Project Committee, Electric Utility Rate Design Study, Electric Power Research Institute
1974-1975	National Academy of Science Review Commission on Sulfer Oxide Emissions
1974-1977	Public Advisory Board, Electric Power Research Institute
1974-1977	Environmental Advisory Committee, Federal Energy Administration
1974-1977	Executive Committee, National Association of Regulatory Utility Commissioners, and Chairman, Committee on Electric Energy
1968-1974	Economic Advisory Board, American Telephone & Telegraph Corporation
1965-1967	Economic Advisory Committee, U.S. Chamber of Commerce
1967-1969	Chairman, Tompkins County Economic Opportunity Corporation
1964-1969	Board of Trustees, Cornell University
1961-1964	Board of Editors, *American Economic Review*
1953-1955	Attorney General's National Committee to Study the Antitrust Laws

HONORS AND AWARDS:

May 1995	Wilbur Cross Medal for outstanding achievement, Yale University
Mar 1989	Burton Gordon Feldman Award for Distinguished Public Service, Gordon Public Policy Center, Brandeis University
Feb 1989	Distinguished Service Award, Public Utility Research Center, University of Florida
Nov 1988	International Film and TV Festival of New York, Bronze Medal presented to The Nightly Business Report/WPBT2 for Editorial/Opinion Series written by Alfred E. Kahn
Apr 1986	Harry E. Salzberg 1986 Honorary Medallion for outstanding achievement in the field of transportation
Oct 1984	Distinguished Transporation Research Award of the Transportation Research Forum
1981-1982	Vice President, American Economic Association
1978	Richard T. Ely lecturer, American Economic Association, 1978
1978	Rejection Scroll, International Association of Professional Bureaucrats
May 1985	State University of New York (Albany), DHL (Hon.)
May 1983	Colgate University, LL.D. (Hon.)
June 1982	Northwestern University, LL.D. (Hon.)
May 1980	Ripon College, LL.D. (Hon.)
May 1979	University of Massachusetts, LL.D. (Hon.)
May 1978	Colby College, LL.D. (Hon.)
1977-	Fellow of the American Academy of Arts and Sciences
1976	Distinguished Alumni Award, New York University

1976	American Economic Association, Section on Public Utilities and Transportation, citation for distinguished contributions
1954-1955	Fulbright Fellowship, Italy
1935-	Phi Beta Kappa
1939-1940	Yale-Brookings Fellow

BOOKS:

The Economics of Regulation, 2 volumes, John Wiley, 1970 and 1971. Reprinted by The MIT Press, 1988, with a new "Introduction: A Postscript, Seventeen Years After," pp. xv-xxxvii.

Integration and Competition in the Petroleum Industry, (with Melvin G. DeChazeau), Petroleum Monograph Series, Volume 3 (Yale University Press, 1959). Reprinted in 1971.

Fair Competition: The Law and Economics of Antitrust Policy (with Joel B. Dirlam) (Cornell University Press, 1954). Reprinted by Greenwood Press, 1970.

Great Britain in the World Economy (Columbia University Press, 1946). Reprinted in 1968.

MAJOR ARTICLES:

"How to Treat the Costs of Shared Voice and Video Networks in a Post-regulatory Age," *Policy Analysis*, #264, November 27, 1996, Cato Institute.

"Competition and Stranded Cost Re-revisited," 36 *Natural Resources Journal* (1996) forthcoming.

"Deregulation of the Public Utilities—Transitional Problems and Solutions," *Economic Papers*, Economic Society of Australia, September 1995, pp. 1-17. (Published in *Réseaux* nos. 72-73 Juillet/Octobre 1995 by CNET as "Déréglementation des Services Publics: Problèmes transitoires et solutions.")

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"Competition in the Electric Industry Is Inevitable and Desirable," *The Electric Industry in Transition*, Public Utility Reports, Inc. and New York State Energy Research and Development Authority, December 1994, Chapter 3, pp. 21-31.

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"Price Deregulation, Corporatization and Competition" (with M.J. Peck), in *What is to be Done? Proposals for the Soviet Transition to the Market*, M.J. Peck and T.J. Richardson, eds., New Haven: Yale University Press, 1991.

"Thinking About Predation--A Personal Diary," in *Review of Industrial Organization*, Vol. 6, The Netherlands: Kluwer Academic Publishers, 1991, pp. 137-146.

"An Economically Rational Approach to Least-Cost Planning For Electric Power," *The Electricity Journal*, Vol. 4, Number 5, June 1991, pp. 11-20.

"The Changing Focus of Electric Utility Regulation," *Research in Law and Economics*, Richard O. Zerbe, Jr., Victor P. Goldberg, eds., Vol. 13, JAI Press, Inc., Spring 1991, pp. 221-231.

"The Soviet Economic Crisis: Steps to Avert Collapse" (co-author), Executive Report 19, International Institute for Applied Systems Analysis, Laxenburg, Austria, February 1991.

"Telecommunications, Competitiveness and Economic Development--What Makes Us Competitive?", *Public Utilities Fortnightly*, Vol. 126, No. 6, September 13, 1990, pp. 12-19.

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Testimony on behalf of Central Telephone Company of Florida before the Public Service Commission, June 12, 1990.

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Testimony before the Federal Communications Commission on behalf of Bell South on adjustment factor for local exchange companies under rate cap regulation, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers (CC Docket 87-313), July 1988.

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Affidavit on behalf of Financial Interchange Inc. in an antitrust arbitration proceeding on the legality of jointly set interchange fees of an electronic funds transfer network, April 1988.

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Testimony on behalf of the U.S. Postal Service on the pricing of Express Mail, March 28, 1988.

Testimony on behalf of Kentucky Industrial Utility Customers Case No. 9934 on the criteria for deciding whether a nuclear plant should be completed, February 8, 1988.

Testimony and Rebuttal Testimony before the Iowa State Utilities Board Department of Commerce on behalf of Northwestern Bell on the regulatory treatment of depreciation reserve deficiencies, October 1987 and November 1987.

Testimony before the State of Connecticut Department of Public Utility Control on behalf of the Connecticut Cable Television Association on regulating cable television rates, November 13, 1987.

Testimony before the Federal Communications Commission on behalf of Bell South In the Matter of Policy and Rules Concerning Rates for Dominant Carriers (CC Docket 87-313) October 1987 and Reply Testimony, November 1987.

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Testimony before the New York State Public Service Commission on behalf of New York Telephone Company on assessing the competitiveness of telecommunications markets, April 1987.

Testimony before the New Jersey Senate Energy and Environment Committee on behalf of Public Service Electric and Gas Company on draft bill, No. 2801, the "Electricity Market Pricing Act of 1986," January 26, 1987.

Testimony before Federal Energy Regulatory Commission on behalf of Interstate Natural Gas Association of America on "Competitive Implications of Natural Gas Pipeline Marketing Affiliates," December 29, 1986.

Testimony before the New York State Public Service Commission on behalf of the Owners Committee on Electric Rates, Inc., on rent-inclusion and submetering, November 19, 1986.
Testimony before the Illinois Commerce Commission on behalf of Commonwealth Edison Company on standard for deciding whether Braidwood Unit 2 should be cancelled, August 4, 1986.

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Statement to Federal Communications Commission on New England Telephone Company's Proposed Interstate Access Tariff Restructure, January 30, 1986.

Testimony before the Public Utilities Commission of the State of Oregon on inverted rate structures on behalf of the Pacific Power & Light company, January 1986.

Rebuttal Testimony before the California Public Utilities Commission on San Onofre nuclear plants on behalf of Southern California Edison Company, January 1986 and En Banc Proceeding, February 1986.

