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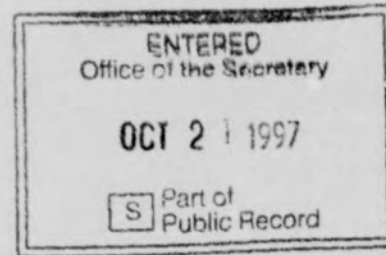


202 347-7170

October 21, 1997

BY HAND DELIVERY

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
Case Control Branch
ATTN: STB Finance Docket 33388
1925 K Street, N.W.
Washington, D.C. 20423-0001



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 for filing under seal in the above-referenced proceeding, please find a separately packaged original and twenty-five (25) copies of the CONFIDENTIAL VERSION of the "Comments of Consumers Energy Company." (CE-04). In accordance with the Board's prior order, we have enclosed Wordperfect 5.1 diskettes containing this filing. Also enclosed for filing please find an original and twenty-five (25) copies of the PUBLIC VERSION of the "Comments of Consumers Energy Company" (CE-05).

We have included an extra copy of each of these filings. Kindly indicate receipt by time-stamping these copies and returning them with our messenger.

Sincerely,

Kelvin J. Dowd
An Attorney for
Consumers Energy Company

KJD:cef
Enclosures

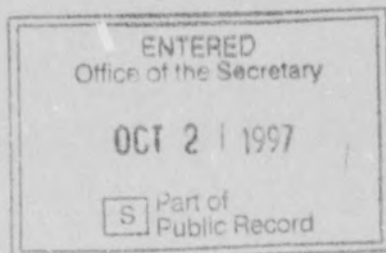
PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

CE-05

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

Finance Docket No. 33388

COMMENTS OF CONSUMERS ENERGY COMPANY



CONSUMERS ENERGY COMPANY

By: A. T. Udry
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(202) 347-7170

Dated: October 21, 1997

Attorneys and Practitioners

BEFORE THE
SURFACE TRANSPORTATION BOARD

CSX CORPORATION AND CSX)	
TRANSPORTATION, INC. AND NORFOLK)	
SOUTHERN CORPORATION AND)	
NORFOLK SOUTHERN RAILWAY)	Finance Docket No. 33388
COMPANY -- CONTROL AND OPERATING)	
LEASES/AGREEMENTS -- CONRAIL INC.)	
AND CONSOLIDATED RAIL CORPORATION)	

COMMENTS OF CONSUMERS ENERGY COMPANY

Consumers Energy Company ("Consumers"), in accordance with the procedural orders entered herein by the Surface Transportation Board ("Board"), hereby submits these Comments in response to the Application filed by CSX Corporation and CSX Transportation, Inc. (jointly, "CSX"); Norfolk Southern Corporation and Norfolk Southern Railway Company (jointly, "NS"); and Conrail, Inc. and Consolidated Rail Corporation (jointly, "Conrail")(hereinafter, collectively, "Applicants"). In the Application, CSX and NS seek the Board's approval, pursuant to 49 U.S.C. §§11323-11326, for the acquisition and control of Conrail, and for the division, use and operation of Conrail assets between CSX and NS.

Consumers opposes the proposed Application. However, if the Board ultimately approves the Application, Consumers requests that it be conditioned, as explained below.

IDENTITY AND INTEREST

Consumers is a Michigan electric utility serving 1.6 million customers in all 68 counties of Michigan's Lower Peninsula. Consumers' five coal-fired generating plants constitute over 77% of its baseload capacity, and burn a total of 7.5 million tons of coal per year, the majority of which coal is transported via rail. Consumers' Campbell Plant -- where 3.6 million tons of coal are delivered annually -- is served only by CSX. Under certain circumstances, coal transportation to Consumers' remaining plants is more competitive, and includes movements in which Conrail participates. See V.S. Garrity, at 5-8. CSX's dominance over Campbell, however, is a major factor limiting Consumers' options.

The interest of Consumers in this proceeding is explained in further detail in the Verified Statement of Mr. William E. Garrity, submitted herewith.

SUMMARY OF POSITION

Consumers submits that the proposed acquisition and division of Conrail assets will allow CSX to solidify its position as the dominant transporter of low sulfur eastern coal to Michigan and the Great Lakes Region, which places Consumers at competitive risk. This risk is not ameliorated by the Applicants' planned joint access to the MGA coal fields, as environmental regulations and facility constraints severely limit Consumers' ability to use MGA coal. Such a situation is at odds with the pro-competitive goals of the National Rail

Transportation Policy that appropriately must influence the Board's consideration of the proposed transaction. 49 U.S.C. §§10101, 11324(b).

Consumers further submits that the proposed acquisition and division of Conrail's assets will harm the public interest by exposing Consumers and other captive shippers to future market power rate abuse, as CSX and NS seek recovery of the multi-billion dollar purchase premium that they have paid for control of Conrail. Based on the evidence, ultimately it will be high-volume, captive traffic -- such as Consumers' coal traffic -- which will finance the debt arising from the acquisition through unreasonably high rail rates. Consistent with the public interest mandate, the Board must evaluate the effect of the premium associated with this acquisition upon captive shippers, and adopt appropriate protections. 49 U.S.C. §11324(b)(3); see also 49 U.S.C. §10101(1).

Accordingly, as explained herein, Consumers urges the Board to deny approval of the proposed acquisition as proposed, or alternatively, to condition the acquisition as described infra, to ensure that Consumers' rights to seek reasonable coal transportation rates are not compromised. In support of its position, Consumers presents the accompanying Verified Statements of Mr. Garrity, Dr. Alfred Kahn, and Mr. Thomas D. Crowley and the argument of counsel.

BEFORE THE
SURFACE TRANSPORTATION BOARD

CSX CORPORATION AND CSX)	
TRANSPORTATION, INC. AND)	
NORFOLK SOUTHERN RAILWAY COMPANY)	Finance Docket No. 33388
COMPANY -- CONTROL AND OPERATING)	
LEASES/AGREEMENTS -- CONRAIL AND)	
CONSOLIDATED RAIL CORPORATION)	

VERIFIED STATEMENT OF
WILLIAM E. GARRITY

My name is William E. Garrity, and my business address is 1945 West Parnall Road, Jackson, Michigan 49201. I am Executive Manager of Fuels and Power Transactions for Consumers Energy Company ("Consumers"), a position that I have held since June 1997. Previously, I was Director of Fossil Fuel Supply from 1991 to June 1996, and Director of Fuel Supply and Plant Operations from June 1996 to June 1997. Among my responsibilities are the planning and purchase of fossil fuels for Consumers' electric generating plants.

The purpose of this Verified Statement is to (1) provide the Board with information on Consumers' electric generating systems and the coal supply and transportation circumstances relied upon to meet those systems' fuel needs; and (2) explain the adverse effects that the proposed acquisition and division of Conrail between CSX Corporation and Norfolk Southern Corporation will have on Consumers' ability to obtain reasonably priced rail transportation service for its utility coal requirements.

I. The Consumers Energy Company System

A. Background

Consumers is an electric and gas utility company serving all 68 counties of Michigan's Lower Peninsula. Consumers is the successor to a Maine corporation that conducted business in Michigan from 1915 to 1968 -- at which time the company was first incorporated in Michigan. Our name was changed from Consumers Power Company to Consumers Energy Company early in 1997. Consumers is the largest subsidiary of CMS Energy, a holding company, and is headquartered in Jackson, Michigan.

Consumers' electric utility operations serve a mix of approximately 1.6 million residential, commercial and industrial customers in the State -- with its largest industrial customer being the automotive industry. Principal cities served by Consumers' electric utility operations include Battle Creek, Flint, Grand Rapids, Jackson, Kalamazoo, Midland, Muskegon and Saginaw.

While Consumers relies to some degree on a mix of generation sources, by far the largest share of our electricity requirements is satisfied by five (5), coal-fired generating plants: the J.H Campbell Station near West Olive, MI; the D.E. Karn and J.C. Weadock Stations near Essexville, MI; the B.C. Cobb Station at Muskegon; and the J.R. Whiting Station near Toledo, Ohio. Together, the twelve (12) generation units operated at these plants have a capacity of 2,830 megawatts (MW) and produce approximately 17.3 million megawatt hours (Mwh) of electricity each year, through the combustion of over 7 million tons of coal.

These plants constitute over 77% of the Company's baseload system capacity.

1. Campbell

Consumers' Campbell plant is located near West Olive in southwestern Michigan. Campbell has three production units, the last of which was completed in 1980. The Campbell units have a capacity of 1,399 MW and produce approximately 8.6 million megawatt hours annually -- approximately one-half of the electricity generated by our coal-fired plants. Campbell consumes approximately 3.6 million tons of coal each year. As described in more detail in subpart B. below, our plants blend various types of coal from different sources to produce a fuel that works effectively, meets environmental requirements and minimizes the cost of fuel to our customers. Based on meeting these criteria, the Campbell units blend western coal with eastern coal in the following maximum ratios (by weight): 30% western at Unit 1, 10% western at Unit 2 and 40% western at Unit 3. To achieve this mix at Campbell Units 1 and 2, we blend low sulfur coal originating from mines in West Virginia and Kentucky (with typical specifications of 12,000 Btu/lb, 0.96% sulfur and 12% ash), with modest amounts of less expensive, very low sulfur Powder River Basin (PRB) western coal from Wyoming (with typical specifications of 8,800 Btu/lb, 0.25-0.5% sulfur and 5% ash). Campbell Unit 3 is a newer facility, and is subject to federal New Source Performance Standards (NSPS). In order to meet these more stringent federal

emission requirements, Campbell 3 blends eastern EPA compliance coal (0.72% sulfur) with western coal.

2. Cobb

Our Cobb plant, located in Muskegon (on Lake Michigan), has two coal-fired units totaling 296 megawatts that were constructed in 1956 and 1957. The plant produces approximately 1.9 million Mwh per year and consumes approximately 900,000 tons of coal annually. Applying the environmental, operational and fuel cost criteria that I described, the Cobb Units can blend a maximum of 70% western coal by weight. This is achieved by blending relatively low heat content, low sulfur, less expensive PRB coal from Montana with higher Btu, higher sulfur, higher cost eastern coals from West Virginia, Pennsylvania, and Kentucky. The coal specifications themselves are similar to those for the fuels used in Campbell Units 1 and 2.

3. Karn/Weadock

The four (4) unit, 825 megawatt Karn-Weadock complex is located in Essexville, in eastern Michigan. Like the Cobb Station, our Karn and Weadock units were constructed in the mid to late 1950s. Collectively, they generate about 5 million Mwh per year and burn approximately 2.2 million tons of coal annually. Based on the same factors that govern fuel blends at Campbell and Cobb, the Karn-Weadock units are limited to the following western coal blends by weight: 30% for Karn Unit 1, 20% for Karn Unit 2,

and 40% for both Weadock Units. These plants are sourced with western coals from the Powder River Basin and eastern coals from West Virginia and Kentucky.

4. Whiting

Consumers' 310-megawatt Whiting Plant consists of three (3) coal-fired units that were constructed between 1952 and 1953. In a normal year, Whiting produces approximately 1.8 million Mwh per year and consumes approximately 750,000 tons of relatively high Btu, low sulfur eastern coal from West Virginia and Kentucky. Due to equipment limitations, Whiting is not able to blend coals.

B. Consumers' Coal Supply and Transportation Arrangements

Between 60 and 70 percent of Consumers' annual coal requirements are purchased under multi-year contracts of varying durations. These contracts, entered at various times and periodically renewed, replaced or extended, provide coal source and quality stability integral to the effective planning and management of powerplant resources. The balance of our coal fuel requirements are satisfied on the short-term or spot market.

As I have noted, Consumers generally blends together coals from various sources to minimize fuel costs, meet environmental requirements and adhere to boiler and plant equipment limitations. Within these parameters, however, blending is limited particularly by the interaction of two (2) factors unre-

lated to minemouth coal prices or transportation rates: the design and capabilities of each plant unit's boilers and associated systems, and the air quality standards and emissions limitations mandated by the State of Michigan and the federal EPA.

With the exception of Campbell Unit No. 3, all of our coal-fired facilities were constructed over 30 years ago. While various repairs, upgrades and other marginal changes have been made over the years, our fuel options for these units largely remain limited to relatively high heating value, low moisture content coals. Among other things, this precludes heavy reliance on abundant, low-cost Powder River Basin coals from Wyoming and Montana, due to their relatively low heating value and high moisture content. Compounding the effects of these quality characteristic limitations, however, are the restrictions imposed by the State of Michigan under Michigan Air Pollution Control Commission (MAPCC) Rule 401. Rule 401 effectively prohibits Consumers from using coal with a sulfur content greater than 1 percent, which precludes most high Btu eastern coals from consideration. One Consumers unit, Campbell Unit 3, is restricted under the federal NSPS in effect at the time the unit was constructed. The applicable standard restricts the use of coal at that unit to a sulfur content of 0.72 percent, or 1.2 lb/mmBtu for a 12,000 Btu/lb coal. Additionally, under the federal Acid Rain Program for emissions after year 1999, Consumers has been

A 1% sulfur limitation for a 12,000 Btu/lb coal is equivalent to a sulfur dioxide emission rate limitation of 1.67 lb/mmBtu.

allocated a limited number of sulfur dioxide (SO₂) emission allowances based on an effective emission rate limitation of 1.10 lbs/mmBtu.

With our western coal options constrained by minimum heating value specifications, the MAPCC Rule 401, NSPS limits, and Acid Rain Program Phase II allocations force us to focus on the narrow range of coal blend options that I have described, for the vast preponderance of our annual supply requirements.

Our coal transportation options are similarly constrained. The Campbell Station -- a baseload plant responsible for about half our coal-fired generation -- is served exclusively by rail and exclusively by CSX, as are many of the eastern mines from which we obtain coal for all five (5) plants. Cobb, Karn and Weadock each have lake vessel access, which depending upon the coal source can present some competition for CSX during part of the year. However, part of the routing is by rail to the various docks, and Cobb has no rail access.

For the Karn-Weadock complex, a Conrail-Canadian National-Central Michigan Railway interline haul from certain eastern mines offers an alternative (at least on the map) to CSX single line service. Due to the limited number of eastern low sulfur mines served by Conrail, however, the impact of the CR-CN-

The statute authorizing the allocation of Phase II allowances specified a provisional allocation limit of 1.2 lb/mmBtu. However, EPA was authorized to reduce the allocation, pro rata, so as to maintain a total allocation of 8.95 million allowances per year for years 2000 through 2009 and 8.9 million allowances per year for years thereafter.

CMGN option is limited. Similarly, a move by Conrail and CN to the Whiting Plant also offers some competition to CSX. CSX's dominance over deliveries to the baseload units at Campbell, however has tempered the impact of potential transportation competition elsewhere, and has enabled CSX to secure a contractual commitment for at least 70% of all coal moving to Consumers' facilities through 1999. Eastern coal moves to Campbell in single line service from CSX origins; western coal for Campbell currently moves via the Burlington Northern Santa Fe to Chicago, for delivery by CSX. Our total coal transportation bill exceeds \$103 million annually, approximately 56% of which is paid to CSX.

II. Impact of the Proposed Division of Conrail

In my capacity as the Consumers executive primarily responsible for coal transportation matters, I have had an opportunity to review the plan for the division of Conrail that has been proposed by CSX and NS in their Application. In particular, I have noted the claims by the Applicants' witnesses Robert Sansom and Raymond Sharp to the effect that Consumers stands to benefit from the transaction, as a result of CSX gaining the ability to offer single line service to Michigan from the so-called MGA coal fields. See Sansom V.S. p. 337.

Contrary to the Applicants' suggestions, I do not see any benefit to Consumers from the CSX-NS Conrail division plan. In fact, the terms of the proposed transaction as I understand them -- including the price being paid for Conrail's assets --

pose a real threat to Consumers' future ability to secure and maintain reasonable rates for coal transportation to Campbell and our other rail-served stations.

A. Improved CSX Access to MGA
Coal Will Not Benefit Consumers

CSX's witness Sansom argues that Consumers will benefit from the Conrail division because CSX would obtain the ability to move MGA coal in single line service from Pennsylvania and West Virginia to our Michigan facilities. His implication is that all that prevents Consumers from greater use of MGA coal today is that it now must move in interline service over both CSX and Conrail. In fact, that is not the case.

As noted above, Michigan environmental restrictions preclude Consumers from burning coal with an average sulfur content in excess of 1 percent for all plants except Campbell Unit 3. Campbell Unit 3 is limited to a federal emissions restriction of 1.2 pounds SO₂ per MMBtu of heat input. Beginning in the year 2000, limitations imposed by Phase II of the federal requirements will limit system-wide SO₂ emissions to 1.1 pounds SO₂ per MMBtu. While MGA coal varies in sulfur content, the average generally ranges from a low of 1.3 percent to over 3 percent. The Applicants are correct that Consumers can utilize blended-coal strategies to satisfy our environmental requirements, and that we can do so with some MGA coal. At present, however, only 5 percent of the coal consumed by our Cobb plant is blended-in MGA coal, delivered by vessel via Conrail and the

Ashtabula Docks. Over the past two years, the sulfur content of the as delivered MGA coal has been 1.487% by weight. Moreover, based upon this sulfur content standard, the table attached to my Statement as Exhibit ____ (WEG-01) shows that Cobb is the only Consumers plant that can use MGA coal in a blend with western coal, and still maintain current emission restrictions. After 1999, no plants (including Cobb) can meet Phase II acid rain restrictions utilizing MGA coals with current maximum blends of western coal. To use MGA coal at the other stations -- particularly Campbell and Karn - we would have to blend in such a high percentage of western coal that the resulting product's heating value would be too low for the plants to maintain full capacity, absent extensive and expensive facilities modifications.

Simply put, improved CSX access to MGA coal mines will have no effect on the breadth of Consumers' source options. It is coal quality -- not the absence of single line rail service -- that sharply limits the utilization of MGA coal in our boilers.

B. The Applicants' Proposed Division
of Conrail Will Expose Consumers to
Higher Rail Rates on Coal

Consumers' major concern with the proposed CSX-NS division of Conrail is the resulting absence of effective competition for the delivery into Michigan of eastern low sulfur and compliance coals with the specification that we typically require (i.e., 12,000 Btu/lb, 12% ash, 0.96% sulfur for low sulfur coal; 0.72% sulfur for compliance coal). It is generally acknowledged

that most eastern low sulfur and compliance coal sources with these specifications are located on CSX, and what is available on NS tends to be a higher quality, higher cost coal that more naturally and economically moves to southeastern destinations. The Applicants' plans for the MGA region and the rest of Conrail will not significantly alter this situation, other than to further concentrate CSX's dominance over this segment of the market. In this respect, substituting NS for Conrail is a net loss for competition. Moreover, for coal shippers such as Consumers with rail captive facilities, Board approval of the Applicants' plans as proposed presents a serious risk of significant harm from future increases in rail rates, as the Applicants move to recover the multi-billion dollar price premium that they and their debt-holders are paying for Conrail.

On the last day of trading prior to CSX and Conrail's initial announcement of a friendly takeover last October, Conrail's common stock was trading at \$71 per share price. In the 12 months prior to this initial offer, the market price of Conrail's stock ranged from a low of \$64.375 per share to a high of \$77.125 per share. Meanwhile, the initial bid for Conrail made by CSX was at \$92.50 per share -- a 30 percent increase over pre-tender trading levels.

CSX's October offer triggered a seven month-long bidding war with NS for control of Conrail. After several rounds of competing bids between the two carriers, a joint offer was consummated on May 23, 1997, with the final purchase price of

Conrail's shares set at \$115 per share. The final purchase price amounted to a 24 percent increase per share over CSX's initial \$92.50 tender offer, and an increase of over 60% in value paid for Conrail over pre-tender stock trading levels.

Both CSX and NS have turned to the debt markets to help raise their respective shares of the Conrail purchase price and related investments. Obviously, the Applicants and their financiers will be looking for a timely recovery of these amounts. While I assume that CSX and NS have high hopes to reduce costs and attract additional traffic from other carriers or modes of transportation, I also have little doubt that current, captive shippers ultimately will be forced to finance a big share of this transaction through increased transportation rates.

Plainly, the ability of either CSX or NS to recover their Conrail investment from traffic subject to competition will be limited sharply by the force of that competition. As a result, one must expect that it will be high volume captive traffic -- such as all coal that must move to the Campbell Plant -- that in the end will bear the burden of the Applicants' inflated Conrail purchase price.

Consumers strongly believes that the break-up of Conrail between CSX and NS will have an overall detrimental impact on competition for transporting coal, because the number of competitive players will be reduced from three to two, with one gaining increased dominance over the typical eastern coal shipments into our service region. If this significant concern

could be adequately addressed and mitigated, Consumers might have no quarrel with CSX and its stockholders paying whatever price they see fit to acquire a share of the Conrail system, regardless of whether that price accurately reflects the value of the system assets. What the Board most definitely should not permit, however, is to allow CSX to force utility coal and other captive shippers to bear the burden of recovering that price, to the extent that it exceeds the value of the assets from which those shippers may derive any transportation benefit.

Upon expiration of our current CSX contract arrangements in 1999, the principal (if not sole) constraint on CSX's pricing aspirations with respect to coal movements to Campbell will be the power of the Board to prescribe a reasonable rate for the subject service. One of the criteria applied in determining maximum coal rates is the relationship of the rate to the carrier's cost of service. To the extent that the Conrail price premium is included in CSX's service cost or investment base for regulatory purposes, the rate ultimately sanctioned for Campbell coal traffic will be higher than that which otherwise would apply. According to the analysis performed on behalf of Consumers by Mr. Thomas D. Crowley, for example, the rate threshold just for access to the Board's ratemaking jurisdiction would increase by some % (or about \$ per ton) on a typical CSX utility coal movement. See Crowley V.S., p 4. CSX could raise its rates at least by that amount and be immune from Board scrutiny, solely because of the premium. For shipments to Campbell

alone, the impact would be over \$4 million each year. Whatever the merits of the Applicants' proposal generally, such a direct and improper forced subsidy of the Conrail purchase price by captive coal traffic should not be permitted by the Board.

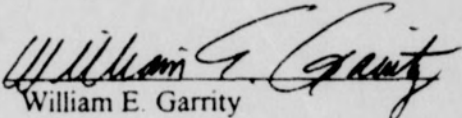
To summarize, contrary to assertions made by the Applicants, the acquisition of Conrail by CSX and NS would not confer competitive benefits on Consumers through increased MGA mine source competition, because Consumers' system requirements preclude us from using more than a modest amount of MGA coal. If anything, the transaction would lessen what little competition already exists, by solidifying CSX control over the eastern low sulfur and compliance coal sources that we rely on. Further, unless modified or properly conditioned, the proposed acquisition would threaten Consumers' ability to control future coal costs, as our captive baseload traffic will be vulnerable to CSX rate hikes to cover the multi-billion dollar premium acquisition price paid by CSX and NS for Conrail.

Consumers respectfully urges the Board to carefully consider our concerns in reviewing the Applicants' plan, and impose protective conditions that will best protect Consumers and other captive coal shippers from exploitive rail rate increases.

Verification

State of Michigan :
: ss:
County of Jackson :

William E. Garrity, 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.


William E. Garrity

Subscribed and sworn to before
me this 17th day of October,
1997:

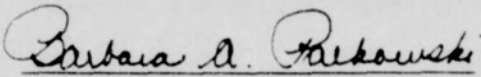

Barbara A. Palkowski
Notary Public, Jackson County
Michigan
My Commission Expires October 24, 2000

Exhibit __ (WEG-01)

Consumers Energy Company
MGA Coal Blending Scenario

<u>Plant</u>	<u>MGA Btu/LB</u>	<u>SUL WT%</u>	<u>WEST BTU/LB</u>	<u>SUL WT%</u>	<u>BLEND % West¹</u>	<u>BLEND WT% SUL</u>	<u>BLEND Btu/LB</u>	<u>#S02 /MMBtu²</u>	<u>MICH/EPA LIMIT #S02/ MMBtu</u>	<u>PHASE II LIMIT #S02/ MMBtu</u>
Camp. 1	13000	1.487 ³	8800	0.4	30	1.161	11740	1.879	1.67	1.10
Camp. 2	13000	1.487	8800	0.4	10	1.379	12580	2.082	1.67	1.10
Camp. 3	13000	1.487	8800	0.4	40	1.052	11320	1.766	1.20	1.10
Cobb. 4-5	13000	1.487	8800	0.4	70	0.726	10060	1.372	1.67	1.10
Karn 1-2	13000	1.487	8880	0.4	25	1.215	11950	1.933	1.67	1.10
Wead 7-8	13000	1.487	8880	0.4	40	1.052	11320	1.766	1.67	1.10
Whit 1-3	13000	1.487	8800	0.4	0	1.487	13000	2.174	1.67	1.10

¹Blends are maximums based on boiler and equipment limitations.

Assumes 5% retained in bottom ash.

³Average sulfur content of actual MGA receipts in 1996-1997.

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 STD, 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

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

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

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;

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

¹⁰ See note 2, above.

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

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 Jovanovich, 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

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:

$$y[i,t] = a + B \cdot x[i,t] + u[i] + e[i,t]$$

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

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 revaluations 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 October 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;

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 before 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.

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.

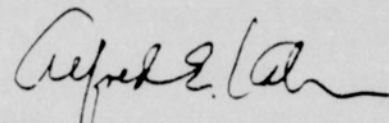
CONCLUSION

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.

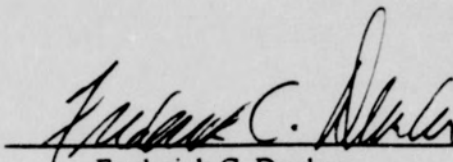
A handwritten signature in cursive script, appearing to read "Alfred E. Kahn", written over a horizontal line.

Alfred E. Kahn

VERIFICATION

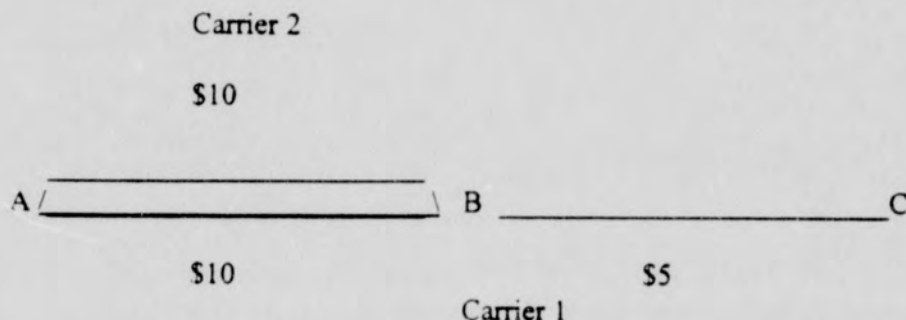
I, Frederick C. Dunbar, declare under penalty of perjury that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed this 17 day of October, 1997.


Frederick C. Dunbar

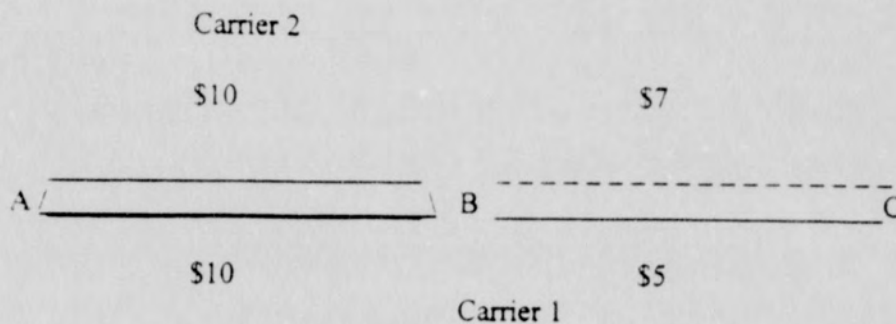
APPENDIX A

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:



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.

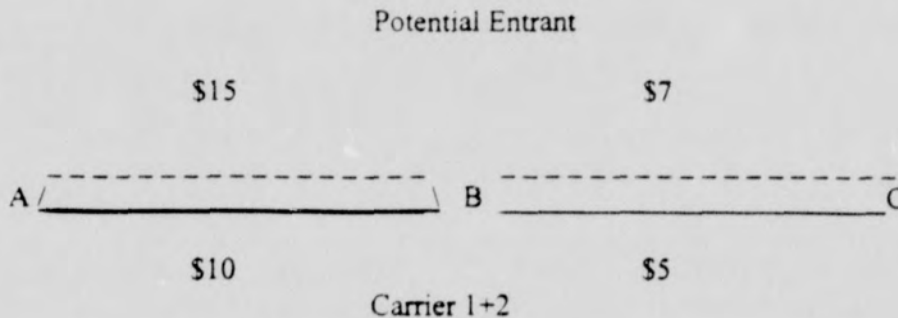
Suppose, however, that it is possible to construct a new route from B to C, and that such a route would have a long-run variable cost of \$7. This situation can be represented like this:



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.

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.



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

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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. District 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 Bulletin* 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, <i>Review of Industrial Organization</i>
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-	<i>The American Heritage Dictionary</i> 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 Sulfur 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, <i>American Economic Review</i>
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 Transportation 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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"Pricing of Telecommunications Services: A Comment," in *Review of Industrial Organization*, Vol. 8, 1993, pp. 39-41.

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"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.

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"Liberals Must Face Facts," *Challenge*, Nov/Dec. 1981, pp. 25-32.

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"Health Care and Inflation: Social Compassion and Efficient Choice," *National Journal*, August 2, 1980, pp. 1294-97.

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"Applications of Economics to an Imperfect World," *Regulation*, Washington, D.C., November/December 1978, Volume 2, No. 6, pp. 17-27; The Richard T. Ely lecture, *The American Economic Review, Papers and Proceedings*, Volume 69, No. 2, May 1979, pp. 1-13.

"The Changing Environment of International Air Commerce," *Air Law*, (Netherlands Journal), Volume 3, No. 3, 1978.

"Deregulation of Air Transportation--Getting from Here to There," *Regulating Business: The Search for an Optimum*, Institute for Contemporary Studies, San Francisco, California, 1978, pp. 37-63.

"Load Control, Resource Conservation and King Charles' Head," Iowa State University Regulating Conference, *Proceedings*, May 19, 1977, pp. 68-74.

"Recent Developments in Cost Analysis and Rate Design," *Proceedings of the Third Annual Symposium on Problems of Regulated Industries*, Kansas City, Missouri, February 14, 1977, pp. 15-28.

"An Economist at Work on Utility Rate Regulation," a series of three articles, *Public Utilities Fortnightly*, Washington, D.C., January 5, 19, and February 2, 1978.

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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.

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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.

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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. 38783 on behalf of Omaha Public Power District, on the grouping of captive shippers for purposes of applying a stand-alone cost test of contested rail rates, November 1984.

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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.

Verified Statement and Surrebuttal Verified Statement Before the Interstate Commerce Commission, Finance Docket No. 30300 on behalf of the Water Transport Association, in opposition to the application of CSX Corporation to acquire American Commercial Barge Lines, Inc., February 14, 1984 and April 19, 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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Testimony for the Department of Justice in the U.S. v. Standard Oil Co. (Indiana) et al. Civil Suit 40212, filed July 28, 1964.

(Rev. 9/97)

APPENDIX C

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EDUCATION

TUFTS UNIVERSITY
Ph.D., Economics, 1971
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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

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With John Havens, "New Approaches to Understanding Travel Behavior." Presented at the Transportation Research Board Meetings, 1979.

"Spatial Choice Models: A Discussion." Presented at the Transportation Research Board Meetings, 1979.

With R. H. Pratt, "Impact of Fare Policy on Operating Deficit and Ridership." Testimony at hearings on *Paying the Operating Costs of Metro*, Washington, D.C., June, 1978.

"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

Crowley

PUBLIC VERSION

**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
Consumer Energy Company
and
GPU Generation, Inc.

Due Date: October 21, 1997

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LIST OF EXHIBITS

EXHIBIT NO.	DESCRIPTION
(1)	(2)
1	Statement of Qualifications
2	Development of Premium Paid for Conrail Assets
3	Impact of Conrail Premium on Variable Cost and Jurisdictional Threshold for Average CSX Coal Movement
4	Impact of Conrail Premium On Variable Cost and Justificational Threshold for Average NS Coal Movement
5	Impact of Conrail and Conrail Premium on 1996 Revenue Adequacy Calculations
6	1995 Conrail Book Value -- Schedule 352B Investment and 335 Accumulated Depreciation

I. 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 to this verified statement as Exhibit __ (TDC-1).

If the CSX/NS^{1/} acquisition of Conrail^{1/} is approved in its current form, CSX/NS will pay a substantial premium for the Conrail assets. If this substantial premium is added into the CSX and NS investment accounts, the Surface Transportation Board's ("STB") determination of the revenue adequacy of CSX and NS will decline artificially i.e., the CSX's and NS' return on investment as calculated for revenue adequacy purposes will decline. Additionally, the STB's Uniform Railroad Costing System ("URCS") unit costs for both CSX and NS will be artificially increased because of the premium, which translates into higher jurisdictional threshold levels. The jurisdictional threshold level is used both to identify traffic that is subject to the STB's jurisdiction and to set a floor for rate setting purposes.

L.E. Peabody & Associates, Inc. was retained by Consumer Energy Company and GPU Generation, Inc. to conduct certain economic analyses related to the premium that CSX/NS proposes to pay to acquire Conrail, as well as the impact the proposed premium will have on the STB's calculation of CSX's and NS' revenue adequacy status and the jurisdictional threshold level for rate setting purposes. Specifically, Consumers and GPU requested that I perform the following analyses which are the subject of this verified statement:

^{1/} CSX Corporation and CSX Transportation, Inc. ("CSX")/Norfolk Southern Corporation and Norfolk Southern Railway Company ("NS") proposed acquisition of Conrail Inc. and Consolidated Rail Corporation ("Conrail").

1. Identify and quantify the amount that the total consideration being paid by CSX and NS for Conrail exceeds Conrail's historic book value of assets;
2. Illustrate the impact of including CSX's portion of the premium into CSX's cost structure on the jurisdictional threshold for a hypothetical eastern utility coal movement;
3. Illustrate the impact of including NS' portion of the premium into NS' cost structure on the jurisdictional threshold for a hypothetical eastern utility coal movement;
4. Quantify the impact of including the premium on CSX's and NS' revenue adequacy status; and,
5. Explain how the premium can be excluded from the CSX's and NS' investment accounts for regulatory costing and revenue adequacy purposes.

My comments are organized under the following topical headings:

- II. Summary and Findings
- III. Identification of Premium for Regulatory Purposes
- IV. Impact of Premium on Jurisdictional Threshold
- V. Impact of Premium on Revenue Adequacy Determination
- VI. Proposed Remedy

II. SUMMARY AND FINDINGS

The following summary and findings are supported by the analyses contained in the balance of my verified statement and accompanying exhibits and are based on my review of CSXT's and NS's documents supporting their purposed acquisition of Conrail, including their witnesses' verified statements and workpapers.

Specifically, my summary and findings include:

1. CSX/NS are paying a significant premium for Conrail that will adversely effect future revenue adequacy and jurisdictional threshold calculations.
2. Table 1 below summarizes the CSX/NS premium for both revenue adequacy and jurisdictional threshold purposes.

Table 1 CSX and NS Premium to Acquire Conrail (\$ in Billions)		
<u>Item</u> (1)	<u>For Revenue Adequacy Purposes</u> (2)	<u>For Jurisdictional Threshold Purposes</u> (3)
1. CSX		
2. NS		
3. Total		

3. I have included CSX's portion of the Conrail premium into a CSX/Conrail URCS formula and calculated the variable cost of providing service for the average CSX coal train movement based on the characteristics of a typical eastern utility coal train identified by CSX's Witness Sharp. I compared the results to CSX's cost of providing service for the average coal train without the premium. Table 2, Column (2) summarizes my results on both the variable cost and jurisdictional threshold calculations.

4. I performed the same analysis using a combined NS/Conrail URCS formula and NS' portion of the Conrail premium. Table 2, Column (3) summarizes the results of this analysis.

<p>Table 2 Impact of Conrail Premium on Variable Costs and Jurisdictional Threshold</p>		
Item	CSX Amount Per Ton	NS Amount Per Ton
(1)	(2)	(3)
1. <u>Variable Cost Per Ton</u>		
a. Without the Conrail Premium		
b. With the Conrail Premium		
c. % Increase		
2. <u>Jurisdictional Threshold Per Ton</u>		
a. Without the Conrail Premium		
b. With the Conrail Premium		
c. % Increase		
Source: Exhibit __ (TDC-3) for CSX and Exhibit __ (TDC-4) for NS.		

By including the premium CSX is paying for Conrail in CSX's URCS formula, both the variable cost of providing service and the resulting jurisdictional threshold associated with the average CSX coal train movement will increase by __%. Similarly, by including the premium NS is paying, the variable cost of service and resulting jurisdictional threshold for a comparable NS movement would increase by __%.

4. When the Conrail premium is included with NS and CSX revenue adequacy calculations based on existing STB's procedures, the NS' and CSX's return on investment are adversely impacted because they are artificially reduced as summarized in Table 3 below.

Table 3
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 Finding For NS	13.0%
3. STB's 1996 Revenue Adequacy Finding For CSX	8.9%
4. 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-5), Columns (8) and (9).

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 both Conrail and the Conrail premium are included in the STB's revenue adequacy calculations.

5. The adverse impact on the jurisdictional threshold and revenue adequacy calculations of including the Conrail premium can 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 procedures, debits placed in Account 80 will be excluded from revenue adequacy calculations. Also monies placed into Account 80 for regulatory costing purposes will not impact the railroads' variable unit costs based on existing URCS procedures. This remedy easily can be implemented by the carriers, with no additional accounting or administrative burden.

III. IDENTIFICATION OF PREMIUM FOR REGULATORY PURPOSES

CSX and NS are purchasing Conrail shares for \$__ billion^{2/}. The book value of Conrail shares equal \$__ billion^{3/}. According to CSX's and NS' testimony and data, their preliminary appraised value of Conrail assets is estimated at \$__ billion^{4/}, which can be contrasted to the historical gross book value of Conrail's assets which equals \$__ billion^{5/}. The purchase price has been allocated __% to CSX and __% to NS.

A premium occurs when an acquiring railroad pays a amount in excess of the acquired railroad's historical book value. In this case, the premium largely results from escalating tender offers made by CSX and NS between October, 1996 and February, 1997, when each was seeking to acquire Conrail separately. Whether a premium is reflected on the carrier's books 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 apply 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 equal 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^{6/}.

^{2/} 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.

^{3/} 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.

^{4/} Preliminary estimates of the appraised value of Conrail made by Price Waterhouse.

^{5/} 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.

^{6/} In the last three mergers, the acquisition costs exceeded the historical book value. These three mergers were Union Pacific/Southern Pacific ("UP/SP"), Burlington Northern/Santa Fe ("BNSF") 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. In none of these cases, however has the STB been called upon to rule on the legitimacy of the carriers' treatment of the premium for regulatory purposes.

**A. PREMIUM FOR
REGULATORY PURPOSES**

If left in its current form, the premium that CSX and NS are paying for Conrail will artificially lower the STB's annual revenue adequacy calculations for CSX and NS. The reduction will be artificial because the increase in net investment would not be the result of any increase in the actual value of Conrail's assets as instrumentalities of transportation. Additionally, the premium will 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 under STB jurisdiction and also used as a floor for regulatory rate setting purposes.

The quantification of the premium may be different for revenue adequacy calculations than it is 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^{7/}.

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.^{8/} The reason the premium may be higher for this regulatory purpose is that the

^{7/} A railroad's assets are determined for revenue adequacy purposes in accordance with GAAP Cost. GAAP Cost equals "...the value of the resources forgone by the entity to acquire the assets. All GAAP Cost, as applied in business combinations, is acquisition cost...". Acquisition Cost equals "...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, pages 59 and 115.