Testimony and rebuttal testimony before the Arizona Corporation Commission on behalf of Arizona Public Service Company on economic and regulatory principles applicable to entry of nuclear plants into rate base, December 1985, March 1986, December 1986 and March 1987.

Testimony before the Corporation Commission of the State of Oklahoma on economic principles applicable to access charges, Cause No. 29321 on behalf of Southwestern Bell Telephone Company, September 1985.

Testimony before the California Public Utilities Commission on regulatory principles applicable to prudence determinations on behalf of Southern California Edison Company, August 1985.

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Verified Statement before the Interstate Commerce Commission, Docket No. 39687, on behalf of Platte River Power Authority, on the proper definition of the cost of capital for purposes of applying a stand-alone cost test of contested rail rates, July 1984.

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Testimony before the Utility Diversification Committee of the Legislature of the State of New Mexico, September 2, 1982.

Testimony before the Ad Hoc Committee on Utility Diversification, National Association of Regulatory Utility Commissioners, May 6, 1982.

Testimony before Motor Carrier Ratemaking Study Commission, Orlando, Florida, April 2, 1982.

Testimony before the State of Connecticut Department of Public Utility Control on methods of regulating rates for basic television cable service, March 9, 1982.

Testimony before the Committee of Energy and Public Utilities, The General Assembly of the State of Connecticut on regulation of cable television, March 1, 1982.

Testimony before the Public Utilities Commission of the State of California, for Pacific Power & Light Company on methods of allocating aggregate revenue requirements, September 24, 1981.

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APPENDIX C

NATIONAL ECONOMIC
RESEARCH ASSOCIATES
1166 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10036
TEL: 212.345.3000 FAX: 212.345.4650

nera
Consulting Economists

TRANSPORTATION VITA
FREDERICK C. DUNBAR

BUSINESS ADDRESS

NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.
50 MAIN STREET
WHITE PLAINS, NEW YORK 10606
(914) 448-4050

EDUCATION

TUFTS UNIVERSITY
Ph.D., Economics, 1971
M.A., Economics, 1969

REED COLLEGE
B.A., Mathematics and Economics, 1966

PROFESSIONAL EXPERIENCE

NATIONAL ECONOMIC RESEARCH ASSOCIATES, INC.

1988- *Senior Vice President.* Directs projects in the economics of antitrust and trade regulation, energy, environment, finance and transportation.

1984-1988 *Vice President.*

1979-1983 *Senior Consultant.*

CHARLES RIVER ASSOCIATES, INC.—Boston, Massachusetts

1976-1979 *Program Manager.* Responsible for studies in transportation, urban development, and various fuels; director of CRA's subsidiary, Econometric Appraisal Systems, Inc.

1971-1976 *Senior Research Associate.* Performed studies on the coal, metals, and computer industries.

NORTHEASTERN UNIVERSITY—Boston, Massachusetts

1969-1971 *Instructor, Department of Economics.* Taught graduate courses in mathematical economics, econometrics, and statistics; taught undergraduate courses in macroeconomics, business cycles and growth, and advanced statistics.

TUFTS UNIVERSITY—Medford, Massachusetts

1969 *Instructor, Department of Economics.* Taught social control of industry.

HONORS AND PROFESSIONAL ACTIVITIES

Adjunct Professor, Fordham University School of Law, 1995-present

Committee on International Trade, The Association of the Bar of the City of New York, 1993-present

New York Mercantile Exchange, Arbitration Committee, 1991-present

Transportation Research Forum, President, 1986-87, formerly Executive Vice President and Vice President - Program Chairman for 1985

Transportation Research Board, National Academy of Sciences, Subcommittees on Research Needs, Spatial Choice, Transportation Energy and 1980 Subcommittee Chairman on Telecommunications in Urban Freight Movement

Advanced Transit Association. Member of the Nominating Committee for Directors and Officers, 1981

American Marketing Association. Co-host of American Marketing Association Workshop: *Marketing Public Transportation*, 1979

Kennedy Memorial Teaching Award, Tufts University

National Science Foundation Trainee, Tufts University, three-year grant

Reviewer for Transportation Research Forum, Transportation Research Record, Journal of Industrial Economics, and Antitrust Bulletin

American Economic Association

American Bar Association, Industrial Organization Economist Associate

INVITED AND REFEREED PUBLICATIONS

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"Impact of Transportation Control Plans." Presented at the conference on Urban and Regional Impact of Regulation, Buffalo, N.Y., May 1978.

"St. Paul DPM Demand Forecasts." Testimony at Twin Cities Metropolitan Council Hearings on DPM Demand, April 1978.

With others, *Advanced Transit Systems Market Study*, Boeing Aerospace Corporation, 1977.

"Disaggregate Simultaneous Equation Models of Travel Behavior." Presented at the Transportation Research Board Meetings, 1977.

September 1997

EXHIBIT 2

ACE, <u>et al</u>. Exhibit 2

BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 33388

CSX CORPORATION AND CSX TRANSPORTATION, INC.,
NORFOLK SOUTHERN CORPORATION AND
NORFOLK SOUTHERN RAILWAY COMPANY
-- CONTROL AND OPERATING LEASES/AGREEMENTS --
CONRAIL INC. AND CONSOLIDATED RAIL CORPORATION

Verified Statement
of
Thomas D. Crowley
President
L. E. Peabody & Associates, Inc.

On Behalf of
Atlantic City Electric Company and Indianapolis Power & Light Company

Due Date: October 21, 1997

PUBLIC VERSION

TABLE OF CONTENTS

LIST OF EXHIBITS

STB FD 33388 10-21-97 D 182968 3/5

INTRODUCTION

My name is Thomas D. Crowley. I am an economist and President of the economic consulting firm of L. E. Peabody & Associates, Inc. The firm's offices are located at 1501 Duke Street, Suite 200, Alexandria, Virginia 22314. My qualifications and experience are attached as Exhibit TDC-1 to this Verified Statement.

I have been asked by ACE et al.[1/] to review the Railroad Control Application filed by CSX Transportation Inc. ("CSX") and Norfolk Southern Railway Company ("NS") in Surface Transportation Board ("STB") Finance Docket No. 33388. This Application specifies the terms of CSX's and NS' purchase of the assets of Consolidated Rail Corporation ("Conrail"). Specifically, I have been asked to determine the impact on coal transportation rates that will occur if the proposed transaction is implemented as presented in the railroads' Application. In making my evaluation, I have reviewed the CSX/NS/Conrail Control Application, the workpapers supporting the railroads' Application, the deposition of the various witnesses supporting the Application, and the Applicants' responses to interrogatory and document requests.

[1/] Atlantic City Electric Company ("Atlantic City") and Indianapolis Power & Light Company ("IP&L").

My comments are organized below under the following topical headings:

II. Summary and Findings

III. STB Criteria to Show Competitive Harm

IV. STB's Costed Waybill Data

V. Rate Changes After Conrail's Purchase of MGA

VI. Railroads' Efforts To Maximize Profits

VII. Rates and Costs for Origin Railroads

VIII. Impact of Premium Paid For Conrail

II. SUMMARY AND FINDINGS

Based on my review of the Railroad Control Application filed by CSX, NS and Conrail, as we as the workpapers, depositions and Applicants' responses to discovery, my findings regarding the acquisition of Conrail by CSX and NS are as follows:

1. The acquisition of Conrail's assets by CSX and NS will cause major competitive harm to the producers and receivers of coal;

2. The analysis of rail transportation rate and cost data in this proceeding indicates that CSX, NS and Conrail face constraints in the ability to maximize coal rates for destinations which are served by only one railroad. These analyses contradict the STB's findings in the recent BN/ATSF[2] and UP/SP[3] mergers related to the vertical effects of railroad mergers;

3. Contrary to the STB's "one lump" theory, the railroad serving a captive destination does not push the revenues of the origin railroad down to a level equal to incremental costs;

4. My analyses rely on, in part, the STB's Costed Waybill Sample ("CWS") data that identifies over the 1988 through 1995 time period the traffic levels and rates for CSX, NS and Conrail coal movements. In addition to utilizing this data in my analyses, this data has been furnished to ACE, et al. Witnesses Kahn and Dunbar for use in their analyses;

5. Conrail purchased the Monongahela Railway Company ("MGA") in 1991. After that purchase, rail rates for coal originating at MGA origins for movement to Conrail destinations increased over the 1991 through 1995 time period. Over the same time period (1991-1995), coal moving from non-MGA origins to Conrail destinations decreased . This analysis shows that rail mergers place shippers at risk for rate increases;

6. The railroads' documents pertaining to ratemaking made available in this proceeding indicate that the railroads consider numerous factors in setting rates but are not, in all cases, able to maximize the net revenue for captive movements;

7. Examples where Conrail is currently not maximizing net revenue are as follows:

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[2] Interstate Commerce Commission, Finance Docket No. 32549, Burlington Northern Inc. and Burlington Northern Railroad Company -- Control and Merger -- Santa Fe Pacific Corporation and The Atchison, Topeka and Santa Fe Railway Company, served August 23, 1995 ("BN/ATSF").

[3] Surface Transportation Board, 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, served August 12, 1996 ("UP/SP").

a.

b.

c.

8. The railroads have provided data that proves that the origin railroad has a substantial profit on its portion of the total haul. For example, CSX documents show that for

9. Witnesses for the Applicants acknowledge

The purchase of Conrail by NS and CSX will enhance each railroad's knowledge of the coal transportation market and decrease competition;

10. CSX and NS are paying $9.9 billion dollars for Conrail assets with a book value of $3.2 billion for Conrail shares or a difference of $6.7 billion. As currently proposed by CSX and NS the transaction could result in an acquisition premium of $9.1 billion for revenue adequacy purposes and $7.7 billion for jurisdictional threshold purposes. After the acquisition of Conrail, CSX and NS will have an incentive to raise rates to recover their premium;

11. By including the premium in CSX's and NS' URCS formula, both the variable cost of providing service and the resulting jurisdictional threshold associated with the average coal train movements will increase by for CSX and for NS;

12. When the Conrail premium is included with NS and CSX revenue adequacy calculations based on existing STB's procedures, NS' and CSX's return on investment are artificially reduced. NS' return on investment will be reduced by (i.e., from 13.0% to) and CSX's return on investment will be reduced by (i.e., from 8.9% to) if Conrail and the Conrail premium are included in the STB's revenue adequacy calculations; and,

13. I recommend that the adverse effect on the jurisdictional threshold and revenue adequacy calculations of including the Conrail premium be avoided. Specifically, the "status quo" can be achieved by including the difference between either the appraised value or the acquisition cost and the pre-acquisition historical book value of Conrail into property Account 80 -- Other Elements of Investment following the existing STB revenue adequacy calculations. Amounts recorded in Account 80 for regulatory costing purposes will also not affect the railroads' variable unit costs based on existing URCS procedures.

I was able to arrive at these conclusions despite the significant limitations imposed by the STB on the discovery sought by ACE, et al. in this proceeding. I advised counsel for ACE, et al. in developing those discovery requests, and had the STB required the Applicants to answer those requests to their full extent, then the analyses I have performed would have been more complete. The analyses I have performed are as broad as the STB's rulings would permit.[4]

Each of my findings is discussed in detail in the remainder of this Verified Statement and exhibits to this Verified Statement.

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[4] See, for example, the motions submitted by ACE, et al. seeking to compel responses to discovery requests identified as ACE, et al. -2, ACE, et al. -3, and ACE, et al. -4.

III. STB CRITERIA TO SHOW COMPETITIVE HARM

Historically, the STB and its predecessor, the Interstate Commerce Commission ("ICC"), have been reluctant to provide relief to shippers due to the vertical effects of a rail merger if the shipper could not show specific competitive harm at the destination. Even in this proceeding, the Applicants' proposed relief has been limited to situations where the shipper can show a loss of competition because it was losing either a railroad that served the destination (i.e., a "2-to-1" location) or losing the opportunity to access an alternative railroad (i.e., a "build-out").

But, if the destination is served by one railroad and the merger results in the loss of competition due to a decrease in competition at origin, the ICC/STB has not granted relief. The ICC/STB based this result on the assumption that:

1. The destination monopoly railroad will keep the monopoly profits;
2. The destination monopoly railroad is maximizing its profits;
3. The destination monopoly railroad has incentives to encourage the most efficient routing; and,
4. The destination monopoly railroad will force the origin railroad to accept the lowest division possible (i.e., incremental costs for the origin railroad).[5]

The results of these conditions can be summarized in a simple example. Assume a two railroad coal movement (e.g., a CSX origin move to a Conrail solely-served destination via interchange at Lurgan, Pennsylvania) where competition exists for the origin leg of the rail movement (e.g., a single line Conrail move or an NS origin movement to Hagerstown, Maryland). Further assume that the origin railroad (CSX) reduces the rail rate by $2 per ton because of competition for the origin leg of the movement. Under the STB's theory, Conrail would receive the $2 per ton, instead of the shipper, because it is able to extract the economic

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[5] See PN/ATSF, page 70.

rent as the monopolist. Thus, under the STB's theory, eliminating the origin competition would not harm shippers because Conrail already has extracted the full economic rent. In order to rebut the presumption that the destination railroad has the ability to maximize its profits, the ICC/STB have established two conditions that must be met. The two conditions were summarized in UP/SP as:

> The record must clearly show, first, that prior to the merger the benefits of origin competition flowed through to the utility and were not captured by the destination monopoly carrier, and, second, that the competitive flow through will be significantly curtailed by the merger. (UP/SP, page 128)

As will be shown below, the railroads involved in this proceeding do not set prices in accordance with the STB's theory. However, the removal of one of the competing railroads (Conrail) will enhance the railroads' knowledge of rates (and the marketplace) so as to allow the destination railroad to retain or gain the savings related to the origin competition to a greater extent than exists now.

IV. STB'S COSTED WAYBILL DATA

In order to test whether or not the railroads are maximizing their rates according to the STB's theory, ACE, et al. requested, through discovery, that CSX, NS and Conrail provide the traffic data for all coal movements for the 1978 through current time period. The railroads objected to this request. The ALJ in this proceeding (Decision No. 11, dated July 18, 1997) denied the ACE, et al. motion to compel in part while ordering the railroads to produce partial data. The STB upheld the ALJ's determination of the plant traffic data required to be produced (Decision No. 17, July 31, 1997). The data produced by the railroads reflected data for the plants owned by the ACE, et al. group.[6] In addition, the ALJ limited the time period required to be produced. All railroads produced data for the 1995 through mid-1997 time period. CSX was ordered to produce data for 1978 through 1982, NS for years 1980 through 1984 and Conrail for years 1988 through 1992.

Because the limited traffic data produced by the railroads is insufficient to test, over time, the railroads ratesetting for destinations captive to one railroad, I instead developed data based on the STB's Costed Waybill Sample ("CWS") for 1988 through 1995.[7] Specifically, the railroads did not provide any data for 1993 or 1994 and only Conrail provided data for 1988 through 1992[8]. After constructing the database from the CWS, I furnished it to Dr. Kahn and Dr. Dunbar for use in their analysis.