^{8/} CFR 49 Part 1201, Rule 2-15.

railroads have the option to utilize appraised (fair) value instead of acquisition cost when assets are acquired for other than cash^{2/}.

I have estimated the premium paid by CSX and NS for Conrail's assets for both revenue adequacy and jurisdictional costing purposes. A summary of the premium calculations is shown in Table 4 below.

<p>Table 4 Summary of CSX and NS Premium Paid for Conrail (\$ in Millions)</p>		
<u>Item</u>	<u>For Revenue</u>	<u>For Jurisdictional</u>
(1)	<u>Adequacy Purposes</u>	<u>Threshold Purposes</u>
	(2)	(3)
1. CSX ^{1/}		
2. NS ^{2/}		
3. Total		
<p>^{1/} Based on of total. ^{2/} Based on of total. Source: Exhibit (TDC-2).</p>		

The results of my analysis is a premium of \$ _ _ billion for revenue adequacy purposes and \$ _ _ billion for regulatory costing purposes.

^{2/} The appraised (fair) value option was followed in recording the road and equipment values for the BNSF 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.

IV. IMPACT OF PREMIUM ON JURISDICTIONAL THRESHOLD

If the premium CSX and NS are paying for Conrail is 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 impact on the STB's jurisdictional threshold calculations to the detriment of a captive shipper seeking regulatory relief from unreasonable rail rates. This detrimental impact will come in two forms.

First, the STB determines whether or not it has jurisdiction over a specific shipper movement by comparing the challenged 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, it will take a higher rate to trigger STB jurisdiction over a captive shipper's movement than would be the case absent the premium. In other words, the railroad could impose greater rate increases and still remain immune from STB scrutiny.

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, in a given case 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.

To illustrate the impact of including the Conrail premium for regulatory costing purposes, I solved the CSX and NS URCS formulas presented by their witnesses in this proceeding assuming that each accounted for the acquisition premium by including the premium in the individual investment property accounts. I then applied these artificially inflated unit costs to an average coal movement to determine the impact of the premium on the jurisdictional threshold level of hypothetical CSX and NS coal movements, again assuming the premium is improperly included in their system of accounts. The results of my analysis are summarized below.

**A. INCLUSION OF
THE PREMIUM**

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. These Form R-1 monies 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^{10/}, the variable costs and jurisdictional threshold for the movement being considered will increase significantly.

^{10/} Based on procedures followed in UP/CNW and BNSF mergers, the railroads have been revaluing the investment amounts in these property accounts without regard to correct accounting rules.

The first step I followed in developing the jurisdictional threshold impact was to record CSX's and NS' portion of the Conrail premium in their respective property accounts^{11/}. 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 unit costs including the Conrail premium for each carrier.

**B. EXAMPLE OF IMPACT ON
AVERAGE CSX COAL MOVEMENT**

During CSX's Witness Sharp's deposition, he described the characteristics of an average eastern unit coal train movement. Specifically, at pages 292-306 of his deposition, Witness Sharp identified the following characteristics as typical for a unit train hauling eastern coal to an electric utility:

Table 5 <u>Average Unit Coal Train Characteristics</u>	
<u>Item</u> (1)	<u>Amount</u> (2)
1. Average loaded direction haul -- miles	
2. Cars per train	
3. Net tons per car	
4. Railcar owner	

^{11/} I followed the methodology used by the railroads in the BNSF merger and the UP/CNW merger.

I applied Witness Sharp's average coal train characteristics to URCS unit costs that are based on CSX operations plus the portion of Conrail that CSX is purchasing. I developed the CSX/Conrail unit costs two different ways i.e., with and without CSX's portion of the premium that it is paying for Conrail. The results of this application is summarized in Table 6 below.

Table 6 Impact of Conrail Premium on CSX Variable Costs and Jurisdictional Threshold	
<u>Item</u> (1)	<u>Amount Per Ton</u> (2)
1. <u>CSX Variable Cost Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	
2. <u>CSX Jurisdictional Threshold Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	
Source: Exhibit __ (TDC-3).	

Table 6 above shows that if the premium that CSX is paying for Conrail is incorrectly included in CSX's system of accounts, CSX's variable cost of service and the resulting jurisdictional threshold will be inflated by __% or over \$ __ per ton.

**C. EXAMPLE OF IMPACT ON
AVERAGE NS COAL MOVEMENT**

I next applied the same coal train characteristics identified in Table 5 above to URCS unit costs that are based on NS operations plus the portion of Conrail that NS is purchasing. I developed the NS/Conrail unit costs two different ways, i.e., with and without NS' portion of the premium that it is paying for Conrail. The results of this application are summarized in Table 7 below.

Table 7
**Impact of Conrail Premium on
NS' Variable Costs and Jurisdictional Threshold**

<u>Item</u> (1)	<u>Amount Per Ton</u> (2)
1. <u>NS Variable Cost Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	
2. <u>NS' Jurisdictional Threshold Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	

Source: Exhibit (TDC-4).

Table 7 above shows that if the premium that NS is paying for Conrail is incorrectly included in NS' system of accounts, NS' variable cost of service and the resulting jurisdictional threshold will increase by __% or by over \$_.__ per ton.

V. 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 annually 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 railway operating income...divided by a calculated net investment base".^{12/} 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 8 below.

Table 8 <u>STB's 1996 Revenue Adequacy Findings</u>	
<u>Item</u> (1)	<u>Amount</u> (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-5), Columns (2) through (4).	

^{12/} 364 I.C.C. at 821.

Table 8 demonstrates that in 1996 and based on the STB's revenue adequacy procedures, NS is a revenue adequate railroad and CSX and Conrail are approximately three points below the revenue adequacy level.

In order to test the impact on NS and CSX revenue adequacy calculations of their acquisition of Conrail, I first combined Conrail with NS and CSX based on each railroad's acquisition percentage i.e., NS is acquiring __% of Conrail and CSX the remaining __%. The results of this combination, before the premium that NS and CSX paid for Conrail is considered, on the STB's revenue adequacy calculation is shown in Table 9 below.

Table 9	
Impact on STB's 1996 Revenue Adequacy Findings of Combining Conrail with NS and CSX Before The Premium is Considered	
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 of Conrail	
b. CSX and of Conrail	
^{1/} Source: Exhibit __ (TDC-5), Columns (5) and (6).	

When NS' portion of Conrail is included before the premium is considered, NS' return on net investment declines from 13.0% (Table 8, Line 2a) to __. __% (Table 9, Line 2a). Similarly, when CSX's portion of Conrail is included before the premium is considered, CSX's return on net investment declines from 8.9% (Table 8, Line 2b) to __. __% (Table 9, Line 2b). These

results are in line with expectations, given Conrail's relative underperformance as compared to CSX and NS (particularly NS).

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 the NS and CSX acquisition percentages i.e., __% for NS and __% for CSX;
3. I eliminated Conrail's booked accumulated depreciation in quantifying the premium paid for Conrail's assets for revenue adequacy purposes. This adjustment equals \$_. _ billion;
4. I included the annual depreciation associated with the Conrail premium; and,
5. The Conrail premium was reduced by \$_. _ billion to reflect new deferred taxes.

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 drop dramatically and wholly disproportionate to Conrail's relative performance for 1996. 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 __% of Conrail and Conrail Premium	
b. CSX and __% of Conrail and Conrail Premium	

^{1/} Source: Exhibit __ (TDC-5), Columns (7) through (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. As I noted above, these reductions are not attributable to Conrail's actual financial performance or a change in the intrinsic value of its assets. Rather, they are simply the artificial, arithmetic result of reflecting in regulatory costs the consequence of CSX's and NS' 1996-1997 tender offer battle.

VI. PROPOSED REMEDY

Simply stated, the premium NS and CSX paid for Conrail should not impact either the jurisdictional threshold calculation of an individual captive movement or the annual revenue adequacy determination of either NS or CSX. To include the premium for either purpose is to require captive shippers and others dependent on the STB's regulatory costing procedures to subsidize CSX's and NS' bidding war. In order to avoid this adverse and improper 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:

A. Revenue Adequacy Calculations

B. Jurisdictional Threshold Calculations

A. REVENUE ADEQUACY CALCULATIONS

For purposes of revenue adequacy calculations, Conrail's net railway operating income ("NROI") and net investment base should be identified at pre-acquisition or existing book levels. These monies then should be separated between NS and CSX on the basis of each railroad's acquisition percentage, i.e., __% for NS and __% for CSX. 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 adjustments to 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 (1)	Return on Investment	
	NS (2)	CSX (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-5).

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, and are consistent with an absorption of Conrail that reflects its actual performance.

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. The adjustment is straight forward, and does not involve any additional accounting or record keeping steps or other administrative burdens on the Carriers.

**B. JURISDICTIONAL THRESHOLD
CALCULATIONS**

For regulatory costing purposes, the STB and its predecessor, the Interstate Commerce Commission ("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,^{13/} the ICC required the property values recorded on the ICC

^{13/} Docket No. 32153, Uniform System of Accounts for Railroad Companies.

valuation records for each railroad to 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"^{14/15/16/}.

In order to maintain consistency with these regulatory costing principles in accounting for the Conrail acquisition, the STB should continue to use the accounting procedures it has in place. Specifically, the STB should 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 artificially inflated. Again, this is an adjustment which easily can be made by the carriers without additional administrative cost or effort.

I have developed Exhibit __ (TDC-6) 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.

^{14/} Annual Report, 1964, page 54.

^{15/} 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).

^{16/} 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.

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 17th day
of October, 1997.

Witness my hand and official seal.

James M. Walton
up to 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

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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.

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

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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

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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.

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Development of Premium Paid for Conrail Assets 1/

Item (1)	Amount (Millions) (2)
Revenue Adequacy Premium	
1 Total Cost to CSXNS of Conrail Shares Acquired	2/
2 Book Value of Conrail Shares	2/
3 Value of Eliminated Accumulated Depreciation and Asset Disposition	3/
4 Premium for Revenue Adequacy Purposes	4/
Regulatory Costing Premium	
5 Appraised Value of Conrail Assets	2/
6 Gross Book Value of Conrail Assets	2/,3/
7 Premium for Regulatory Costing Purposes	5/
Premium Deferred Taxes	
8 Deferred Taxes associated with Fair Value	6/

1/ The Conrail Premium is measured on two bases, an Acquisition basis for Revenue Adequacy Purposes and an Appraisal basis for Regulatory Costing and Jurisdictional Threshold Purposes.

2/ Whitehurst Deposition Exhibit No. 1.

3/ Conrail's 1995 Form 10-K Page 45. Asset Disposition equals \$285 million and Accumulated Depreciation equals \$2,102 million.

4/ Line 1 - Line 2 + Line 3.

5/ Line 6 - Line 6.

6/ Whitehurst Deposition Exhibit No. 1 identifies CSX's portion of deferred taxes. By dividing this amount by CSX's share of Conrail, total deferred taxes are calculated. Deferred taxes reduce the investment base for both revenue adequacy and regulatory costing.

Note: The Revenue Adequacy Premium is based on Acquisition Cost. The Railroad Accounting Principles Board ("RAPB") adopted GAAP costs as the basis for valuing the railroads assets for Revenue Adequacy Purposes. The RAPB defined GAAP costs as "The value of the resources forgone by the entity to acquire the assets. GAAP cost, as applied in business combinations, is acquisition cost except in a "pooling of interests." GAAP cost is the net book values of the pooling entities."

Note: The Regulatory Costing Premium is based on Appraisal Cost. Recent railroad mergers have used appraised value or fair market value in adjusting the acquired assets of the purchased railroad. The last two mergers (i.e. BNSF and UP/CNW) used appraised value in adjusting the property accounts of the acquired railroads.

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Impact of Conrail Premium on Variable Cost and Jurisdictional Threshold For Average CSX Coal Movement

A. Movement Assumptions For Costing

	Source
1 Line Haul Miles	Sharp Deposition Page No 306
2 Car Train	Sharp Deposition Page No 292
3 Tons Net Load Per Car	Sharp Deposition Page No 292
4 Railcar is Owned and Provided by CSX	Sharp Deposition Page No 296
5 Ex Parte No 270 (Sub 4) Unit Train Adjustments	STB Methodology
6 CSXT's Premium Equals \$ Billion - Exhibit_(TDC-2) \$ Billion times CSX share of Conrail	Whitehurst Exhibit -1, CRC 1995 10-K and Klick Electronic Workpapers

B. Variable Cost and Jurisdictional Threshold

Item (1)	Source (2)	1995 CSXT W/CRC Portion of Premium (3)
Without Premium		
7 Variable Cost Per Ton	Phase III URCS	
8 Jurisdictional Threshold Per Ton	Line 7 x 1.80	
With Premium		
9 Variable Cost Per Ton	Phase III URCS	
10 Jurisdictional Threshold Per Ton	Line 9 x 1.80	
Increase		
11 Increase In Variable Cost or Jurisdictional Threshold	(Line 9 - Line 7) or (Line 10 - Line 8)	

**Impact of Conrail Premium on Variable Cost and Jurisdictional Threshold
For Average NS Coal Movement**

A. Movement Assumptions For Costing

		Source
1	Line Haul Miles	Sharp Deposition Page No 306
2	Car Train	Sharp Deposition Page No 292
3	Tons Net Load Per Car	Sharp Deposition Page No 292
4	Railcar is Owned and Provided by NS	Sharp Deposition Page No 296
5	Ex Parte No. 270 (Sub 4) Unit Train Adjustments	STB Methodology
6	NS's Premium Equals \$ Billion - Exhibit_(TDC-2) \$ Billion times NS share of Conrail	Whitehurst Exhibit -1, CRC 1995 10-K and Klick Electronic Workpapers

B. Variable Cost and Jurisdictional Threshold

Item (1)	Source (2)	1995 NS W/CRC Portion of Premium (3)
Without Premium		
7 Variable Cost Per Ton	Phase III URCS	
8 Jurisdictional Threshold Per Ton	Line 7 x 1.80	
With Premium		
9 Variable Cost Per Ton	Phase III URCS	
10 Jurisdictional Threshold Per Ton	Line 9 x 1.80	
Increase		
11 Increase In Variable Cost or Jurisdictional Threshold	(Line 9 + Line 7) or (Line 10 + Line 8)	

IMPACT OF CONRAIL AND CONRAIL PREMIUM ON
1996 REVENUE ADEQUACY CALCULATIONS

Railroad (1)	1996 STB FINDING			CSX & NS With CR		CSX & NS With CR And Acquisition Premium		
	Conrail (2)	CSX (3)	NS (4)	CSX With CR 4/ (5)	NS With CR 4/ (6)	Conrail Premium (7)	CSX With CR 5/ (8)	NS With CR 5/ (9)
Combined/Consolidated NROI	435,305	610,621	787,725					
+ Interest From Working Cap. Cash	253	8,929	12,835					
+ Inc Tax Non-rail	(6,166)	3,241	23,660					
Incremental Depreciation	0					1/		
+ Net gain transfers	11,014	13,133	16,646					
** Adjusted NROI **	440,406	635,924	840,866					
Comb Net Inv R&E End	6,591,515	9,482,069	8,912,338			2/		
Comb Net Inv R&E Start	6,355,952	8,949,689	8,589,425			2/		
Comb Net Inv R&E Av	6,473,734	9,215,879	8,750,882					
OE Inv End	0	0	0					
OE Inv Start	0	0	0					
OE Inv Av	0	0	0					
IDC End	0	0	3,014					
IDC Start	0	0	3,197					
IDC Av	0	0	3,106					
Net Rail Rel Ass. End	23,017	0	0					
Net Rail Rel Ass. Start	31,919	0	0					
Net Rail Rel Ass. Av	27,468	0	0					
Work Cap End	144,679	123,537	267,241					
Work Cap Start	208,202	109,665	268,265					
Work Cap Av	176,441	116,601	267,753					
Acc Def Tax End	1,484,091	2,310,618	2,612,504			3/		
Acc Def Tax Start	1,400,411	2,063,544	2,524,852			3/		
Acc Def Tax Av	1,442,251	2,187,081	2,568,678					
Tax Adj Net Inv Base End	5,275,120	7,294,988	6,564,061					
Tax Adj Net Inv Base Start	5,195,662	6,995,810	6,329,641					
* Tax Adj Net Inv Base *	5,235,391	7,145,399	6,446,851					
TAX ADJUSTED ROI	8.4%	8.9%	13.0%					

1/ CSX workpapers --CSX 26 HC 000210

2/ The Premium for Revenue Adequacy Purposes is \$ Billion ((Acquisition minus Book Cost) Plus Eliminated Accum. Depreciation) -- Exhibit_(TDC-2)
Line 1 Minus Line 2 Plus Line 4

3/ Whitehurst Deposition Exhibit No. 1 identifies CSX's portion of deferred taxes. By dividing this amount by CSX's share of Conrail, total deferred taxes are calculated.

4/ CSX = Column (2) x plus Column (3); NS = Column (2) x plus Column (4)

5/ CSX = Column (5) + of Column (7); NS = Column (6) + of Column (7)

1995 Conrail Book Value --
Schedule 352B Investment and 335 Accumulated Depreciation

Line No	Account	Conrail 1995 Schedule 352B Column (b) (1)	Gross Investment		Accumulated Depreciation		
			1995 CSXT Schedule 352B Column (b) 2/ (4)	1995 NS Schedule 352B Column (b) 2/ (5)	Conrail 1995 Schedule 335 Column (g) (6)	1995 CSXT Schedule 335 Column (g) 3/ (7)	1995 NS Schedule 335 Column (g) 3/ (8)
1	(2) Land	\$109,942			\$0		
2	(3) Grading	209,689			22,811		
3	(4) Other ROW	2,586			757		
4	(5) Tunnels and subways	27,688			2,874		
5	(6) Bridges, trestles	227,358			51,941		
6	(7) Elevated Structures	2,575			2,769		
7	(8) Ties	1,294,855			201,778		
8	(9) Rails and Other Track Material	2,503,630			304,233		
9	(11) Ballast	877,012			(10,865)		
10	(13) Fences, snowsheds, & signs	1,309			543		
11	(16) Station & office Bldgs	183,645			59,494		
12	(17) Roadway Bldgs	11,937			4,574		
13	(18) Water Stations	480			343		
14	(19) Fuel Stations	33,619			8,964		
15	(20) Shops and enginehouses	84,747			33,860		
16	(22) Storage warehouses	0			0		
17	(23) Wharves and docks	936			58		
18	(24) Coal and ore wharves	79,151			23,957		
19	(25) TOFC/COFC terminals	77,212			31,587		
20	(26) Comm systems	121,275			76,965		
21	(27) Signals & interlockers	368,989			131,446		
22	(29) Power Plants	1,140			476		
23	(31) Power Trans	8,981			5,293		
24	(35) Misc Struct	3,868			530		
25	(37) Roadway Machines	98,537			73,495		
26	(39) Public improvements	43,207			5,225		
27	(44) Shop machinery	52,041			27,817		
28	(45) Power-plant machinery	3,739			3,198		
29	Other	0			45,569		
30	Amortization Adjustments	0			438,536		
31	TOTAL ROAD	\$6,430,148			\$1,548,228		
32	(52) Locomotives	\$1,138,328			\$469,155		
33	(53) Freight-train cars	741,841			313,823		
34	(54) Passenger-train cars	0			0		
35	(55) Highway Revenue	2,790			1,920		
36	(56) Floating Equipment	0			0		
37	(57) Work Equipment	84,682			50,271		
38	(58) Misc Equipment	31,401			26,735		
39	(59) Computer Equipment	79,785			62,374		
40	Amortization Adjustments	0			300		
41	TOTAL EQUIPMENT	\$2,078,827			\$924,578		
42	(76) Interest during Const				\$0		
43	(80) Other elements of investments				0		
	(90) Construction work in progress				0		
	GRAND TOTAL				\$2,472,806		

1/ Estimated Fair Value -- Deposition Exhibit No. 1 - W. W. Whitehurst, value in Account 80 equals premium shown in Exhibit (TDC-2), Line 7

2/ Column (3) x CSXT- or NS-

3/ Column (6) x CSXT- or NS-

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valuation records for each railroad to 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"^{14/15/16/}.