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[6] At that time, ACE, et al. included American Electric Power ("AEP"), Delmarva Power & Light Company ("DP&L") and the Ohio Valley Coal Company. For AEP, only the data for it's Cardinal plant was furnished.

[7] 1995 is the latest year available for the CWS. Additionally, 1995 reflects the year of the railroads' traffic analysis in the Control Application. As discussed below, 1988 was chosen as the initial year because the STB does not have variable cost data for the prior years.

[8]

The procedure I followed to develop the CWS database are discussed under the following topics:

A. Data on the CWS

B. Selection Criteria

C. Masking Factors

D. Railroads Serving Destination

Each is discussed below.

A. DATA ON THE CWS

For purposes of the analysis of the STB's theory regarding the railroads maximizing its profits, the relevant data extracted from the CWS included:

1. Year of movement;
2. Origin Standard and Point Location Code ("SPLC");
3. Destination SPLC;
4. Involved railroads (i.e., routing);
5. Tons shipped[9];
6. Rail mileage;
7. Revenues (by railroad);[9] and,
8. Variable costs (by railroad).

The CWS data furnished by the STB (through its contractor ALK Associates, Inc. ("ALK")) did not contain variable costs for years prior to 1988. I requested the variable costs for the years prior to 1988 from both the STB and ALK, but I was not provided this data.

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[9] The CWS shows revenues and tons for the sample car and expanded amount. My analysis is based on expanded revenues and tons.

B. SELECTION CRITERIA

Three criteria were utilized to select the movements covered in the analysis of the CWS. First, only coal moves were selected (STCC 112). Second, the route utilized contains at least one of the Applicants (CSX, NS or Conrail). Third, the destination SPLC reflected a recent volume movement of coal, i.e., received at least 250,000 tons in at least one year between 1990 and 1995. The use of this criteria identified 166 destinations. Each destination is identified in Exhibit TDC-2 by SPLC, name and railroad(s) terminating coal at the destination during the 1988 through 1995 time period.

C. MASKING FACTORS

In reviewing the CWS data, it was necessary to take into account the fact that the CWS does not reflect the actual revenues paid by the shippers. A "masking factor" is applied by the railroad before submitting the waybill data to the STB. An interrogatory from ACE, et al. requested the "masking factor(s)" applied by the destination railroad. CSX, NS and Conrail objected to these requests on September 11, 1997. ACE, et al. sought a motion to compel to obtain the "masking factor(s)" which was granted, in part, by the ALJ in this proceeding on September 19, 1997. CSX, NS and Conrail appealed this ruling to the STB and the STB granted their appeal on October 3, 1997 (Decision No. 42). Thus, the "masking factor(s)" were not provided to me.

The STB does not require that my CWS analysis reflect "unmasked" revenues noting that there is "no real need for the data anyway..." (Decision No. 42, page 8) and that there is no "legitimate issue" regarding the "masking factors" (Decision No. 7). Therefore, I could have performed my analysis based on the revenues shown on the CWS.

However, in order to restate the CWS revenues to accurately reflect the amount paid by the shipper, I have developed the "masking factors" by comparing the 1995 coal revenue per ton shown on the CWS with the 1995 coal revenue per ton shown on the 100% traffic tapes utilized by CSX, NS and Conrail in the Application. For this analysis, the data reflects coal terminations only (i.e., local and interline received movements). Table 1 below summarizes the "masking factor" for each railroad.

Table 1
Calculation of CWS "Masking Factors"

	Item (1)	Source (2)	CSX (3)	NS (4)	Conrail (5)
1.	1995 CWS -- Coal				
	a. Revenues (millions)	1/			
	b. Tons (millions)	1/			
	c. Revenue Per Ton (L1a ÷ Llb)	(L1a ÷ Llb)			
2.	1995 100% Traffic Tapes -- Coal				
	a. Revenues (millions)	2/			
	b. Tons (millions)	2/			
	c. Revenue Per Ton (L2a ÷ L2b)	(L2a ÷ L2b)			
3.	"Masking Factors"	(L1c ÷ L2c)			

1/ As summarized from the CWS.
2/ As summarized from the 100% Traffic Tapes.

Based on my calculations, the revenue "masking factors" equal for CSX, for NS and for Conrail. For example, if the CWS revenue for a movement terminated by CSX equals $10 per ton, then the "unmasked" revenue was developed by dividing the CWS revenue by the "masking factor" producing a result of per ton ($10.00 per ton divided by

10/

10/ For movements that were not terminated by CSX, NS or Conrail, no data is available to develop a "masking factor" and, therefore, the CWS revenues were not adjusted.

D. RAILROADS SERVING DESTINATION

The CWS identifies all railroads participating in movements to a given destination. The summary of the involved railroad(s) for each destination is summarized in Exhibit TDC-2 to this Verified Statement.

V. RATE CHANGES AFTER CONRAIL'S PURCHASE OF MGA

The Applicants maintain that the creation of a single-line haul from previously interline movements to Conrail destinations will enhance competition. Under the STB's theory, the shippers will not be harmed because any benefits of origin railroad competition are already accruing to the terminating railroad. However, a recent example exists where the terminating railroad was allowed to merge with the originating railroad. From this example, the change in rates after the merger can be observed. In ICC Finance Docket No. 31875, Consolidated Rail Corp. -- Merger -- Monongahela Railway Company, Conrail sought to acquire the MGA ("MGA Merger"). The merger was approved in a decision served October 10, 1991. The ICC's review of the Application for Conrail's merger with MGA can be summarized as follows:

> The merger is intended to increase efficiencies between MGA and Conrail and thus to improve the combined system's ability to compete with NS and CSXT. (MGA Merger, page 2)
>
> We conclude that the merger is not likely to result in a substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States. (MGA Merger, page 4)

Utilizing the CWS data, I have reviewed the change in the volumes and rates for movements to Conrail destinations before and after the merger. For this analysis, I have compared CWS data for 1991 (the year of the merger) and 1995 (the latest available). For this analysis, I have separated coal movements to Conrail destinations into two groups. First, I identified the coal moving from MGA origins to Conrail destinations as shown in Exhibit TDC-3[11]. Second, I identified the coal moving from all other non-MGA origins to Conrail destinations as shown in Exhibit TDC-4. The total tons shipped and weighted average rate per ton were developed for each group.

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[11] In 1991, the MGA origins are identified by the originating railroad, i.e., the MGA. In 1995 the MGA origins were identified based on matching the SPLC for the origin to the 1991 data.

The results of my analysis are summarized in Table 2 below:

Table 2
Summary of Impact of Conrail/MGA Merger

Item (1)	1991 (2)	1995 (3)	Percent Change (4)
1. Tons (millions)			
a. MGA origins			
b. All other origins			
2. Average Rate Per Ton			
a. MGA origins			
b. All other origins			

Source: Exhibit TDC-3 and Exhibit TDC-4.

VI. RAILROADS' EFFORTS TO MAXIMIZE PROFITS

Data provided by CSX, NS and Conrail in this proceeding refutes the STB's theory that the destination railroad, where a shipper is captive, is maximizing its share of the revenues and profits. Neither the Application, workpapers, depositions or responses to interrogatories prove that the railroads are currently maximizing profits for moves where the destination is captive to one railroad.

However, after the CSX's and NS' acquisition of Conrail, the increased knowledge of the market will allow the railroads to increase rates. My analysis of the issue is discussed under the following topics:

A. Railroads' Position on Maximizing Profits

B. Applicants' Statement on Ratesetting

C. Examples Showing That Railroads Do Not Maximize Profits

Each is discussed below.

A. RAILROADS' POSITION ON MAXIMIZING PROFITS

I agree with the STB that the railroads have every incentive to maximize profits.[12] Thus the STB's assertions in Decisions Nos. 17 and 42 that ACE, et al. are challenging a basic principle of economics is simply wrong and contrary to the Affidavits filed by Drs. Kahn and

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[12] See, for example, BN/ATSF, page 70.

Dunbar and me with the ACE, et al. appeal of July 22, 1997. However, as shown below the assumed profit maximization does not always occur and the shipper benefits from this fact.

CSX's Witness Sharp, in his deposition, stated

He

reiterated this position when specifically asked

NS' Witness Fox, in his deposition, had a similar view of .

When asked

If the railroad behaves in this manner, then the ratesetting analyses developed by the railroad would be based on the railroads' review of the cost of the movement, the development of the maximum contribution achievable and the rate based on the cost plus the maximum contribution.

13/

14/

13/

14/

B. APPLICANTS' STATEMENT ON RATESETTING

The

CSX and NS acquisition of Conrail will create more potential markets where CSX or NS will have to consider the competing railroads' response to changes in rates, thus, further decreasing competition.

C. EXAMPLES SHOWING THAT RAILROADS DO NOT MAXIMIZE PROFITS

I have reviewed the Applicants ratesetting documents in order to demonstrate that the railroads are not maximizing profits. I have included in this Verified Statement three examples which show that the railroads do not (or cannot) maximize profits. My analysis is summarized below.

VII. RATES AND COSTS FOR ORIGIN RAILROADS

One corollary of the STB's theory is the ability of the destination railroad to force the origin railroad to accept the lowest division possible. Simply stated, this requires the destination railroad to be able to force the origin (i.e., competing) railroad to an amount close to its incremental costs. By doing this, the destination (monopoly) railroad maintains the economic rent.

However, as shown below, this does not occur in practice.

VIII. IMPACT OF PREMIUM PAID FOR CONRAIL

CSX and NS purchased Conrail shares for $9.9 billion[15]. The book value of Conrail shares equal $3.2 billion[16]. The market value of Conrail prior to the announcement of the merger with CSX equalled $6.1 billion.[17] The preliminary appraised value of Conrail property and equipment is estimated at $16.2 billion[18] by CSX and NS which can be contrasted to the historical gross book value of Conrail's assets which equals $8.5 billion[19]. CSX is purchasing 42% of Conrail's assets and NS is purchasing the remaining 58%.

Prior to discussing the impact the premium associated with CSX's and NS' purchase of Conrail will have on revenue adequacy and variable cost calculations, I have developed an overall summary of the change in the financial statements that the Applicants' state will result from this transaction. Table 5 below summarizes the Applicants characterization of the financial impact of the Conrail transaction:

15/ The purchase price equals the monies CSX and NS paid to purchase the shares of Conrail. It does not include the $2.1 billion in Conrail debt that CSX and NS assumed.

16/ The book value of Conrail net investment represents the value used to calculate whether or not Conrail is revenue adequate following the STB's existing revenue adequacy procedures.

17/ CSX October 16, 1996 tender offer of $71 per share multiplied by 86.475 million shares.

18/ The workpapers provided by the Applicants' to support this calculation are included as Exhibit TDC-10 to this Verified Statement.

19/ The historical book value represents the value of the Conrail assets used for regulatory costing purposes, i.e., gross investment in assets less accumulated depreciation (including asset disposition).

Table 5
Summary of Financial Impact of Conrail Acquisition

			Amount (millions)		
	Item	Source	CSX	NS	Total
	(1)	(2)	(3)	(4)	(5)
1.	Transaction Costs to Acquire Conrail	1/ pp. 26-27; 2/, p. 2	$100		
2.	Amortization of Goodwill	1/ , p.3; 2/ p.1			
3.	Increase in Interest on Debt	3/; 2/, p.1			
4.	Debt for Acquisition				
	a. Total	4/; 2/			
	b. Repayment in first 3 years	4/; 2/, p.1			
5.	Impact on Residual Cashflow	4/; 2/, p.1			
6.	Impact on Net Income	6/	42	44	86

1/ Deposition of Witness Whitehurst.
2/
3/
4/
5/ Witness Wolf, page 382.
6/ Volume No. 1, Exhibit No. 17, Appendix D, p. 150 (CSX) and Appendix H, p. 181 (NS).

As shown above, the heavy financial price for Conrail produces limited financial gain in net income.

A premium occurs when the acquiring railroad pays an amount in excess of the acquired railroads' historical book value. The existence of a premium depends upon the accounting rules used for a merger. If the merger is treated for accounting purposes as a "pooling of interests", a premium would not exist for accounting purposes because the historical book values of both railroads are simply combined. If the merger is treated for accounting purposes as a "purchase", a premium would exist for accounting purposes and would be equal to the difference between the consideration given for the acquired company and its book value. CSX and NS are utilizing the "purchase" accounting methodology in their acquisition of Conrail.[20]

A. PREMIUM FOR REGULATORY PURPOSES

If the premium CSX and NS are paying for Conrail is permitted to affect the property and equipment accounts of CSX and NS, then the STB's annual revenue adequacy calculations for CSX and NS will be artificially lowered. Additionally, the premium would increase CSX's and NS' variable cost of providing service based on the STB's Uniform Railroad Costing System ("URCS") which, in turn, will artificially increase the jurisdictional threshold level used to identify traffic that falls below STB jurisdiction. The jurisdictional threshold level is also the floor for regulatory ratesetting purposes.

The calculation of the premium for revenue adequacy purposes differs from the calculation for jurisdictional costing purposes. For revenue adequacy determinations following current STB procedures, the net investment base of the acquiring railroad(s), i.e., CSX and NS, is increased by the lower of the purchase price or the appraised (fair) value.[21] For jurisdictional costing purposes, the purchase accounting rules for the Uniform System of Accounts ("USOA") used in URCS specify how road and equipment property will be recorded.[22] The reason the premium may be higher for this regulatory purpose is that the railroads have the option of using appraised

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[20] In the last three mergers, the acquisition costs exceeded the historical book value. These three mergers were UP/SP, BN/ATSF and Union Pacific/Chicago and NorthWestern ("UP/CNW"). In two of the three mergers the premiums have been quantified and recorded in the financial records of the railroads. The UP/SP have yet to consolidate for financial reporting purposes, so the premium is still not publicly reported.

[21] A railroad's assets are determined for revenue adequacy purposes in accordance with GAAP Cost. GAAP Cost, as applied in business combinations is equal to acquisition cost. GAAP Cost equals "the value of the resources forgone by the entity to acquire the assets. For all assets acquired through a business combination, acquisition cost is the lower of (1) the aggregate purchase price of the firm or (2) the fair value of the tangible and identifiable intangible assets at the time of the business combination." Railroad Accounting Principles, Final Report, Sept. 1, 1987, Volume 2, pp. 59 and 115.

[22] CFR 49 Part 1201, Rule 2-15.

(fair) value instead of acquisition cost when assets are acquired for other than cash.[23] In this proceeding, CSX and NS would use the appraised value of Conrail of $16.2 billion for regulatory purposes.

In summary, if the CSX and NS follow the procedures that the railroads utilized in UP/CNW and BN/ATSF, the two railroads will increase the gross investment in Conrail's plant and equipment to $16.2 billion (the appraised value). This overstated value will then be utilized to create an overstated value for annual depreciation costs.