In order to maintain consistency with these regulatory costing principles in accounting for the Conrail acquisition, the STB should continue to use the accounting procedures it has in place. Specifically, the STB should 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 artificially inflated. Again, this is an adjustment which easily can be made by the carriers without additional administrative cost or effort.

I have developed Exhibit __ (TDC-6) 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.

^{14/} Annual Report, 1964, page 54.


^{15/} 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).

^{16/} 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.

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

Sworn to and subscribed
before me this 17th day
of October, 1997.

Witness my hand and official seal.

James M. Keltner
upms 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

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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.

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

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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

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ECONOMIC CONSULTANTS

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.

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Development of Premium Paid for Conrail Assets 1/

Item (1)	Amount (Millions) (2)
Revenue Adequacy Premium	
1 Total Cost to CSXNS of Conrail Shares Acquired	2/
2 Book Value of Conrail Shares	2/
3 Value of Eliminated Accumulated Depreciation and Asset Disposition	3/
4 Premium for Revenue Adequacy Purposes	4/
Regulatory Costing Premium	
5 Appraised Value of Conrail Assets	2/
6 Gross Book Value of Conrail Assets	2/,3/
7 Premium for Regulatory Costing Purposes	5/
Premium Deferred Taxes	
8 Deferred Taxes associated with Fair Value	6/

1/ The Conrail Premium is measured on two bases, an Acquisition basis for Revenue Adequacy Purposes and an Appraisal basis for Regulatory Costing and Jurisdictional Threshold Purposes.

2/ Whitehurst Deposition Exhibit No. 1.

3/ Conrail's 1995 Form 10-K Page 45. Asset Disposition equals \$285 million and Accumulated Depreciation equals \$2,102 million.

4/ Line 1 - Line 2 + Line 3.

5/ Line 6 - Line 6.

6/ Whitehurst Deposition Exhibit No. 1 identifies CSX's portion of deferred taxes. By dividing this amount by CSX's share of Conrail, total deferred taxes are calculated. Deferred taxes reduce the investment base for both revenue adequacy and regulatory costing.

Note: The Revenue Adequacy Premium is based on Acquisition Cost. The Railroad Accounting Principles Board ("RAPB") adopted GAAP costs as the basis for valuing the railroads assets for Revenue Adequacy Purposes. The RAPB defined GAAP costs as "The value of the resources forgone by the entity to acquire the assets. GAAP cost, as applied in business combinations, is acquisition cost except in a "pooling of interests." GAAP cost is the net book values of the pooling entities."

Note: The Regulatory Costing Premium is based on Appraisal Cost. Recent railroad mergers have used appraised value or fair market value in adjusting the acquired assets of the purchased railroad. The last two mergers (i.e. BNSF and UP/CNW) used appraised value in adjusting the property accounts of the acquired railroads.

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ECONOMIC CONSULTANTS

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Increase		
11 Increase In Variable Cost or Jurisdictional Threshold	(Line 9 - Line 7) or (Line 10 - Line 8)	

**Impact of Conrail Premium on Variable Cost and Jurisdictional Threshold
For Average NS Coal Movement**

A. Movement Assumptions For Costing

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IMPACT OF CONRAIL AND CONRAIL PREMIUM ON
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1995 Conrail Book Value --
Schedule 352B Investment and 335 Accumulated Depreciation

Line No	Account	Gross Investment			Accumulated Depreciation		
		Conrail 1995 Schedule 352B Column (b)	1995 CSXT Schedule 352B Column (b) 2/	1995 NS Schedule 352B Column (b) 2/	Conrail 1995 Schedule 335 Column (g)	1995 CSXT Schedule 335 Column (g) 3/	1995 NS Schedule 335 Column (g) 3/
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	(2) Land	\$109,942			\$0		
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42	(76) Interest during Const				\$0		
43	(80) Other elements of investments				0		
	(90) Construction work in progress				0		
	GRAND TOTAL		1/		\$2,472,806		

1/ Estimated Fair Value -- Deposition Exhibit No. 1 - W. W. Whitehurst, value in Account 80 equals premium shown in Exhibit_(TDC-2), Line 7

2/ Column (3) x CSXT - or NS-

3/ Column (6) x CSXT - or NS-

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

Finance Docket No. 33388

Consumers respectfully submits that the proposed acquisition and division of Conrail's assets between CSX and NS is not in the public interest and should not be approved. As explained below, the transaction (1) is anti-competitive because a major carrier is disappearing, the effect of which will be to reduce Consumers' competitive rail transportation options; and (2) generates additional, multi-billion dollar fixed charges through an acquisition price premium, the allocation of which for regulatory purposes remains undecided, and yet the effect of which is to increase the exposure of captive shippers like Consumers to unreasonable rates.

Accordingly, the transaction should not be approved absent a condition that will ensure effective competition for coal transportation to Consumers' CSX-captive Campbell Generating Station, and a condition that protects captive coal shippers from

future pricing abuse by controlling the regulatory cost allocation of the acquisition premium.

I

THE APPLICABLE LEGAL STANDARD

Under the Board's governing statute, the ICC Termination Act, the Board's "single and essential standard of approval" in merger proceedings is that "the [Board] find the [transaction] to be 'consistent with the public interest.'" Finance Docket No. 32760, Union Pacific Corp., Union Pacific R.R. Co., and Missouri Pacific R.R. Co. -- Control and Merger -- Southern Pacific Rail Corp., Southern Pacific Transp. Co., St. Louis Southwestern Ry. Co., SPCSL Corp., and The Denver and Rio Grande Western R.R. Co., Decision No. 44, served August 12, 1996, at 98 (unprinted)("UP/SP"), citing, Missouri-Kansas-Texas R.R. Co. v. United States, 632 F.2d 392, 395 (5th Cir. 1980), cert. denied, 451 U.S. 1017 (1981); see also Finance Docket No. 32549, Burlington Northern Inc. and Burlington Northern R.R. Co. -- Control and Merger -- Santa Fe Pacific Corp. and The Atchison, Topeka and Santa Fe Ry. Co., Decision No. 38, served August 23, 1995, at 50-54 (unprinted)("BN/Santa Fe").

The Board's "public interest" analysis requires the Board to evaluate, among other factors:

- * 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.

49 U.S.C. §11324(b)(1),(3) and (5).

When performing this public interest analysis, the essential issue is whether the perceived public benefits are overshadowed by purely private benefits, which accrue solely to the merging carriers at the expense of the public. See CSX Corp. -- Control -- Chessie and Seaboard C.L.I., 363 I.C.C. 518, 551-52 (1980).¹ In making this determination, the Board focuses, inter alia, on the competitive effects of a proposed merger. This pro-competitive theme is echoed in the National Rail Transportation Policy ("N RTP"), which influences the Board's public interest analysis and thus provides additional guidance. See UP/CNW, supra at 53-54, citing, Norfolk Southern Corp. - Control - Norfolk & W. Ry. Co., 366 I.C.C. 171, 190 (1982). The N RTP

¹ The former Interstate Commerce Commission expounded upon this point in its UP/CNW decision and stated that:

[B]enefits to the combining carriers which are the result of increased market power, such as the ability to increase rates at the same or reduced service levels, are exclusively private benefits that detract from any public benefits associated with the control transaction.

See Finance Docket No. 32133, Union Pacific Corp., Union Pacific R.R. Co. and Missouri Pacific R.R. Co. -- Control -- Chicago and North Western Transp. Co. and Chicago and North Western Ry. Co., Decision served February 21, 1995, at 53 ("UP/CNW").

directs the Board, inter alia, to:

- * Allow to the maximum extent possible, competition and the demand for services to establish reasonable rates for rail transportation;
- * Maintain reasonable rates where there is an absence of effective competition;
- * Prohibit predatory pricing and practices, to avoid undue concentrations of market power and prohibit unlawful discrimination; and
- * Ensure the availability of accurate cost information in regulatory proceedings.

See 49 U.S.C. §10101(1),(6),(12) and (13).

The Board's general policy statement governing mergers also emphasizes the importance of competition:

[T]he [Board] does not favor consolidations that substantially reduce the transport alternatives available to shippers unless there are substantial and demonstrable benefits to the transaction that cannot be achieved in a less anticompetitive fashion. Our analysis of the competitive impacts of a consolidation is especially critical in light of the Congressionally mandated commitment to give railroads greater freedom to price without regulatory interference.

49 C.F.R. § 1180.1(a)(emphasis added).

Even if the Board determines that the overall effect of a proposed transaction is in the public interest, the Board still has broad authority to impose conditions on consolidations and control transactions in order to ameliorate potential harmful and/or anti-competitive effects. See Union Pacific -- Control --

Missouri Pacific; Western Pacific, 366 I.C.C. 459, 562-64 (1992),
aff'd sub. nom. Southern Pacific Transp. Co. v. I.C.C., 736 F.2d
708 (D.C. Cir. 1984), cert. denied, 469 U.S. 1208 (1985); Santa
Fe Southern Pacific Corp. -- Control -- Southern Pacific Transp.
Co., 2 I.C.C. 2d 709, 807-08 (1986); see also 49 U.S.C.
§11324(c).

The criteria for imposing conditions to remedy anti-competitive effects of a proposed merger were described in the 1995 BN/Santa Fe decision as follows:

[W]e will not impose conditions unless we find that the consolidation may produce effects harmful to the public interest (such as a significant reduction of competition in an affected market), and that the conditions will ameliorate or eliminate the harmful effects, will be operationally feasible, and will produce public benefits (through reduction or elimination of the possible harm) outweighing any reduction to the public benefits produced by the merger.

BN/Santa Fe, supra, at 55-56.

As Consumers demonstrates in these Comments, and in the attached testimonies of Messrs. Garrity and Crowley and Dr. Kahn, (1) the Applicants' proposal is anti-competitive because the disappearance of Conrail will reduce Consumers' future effective rail transportation options for coal shipments to the stations not already captive to CSX, without meaningful mitigation resulting from the Applicants' planned joint access to the MGA coal fields; and (2) the acquisition premium² paid by CSX and NS

² The amount and source of the acquisition premium is discussed in Part III, infra.

will -- unless the carriers are prohibited from including it in their regulatory rate bases -- make it much more difficult for shippers like Consumers who are captive to CSX to establish the Board's jurisdiction over and obtain meaningful relief from unreasonable rail rates on coal, pursuant to 49 U.S.C. §10701, et seq. Accordingly, the public interest requires that approval of the proposed transaction be denied. Alternatively, if the Board determines that approval of the merger is warranted, then the public interest requires that the Board impose the conditions described below in order to protect Consumers' legitimate right to seek reasonable coal rates.

II

THE TRANSACTION IS NOT IN THE PUBLIC INTEREST BECAUSE THE DISAPPEARANCE OF CONRAIL WILL REDUCE CONSUMERS' COMPETITIVE OPTIONS FOR THE RAIL TRANSPORTATION OF COAL

The loss of Conrail as a transportation option produces the obvious effect that the rail transportation picture in the East will shrink from three major carriers to only two. This is a problem, because "[t]he existence of only two firms in an industry does not satisfy the general economic definition of pure competition, which requires the existence of many firms, no one of which has a significant influence on the market price."

International Detective Serv. v. I.C.C., 613 F.2d 1067, 10th 5 n.18 (D.C. Cir. 1979), citing, E. Chamberlin, The Theory of Monopolistic Competition, at 30-31 (7th ed. 1960) (describing a two-firm industry or "duopoly" as one type of monopolistic

industry). As Witness Garrity explains, the acquisition and division of Conrail between CSX and NS will have a particular, detrimental impact on Consumers' eastern coal transportation options. V.S. Garrity, at 9-11.

Consumers recognizes that a reduction in the number of rail options from 3 to 2 may not always result in a significant loss of competition. See UP/SP, supra, at 119-21. In Consumers' case, however, the relevant facts show that for the stations not already captive to CSX, the loss of an independent Conrail will lead to an undue concentration of market power in CSX's hands. V.S. Garrity, at 11. See also Williams Depo. Tr. at 374.³ Put another way, NS is not an effective substitute for Conrail when it comes to lower sulfur coal traffic moving north to Consumers' facilities. See 49 U.S.C. §11324(b)(1) and (5).

First, the principal offsetting "benefit" that Applicants tout as an ameliorative factor vis-a-vis the elimination of Conrail -- Applicants' joint access to the MGA coal fields -- will be of little or no value to Consumers. While Applicants' witness Sansom initially claimed that expanded MGA rail access should increase Consumers' options (see Application, Volume 2A, V.S. Sansom at 315, 337), Dr. Sansom later admitted that he had not examined Consumers' internal coal use data, its boiler specifications, or the environmental limitations which

³In these Comments, citations to transcripts of witness depositions are by witness name and page number. Copies of those portions of witness depositions referenced herein are included in the Appendix to this Argument.

affect coal burn at Consumers' generating facilities in drawing his conclusions. See Sansom Depo. Tr. at 51-52. In fact, MGA coal has no meaningful role to play in satisfying Consumers' fuel requirements.

In his Statement, Mr. Garrity addresses Consumers' burn requirements and the environmental regulations which govern Consumers' plant emissions. See V.S. Garrity at 3-7. In that regard, Mr. Garrity notes that the particular configuration of Consumers' plants, the regulatory requirements imposed by the Environmental Protection Agency ("EPA") and the State of Michigan effectively preclude Consumers from utilizing higher sulfur MGA coal. For example, the use of MGA coal at Consumers' Campbell and Karn plants would require the blending of such a high percentage of western coal "that the resulting product's heating value would be too low for the plants to maintain full capacity, absent extensive and expensive facility modifications." V.S. Garrity at 10. Mr. Garrity also explains that while one facility, the Cobb plant (which is responsible for only 11% of Consumers' coal-derived energy output) is capable of burning a small amount of MGA coal, after 1999 "no plants (including Cobb) can meet Phase II acid rain restrictions utilizing MGA coals with current maximum blends of western coal." V.S. Garrity at 10.

While dual access by NS and CSX to the MGA coal fields may provide source competition for other utilities, Consumers will see no concomitant benefit. Consumers' inability to burn

MGA coal, in conjunction with its captivity to CSX at the Campbell Plant, essentially renders the Applicants' dual access to the MGA region irrelevant.

Moreover, the disappearance of Conrail is particularly threatening to Consumers because post-acquisition, CSX will dominate most eastern low sulfur coal traffic traveling by rail to the Great Lakes area. At this time, CSX already serves the majority of eastern mines which offer the low sulfur coal which is needed in Consumers' plants. That fact, in conjunction with the acknowledged bias of NS's natural traffic patterns, as well as its primary customer base, in a southeasterly direction -- i.e., away from Consumers' generating facilities -- will guarantee CSX's lock on Great Lakes rail transportation of eastern low sulfur coals. Even if NS' focus were trained on the Great Lakes, the agreed division of Conrail lines, e.g., in Ohio leaves NS with more circuitous routings to important interchanges such as Toledo, than the Conrail lines that operate today. See Application, Vol. 8, Map Addendum. As a result, the subject transaction will severely limit what little competition already exists for Consumers, as CSX's control over the eastern low sulfur coal sources will be solidified. V.S. Garrity at 7-8, 11.

In sum, if the subject transaction is approved, and Conrail's carrier services dissolve, the rail transportation options now open to Consumers, at least with respect to stations other than Campbell, will be constrained sharply by two factors: the power of CSX in relation to the Great Lakes transportation

market, and the irrelevance of MGA coal for Consumers' energy needs. This anti-competitive result is inconsistent with the public interest mandate inherent in the governing statute, and should be addressed by the Board through appropriate conditions. 49 U.S.C. §11324(c).

III

**ABSENT CONDITIONS GOVERNING THE APPLICANTS'
ACQUISITION PREMIUM, THE TRANSACTION IS NOT
IN THE PUBLIC INTEREST BECAUSE IT
EXPOSES CONSUMERS AND OTHER CAPTIVE
SHIPPER TO UNREASONABLE FUTURE RAIL RATES**

The "total fixed charges" arising from the proposed acquisition and division of Conrail's assets include the premium that NS and CSX have paid for Conrail's shares. See 49 U.S.C. §11324(b)(3). To the extent that captive shippers, such as Consumers, are forced to shoulder a disproportionate burden of the premium recovery via higher rail rates, approval of the subject transaction would directly contravene multiple goals of the NRTP. Yet, absent intervention by the Board through appropriate conditions, that is precisely the result that the Applicants' proposal threatens.

**A. The Acquisition Premium Implicates
Consumers' Public Interest Concerns**

As used in these Comments, "acquisition premium" refers to the amount paid by CSX and NS in excess of the book value of Conrail's assets. Consumers submits that in order to protect captive shippers from being forced unfairly to subsidize the stock price war waged by the Applicants before they settled on a

division of Conrail, only the book value of the Conrail assets being acquired should be included in CSX's and NS's investment bases for regulatory purposes.

1. The Size of the Premium is Significant.

Based upon record evidence submitted to date, the potential size of the premium varies from \$ billion to \$ billion, depending upon the basis for its calculation. See V.S. Crowley at 6-8 and Exhibit __ (TDC-2). Virtually all of this is attributable not to substantive changes in Conrail's performance or intrinsic asset value, but to a stock tender offer bidding war which led to an over sixty percent (60%) increase in the price paid for Conrail's shares by CSX and NS over pre-tender stock trading levels. See V.S. Garrity at 12. It safely may be assumed that Applicants (and their financiers) will be looking to recover the value of their investment. In the abstract, this is not remarkable. The fact remains, however, that the premium is an extraordinarily high number relative to the value of Conrail before the bidding started. Absent Board intervention, CSX and NS might simply roll their respective shares of the premium into their investment bases for regulatory accounting purposes. V.S. Crowley at 6 n.6. Therein arises the problem for captive shippers.

2. The Book Value of Conrail's Assets Should Determine Applicants' Future Investment Bases.

In light of the role played by a rail carrier's investment base in regulatory determinations, including maximum

rates on captive coal traffic, Consumers submits that only the book value of Conrail's assets (i.e., \$3.2 billion),⁴ and not the premium, should be included in CSX's and NS's investment bases for regulatory costing purposes. V.S. Crowley at 6. Consumers focuses the Board's attention on this issue because if the subject transaction is approved, captive rail traffic will be the likely targeted candidate to pick up any slack in investment recovery, particularly if NS and CSX's projected revenues fall short of their rigorous estimates.

The risk of Applicants' potential failure to cover their investment cannot fairly or properly be placed upon Consumers and other shippers in the form of increased rail rates, because those shippers have not been offered (much less guaranteed) a share in any additional profits which might arise from the proposed transaction if the Applicants' revenue projections prove to be conservative. See Williston Basin Interstate Pipeline Co. v. Federal Energy Regulatory Comm'n, 115 F.3d 1042, 1044 (D.C. Cir. 1997) ("a rule assigning the firm the benefit of good outcomes and customers the burden of bad ones a kind of 'heads, I win, tails, you lose' rule, would seem to give the utility's management an unhealthy incentive to gamble"); cf. Democratic Cent. Comm. v. Washington Metro. Area Transit Comm'n, 485 F.2d 786, 806-07 (D.C. Cir. 1973) ("[t]he proposition that capital gain rightly inures to the benefit of him who bore the risk of capital loss has been accepted in ratemaking law").

⁴V.S. Crowley at 6.

In analogous contexts and for the same reasons, it has long been recognized that the purchase price of new or additional assets is not the proper measure of a utility's increased investment base. See Farmers Union Cent. Exch. v. United States, 734 F.2d 1486, 1528 (D.C. Cir. 1984) (an oil pipeline attempted to include acquisition costs in its rate base and was prohibited from doing so); Transcontinental Gas Pipe Line Corp. v. Federal Energy Regulatory Comm'n, 652 F.2d 179, 180 (D.C. Cir. 1981). See also Montana Power Co. v. Federal Energy Regulatory Comm'n, 599 F.2d 295 (9th Cir. 1979) ("the original cost method has been applied to property acquisitions by utilities to prevent utilities from artificially inflating their rate bases by acquiring properties at unrealistically high prices"). The rationale for the proposition that acquisition premiums should be excluded from a regulatory investment base is, as the Federal Energy Regulatory Commission has stated, that "a mere change in ownership should not result in an increase in the rate charged for a service *if the basic service rendered itself remains unchanged.*" Docket No. OR79-1-000, Williston Pipe Line Co., 21 FERC Para. 61,260, at 61,635, quoted in part in Farmers Union, 734 F.2d at 1528 n.78. In this case, Consumers' basic rail service will remain essentially unchanged, and Consumers should not be expected to bear the risk of Applicants' investment -- in particular, Applicants' hefty acquisition premium. As the Montana Power Co. court observed: "[t]he task of regulation is to prevent consumers from bearing more than their fair share of

[the burden of the cost of their vendors' plant facilities] in industries where competitive forces do not otherwise protect them." 599 F.2d at 299-300. In the specific context of this case, Professor Kahn agrees:

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 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 maximized 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.

See V.S. Kahn at 18.

Consumers' witnesses are by no means alone in the view that an investment base calculated by reference to acquisition price instead of book value is inappropriate for regulatory costing purposes. For example, Applicants' witness John Klick recognized that for purposes of constructing 1995 Uniform Rail

Costing System ("URCS") unit costs for the combined CSX/Conrail railroad (assuming approval), the book value of the assets procured was the relevant figure. See Application, Vol. 1, V.S. Klick at 4. When questioned whether he considered it "relevant or necessary to the calculation of an URCS application for the combined system to reflect the acquisition price in the gross investment as opposed to the book value," Mr. Klick categorically responded "no." Klick Depo. Tr. at 47. Mr. Klick's testimony is, of course, highly relevant, because an URCS analysis such as the one performed by Mr. Klick forms the basis for variable cost analyses conducted for purposes of captive shipper rate review.

In short, Applicants cannot and should not be able to guarantee their future ability to pass-through the risk of the underrecovery of the acquisition premium to their captive customers, especially where those customers -- like Consumers -- would not benefit from any future windfall to Applicants, should such a benefit arise. Contrary to Board precedent, such a scenario raises the likelihood that any perceived public benefits of the proposed transaction certainly would be overshadowed by a purely private benefit (i.e., guaranteed risk recovery) which would accrue solely to CSX and NS at the expense of the shipping public. See CSX Corp. -- Control -- Chessie and Seaboard C.L.I., 363 I.C.C. at 551-52 (1980).

3. The Premium Would Profoundly Affect Shipper Protections Under the Revenue Adequacy Standards and the Jurisdictional Threshold.

Given the paramount importance of the proper allocation of the acquisition premium for regulatory costing purposes, it is particularly troubling that Applicants have offered no assurances that the premium will not be inserted into their investment bases for purposes of future rail rate reasonableness determinations.⁵ Consequently, captive shippers are at risk of future unreasonable rail rates because, as witness Crowley demonstrates, inclusion of the premium in a regulatory costing context simultaneously deflates a carrier's performance for revenue adequacy purposes, and inflates its variable costs. See V.S. Crowley at 1, 7. Revenue adequacy and variable costs form the backbone of maximum reasonable rate regulation. See 49 U.S.C. §10701 et seq. Rates charged by a revenue inadequate railroad are subject to less scrutiny by the Board. See Coal Rate Guidelines Nationwide, 1 I.C.C.2d 520 (1985), aff'd. sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3rd Cir. 1987). Perhaps more importantly, the higher a carrier's variable costs, the higher the rate it may charge a captive shipper before triggering the Board's 180% revenue-variable cost jurisdictional threshold. See 49 U.S.C. §10707. As Applicants' own witness Sansom confirmed,

⁵ In its financial statements, CSX does acknowledge the existence of its portion of the acquisition premium. See Application, Volume 7A at 441. CSX notes that it intends to utilize acquisition cost accounting procedures to track this debt. Id. The public is not told, however, where exactly the premium will fit under such procedures. NS does not address accounting procedures for the premium at all.

if the Conrail acquisition premium were included in the net investment base used to calculate variable costs, then captive shippers -- i.e., those who rely on a market dominant carrier for service -- would face both higher rates and a higher jurisdictional threshold for access to rate review by the Board. See Sansom Depo. Tr. at 133-35.

In his testimony, witness Crowley analyzes and quantifies the impact of inclusion of the Conrail premium in the Applicants' investment bases on both the determination of revenue adequacy, and the variable costs/jurisdictional threshold for a typical CSX utility coal unit train movement.⁶ The results of his analyses may be summarized as follows:

* Revenue Adequacy. Overall, the amount of NS and CSX's debt will be significantly greater than revenues generated, the effect of which is to ensure that the carriers are deemed seriously "revenue inadequate" (thus subjecting their rates to lesser scrutiny by the Board). As determined by the Board, the 1996 railroad industry cost of capital was 11.9%. See Ex Parte No. 552 (Sub-No. 1), Railroad Revenue Adequacy - 1996 Determination, Decision served August 14, 1997. Assuming the Conrail transaction had taken place in 1996, if Conrail's assets were valued at book value then CSX's return on investment would

⁶ The parameters for Mr. Crowley's hypothetical eastern coal train (i.e., number of cars, tonnage, costs) were derived from information provided by Applicants' witnesses Sharp and Klick. See Sharp Depo. Tr. at 290-306; see also Application, Vol. 1, V.S. Klick at 7-23.

have equalled %; NS's return on investment likewise would have fallen, to %. See V.S. Crowley, at 16-17 and Exhibit ____ (TDC-5). Neither result would be unexpected, as Conrail modestly underperformed both CSX and NS in 1996. In stark contrast, however, if Conrail's assets are valued including the acquisition premium, CSX's return on investment drops to %, while NS's return on investment plummets to %. See V.S. Crowley at 17-18 and Exhibit ____ (TDC-5). The negative impact for revenue adequacy purposes of including the premium in Applicants' investment bases is enormous, at once placing both carriers farther away from the goal, and captive shippers farther away from the additional rate scrutiny that revenue adequacy brings. Coal Rate Guidelines, supra 1 I.C.C.2d at 537-38.

* Variable Costs. Using CSX's own 1995 CSXT URCS unit costs (as developed by witness Klick), CSX's variable for witness Sharp's typical eastern coal movement -- and the resulting jurisdictional threshold for Board review of CSX's rates -- increase by % over the levels that obtain if CSX's investment base is determined using the book value of its share of Conrail. See V.S. Crowley at 4, 9-14 and Exhibit ____ (TDC-3).

Under this illustrative example, a captive shipper transporting coal in CSX unit train service conservatively⁷ is exposed to a % increase in variable costs when the premium is included in the carrier's net investment bases for regulatory

⁷ Witness Crowley's calculations included no adjustments for recognized efficiencies associated with unit train service.

costing purposes. This would be in addition to CSX's enhanced ability to hide from Board scrutiny behind its "revenue inadequate" status. In rate terms, the inflated variable cost means a multi-million (or billion) dollar subsidy of the Conrail acquisition by captive shippers, statutorily immune from Board scrutiny. For example, per witness Crowley's analysis, the hypothetical CSX shipper's quantifiable exposure (in the form of increased rail rates) from the inclusion of the acquisition premium in the net investment bases would run approximately \$ per ton (based on a \$ billion dollar premium for jurisdictional threshold purposes). See V.S. Crowley at 11-12 and Exhibit ____ (TDC-3). Plainly, Consumers' and other captive shippers' exposure is in the millions of dollars.

**B. Consumers And Other Captive
Shippers Are At Risk For Future
Pricing Abuses**

As witness Garrity explains in his testimony, the Campbell Station produces approximately one-half of Consumers' coal-fired generation, and is served exclusively by CSX. See V.S. Garrity at 3, 7. Campbell's rail transportation needs currently are served by CSX under a contract which is due to expire in 1999. Id. at 8, 12.

Upon expiration of Campbell's CSX contract, Consumers' principal avenue of rate protection will be the Board's jurisdiction over maximum reasonable rates. The Board's protection at that time is paramount, because captive shippers are peculiarly susceptible to carrier attempts to extract the

highest rate possible from their customers. As Applicants' witnesses confirmed, railroads try to maximize their profits on individual movements. See Bryan Depo. Tr. at 140 ("[a]ll carriers are trying to get as much out of a market as they can"); see also Williams Depo. Tr. at 369-70.

Consumers' high-volume, CSX-captive, Campbell traffic is at prime risk for rail pricing abuses, as CSX seeks easy sources of added revenue to cover any shortfalls created by the Conrail acquisition premium. As Mr. Garrity notes:

Plainly, the ability of either CSX or NS to recover their Conrail investment from traffic subject to competition will be limited sharply by the force of that competition. As a result, one must expect that it will be high volume captive traffic -- such as all coal moving to the Campbell Plant -- that in the end will bear the burden of Applicants' inflated Conrail purchase price.

V.S. Garrity, at 12.

As discussed above, if the Board does not act to exclude the acquisition premium from Applicants' net investment bases, the effect will be to severely limit the ability of Consumers and other captive shippers, to effectively enforce their statutory entitlement to maximum reasonable rate protection. Particularly given that the acquisition premium has virtually no connection to the railroads' cost of providing service to these shippers, such a result is directly at odds with the N RTP.

C. Applicants Have Over-Estimated The
Amount Of Revenues Expected From
Post-Merger Diversions Of Motor
Carrier Traffic

Applicants' acquisition premium is a cause for concern because it constitutes a significant fixed charge burden which CSX and NS must recover in order to satisfy the debt and capital markets that provided the initial investment. Despite the enormity of the above-quoted figures, however, CSX and NS confidently proclaim that most of the investment will be quickly recovered via new revenues from diverted intermodal traffic, and operating cost savings. See Application, Vol. 1, at 73-83. By implication, these sources allegedly will lift the burden from captive coal and other bulk traffic. As shown below, Applicants' confidence is misplaced. However, even if the Board assumes that Applicants' estimates regarding future revenues are accurate, preliminary calculations still suggest that there will still be a shortfall of some \$ billion dollars -- the recovery of which has not been addressed by Applicants.⁸ Consumers, and other captive shippers, are the most likely candidates for recovery of this shortfall.

As noted, NS and CSX submit that the majority of the acquisition premium easily will be recovered in the form of cost savings and traffic diversions. See Application, Vol. 1, at 73-

⁸ Volume 1 of the Application (at 73-83) provides a discussion of the CSX's and NS's respective "Market Impact Analysis." Measured against a premium of \$ billion for jurisdictional threshold purposes, a significant balance still remains.

83; see also Application, Vol. 2A, V.S. Bryan at 10-16 (quantifying CSX's expected traffic diversion revenues).

Applicants' assumptions regarding the contribution of diverted motor carrier traffic to the projected net revenue increase, however, appear fraught with absent or shaky foundations that cast serious doubt on their accuracy or reliability.

First, on the most basic level, Applicants assume a seamless and smooth transition to new operations of the Conrail properties by CSX and NS almost instantly upon closing of the transaction. One need only consider briefly the enormous, publicized problems encountered by the Union Pacific system in attempting to integrate the Southern Pacific properties into its network to appreciate the fallacy of this assumption. Indeed, the risk of dislocations and severe operational difficulties should be considered even greater here, as neither CSX nor NS have ever operated in Conrail's territory.

Second, Applicants seem to dismiss a competitive price response by, e.g., motor carriers to an intermodal threat to their current business. Applicants' Witness Bryan, at his deposition, remarked that while some motor carriers may "try to compete on a cost basis with intermodal," he did not believe that they would be successful. See Bryan Depo. Tr. at 143-44. However, it is certainly not logical to assume that the majority of motor carriers will simply watch their traffic, their livelihood, be transferred to rail without a fight. An

examination of Mr. Bryan's diversion analysis reveals the flaws of his reasoning and the tenuous support for his assumptions.

Efficiencies and overall service improvements aside, Mr. Bryan's assumption that motor carriers will price their service no lower than levels that yield a 93.5% operating ratio is unrealistic. Mr. Bryan relies upon the average operating ratio of the most efficient truckers -- 93.5% -- to provide "the surrogate for truck price in the lane." Application, Vol. 2A, V.S. Bryan at A-4; see also Bryan Depo. Tr. at 136-37. In other words, Mr. Bryan assumes that a motor carrier would rather let business divert to rail then set a rate that would produce an operating ratio higher than 93.5%. At Mr. Bryan's deposition, however, this operating ratio was actually exposed as the weighted average of twelve (12) very specific carriers. See Bryan Depo. Tr. at 137-38; see also Document No. CSX 27 CO 000126. As Mr. Bryan's workpapers indicate, of these twelve carriers, at least four (4) had operating ratios greater than 93.5% in 1995. See CSX 27 CO 000126. The record shows that one-third of Mr. Bryan's "sample" carriers, including the second largest carrier in the sample, are willing to conduct their businesses (and compete with railroads) at slimmer profit margins. It is a truism, therefore, that there are motor carriers below the levels assumed by Mr. Bryan who would readily lower their transportation rates in order to keep the business.

Indeed, in the UP/SP merger, Mr. Bryan's Reebe Associates colleague who performed a similar intermodal diversion

analysis, Mr. Don Ainsworth, relied upon an operating ratio of 97% to establish "the surrogate for truck price in the market." See UP/SP Railroad Merger Application, Volume I, at 456. As explained below, Mr. Bryan selectively relies on Mr. Ainsworth's assumptions regarding rail margins. Had Mr. Bryan employed a 97% operating ratio for motor carrier traffic, Applicants' projected revenues would include significantly less revenues diverted from motor carriers.

On the railroad side of the equation, Applicants assume rail revenues based upon a revenue to variable cost ratio (RVC ratio) of 130% for high volume traffic (such as coal traffic), in order to establish the projected rail rates/margins (and resulting revenues) for the new, post-merger expected intermodal rail traffic. See Application, Vol. 2A, V.S. Bryan at A-4. Reliance upon a 130% RVC ratio for western high-volume bulk traffic is unrealistic in terms of eastern intermodal movements.

In the first place, Mr. Bryan did not rely on any documented analysis in assuming a 130 percent RVC ratio with respect to intermodal traffic. Mr. Bryan testified at his deposition simply that the 130% RVC ratio was derived from Union Pacific Railroad Company movements in the western United States. See Bryan Depo. Tr. at 128. Indeed, as mentioned above, Mr. Bryan's RVC ratio is lifted directly from Mr. Ainsworth's testimony in the UP/SP merger, without any explanation as to why an RVC ratio derived from western bulk movements presumptively can serve as a surrogate for eastern intermodal revenues.

Mr. Bryan acknowledged that no specific comparison of eastern and western lanes of rail traffic was performed in order to support the 130% RVC assumption. See Bryan Depo. Tr. at 130, 133. At a minimum, this fact is relevant because eastern intermodal traffic would be expected to operate at an RVC ratio which is substantially less than 130%, in part due to the concentrated urban areas through which much of the traffic must move. Flatter terrain, different seasonal weather patterns and longer hauls likewise should raise a presumption that western RVC ratios on average will be higher than their eastern counterparts.

D. Summary

As discussed above, the acquisition premium is not only very large, it is also a very real threat to captive shippers' access to regulatory protection from future rail pricing abuses. If Applicants' proposed acquisition is approved, it is reasonable to expect that as new revenues begin to fall short of the very optimistic estimates outlined above, NS and CSX will turn to their captive rail traffic to extract higher rail rates in an effort to finance the initial investment. Captive shippers such as Consumers thus are at risk of being forced to foot the bill for Applicants' "Wall Street war." As shown above, however, those shippers legally and fairly cannot be accountable for the burden of a risk that Applicants have voluntarily undertaken. Under applicable law and sound economic policy, they should be protected from that risk.

Applicants may be entitled to spend whatever capital they can raise to acquire Conrail's assets. However, Applicants are not legally entitled to bid-up the price of those assets, and assume that captive shippers' traffic will cover any future shortfalls.

IV

THE TRANSACTION SHOULD BE CONDITIONED UPON TRACKAGE RIGHTS AND THE EXCLUSION OF THE ACQUISITION PREMIUM FROM APPLICANTS' NET INVESTMENT BASES

The Board imposes conditions on proposed consolidations where those conditions will ameliorate the harmful effects of the consolidation, will be operationally feasible, and will produce public benefits which outweigh any reduction to the public benefits produced by the consolidation. See BN/Santa Fe, supra. at 55-56, citing, UP/MP/WP, 366 I.C.C. at 562-65. Consumers requests that, if the proposed acquisition and division of Conrail assets is approved by the Board, the Board impose the following conditions upon Applicants, pursuant to 49 U.S.C. §11344(c).

A. Trackage Rights.

The most effective means by which to protect Consumers from rail market power abuse vis-a-vis future rates to the Campbell Station, would be to open Campbell to effective rail competition. Consumers therefore requests that the Board condition any approval of the subject transaction on the granting of trackage or haulage rights by CSX, on reasonable terms, in

favor of the point of interchange between CSX and (currently) Conrail at Grand Rapids, MI, through Holland, MI to West Olive, MI, a total distance of approximately 36 miles. The requested rights will ameliorate the harmful effects of the consolidation, by neutralizing Consumers' present and future captivity to CSX. The rights are operationally feasible, as no additional traffic would move over the subject lines that was not offset by a commensurate reduction in traffic on alternative lines, and existing facilities are adequate to handle Consumers' coal trains.

Finally, the trackage rights will produce positive public benefits in the form of an enhancement of competition and adequate rail service, without an adverse impact on the purported public benefits which Applicants tout. As the Board has held previously, the ability to raise rates on captive traffic is not a public benefit cognizable in evaluating a proposed consolidation. See UP/CNW, supra at 53.

B. Exclusion Of The Premium From Applicants' Investment Bases.

Likewise, exclusion of the acquisition premium from Applicants' net investment bases for regulatory purposes will eliminate the harmful effects of the consolidation by protecting captive shippers from future railroad pricing abuses. The requested condition is narrowly tailored and will only benefit those shippers who are able to demonstrate, in a regulatory

context, that they are subject to rail market dominance and thus are entitled to regulatory protections.

Exclusion of the premium for Applicants' ratemaking purposes is also feasible. As Mr. Crowley explains, allocation of the value of the premium to a Goodwill Account (i.e., Account 80) is a simple matter for Applicants. See V.S. Crowley at 19-22 and Exhibit __ (TDC-6). If this allocation is adopted, then Board precedent will ensure exclusion of the premium for ratemaking purposes. Docket No. 40581, Georgia Power Co., et al. v. Southern Ry. Co. and Norfolk Southern Corp., Decision served November 8, 1993, at 14 (Appendix A). Applicants' witness Klick agrees. At his deposition, Mr. Klick spoke about the complexity of his URCS analysis and the complexity of railroads' R-1 data upon which he relied for that analysis. See Klick Depo. Tr. at 36-51. Mr. Klick further stated that, in developing his URCS model, the acquisition price of Conrail's assets was simply not relevant. Klick Depo. Tr. at 46-48.

Finally, exclusion of the premium will produce public benefits which outweigh any reduction to the public benefits produced by the consolidation. Only captive shippers will benefit from the requested condition; if a captive shipper does not prove its case, the condition requested herein will have no effect. Exclusion of the premium from Applicants' investment bases has absolutely no adverse effect on the public benefits that Applicants believe will be achieved by the proposed

transaction; the ability to reap monopoly profits
quintessentially is a private, not a public "benefit."

v

CONCLUSION

For all the reasons discussed herein, Consumers respectfully requests that the proposed transaction not be approved. Alternatively, if the Board approves the transaction, Consumers requests that the conditions outlined above be imposed upon Applicants.

Respectfully submitted,

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I certify that I have this 21st day of October, 1997,
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I further certify that copies of the Public Version of
the foregoing Comments were served by first class mail, postage
prepaid on:

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and upon all other parties of record in Finance Docket No. 33388.