I have estimated the premium paid by CSX and NS for Conrail's assets for both revenue adequacy and jurisdictional costing purposes. The premium for revenue adequacy purposes equals the total cost of the Conrail shares acquired less the book value of Conrail's shares plus the value of CSX's and NS' elimination of Conrail's amounts for accumulated depreciation and disposition of assets. For costing purposes, the premium reflects the difference between the appraised value of Conrail's assets and the gross book value of Conrail's assets. A summary of the premium calculations for CSX and NS is shown in Table 6 below.

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[23] The appraised (fair) value option was followed in recording the road and equipment values for the BN/ATSF and UP/CNW mergers. In both cases the appraised value was greater than the purchase value. The UP/SP have yet to consolidate for financial reporting purposes, so the premium is still not publicly reported.

Table 6
Summary of CSX and NS Premium Paid for Conrail
($ in Millions)

Item (1)	For Revenue Adequacy Purposes (2)	For Jurisdictional Threshold Purposes (3)
1. CSX[1/]	$3,827	$3,248
2. NS[2/]	$5,286	$4,485
3. Total	$9,113	$7,733

[1/] Based on 42% of total.
[2/] Based on 58% of total.
Source: Exhibit TDC-11.

The results of my analysis are a premium of $9.1 billion for revenue adequacy purposes and $7.7 billion for regulatory costing purposes.

B. IMPACT OF PREMIUM ON JURISDICTIONAL THRESHOLD

If the premium CSX and NS are paying for Conrail is improperly included in each railroad's general purpose costing formula ("URCS"), each railroad's unit costs will artificially increase. In turn, each railroad's variable cost of providing service will artificially increase which will have an adverse effect on the STB's jurisdictional threshold calculations to the detriment of the captive shipper that has filed a rate complaint. This detrimental impact will come in two forms.

First, STB determines whether or not it has jurisdiction over a specific shipper movement by comparing the complained about rate to the railroad's variable cost of providing service. If the resulting rate to variable cost ratio exceeds the STB's current jurisdictional threshold ratio, which is currently 1.80, then the STB has jurisdiction over the specific movement. If CSX's or NS' variable costs have been artificially increased because of the premium paid for Conrail, a captive shipper's movement may not be considered by the STB because the rate to cost ratio is less than 180%.

Second, during the maximum rate determination phase of a complaint case based on Constrained Market Pricing, the STB will set rates at the higher of stand-alone costs or the jurisdictional threshold level, i.e., the jurisdictional threshold level is a floor for rate setting purposes.

If CSX's and NS' variable costs have been artificially increased because of the premium paid for Conrail, the STB may prescribe a higher rate for a captive shipper's movements than the STB would have prescribed if the Conrail premium were not included in the individual railroad URCS cost formula.

The impact of costs on the minimum rates available to shippers cannot be overlooked. In response to

Thus, an increase in CSX's and NS' variable costs associated with the acquisition premium will raise the cost

The remainder of this section of my testimony describes the adjustments I made to CSX's and NS' URCS formula assuming CSX and NS improperly account for the acquisition premium by including the premium in the individual investment property accounts. Also, I will apply these artificially inflated CSX and NS unit costs to an average coal movement to determine the impact CSX's and NS' portion of the premium will have on the jurisdictional threshold level of a CSX and NS movement, again assuming the premium is improperly included in CSX's and NS' system of accounts.

Railroad investment is recorded in individual property accounts and annually reported to the STB in each railroad's Annual Reports Form R-1. Most accounts are depreciable accounts following GAAP accounting rules with the exception of certain non-depreciable accounts, e.g., land. The Form R-1 amounts for investment and depreciation are included in URCS. URCS applies these investment values to the applicable cost of capital rate, variability percentages and activity in developing the return on investment ("ROI") variable unit costs and depreciation unit costs. If the premium is not excluded in developing URCS unit costs[24/], the variable costs and jurisdictional threshold for the movement being considered will increase significantly.

The first step I followed in developing the jurisdictional threshold impact was to record CSX's and NS' portion of the Conrail premium in the property accounts.[25/] I followed the methodology used by the railroads in the BN/ATSF merger and the UP/CNW merger. In addition, I increased the reported annual depreciation values to account for the incremental annual depreciation associated with the Conrail premium. After I made these modifications, I included the inflated property accounts and assumed depreciation in the CSX and NS URCS formulas which resulted in CSX's and NS' unit costs including the Conrail premium.

C. EXAMPLE OF IMPACT ON AVERAGE UTILITY COAL MOVEMENT

that are summarized in Table 7 below.

[24/] Based on procedures followed in UP/CNW and BN/ATSF mergers, the railroads have been revaluing the investment amounts in these property accounts without regard to correct accounting rules.

[25/] I followed the methodology used by the railroads in the BN/ATSF merger and the UP/CNW merger.

Table 7
Average Utility Coal Train Characteristics

Item (1)	Amount (2)
1. Average loaded direction haul -- miles	
2. Cars per train	
3. Net tons per car	
4. Railcar owner	

I applied to URCS unit costs that are based on CSX and NS operations plus the appropriated portion of Conrail that CSX and NS are purchasing. I developed the unit costs two different ways, i.e., with and without the portion of the premium that CSX and NS are paying for Conrail. The results of this application are summarized in Table 8 below.

Table 8
Impact of Conrail Premium on Variable Costs and Jurisdictional Threshold

Item	Amount Per Ton CSX	Amount Per Ton NS
(1)	(2)	(3)
1. Variable Cost Per Ton		
a. Without the Conrail Premium		
b. With the Conrail Premium		
c. Percent Increase		
2. Jurisdictional Threshold Per Ton		
a. Without the Conrail Premium		
b. With the Conrail Premium		
c. Percent Increase		

Source: Exhibit TDC-12 and Exhibit TDC-13.

Table 8 above shows that if the premium that CSX and NS are paying for Conrail is incorrectly included in the system of accounts, variable cost of service and the resulting jurisdictional threshold will increase by percent for CSX and percent for NS.[26]

D. IMPACT OF PREMIUM ON REVENUE ADEQUACY DETERMINATION

The STB has established that a railroad has adequate revenue to cover expenses and attract capital when its return on investment equals or exceeds the railroad industry cost of capital rate. The STB calculates the cost of capital rate as the railroad industry capital rate using current market rates for debt and equity. The rate of return on investment is defined by STB as "net

[26] Another way to view this change is the premium will increase the jurisdictional threshold from 180 percent to percent for CSX and percent for NS.

railway operating income...divided by a calculated net investment base".[27] In 1996, the STB found that the railroad industry cost of capital was 11.9% after taxes. The STB's 1996 revenue adequacy calculations for the three railroads involved in the Conrail acquisition are summarized in Table 9 below.

Table 9
STB's 1996 Revenue Adequacy Findings

	Item (1)	Amount (2)
1.	STB's 1996 Cost of Capital Rate	11.9%
2.	STB's 1996 Revenue Adequacy Calculations[1]	
	a. NS	13.0%
	b. CSX	8.9%
	c. Conrail	8.4%

[1] Source: Exhibit TDC-14, Columns (2) through (4).

Table 9 demonstrates that in 1996 and based on the STB's revenue adequance procedures, NS is a revenue-adequate railroad which CSX and Conrail are approximately three points below the revenue adequacy level.

In order to test the impact of including the premium that NS and CSX are paying for Conrail on the STB's calculation of revenue adequacy for NS and CSX, I utilized the following procedures:

1. I requested and utilized the STB's 1996 revenue adequacy workpapers as the starting point for my calculation;
2. I divided all the Conrail revenue adequacy components on the basis of the NS and CSX acquisition percentages i.e., 58% for NS and 42% for CSX;

[27] 364 I.C.C. at 821.