Kelvin J. Dowd

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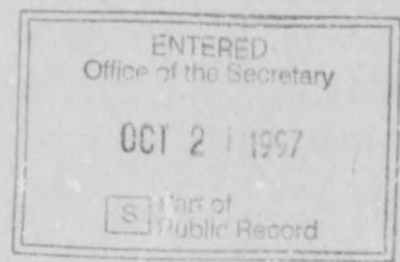
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PUBLIC VERSION
BEFORE THE
SURFACE TRANSPORTATION BOARD

GPU-03

CSX CORPORATION AND CSX)	
TRANSPORTATION, INC. AND NORFOLK)	
SOUTHERN CORPORATION AND)	
NORFOLK SOUTHERN RAILWAY)	Finance Docket No. 33388
COMPANY -- CONTROL AND OPERATING)	
LEASES/AGREEMENTS -- CONRAIL INC.)	
AND CONSOLIDATED RAIL CORPORATION)	

COMMENTS OF GPU GENERATION, INC.



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BEFORE THE
SURFACE TRANSPORTATION BOARD

CSX CORPORATION AND CSX)	
TRANSPORTATION, INC. AND NORFOLK)	
SOUTHERN CORPORATION AND)	
NORFOLK SOUTHERN RAILWAY)	Finance Docket No. 33388
COMPANY -- CONTROL AND OPERATING)	
LEASES/AGREEMENTS -- CONRAIL INC.)	
AND CONSOLIDATED RAIL)	
CORPORATION)	

COMMENTS OF GPU GENERATION, INC.

GPU Generation, Inc. ("GPU"), by and through its undersigned counsel, and in accordance with the procedural orders entered herein by the Surface Transportation Board ("Board"), hereby submits these Comments in response to the Application filed by CSX Corporation and CSX Transportation, Inc. (jointly, "CSX"); Norfolk Southern Corporation and Norfolk Southern Railway Company (jointly, "NS"); and Conrail, Inc. and Consolidated Rail Corporation (jointly, "Conrail") (hereinafter, collectively, "Applicants"). In the Application, CSX and NS seek the Board's approval, pursuant to 49 U.S.C. §§ 11323-11326, for the acquisition and control of Conrail, and for the division, use and operation of Conrail assets between CSX and NS.

For the reasons stated herein, GPU opposes the proposed Application. However, if the Board ultimately approves the Application, GPU requests that it be conditioned, as explained below.

IDENTITY AND INTEREST

Among other operations, GPU runs the coal-fired generation operations for three domestic electric utility companies which serve customers in New Jersey and Pennsylvania. GPU generates electricity, in part, from eight coal-fired generation stations which burn a total of 16 million tons of coal per year. Among these stations are GPU's Portland and Titus Stations, both of which are located in Pennsylvania, and both of which currently rely upon Conrail for the rail transportation of coal.

The Portland Station burns approximately 800,000 tons of coal per year; the Titus Station burns approximately 500,000 tons of coal per year. Together, these two stations generate 642 Megawatts of electricity each year. The Portland and Titus stations currently burn coal which originates in the so-called MGA coal fields and is transported via Conrail under contract arrangements which will expire on December 31, 1998.

Notably, both stations are served only by Conrail at both origin and destination. If the Board approves the proposed transaction, then post-merger, the stations will be exclusively served by NS. NS's control over GPU's rail needs is virtually guaranteed post-merger. This is so because NS's post-merger control over the lines into GPU's stations will negate the effect of CSX's post-merger ability to haul coal from the MGA coal fields -- i.e., GPU expects that NS will not short-haul its transportation to GPU's stations by sharing its business with CSX

post-merger. After 1998, upon expiration of the Portland and Titus coal transportation contracts, GPU will be exposed to financial harm in the form of increased rail rates should this proposed transaction be approved by the Board.

The identity and interest of GPU is explained in further detail in the Verified Statement of Mr. Jerome A. Stephens, submitted herewith.

SUMMARY OF POSITION

GPU submits that the proposed acquisition harms the public interest because the acquisition premium paid by Applicants to Conrail hampers NS and CSX with substantial total fixed charges. GPU strongly suspects that NS and CSX will have difficulty recovering those charges, despite their rosy projections to the contrary. Herein, GPU demonstrates that Applicants' assumptions regarding post-merger cost savings and expected diverted intermodal traffic will simply not generate the required amount of revenues. This is bad news for captive shippers such as GPU because, upon expiration of GPU's existing rail contracts for its Portland and Titus stations, GPU will be exposed to increased NS rail rates if Applicants' projections regarding revenue generation, post-merger, are not met. In other words, captive shippers' market position makes them peculiarly susceptible to financing, via unreasonable rate increases, the "acquisition premium" paid by Applicants for Conrail's assets. The Board therefore must examine the effect of the debt

associated with this acquisition upon the public. See 49 U.S.C. § 11324(b)(3); see also 49 U.S.C. § 10101(1).

As explained herein, GPU thus urges the Board to deny approval of the proposed acquisition, or alternatively, to condition the acquisition to protect GPU and other captive shippers from being forced to subsidize the Conrail acquisition premium through higher rail rates. In support of its position, GPU presents the accompanying Verified Statements of Mr. Stephens and Mr. Thomas D. Crowley, along with the argument of counsel.

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

Finance Docket No. 33388

My name is Jerome A. Stephens, Jr. I am Manager of Fuels for GPU Generation, Inc. My business address is 1001 Broad Street, Johnstown, Pennsylvania 15907. As fuels manager, I have primary responsibility for the procurement and transportation of coal used by GPU¹ in the generation of electricity. The purpose of this statement is to briefly describe to the Surface Transportation Board GPU's overall electric generation system, review the negative impact that approval of the proposed acquisition of Conrail by CSX Corporation (CSX) and Norfolk Southern Corporation (NS) will have on GPU's ability to procure competitive coal transportation rates, and to request that the Board impose as a condition to any approval of this transaction appropriate remedial protection measures that will protect GPU from the these associated harms.

¹ For the purposes of this Statement, references made to GPU shall mean GPU Generation, Inc. only, and not to other GPU, Inc. companies.

I. GPU's Generation Systems

GPU, Inc., a Pennsylvania corporation, is a holding company that owns, among other companies, all the outstanding common stock of three electric utility companies. These companies are Jersey Central Power & Light Company, which serves customers in New Jersey, and Metropolitan Edison Company and Pennsylvania Electric Company, which serve customers in Pennsylvania (collectively, the Utilities). The Utilities conduct business under the name GPU Energy. The generation operations of the Utilities are conducted by my employer, GPU Generation, Inc. and by GPU Nuclear, Inc.

The Utilities own (in whole or in part) and GPU operates 87 electric generation units with a combined capacity of 9,389 megawatts, of which the Utilities own 5,052 megawatts. These generation units use a variety of fuel sources including coal, natural gas, oil, and water for hydroelectric operations. The Utilities have an investment of \$1.1 billion in plant assets. GPU operates eight (3) coal-fired generation stations in Pennsylvania that burn more than 16 million tons of coal per year. These stations represent 6,803 megawatts of capacity, and the Utilities ownership in these plants totals 3,024 megawatts. Of primary concern to GPU in this proceeding are two (2) of our Pennsylvania stations that are part of Metropolitan Edison Company: the Portland Station and the Titus Station.

A. Portland Station

The Portland Station is located 10 miles from Stroudsburg, Pennsylvania, along the west bank of the Delaware River in Northampton County. Portland has two (2) coal-fired production units. These units were completed in 1958 and 1962, and have a combined capacity of 401 Megawatts (Unit 1, 158 megawatts, and Unit 2, 243 megawatts).² Portland burns approximately 800,000 tons of coal per year, and it has the capacity to burn approximately 3,000 tons per day.

B. Titus Station

GPU's Titus Station is located two miles south of Reading, Pennsylvania along the Schuylkill River in Berks County. Titus has three (3) production units, the last going into service in 1953. These units have a combined capacity of 241 megawatts (Units 1 and 3, 81 megawatts each, and Unit 2, 79 megawatts).³ Titus burns approximately 500,000 tons of coal annually, and the units can burn 2,000 tons of coal per day when operating at full capacity.

II. Coal Supply and Rail Transportation Service

GPU has entered into a number of long-term contracts with mining companies for the supply of coal for consumption by

² Portland also has 2 much smaller production units that are combustion turbine units. These two units have a combined capacity of 35 megawatts.

³ Titus also has 2 combustion turbine production units that have a combined capacity of 31 megawatts.

their generating stations. The contracts, which expire at various dates between 1997 and 2007, provide for the purchase of either a fixed or a minimum/maximum amount of the stations' coal needs.

Coal supplied for Portland and Titus arrives via rail from Consol mines located in the Pittsburgh seam along the lines of the former Monongahela railroads. GPU recently entered into a new coal supply contract with Mine 84 that commences January 1, 1998, and continues for five (5) years until December 31, 2002. Under the contract, Mine 84 will supply GPU with up to 1.3 million net tons of coal annually plus or minus twenty (20) percent, depending on market conditions.

Conrail is the sole origin and destination railroad to Portland and Titus. In November, 1994, GPU entered into a coal transportation agreement with Conrail to provide the coal transportation requirements of the Portland and Titus plants from specified MGA coal mines. The transportation contract expires December 31, 1998.

III. The Impact of the Proposed Division of Conrail

Among my responsibilities as fuels supply manager for GPU, I am in charge of securing efficient and economical transportation service for coal used at the Portland and Titus generation stations. As the Board is aware, the presence of competitive intramodal rail transportation alternatives for individual shippers can significantly aid shippers in their efforts to obtain reasonably priced transportation service.

The Portland and Titus stations would remain captive to a single carrier under the Applicants' plan. Under their proposal, NS would control operations over the former Monongahela Railway lines servicing MGA mines, subject to a joint use agreement allowing CSX equal access to all facilities that are served by the former Monongahela Railway. (see Volume 3A, at 255). Mine 84 is not part of the Applicants' MGA joint service arrangement, and will be exclusively served by NS. Likewise, NS will control all of the current Conrail lines that serve Titus and Portland. Simply put, if the Applicants' proposed division of Conrail is approved, NS will be the only carrier capable providing Portland and Titus with coal transportation service.

GPU's most significant concern with the proposed division of Conrail by CSX and NS is the substantial acquisition premium that the Applicants have paid for Conrail assets. The exact calculation of the premium paid in this case is a complicated issue, and GPU has retained an expert witness, Mr. Thomas Crowley, to elaborate on the premium situation in more detail. Mr. Crowley has performed a comprehensive study of the Conrail price premium and its impact, which is included as a part of GPU's comments. His study reflects that for regulatory purposes, the premium paid by CSX and NS for Conrail amounts to between \$7.7 and \$9.1 million. (See Crowley V.S., at 3).

One need only look to the financial markets and the bidding war that erupted between CSX and NS over the purchase of Conrail to see the cause of this exorbitant acquisition cost

premium. Conrail's common stock was trading at \$71 per share the day before CSX and Conrail's initial acquisition announcement made last October. After months of "one-upmanship" with competing offers made by CSX and NS, the final joint purchase price for Conrail's shares was set last spring at \$115 dollars per share -- an approximately 65 percent increase over pre-announcement trading levels.

As explained above, the Portland and Titus stations are presently captive to Conrail, and post-merger these stations will be captive to NS. The present transportation contract for Portland and Titus will expire in 1998, and if the Applicants' proposal is approved, GPU will soon thereafter be attempting to negotiate with NS over coal transportation service and rates. Meanwhile, NS will be under great pressure to maximize earnings on coal traffic, because of the premium being paid to acquire Conrail's assets, and will be actively seeking opportunities to increase revenues. GPU is extremely concerned that absent protection from the Board, we will be a prime candidate for NS to pass through this premium in the form of substantial rate increases.

GPU's only recourse to combat future transportation price increases may be to seek regulatory rate protection from the Board through a maximum rate case. As is demonstrated by Mr. Crowley in his accompanying Verified Statement, however, if the Board does not protect captive customers like GPU by excluding from CSX and NS's rate bases the extraordinary acquisition

premium costs associated with Conrail, GPU's prospects for rate relief would be substantially inhibited. It is well-understood that a key component both of the determination whether the Board has jurisdiction over a rate, and of the maximum reasonable rate that is allowed, is the relationship of the rate to the railroad's variable cost of service. According to Mr. Crowley's study, if the Conrail acquisition is approved, and NS records the purchase premium in its regulatory investment base, its calculated variable cost of service will be inflated accordingly. In fact, for a "typical" NS utility coal movement, the Board's jurisdictional threshold levels for obtaining rate relief will be increased by an average of 24 percent (or about \$2.00 per ton). (See Crowley V.S., at 4). This increase in the threshold of railroad rate immunity amounts to a direct potential subsidy of NS's purchase of Conrail by captive shippers, such as GPU.

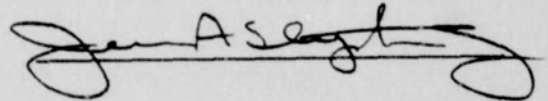
The Board must take action in this proceeding to protect exclusively-served shippers like GPU from the rate-related harms associated with the Applicants' proposed acquisition plan. For the above discussed reasons, GPU requests that the Board impose a protective condition assuring that the acquisition premium will not adversely affect regulatory rate-making if, in the future, GPU decides to institute a rate proceeding before the Board. This condition will help ensure that GPU, the Utilities, and their customers retain the rights and protections they now have, and that those rights will not be

eroded simply because of CSX's and NS's tender offer battle for
Conrail.

Verification

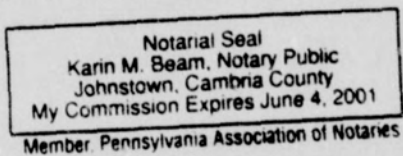
State of Pennsylvania)
)
) ss:
)
County of Cambria)

Jerome A. Stephens, Jr., 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 to the best of his knowledge, information and belief.



Subscribed and sworn to before me
on this 17th day of October,
1997.

Karin M. Beam
Notary Public in and for the
State of Pennsylvania



Crowley

PUBLIC VERSION

**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
Consumer Energy Company
and
GPU Generation, Inc.

Due Date: October 21, 1997

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LIST OF EXHIBITS

<u>EXHIBIT NO.</u> (1)	<u>DESCRIPTION</u> (2)
1	Statement of Qualifications
2	Development of Premium Paid for Conrail Assets
3	Impact of Conrail Premium on Variable Cost and Jurisdictional Threshold for Average CSX Coal Movement
4	Impact of Conrail Premium On Variable Cost and Justificational Threshold for Average NS Coal Movement
5	Impact of Conrail and Conrail Premium on 1996 Revenue Adequacy Calculations
6	1995 Conrail Book Value -- Schedule 352B Investment and 335 Accumulated Depreciation

I. 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 to this verified statement as Exhibit __ (TDC-1).

If the CSX/NS^{1/} acquisition of Conrail^{1/} is approved in its current form, CSX/NS will pay a substantial premium for the Conrail assets. If this substantial premium is added into the CSX and NS investment accounts, the Surface Transportation Board's ("STB") determination of the revenue adequacy of CSX and NS will decline artificially i.e., the CSX's and NS' return on investment as calculated for revenue adequacy purposes will decline. Additionally, the STB's Uniform Railroad Costing System ("URCS") unit costs for both CSX and NS will be artificially increased because of the premium, which translates into higher jurisdictional threshold levels. The jurisdictional threshold level is used both to identify traffic that is subject to the STB's jurisdiction and to set a floor for rate setting purposes.

L.E. Peabody & Associates, Inc. was retained by Consumer Energy Company and GPU Generation, Inc. to conduct certain economic analyses related to the premium that CSX/NS proposes to pay to acquire Conrail, as well as the impact the proposed premium will have on the STB's calculation of CSX's and NS' revenue adequacy status and the jurisdictional threshold level for rate setting purposes. Specifically, Consumers and GPU requested that I perform the following analyses which are the subject of this verified statement:

^{1/} CSX Corporation and CSX Transportation, Inc. ("CSX")/Norfolk Southern Corporation and Norfolk Southern Railway Company ("NS") proposed acquisition of Conrail Inc. and Consolidated Rail Corporation ("Conrail").

1. Identify and quantify the amount that the total consideration being paid by CSX and NS for Conrail exceeds Conrail's historic book value of assets;
2. Illustrate the impact of including CSX's portion of the premium into CSX's cost structure on the jurisdictional threshold for a hypothetical eastern utility coal movement;
3. Illustrate the impact of including NS' portion of the premium into NS' cost structure on the jurisdictional threshold for a hypothetical eastern utility coal movement;
4. Quantify the impact of including the premium on CSX's and NS' revenue adequacy status; and,
5. Explain how the premium can be excluded from the CSX's and NS' investment accounts for regulatory costing and revenue adequacy purposes.

My comments are organized under the following topical headings:

- II. Summary and Findings
- III. Identification of Premium for Regulatory Purposes
- IV. Impact of Premium on Jurisdictional Threshold
- V. Impact of Premium on Revenue Adequacy Determination
- VI. Proposed Remedy

II. SUMMARY AND FINDINGS

The following summary and findings are supported by the analyses contained in the balance of my verified statement and accompanying exhibits and are based on my review of CSXT's and NS's documents supporting their purposed acquisition of Conrail, including their witnesses' verified statements and workpapers.

Specifically, my summary and findings include:

1. CSX/NS are paying a significant premium for Conrail that will adversely effect future revenue adequacy and jurisdictional threshold calculations.
2. Table 1 below summarizes the CSX/NS premium for both revenue adequacy and jurisdictional threshold purposes.

Table 1 CSX and NS Premium to Acquire Conrail (\$ in Billions)		
<u>Item</u> (1)	<u>For Revenue Adequacy Purposes</u> (2)	<u>For Jurisdictional Threshold Purposes</u> (3)
1. CSX		
2. NS		
3. Total		

3. I have included CSX's portion of the Conrail premium into a CSX/Conrail URCS formula and calculated the variable cost of providing service for the average CSX coal train movement based on the characteristics of a typical eastern utility coal train identified by CSX's Witness Sharp. I compared the results to CSX's cost of providing service for the average coal train without the premium. Table 2, Column (2) summarizes my results on both the variable cost and jurisdictional threshold calculations.

4. I performed the same analysis using a combined NS/Conrail URCS formula and NS' portion of the Conrail premium. Table 2, Column (3) summarizes the results of this analysis.

<p align="center">Table 2 Impact of Conrail Premium on Variable Costs and Jurisdictional Threshold</p>		
<p align="center"><u>Item</u> (1)</p>	<p align="center"><u>CSX</u> <u>Amount</u> <u>Per Ton</u> (2)</p>	<p align="center"><u>NS</u> <u>Amount</u> <u>Per Ton</u> (3)</p>
1. <u>Variable Cost Per Ton</u>		
a. Without the Conrail Premium		
b. With the Conrail Premium		
c. % Increase		
2. <u>Jurisdictional Threshold Per Ton</u>		
a. Without the Conrail Premium		
b. With the Conrail Premium		
c. % Increase		
<p>Source: Exhibit __ (TDC-3) for CSX and Exhibit __ (TDC-4) for NS.</p>		

By including the premium CSX is paying for Conrail in CSX's URCS formula, both the variable cost of providing service and the resulting jurisdictional threshold associated with the average CSX coal train movement will increase by __% . Similarly, by including the premium NS is paying, the variable cost of service and resulting jurisdictional threshold for a comparable NS movement would increase by __%.

4. When the Conrail premium is included with NS and CSX revenue adequacy calculations based on existing STB's procedures, the NS' and CSX's return on investment are adversely impacted because they are artificially reduced as summarized in Table 3 below.

Table 3
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 Finding For NS	13.0%
3. STB's 1996 Revenue Adequacy Finding For CSX	8.9%
4. 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-5), Columns (8) and (9).

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 both Conrail and the Conrail premium are included in the STB's revenue adequacy calculations.

5. The adverse impact on the jurisdictional threshold and revenue adequacy calculations of including the Conrail premium can 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 procedures, debits placed in Account 80 will be excluded from revenue adequacy calculations. Also monies placed into Account 80 for regulatory costing purposes will not impact the railroads' variable unit costs based on existing URCS procedures. This remedy easily can be implemented by the carriers, with no additional accounting or administrative burden.

III. IDENTIFICATION OF PREMIUM FOR REGULATORY PURPOSES

CSX and NS are purchasing Conrail shares for \$__ billion^{2/}. The book value of Conrail shares equal \$__ billion^{3/}. According to CSX's and NS' testimony and data, their preliminary appraised value of Conrail assets is estimated at \$__ billion^{4/}, which can be contrasted to the historical gross book value of Conrail's assets which equals \$__ billion^{5/}. The purchase price has been allocated __% to CSX and __% to NS.

A premium occurs when an acquiring railroad pays a amount in excess of the acquired railroad's historical book value. In this case, the premium largely results from escalating tender offers made by CSX and NS between October, 1996 and February, 1997, when each was seeking to acquire Conrail separately. Whether a premium is reflected on the carrier's backs 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 apply 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 equal 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^{6/}.

^{2/} 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.

^{3/} 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.

^{4/} Preliminary estimates of the appraised value of Conrail made by Price Waterhouse.

^{5/} 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.

^{6/} In the last three mergers, the acquisition costs exceeded the historical book value. These three mergers were Union Pacific/Southern Pacific ("UP/SP"), Burlington Northern/Santa Fe ("BNSF") 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. In none of these cases, however has the STB been called upon to rule on the legitimacy of the carriers' treatment of the premium for regulatory purposes.

**A. PREMIUM FOR
REGULATORY PURPOSES**

If left in its current form, the premium that CSX and NS are paying for Conrail will artificially lower the STB's annual revenue adequacy calculations for CSX and NS. The reduction will be artificial because the increase in net investment would not be the result of any increase in the actual value of Conrail's assets as instrumentalities of transportation. Additionally, the premium will 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 under STB jurisdiction and also used as a floor for regulatory rate setting purposes.

The quantification of the premium may be different for revenue adequacy calculations than it is 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^{7/}.

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.^{8/} The reason the premium may be higher for this regulatory purpose is that the

^{7/} A railroad's assets are determined for revenue adequacy purposes in accordance with GAAP Cost. GAAP Cost equals "...the value of the resources forgone by the entity to acquire the assets. All GAAP Cost, as applied in business combinations, is acquisition cost...". Acquisition Cost equals "...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, pages 59 and 115.

^{8/} CFR 49 Part 1201, Rule 2-15.

railroads have the option to utilize appraised (fair) value instead of acquisition cost when assets are acquired for other than cash^{9/}.

I have estimated the premium paid by CSX and NS for Conrail's assets for both revenue adequacy and jurisdictional costing purposes. A summary of the premium calculations is shown in Table 4 below.

Table 4 Summary of CSX and NS Premium Paid for Conrail (\$ in Millions)		
<u>Item</u> (1)	<u>For Revenue Adequacy Purposes</u> (2)	<u>For Jurisdictional Threshold Purposes</u> (3)
1. CSX ^{1/}		
2. NS ^{2/}		
3. Total		
^{1/} Based on of total.		
^{2/} Based on of total.		
Source: Exhibit __ (TDC-2).		

The results of my analysis is a premium of \$ _ _ billion for revenue adequacy purposes and \$ _ _ billion for regulatory costing purposes.

^{9/} The appraised (fair) value option was followed in recording the road and equipment values for the BNSF 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.

IV. IMPACT OF PREMIUM ON JURISDICTIONAL THRESHOLD

If the premium CSX and NS are paying for Conrail is 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 impact on the STB's jurisdictional threshold calculations to the detriment of a captive shipper seeking regulatory relief from unreasonable rail rates. This detrimental impact will come in two forms.

First, the STB determines whether or not it has jurisdiction over a specific shipper movement by comparing the challenged 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, it will take a higher rate to trigger STB jurisdiction over a captive shipper's movement than would be the case absent the premium. In other words, the railroad could impose greater rate increases and still remain immune from STB scrutiny.

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, in a given case 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.

To illustrate the impact of including the Conrail premium for regulatory costing purposes, I solved the CSX and NS URCS formulas presented by their witnesses in this proceeding assuming that each accounted for the acquisition premium by including the premium in the individual investment property accounts. I then applied these artificially inflated unit costs to an average coal movement to determine the impact of the premium on the jurisdictional threshold level of hypothetical CSX and NS coal movements, again assuming the premium is improperly included in their system of accounts. The results of my analysis are summarized below.

A. INCLUSION OF THE PREMIUM

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. These Form R-1 monies 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^{10/}, the variable costs and jurisdictional threshold for the movement being considered will increase significantly.

^{10/} Based on procedures followed in UP/CNW and BNSF mergers, the railroads have been revaluing the investment amounts in these property accounts without regard to correct accounting rules.

The first step I followed in developing the jurisdictional threshold impact was to record CSX's and NS' portion of the Conrail premium in their respective property accounts^{11/}. 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 unit costs including the Conrail premium for each carrier.

**B. EXAMPLE OF IMPACT ON
AVERAGE CSX COAL MOVEMENT**

During CSX's Witness Sharp's deposition, he described the characteristics of an average eastern unit coal train movement. Specifically, at pages 292-306 of his deposition, Witness Sharp identified the following characteristics as typical for a unit train hauling eastern coal to an electric utility:

Table 5 <u>Average Unit Coal Train Characteristics</u>	
<u>Item</u> (1)	<u>Amount</u> (2)
1. Average loaded direction haul -- miles	
2. Cars per train	
3. Net tons per car	
4. Railcar owner	

^{11/} I followed the methodology used by the railroads in the BNSF merger and the UP/CNW merger.

I applied Witness Sharp's average coal train characteristics to URCS unit costs that are based on CSX operations plus the portion of Conrail that CSX is purchasing. I developed the CSX/Conrail unit costs two different ways i.e., with and without CSX's portion of the premium that it is paying for Conrail. The results of this application is summarized in Table 6 below.

Table 6 Impact of Conrail Premium on CSX Variable Costs and Jurisdictional Threshold	
Item (1)	Amount Per Ton (2)
1. <u>CSX Variable Cost Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	
2. <u>CSX Jurisdictional Threshold Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	
Source: Exhibit __ (TDC-3).	

Table 6 above shows that if the premium that CSX is paying for Conrail is incorrectly included in CSX's system of accounts, CSX's variable cost of service and the resulting jurisdictional threshold will be inflated by __% or over \$_. per ton.

**C. EXAMPLE OF IMPACT ON
AVERAGE NS COAL MOVEMENT**

I next applied the same coal train characteristics identified in Table 5 above to URCS unit costs that are based on NS operations plus the portion of Conrail that NS is purchasing. I developed the NS/Conrail unit costs two different ways, i.e., with and without NS' portion of the premium that it is paying for Conrail. The results of this application are summarized in Table 7 below.

Table 7
**Impact of Conrail Premium on
NS' Variable Costs and Jurisdictional Threshold**

<u>Item</u> (1)	<u>Amount Per Ton</u> (2)
1. <u>NS Variable Cost Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	
2. <u>NS' Jurisdictional Threshold Per Ton</u>	
a. Without the Conrail Premium	
b. With the Conrail Premium	
c. % Increase	

Source: Exhibit __ (TDC-4).

Table 7 above shows that if the premium that NS is paying for Conrail is incorrectly included in NS' system of accounts, NS' variable cost of service and the resulting jurisdictional threshold will increase by __% or by over \$_.__ per ton.

V. 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 annually 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 railway operating income...divided by a calculated net investment base".^{12/} 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 8 below.

Table 8 <u>STB's 1996 Revenue Adequacy Findings</u>	
<u>Item</u> (1)	<u>Amount</u> (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-5), Columns (2) through (4).	

^{12/} 364 I.C.C. at 821.

Table 8 demonstrates that in 1996 and based on the STB's revenue adequacy procedures, NS is a revenue adequate railroad and CSX and Conrail are approximately three points below the revenue adequacy level.

In order to test the impact on NS and CSX revenue adequacy calculations of their acquisition of Conrail, I first combined Conrail with NS and CSX based on each railroad's acquisition percentage i.e., NS is acquiring __% of Conrail and CSX the remaining __%. The results of this combination, before the premium that NS and CSX paid for Conrail is considered, on the STB's revenue adequacy calculation is shown in Table 9 below.

Table 9
**Impact on STB's 1996 Revenue Adequacy Findings
of Combining Conrail with NS and CSX
Before The Premium is Considered**

<u>Item</u> (1)	<u>Amount</u> (2)
1. STB's 1996 Cost of Capital Rate	11.9%
2. STB's 1996 Revenue Adequacy Calculations Assuming ^{1/}	
a. NS and of Conrail	
b. CSX and of Conrail	

^{1/} Source: Exhibit __ (TDC-5), Columns (5) and (6).

When NS' portion of Conrail is included before the premium is considered, NS' return on net investment declines from 13.0% (Table 8, Line 2a) to __. __% (Table 9, Line 2a). Similarly, when CSX's portion of Conrail is included before the premium is considered, CSX's return on net investment declines from 8.9% (Table 8, Line 2b) to __. __% (Table 9, Line 2b). These

results are in line with expectations, given Conrail's relative underperformance as compared to CSX and NS (particularly NS).

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 the NS and CSX acquisition percentages i.e., __% for NS and __% for CSX;
3. I eliminated Conrail's booked accumulated depreciation in quantifying the premium paid for Conrail's assets for revenue adequacy purposes. This adjustment equals \$__ billion;
4. I included the annual depreciation associated with the Conrail premium; and,
5. The Conrail premium was reduced by \$.__ billion to reflect new deferred taxes.

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 drop dramatically and wholly disproportionate to Conrail's relative performance for 1996. 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 ___% of Conrail and Conrail Premium	
b. CSX and ___% of Conrail and Conrail Premium	

^{1/} Source: Exhibit __ (TDC-5), Columns (7) through (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. As I noted above, these reductions are not attributable to Conrail's actual financial performance or a change in the intrinsic value of its assets. Rather, they are simply the artificial, arithmetic result of reflecting in regulatory costs the consequence of CSX's and NS' 1996-1997 tender offer battle.

VI. PROPOSED REMEDY

Simply stated, the premium NS and CSX paid for Conrail should not impact either the jurisdictional threshold calculation of an individual captive movement or the annual revenue adequacy determination of either NS or CSX. To include the premium for either purpose is to require captive shippers and others dependent on the STB's regulatory costing procedures to subsidize CSX's and NS' bidding war. In order to avoid this adverse and improper 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:

A. Revenue Adequacy Calculations

B. Jurisdictional Threshold Calculations

A. REVENUE ADEQUACY CALCULATIONS

For purposes of revenue adequacy calculations, Conrail's net railway operating income ("NROI") and net investment base should be identified at pre-acquisition or existing book levels. These monies then should be separated between NS and CSX on the basis of each railroad's acquisition percentage, i.e., __% for NS and __% for CSX. 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 adjustments to 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**

<u>Item</u> (1)	<u>Return on Investment</u>	
	<u>NS</u> (2)	<u>CSX</u> (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-5).

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, and are consistent with an absorption of Conrail that reflects its actual performance.

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. The adjustment is straight forward, and does not involve any additional accounting or record keeping steps or other administrative burdens on the Carriers.

B. JURISDICTIONAL THRESHOLD CALCULATIONS

For regulatory costing purposes, the STB and its predecessor, the Interstate Commerce Commission ("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,^{13/} the ICC required the property values recorded on the ICC

^{13/} Docket No. 32153, Uniform System of Accounts for Railroad Companies.

valuation records for each railroad to 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"^{14/15/16/}.

In order to maintain consistency with these regulatory costing principles in accounting for the Conrail acquisition, the STB should continue to use the accounting procedures it has in place. Specifically, the STB should 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 artificially inflated. Again, this is an adjustment which easily can be made by the carriers without additional administrative cost or effort.

I have developed Exhibit __ (TDC-6) 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.

^{14/} Annual Report, 1964, page 54.


^{15/} 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).

^{16/} 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.

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

Sworn to and subscribed
before me this 17th day
of October, 1997.

Witness my hand and official seal.

James M. Welter
Apr 15/31/98

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

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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.

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

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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

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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.

Development of Premium Paid for Conrail Assets 1/

Item (1)	Amount (Millions) (2)
Revenue Adequacy Premium	
1 Total Cost to CSX/NS of Conrail Shares Acquired	2/
2 Book Value of Conrail Shares	2/
3 Value of Eliminated Accumulated Depreciation and Asset Disposition	3/
4 Premium for Revenue Adequacy Purposes	4/
Regulatory Costing Premium	
5 Appraised Value of Conrail Assets	2/
6 Gross Book Value of Conrail Assets	2/,3/
7 Premium for Regulatory Costing Purposes	5/
Premium Deferred Taxes	
8 Deferred Taxes associated with Fair Value	6/

1/ The Conrail Premium is measured on two bases, an Acquisition basis for Revenue Adequacy Purposes and an Appraisal basis for Regulatory Costing and Jurisdictional Threshold Purposes.

2/ Whitehurst Deposition Exhibit No. 1.

3/ Conrail's 1995 Form 10-K Page 45, Asset Disposition equals \$285 million and Accumulated Depreciation equals \$2,102 million.

4/ Line 1 - Line 2 + Line 3.

5/ Line 5 - Line 6.

6/ Whitehurst Deposition Exhibit No. 1 identifies CSX's portion of deferred taxes. By dividing this amount by CSX's share of Conrail, total deferred taxes are calculated. Deferred taxes reduce the investment base for both revenue adequacy and regulatory costing.

Note: The Revenue Adequacy Premium is based on Acquisition Cost. The Railroad Accounting Principles Board ("RAPB") adopted GAAP costs as the basis for valuing the railroads assets for Revenue Adequacy Purposes. The RAPB defined GAAP costs as "The value of the resources forgone by the entity to acquire the assets. GAAP cost, as applied in business combinations, is acquisition cost except in a "pooling of interests." GAAP cost is the net book values of the pooling entities."

Note: The Regulatory Costing Premium is based on Appraisal Cost. Recent railroad mergers have used appraised value or fair market value in adjusting the acquired assets of the purchased railroad. The last two mergers (i.e. BNSF and UP/CNW) used appraised value in adjusting the property accounts of the acquired railroads.

**Impact of Conrail Premium on Variable Cost and Jurisdictional Threshold
For Average CSX Coal Movement**

A. Movement Assumptions For Costing

	Source
1. Line Haul Miles	Sharp Deposition Page No. 306
2. Car Train	Sharp Deposition Page No. 292
3. Tons Net Load Per Car	Sharp Deposition Page No. 292
4. Railcar is Owned and Provided by CSX	Sharp Deposition Page No. 296
5. Ex Parte No. 270 (Sub 4) Unit Train Adjustments	STB Methodology
6. CSXT's Premium Equals \$ Billion - Exhibit_(TDC-2) \$ Billion times CSX share of Conrail	Whitehurst Exhibit -1, CRC 1995 10-K and Klick Electronic Workpapers

B. Variable Cost and Jurisdictional Threshold

Item (1)	Source (2)	1995 CSXT W/CRC Portion of Premium (3)
Without Premium		
7. Variable Cost Per Ton	Phase III URCS	
8. Jurisdictional Threshold Per Ton	Line 7 x 1.80	
With Premium		
9. Variable Cost Per Ton	Phase III URCS	
10. Jurisdictional Threshold Per Ton	Line 9 x 1.80	
Increase		
11. Increase In Variable Cost or Jurisdictional Threshold	(Line 9 + Line 7) or (Line 10 + Line 8)	

**Impact of Conrail Premium on Variable Cost and Jurisdictional Threshold
For Average NS Coal Movement**

A. Movement Assumptions For Costing

	Source
1. Line Haul Miles	Sharp Deposition Page No. 306
2. Car Train	Sharp Deposition Page No. 292
3. Tons Net Load Per Car	Sharp Deposition Page No. 292
4. Railcar is Owned and Provided by NS	Sharp Deposition Page No. 296
5. Ex Parte No. 270 (Sub 4) Unit Train Adjustments	STB Methodology
6. NS's Premium Equals \$ Billion - Exhibit_(TDC-2) \$ Billion times NS share of Conrail	Whitehurst Exhibit -1, CRC 1995 10-K and Klick Electronic Workpapers

B. Variable Cost and Jurisdictional Threshold

Item (1)	Source (2)	1995 NS W/CRC Portion of Premium (3)
Without Premium		
7. Variable Cost Per Ton	Phase III URCS	
8. Jurisdictional Threshold Per Ton	Line 7 x 1.80	
With Premium		
9. Variable Cost Per Ton	Phase III URCS	
10. Jurisdictional Threshold Per Ton	Line 9 x 1.80	
Increase		
11. Increase in Variable Cost or Jurisdictional Threshold	(Line 9 + Line 7) or (Line 10 + Line 8)	

IMPACT OF CONRAIL AND CONRAIL PREMIUM ON
1996 REVENUE ADEQUACY CALCULATIONS

Railroad (1)	1996 STB FINDING			CSX & NS With CR		CSX & NS With CR And Acquisition Premium		
	Conrail (2)	CSX (3)	NS (4)	CSX With CR 4/ (5)	NS With CR 4/ (6)	Conrail Premium (7)	CSX With CR 5/ (8)	NS With CR 5/ (9)
Combined/Consolidated NROI	435,305	610,621	787,725					
+ Interest From Working Cap. Cash	253	8,929	12,835					
+ Inc Tax Non-rail	(6,166)	3,241	23,660					
- Incremental Depreciation	0					1/		
+ Net gain transfers	11,014	13,133	16,646					
** Adjusted NROI **	440,406	635,924	840,866					
Comb Net Inv R&E End	6,591,515	9,482,069	8,912,338			2/		
Comb Net Inv R&E Start	6,355,952	8,949,689	8,589,425			2/		
Comb Net Inv R&E Av	6,473,734	9,215,879	8,750,882					
OE Inv End	0	0	0					
OE Inv Start	0	0	0					
OE Inv Av	0	0	0					
IDC End	0	0	3,014					
IDC Start	0	0	3,197					
IDC Av	0	0	3,106					
Net Rail Rel Ass. End	23,017	0	0					
Net Rail Rel Ass. Start	31,919	0	0					
Net Rail Rel Ass. Av	27,468	0	0					
Work Cap End	144,679	123,537	267,241					
Work Cap Start	206,202	109,665	268,265					
Work Cap Av	176,441	116,601	267,753					
Acc Def Tax End	1,484,091	2,310,618	2,612,504			3/		
Acc Def Tax Start	1,400,411	2,063,544	2,524,852			3/		
Acc Def Tax Av	1,442,251	2,187,081	2,568,678					
Tax Adj Net Inv Base End	5,275,120	7,294,988	6,564,061					
Tax Adj Net Inv Base Start	5,195,662	6,995,810	6,329,641					
* Tax Adj Net Inv Base *	5,235,391	7,145,399	6,446,851					
TAX ADJUSTED ROI	8.4%	8.9%	13.0%					

1/ CSX workpapers --CSX 26 HC 000210

2/ The Premium for Revenue Adequacy Purposes is \$ Billion ((Acquisition minus Book Cost) Plus Eliminated Accum. Depreciation) -- Exhibit_(TDC-2)
Line 1 Minus Line 2 Plus Line 4

3/ Whitehurst Deposition Exhibit No. 1 identifies CSX's portion of deferred taxes. By dividing this amount by CSX's share of Conrail, total deferred taxes are calculated.