3. I eliminated Conrail's booked accumulated depreciation and asset disposition in quantifying the premium paid for Conrail's assets for revenue adequacy purposes. This adjustment equals $2.4 billion;

4. I included the annual depreciation associated with the Conrail premium; and,

5. I deducted $3.49 billion in new deferred taxes from the Conrail premium.

When the Conrail premium is included with NS and CSX income and investment and incorporated into the STB's revenue adequacy calculations, NS' and CSX's return on investment are adversely affected because they are artificially reduced. The results of including the Conrail premium on NS' and CSX's return on investment are summarized in Table 10 below.

Table 10
Impact of Including Conrail and Conrail Premium on STB's 1996 Revenue Adequacy Findings for NS and CSX

Item (1)	Amount (2)
1. STB's 1996 Cost of Capital Rate	11.9%
2. STB's 1996 Revenue Adequacy Calculations Assuming[1/]	
a. NS and 58% of Conrail and Conrail Premium	
b. CSX and 42% of Conrail and Conrail Premium	

[1/] Source: Exhibit TDC-14, Columns (8) and (9).

NS' return on investment will be reduced by (i.e., from 13.0% to) if NS' portion of Conrail and the Conrail premium are included in the STB's revenue adequacy calculation for NS. CSX's return on investment will be reduced by (i.e., from 8.9% to) if CSX's portion of Conrail and the Conrail premium are included in the STB's revenue adequacy calculation for CSX.

E. REQUEST FOR STATUS QUO

Simply stated, the premium NS and CSX paid for Conrail should not affect either the jurisdictional threshold calculation of an individual captive movement or the annual revenue adequacy determination of either NS or CSX. In order to avoid this adverse outcome, the STB should condition the acquisition of Conrail by not allowing the premium paid by NS and CSX to be included for purposes of jurisdictional threshold and revenue adequacy calculations. The procedures that I suggest the STB adopt in order to maintain the status quo are outlined below under the following topical headings:

1. Revenue Adequacy Calculations
2. Jurisdictional Threshold Calculations

1. Revenue Adequacy Calculations

For purposes of revenue adequacy calculations, I suggest that Conrail's net railway operating income ("NROI") and net investment base be identified at pre-acquisition or existing book levels. These monies should then be separated between NS and CSX on the basis of each railroad's acquisition percentage i.e., 58% of NS and 42%. The resulting return on investment values will reflect the STB's revenue adequacy calculations without consideration of the premium NS and CSX paid for Conrail. Table 11 below summarizes the impact of making these suggested adjustments on the STB's 1996 NS and CSX revenue adequacy calculations and compares the results to the STB's 1996 revenue adequacy findings for NS and CSX.

Table 11
Comparison of Results of Applying Suggested Revenue Adequacy Procedures to STB's 1996 Revenue Adequacy Findings for NS and CSX

Item	Return on Investment NS	CSX
(1)	(2)	(3)
1. STB's 1996 Revenue Adequacy Calculation	13.0%	8.9%
2. STB's 1996 Revenue Adequacy Calculation Including Conrail Without the Premium		

Source: Exhibit TDC-14.

By combining Conrail into NS' and CSX's revenue adequacy calculations (without consideration of the premium) based on the STB's procedures, NS' 1996 return on investment declines from 13.0% to and CSX's 1996 return on investment declines from 8.9% to These suggested procedures maintain the status quo.

Mechanically, the above revenue adequacy condition can be accomplished by including each railroad's portion of the Conrail premium into property Account 80 -- Other Elements of Investment. Debits included in property Account 80 are excluded from revenue adequacy following the STB's existing procedures.

2. **Jurisdictional Threshold Calculations**

For regulatory costing purposes, the STB and its predecessor, the ICC, developed specific accounting rules to follow when the consideration paid to acquire rail assets is greater or less than original book values.

The importance of original book values originated in the Interstate Commerce Act of 1887. Section 20 of the 1887 Act authorized the ICC to require annual reports from the railroads to show the cost and value of the carriers' property. Without accurate and dependable property records, it was impossible to calculate the proper relationship between the cost of property and the capitalization of the railroads. With the passage of the 1913 Valuation Act, the ICC determined the original cost of railway property. The governing principle behind the railway property accounts during the 1913 valuation is that transportation property was to be recorded for ratemaking purposes according to the original cost.

In 1963, a difference existed between the ICC's valuation records adjusted for annual additions and retirements and the railroads' reported property values. The ICC adopted Account 80 -- Other Elements of Investment to reconcile the railroads' historical book values to the values shown in the ICC's valuation studies.

During the 1963 proceeding, the ICC recognized that the historical amounts originally entered by the railroads as the cost of property were no longer reliable as a measure of actual cost. In its April 17, 1963 order,[28] the ICC required the property values recorded on the ICC valuation records for each railroad be recorded in the railroads' books and the difference recorded in Account 80. This was done to provide "an accurate record of the cost of property used in transportation service"[29][30][31].

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[28] Docket No. 32153, Uniform System of Accounts for Railroad Companies.

[29] Annual Report, 1964, page 54.

[30] From a general purpose costing perspective, the methodology consistently employed by the ICC in measuring investment has been original investment cost (i.e., the book value). In Ex Parte No. 271 decided August 20, 1976 the ICC found that "...the present original cost net investment rate base adequately reflects the value of railroad property and should be retained..." and "that the net debits in Account 80, Other Items of Investment, should not be included in the investment base, nor should the Account 80 credits be included while the debits are excluded...". See, Ex Parte No. 271, Net Investment-Railroad Rate Base & Rate of Return, 345 I.C.C. 1494 (1976).

[31] In Georgia Power, the ICC acknowledged that Account 80 should be excluded from the development of unit costs, noting that "the URCS program currently excludes Account 80...for general railroad variable cost development" (Appendix, page 14). ICC Docket No. 40581, Georgia Power Company, et al. v. Southern Railway Company et al., served November 8, 1993.

In order to maintain the status quo for regulatory costing purposes, I suggest that STB continue to use the accounting procedures it has in place. Specifically, I suggest that the STB require CSX and NS to record their portion of Conrail's historical gross book value and accumulated depreciation as it was reported to the STB before the acquisition. The difference between appraised (fair) value and the historical book value would be recorded in CSX's and NS' property Account 80 -- Other Elements of Investment. By placing the Conrail premium in property Account 80, the CSX and NS unit costs as developed in the URCS formula will not be affected.

I have developed Exhibit TDC-15 which separates Conrail's 1995 gross investment and accumulated depreciation (including the premium) between NS and CSX. This separation of Conrail would be consistent with existing STB accounting procedures and would avoid including the Conrail premium into NS and CSX variable unit costs.

VERIFICATION

COMMONWEALTH OF VIRGINIA)
)
CITY OF ALEXANDRIA)

THOMAS D. CROWLEY, being duly sworn, deposes and says that he has read the foregoing statement, knows the contents thereof and that the same are true as stated.

Thomas D. Crowley

Thomas D. Crowley

Sworn to and subscribed
before me this 20 day
of October, 1997.

Witness my hand and official seal.

Joanne M. Felton
expires 12/31/98

STATEMENT OF QUALIFICATIONS

My name is Thomas D. Crowley. I am an economist and President of the economic consulting firm of L. E. Peabody & Associates, Inc. The firm's offices are located at 1501 Duke Street, Suite 200, Alexandria, Virginia 22314.

I am a graduate of the University of Maine from which I obtained a Bachelor of Science degree in Economics. I have also taken graduate courses in transportation at George Washington University in Washington, D.C. I spent three years in the United States Army and since February 1971 have been employed by L. E. Peabody & Associates, Inc.

I am a member of the American Economic Association, the Transportation Research Forum, and the American Railway Engineering Association.

The firm of L. E. Peabody & Associates, Inc. specializes in solving economic, marketing and transportation problems. As an economic consultant, I have organized and directed economic studies and prepared reports for railroads, freight forwarders and other carriers, for shippers, for associations and for state governments and other public bodies dealing with transportation and related economic problems. Examples of studies I have participated in include organizing and directing traffic, operational and cost analyses in connection with multiple car movements, unit train operations for coal and other commodities, freight forwarder facilities, TOFC/COFC rail facilities, divisions of through rail rates, operating commuter passenger service, and other studies dealing with markets and the transportation by different modes of various commodities from both eastern and western origins to various destinations in the United

STATEMENT OF QUALIFICATIONS

States. The nature of these studies enabled me to become familiar with the operating and accounting procedures utilized by railroads in the normal course of business.

Additionally, I have inspected both railroad terminal and line-haul facilities used in handling various commodities to various destinations in all portions of the United States. These field trips were used as a basis for the determination of the traffic and operating characteristics for specific movements of coal, both inbound raw materials and outbound paper products to and from paper mills, crushed stone, soda ash, aluminum, fresh fruits and vegetables, TOFC/COFC traffic and numerous other commodities handled by rail.

I have presented evidence before the Interstate Commerce Commission ("ICC") in Ex Parte No. 347 (Sub-No. 1), Coal Rate Guidelines - Nationwide which is the proceeding that established the methodology for developing a maximum rail rate based on stand-alone costs.

Moreover, I have developed numerous variable cost calculations utilizing the various formulas employed by the ICC for the development of variable costs for common carriers with particular emphasis on the basis and use of Rail Form A. I have utilized Rail Form A costing principles since the beginning of my career with L. E. Peabody & Associates Inc. in 1971.[1/]

1/ Rail cost finding has been the cornerstone of this firm. Dr. Ford K. Edwards the senior partner of the firm Edwards & Peabody*, was the major architect in the development of Rail Form A. Mr. Peabody carried on this tradition of innovative cost finding until his retirement in 1983. Mr. Peabody's work included participation in the Tennessee Valley Authority's ("TVA") computerization of Rail Form A. Mr. Peabody was a member of a committee of transportation consultants which was organized to assess the TVA procedure in order to make available more complete and simplified input data for the Rail Form A computer program.

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* Subsequent to the retirement of Dr. Edwards in 1965, the firm name was changed to L. E. Peabody & Associates, Inc.

STATEMENT OF QUALIFICATIONS

I have also analyzed in detail, the Uniform Railroad Costing System ("URCS") and presented the results of my findings to the ICC in Ex Parte No. 431, *Adoption of the Uniform Railroad Costing System for Determining Variable Costs for the Purposes of Surcharge and Jurisdictional Threshold Calculations*. I have been involved in the URCS process, either directly or indirectly, since the first interim report of the contractors was released.

I have frequently presented both oral and written testimony before the Surface Transportation Board (and its predecessor, the Interstate Commerce Commission), Federal Energy Regulatory Commission, Railroad Accounting Principles Board, Postal Rate Commission and numerous state regulatory commissions, federal courts and state courts. This testimony was generally related to the development of variable cost of service calculations, fuel supply economics, contract interpretations, economic principles concerning the maximum level of rates, implementation of maximum rate principles, and calculation of reparations, including interest. I have also presented testimony in a number of court and arbitration proceedings concerning the level of rates and rate adjustment procedures in specific contracts.

Since the implementation of the *Staggers Rail Act of 1980*, which clarified that rail carriers could enter into transportation contracts with shippers, I have been actively involved in negotiating transportation contracts on behalf of shippers. Specifically, I have advised shippers concerning transportation rates based on market conditions and carrier competition, movement specific service commitments, specific cost-based rate adjustment provisions, contract reopeners that recognize changes in productivity, and cost-based ancillary charges. In particular, I have advised shippers on the theory and application of different types of rate adjustment mechanisms

STATEMENT OF QUALIFICATIONS

for inclusion in transportation contracts. As a result of assisting shippers in the eastern and western portions of the United States, I have become familiar with operations and practices of the rail carriers that move traffic over the major rail routes in the United States as well as their cost and pricing practices.

In the two recent Western rail mergers that resulted in the creation of BNSF and UP/SP, I reviewed the railroads' applications including their supporting traffic, cost and operating data and provided detailed evidence supporting requests for conditions designed to maintain the competitive rail environment that existed before the proposed mergers. In these proceedings, I represented shipper interests, including plastic, chemical, coal, paper and steel shippers.

I have participated in various proceedings involved with the division of through rates. For example, I participated in ICC Docket No. 35585, *Akron, Canton & Youngstown Railroad Company, et al. v. Aberdeen and Rockfish Railroad Company, et al.* which was a complaint filed by the northern and midwestern rail lines to change the primary north-south divisions. I was personally involved in all traffic, operating and cost aspects of this proceeding on behalf of the northern and midwestern rail lines. I was the lead witness on behalf of the Long Island Rail Road in ICC Docket No. 36874, *Notice of Intent to File Division Complaint by the Long Island Rail Road Company*.

SUMMARY OF RAILROADS SERVING
CSXT, NS AND CR COAL DESTINATIONS -- 1988 TO 1995

	Destination		Rail
	SPLC	Location	Service
	(1)	(2)	(3)
1.			
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SUMMARY OF RAILROADS SERVING
CSXT, NS AND CR COAL DESTINATIONS -- 1988 TO 1995

	Destination SPLC (1)	Destination Location (2)	Rail Service (3)
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SUMMARY OF RAILROADS SERVING
CSXT, NS AND CR COAL DESTINATIONS – 1988 TO 1995

Destination		Rail
SPLC	Location	Service
(1)	(2)	(3)
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SUMMARY OF RAILROADS SERVING
CSXT, NS AND CR COAL DESTINATIONS -- 1988 TO 1995

Destination		Rail
SPLC	Location	Service
(1)	(2)	(3)
163.		
164.		
165.		
166.		

Source: STB Costed Waybill Sample for 1988 through 1995.

IMPACT ON TONS AND RATES FOR CONRAIL ROUTES FROM MGA ORIGINS TO CONRAIL DESTINATIONS

	Destination		Tons		Avg Rate per Ton	
	SPLC	Location	1991	1995	1991	1995
	(1)	(2)	(3)	(4)	(5)	(6)
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29.	Total/ Weighted Average					
	a. All moves					
	b. Tonnage moving in 1991 and 1995					
30.	Percent Change					
	a. All moves					
	b. Tonnage moving in 1991 and 1995					

IMPACT ON TONS AND RATES FOR CONRAIL ROUTES
FROM NON-MGA ORIGINS TO CONRAIL DESTINATIONS

	Destination		Tons		Avg Rate per Ton	
	SPLC	Location	1991	1995	1991	1995
	(1)	(2)	(3)	(4)	(5)	(6)
1.						
2.						
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IMPACT ON TONS AND RATES FOR CONRAIL ROUTES
FROM NON-MGA ORIGINS TO CONRAIL DESTINATIONS

	Destination		Tons		Avg Rate per Ton	
	SPLC	Location	1991	1995	1991	1995
	(1)	(2)	(3)	(4)	(5)	(6)
47.						
48.						
49.						
50. Total/ Weighted Average						
a. All moves						
b. Tonnage moving in 1991 and 1995						
51. Percent Change						
a. All moves						
b. Tonnage moving in 1991 and 1995						