4/ CSX = Column (2) x plus Column (3); NS = Column (2) x plus Column (4)

5/ CSX = Column (5) + of Column (7); NS = Column (6) + of Column (7)

1995 Conrail Book Value --
Schedule 352B Investment and 335 Accumulated Depreciation

Line No	Account	Gross Investment			Accumulated Depreciation		
		Conrail 1995 Schedule 352B Column (b)	1995 CSXT Schedule 352B Column (b) 2/ (4)	1995 NS Schedule 352B Column (b) 2/ (5)	Conrail 1995 Schedule 335 Column (g)	1995 CSXT Schedule 335 Column (g) 3/ (7)	1995 NS Schedule 335 Column (g) 3/ (8)
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	(2) Land	\$109,942			\$0		
2	(3) Grading	209,689			22,811		
3	(4) Other ROW	2,586			757		
4	(5) Tunnels and subways	27,688			2,874		
5	(6) Bridges, trestles	227,358			51,941		
6	(7) Elevated Structures	2,575			2,769		
7	(8) Ties	1,294,855			201,778		
8	(9) Rails and Other Track Material	2,503,630			304,233		
9	(11) Ballast	877,012			(10,865)		
10	(13) Fences, snowsheds, & signs	1,309			543		
11	(16) Station & office Bldgs	183,645			59,494		
12	(17) Roadway Bldgs	11,937			4,574		
13	(18) Water Stations	480			343		
14	(19) Fuel Stations	33,619			8,964		
15	(20) Shops and enginehouses	84,747			33,860		
16	(22) Storage warehouses	0			0		
17	(23) Wharves and docks	936			58		
18	(24) Coal and ore wharves	79,151			23,957		
19	(25) TOFC/COFC terminals	77,212			31,587		
20	(26) Comm systems	121,275			76,965		
21	(27) Signals & interlockers	368,989			131,446		
22	(29) Power Plants	1,140			476		
23	(31) Power Trans	8,981			5,293		
24	(35) Misc. Struct	3,868			530		
25	(37) Roadway Machines	98,537			73,495		
26	(39) Public improvements	43,207			5,225		
27	(44) Shop machinery	52,041			27,817		
28	(45) Power-plant machinery	3,739			3,198		
29	Other	0			45,569		
30	Amortization Adjustments	0			438,536		
31	TOTAL ROAD	\$6,430,148			\$1,548,228		
32	(52) Locomotives	\$1,138,328			\$469,155		
33	(53) Freight-train cars	741,841			313,823		
34	(54) Passenger-train cars	0			0		
35	(55) Highway Revenue	2,790			1,920		
36	(56) Floating Equipment	0			0		
37	(57) Work Equipment	84,682			50,271		
38	(58) Misc Equipment	31,401			26,735		
39	(59) Computer Equipment	79,785			62,374		
40	Amortization Adjustments	0			300		
41	TOTAL EQUIPMENT	\$2,078,827			\$924,578		
42	(76) Interest during Const				\$0		
43	(80) Other elements of investments				0		
	(90) Construction work in progress				0		
	GRAND TOTAL		1/		\$2,472,806		

1/ Estimated Fair Value -- Deposition Exhibit No. 1 - W. W. Whitehurst, value in Account 80 equals premium shown in Exhibit (TDC-2), Line 7

2/ Column (3) x CSXT- or NS-

3/ Column (6) x CSXT- or NS-

L. E. PEABODY & ASSOCIATES, INC.
ECONOMIC CONSULTANTS

BEFORE THE
SURFACE TRANSPORTATION BOARD

CSX CORPORATION AND CSX)	
TRANSPORTATION, INC. AND NORFOLK)	
SOUTHERN CORPORATION AND)	
NORFOLK SOUTHERN RAILWAY)	Finance Docket No. 33388
COMPANY -- CONTROL AND OPERATING)	
LEASES/AGREEMENTS -- CONRAIL INC.)	
AND CONSOLIDATED RAIL)	
CORPORATION)	

ARGUMENT

GPU respectfully submits that the proposed acquisition and division of Conrail's assets between CSX and NS is not in the public interest and should not be approved. As explained below, the transaction generates significant additional fixed charges in the form of an "acquisition premium,"¹ the recovery of which is highly speculative. Because the recovery of the premium is uncertain, GPU and other captive shippers face an increase in exposure to unreasonable rail rates from the Applicants' unchecked regulatory cost allocation choices. Accordingly, GPU submits that the transaction should not be approved absent a condition that protects captive coal shippers from future rail pricing abuse by controlling the regulatory cost allocation of the acquisition premium.

¹The amount and source of the acquisition premium is discussed infra in Part II.

I. THE PUBLIC INTEREST STANDARD

The proposed acquisition and division of Conrail is subject to the Board's review pursuant to the ICC Termination Act of 1995, Pub. L. No. 104-88, 109 Stat. 803 (1995) ("ICCTA"). As the Board has explained, the "single and essential standard of approval" for merger transactions is the public interest standard set forth at 49 U.S.C. §11324(b)(1) and (2). Finance Docket No. 32760, Union Pacific Corp., Union Pacific R.R. Co., and Missouri Pacific R.R. Co. -- Control and Merger -- Southern Pacific Rail Corp., Southern Pacific Transp. Co., St. Louis Southwestern Ry. Co., SPCSL Corp., and The Denver and Rio Grande Western R.R. Co., Decision No. 44, served August 12, 1996, at 98 (unprinted) ("UP/SP").²

The statutory provisions that define the parameters of the Board's public interest analysis for rail consolidations are set forth at 49 U.S.C. §§11321-27. Among other factors, the Board must consider "the total fixed charges that result from the proposed transaction" (49 U.S.C. §11324(b)(3)), and whether claimed or perceived public benefits are overshadowed by purely private benefits, which accrue solely to the merging carriers at the expense of the public. See CSX Corp. -- Control -- Chessie and Seaboard C.L.I., 363 I.C.C. 518, 551-52 (1980). As the

²Citing, Missouri-Kansas-Texas R.R. Co. v. United States, 632 F.2d 392, 395 (5th Cir. 1980), cert. denied, 451 U.S. 1017 (1981); Penn-Central Merger and N&W Inclusion Cases, 389 U.S. 486, 498-99 (1968).

former Interstate Commerce Commission stated in its UP/CNW decision:

[B]enefits to the combining carriers which are the result of increased market power, such as the ability to increase rates at the same or reduced service levels, are exclusively private benefits that detract from any public benefits associated with the control transaction.

See Finance Docket No. 32133, Union Pacific Corp., Union Pacific R.R. Co. and Missouri Pacific R.R. Co. -- Control -- Chicago and North Western Transp. Co. and Chicago and North Western Ry. Co., Decision served February 21, 1995, at 53.

Of particular importance to GPU in this case, the Board's public interest analysis also must be informed by the Congressional goals set forth in the National Rail Transportation Policy ("N RTP"), especially those which speak to the need to protect captive shippers and maintain the integrity of regulatory cost-finding and rate-making functions. See UP/CNW, supra, at 53-54, citing, Norfolk Southern Corp. - Control - Norfolk & W. Ry. Co., 366 I.C.C. 171, 190 (1982). For example, the N RTP directs the Board, among other factors, to:

- * Maintain reasonable rates where there is an absence of effective competition;
- * Prohibit predatory pricing and practices, avoid undue concentrations of market power and prohibit unlawful discrimination; and
- * Ensure the availability of accurate cost information in regulatory proceedings.

See 49 U.S.C. §10101(1), (6), (12) and (13).

Consistent with the breadth of its oversight and review responsibilities, the Board has broad authority to protect and promote the public interest by imposing conditions on rail consolidations so as to reduce or eliminate its detrimental effects. See Union Pacific -- Control -- Missouri Pacific; Western Pacific, 366 I.C.C. 459, 562-64 (1992), aff'd sub. nom. Southern Pacific Transp. Co. v. I.C.C., 736 F.2d 708 (D.C. Cir. 1984), cert. denied, 469 U.S. 1208 (1985). See also 49 U.S.C. §11324(c). Where harmful effects are shown to result from a proposed consolidation or control transaction, conditions are appropriate if:

[T]he conditions will ameliorate or eliminate the harmful effects, will be operationally feasible, and will produce public benefits (through reduction or elimination of the possible harm) outweighing any reduction to the public benefits produced by the merger.

Finance Docket No. 32549, Burlington Northern Inc. and Burlington Northern R.R. Co. -- Control and Merger -- Santa Fe Pacific Corp. and The Atchison, Topeka and Santa Fe Ry. Co., Decision No. 38, served August 23, 1995, at 55-56 (unprinted) ("BN/Santa Fe"). Cf. Lamoille Valley R.R. Co. v. Interstate Commerce Comm'n, 711 F.2d 295, 300 (D.C. Cir. 1983).

In these Comments, and in the attached testimony of Messrs. Stephens and Crowley, GPU demonstrates that unless the carriers are prohibited from including the Conrail acquisition premium in their regulatory rate bases, that premium will make it much more difficult for shippers, like GPU, who are captive to

one of the carriers for service, to establish the Board's jurisdiction over and to seek relief from unreasonable rail rates on coal, pursuant to 49 U.S.C. §10701 et seq. In essence, a business risk that rightfully should rest squarely and solely on the Applicants -- that they paid too much for Conrail³ -- unfairly would be shifted to coal and other rail-dependent shippers. Accordingly, if the Board determines that approval of the instant transaction is warranted, then the public interest requires that the Board impose the condition described below in order to protect GPU's legitimate right to reasonable coal rates.

II. AS PROPOSED, THE TRANSACTION IS NOT
CONSISTENT WITH THE PUBLIC INTEREST

The "total fixed charges" arising from the proposed acquisition and division of Conrail include the premium that Applicants NS and CSX have paid for the company and its assets. See 49 U.S.C. §11324(b)(3). As used in these Comments, "acquisition premium" refers to the amount paid by CSX and NS for controlling interests in Conrail, in excess of the book value of Conrail's assets. To the extent that captive shippers such as GPU are forced to subsidize Applicants' recovery of the premium via higher rail rates, approval of the subject transaction would directly contravene multiple goals of the NRTP. GPU submits that in order to protect captive shippers from such a result, the

³See McClellan Depo. Tr. at 86. References herein to the transcripts of witness depositions taken in this proceeding are indicated by the witness' name, followed by "Depo. Tr." and the appropriate page reference. An Appendix to these Comments contains excerpts from the deposition transcripts cited herein.

Board must intervene to ensure that only the book value of the Conrail assets being acquired is included in CSX and NS's investment bases for regulatory costing purposes.

A. The Book Value Of Conrail's Assets Should Determine Applicants' Future Regulatory Investment Bases.

As Mr. Crowley demonstrates, depending on the regulatory purpose to be served, the potential size of the premium varies from \$ billion to \$ billion. See V.S. Crowley, at 6-8 and Exhibit____(TDC-2). The majority of this premium is directly linked to the bidding war which led to a sixty-five percent (65%) increase in the price paid for Conrail by CSX and NS over pre-tender stock trading levels. See V.S. Stephens, at 5-6. Applicants may be entitled to spend any amount they wish to acquire Conrail's assets, so long as they and their shareholders bear the risk of recovery. However, at either above-stated amount, the premium is an extraordinarily high figure relative to the net book value of Conrail's assets (\$3.2 billion). See V.S. Crowley, at 6. The obvious fact that Applicants (and their financiers) will be looking to recover the value of their investment lies at the heart of the problem this transaction causes for captive shippers.

GPU submits that only the uninflated (by the premium) net book value of Conrail's assets is properly allocable to CSX's and NS's investment bases for regulatory costing purposes. In this manner, the risk that Applicants have paid too much for Conrail will be placed exactly where it belongs -- upon

Applicants.⁴ In no case should captive traffic bear the burden of that risk, particularly where GPU and other captive shippers in no way are assured an allocated share of any additional profits which might arise from the proposed transaction if the Applicants' revenue projections prove conservative. See Democratic Central Comm. v. Washington Metro. Area Transit Comm'n, 485 F.2d 786, 806-07 (D.C. Cir. 1973) ("[t]he proposition that capital gain rightly inures to the benefit of him who bore the risk of capital loss has been accepted in ratemaking law").⁵

Long-standing precedent in the area of utility maximum rate regulation holds that acquisition-related asset write-ups are not properly includable in a utility's investment base. Were this not the case, "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. F.P.C., 299 F.2d 111 (D.C. Cir. 1962); cf. Farmers Union Cent.

⁴In Montana Power Co. v. Federal Energy Regulatory Comm'n, 599 F.2d 295, 299-300 (9th Cir. 1979), the court observed that "[t]he task of regulation is to prevent consumers from bearing more than their fair share of [the burden of the cost of their vendors' plant facilities] in industries where competitive forces do not otherwise protect them."

⁵See also Williston Basin Interstate Pipeline Co. v. Federal Energy Regulatory Comm'n, 115 F.3d 1042, 1044 (D.C. Cir. 1997) (stating that "a rule assigning the firm the benefit of good outcomes and customers the burden of bad ones a kind of 'heads, I win, tails, you lose' rule, would seem to give the utility's management an unhealthy incentive to gamble").

Exch. v. United States, 734 F.2d 1486, 1528 (D.C. Cir. 1984) (an oil pipeline attempted to include acquisition costs in its rate base and was prohibited from doing so).⁶

As the Federal Energy Regulatory Commission has explained in closely analogous contexts, the reason why acquisition premiums should be excluded from rate bases is that "a mere change in ownership should not result in an increase in the rate charged for a service *if the basic service rendered itself remains unchanged.*" Docket No. OR79-1-000, Williston Pipe Line Co., 21 FERC ¶ 61,260, at 61,635, quoted in part in Farmers Union, 734 F.2d at 1528 n.78. Indeed, the "purchase price is not entitled to any recognition at all for ratemaking purposes." Id. at 61,636. In this case, GPU's basic rail service will remain essentially unchanged; GPU thus should not be expected to bear the risk of Applicants' substantial acquisition premium.

Applicants' witnesses intuitively accept the fact that an investment base calculated by reference to acquisition price instead of book value is inappropriate for regulatory costing purposes. For example, CSX's witness John Klick recognized that for purposes of constructing a 1995 Uniform Rail Costing System ("URCS") analysis for the combined CSX/Conrail railroad (assuming

⁶To the same effect, see Transcontinental Gas Pipe Line Corp. v. Federal Energy Regulatory Comm'n, 652 F.2d 179, 180 (D.C. Cir. 1981); see also Montana Power Co., 599 F.2d at 300 ("the original cost method has been applied to property acquisitions by utilities to prevent utilities from artificially inflating their rate bases by acquiring properties at unrealistically high prices"); Northwestern Elec. Co. v. F.P.C., 321 U.S. 119 (1944).

approval), the book value of the assets procured was the relevant figure. See V.S. Klick, Application, Volume 1, at 429; see also Klick Depo. Tr. at 47 (acknowledging that acquisition price was not relevant for purposes of URCS calculations). Consistent with this conclusion is the more colloquial -- though equally relevant -- testimony of NS' witness McClellan, who confirmed in his deposition that recovery of the acquisition premium is "a risk NS takes." See McClellan Depo. Tr. at 86.⁷

In sum, pursuant to legal precedent and economic policy considerations, Applicants cannot and should not be able to guarantee their future ability to pass-through the risk of an underrecovery of the acquisition premium to their captive customers (through the medium of higher rail rates). That risk should be placed squarely upon Applicants.

B. Absent Board Action, The Premium Would Expose Captive Shippers To Unreasonable Rates.

Given the importance of the proper allocation of the acquisition premium for regulatory costing purposes, it is conspicuous, if not ominous, that Applicants have offered no assurances that the premium will not be included in their investment bases for purposes of future rail rate regulation.⁸

⁷See also Depo. Tr. Snow, Exh. 4 (May 8, 1997 letter to CSX "customers" stating that "we [CSX] do not see raising prices as the path to funding this acquisition").

⁸In its financial statements, CSX does acknowledge the existence of its portion of the acquisition premium. See Application, Volume 7A, at 441. CSX notes that it intends to utilize acquisition cost accounting procedures to track this debt. Id. The public is not told, however, where exactly the premium will fit under such procedures. Applicant NS does not

For captive shippers, however, the risk of resultant future unreasonable rail rates is real, because as Mr. Crowley demonstrates, inclusion of the premium in a regulatory costing context simultaneously deflates a carrier's performance for revenue adequacy purposes, and inflates its variable costs. See V.S. Crowley, at 1, 7. The proper determination of a carrier's revenue adequacy and its variable costs, which form the very heart of the Board's maximum reasonable rate regulation authority, thus would be distorted against the interest of the shipper. See 49 U.S.C. §10701 et seq.

1. Inclusion of the Premium in Applicants' Rate Bases Artificially Favors a Finding of Revenue Inadequacy.

Rates charged by a revenue inadequate railroad are subject to less scrutiny by the Board. See Coal Rate Guidelines Nationwide, 1 I.C.C.2d 520, 547 n.70 (1985), aff'd. sub nom. Consolidated Rail Corp. v. United States, 812 F.2d 1444 (3rd Cir. 1987). In his testimony, Mr. Crowley analyzes and quantifies the effect of inclusion of the Conrail premium in Applicants' investment bases for revenue adequacy purposes. Mr. Crowley concludes that overall, the amount of NS's and CSX's debt will be significantly greater than revenues generated, the effect of which is to ensure that the carriers are deemed seriously "revenue inadequate" (thus subjecting their rates to lesser scrutiny by the Board). See V.S. Crowley, at 15-18.

address accounting procedures for the premium at all.

As recently determined by the Board, the 1996 railroad industry cost of capital was 11.9%. See STB Ex Parte No. 552 (Sub-No. 1), Railroad Revenue Adequacy - 1996 Determination, Decision served August 14, 1997, at 1. Pursuant to this determination, NS was deemed revenue adequate. Id., at 4. Assuming the Conrail transaction had taken place in 1996, if Conrail's assets were valued at book value then CSX's return on investment would have equalled %; NS's return on investment likewise would have fallen modestly, to %. See V.S. Crowley, at 16-17 and Exhibit____(TDC-5). This result would be expected and not particularly alarming, as it generally reflects Conrail's underperformance relative to NS and CSX. Id. In contrast, however, if Conrail's assets are valued at acquisition price, CSX's return on investment drops to %, while NS's return on investment plummets to %. See V.S. Crowley, at 17-18 and Exhibit____ (TDC-5).

The negative impact for revenue adequacy purposes of including the premium in Applicants' investment bases is both obvious and substantial: Applicants will be pushed farther away from the goal of revenue adequacy, and captive shippers will be farther away from the additional rate scrutiny that revenue adequacy brings. Coal Rate Guidelines, 1 I.C.C.2d at 547 n.70. The end result, then, is that Applicants' rates will face less scrutiny by the Board, essentially for no reason other than the decisions of CSX and NS top management to engage in a proxy war for Conrail in 1996. For the Board to permit such an outcome is

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to stand the revenue adequacy promotion element of the N RTP on its head.

2. Inclusion of the Premium in Applicants' Rate Bases Raises the Jurisdictional Threshold at which Captive Shippers May Seek Rate Relief.

Equally if not more important than the effect of the premium upon Applicants' revenue adequacy status is the potential effect of the premium upon the determination of the Applicants' variable cost of service. The higher a carrier's variable costs, the higher the rate it may charge a shipper before triggering the Board's 180% revenue-variable cost jurisdictional threshold for market dominance. See 49 U.S.C. §10707. As Applicants' own witness Sansom confirmed, if the Conrail acquisition premium is included in the net investment base used to calculate variable costs, then captive shippers -- i.e., those who rely on a market dominant carrier for service -- would face both higher rates and a higher jurisdictional threshold for access to rate review by the Board. See Sansom Depo. Tr. at 133-35.

If the Board permits Applicants to insinuate the acquisition premium into their investment bases, GPU's jurisdictional threshold for rate review will be raised, thus raising the bar to GPU's ability to demonstrate to the Board that its market-dominant carrier (NS, post-acquisition), is exploiting its market power. This result undermines the Board's statutory responsibility to maintain just and reasonable rail rates in the absence of effective competition. See H.R. Rep. 96-1430, 96th Cong., 2nd Sess. 88 (1980), reprinted in 1980 U.S.C.C.A.N. 4110,

4120; see also Western Coal Traffic League v. United States, 719 F.2d 772, 778 (5th Cir. 1983)(en banc), cert. denied 466 U.S. 953 (1984).

As Mr. Crowley shows, if the premium is included in Applicants' net investment bases for regulatory costing purposes, the effective jurisdictional threshold for a typical NS unit train coal movement will increase by %. See V.S. Crowley, at 4, 13-14 and Exhibit____(TDC-4). In other words, the hypothetical NS-captive shipper's quantifiable exposure (in the form of increased rail rates) from the inclusion of the acquisition premium in the net investment bases could equal \$ per ton (based on a \$ billion dollar premium for jurisdictional threshold purposes). See V.S. Crowley, at 13-14 and Exhibit____(TDC-4). The stated amount is a significant penalty to impose upon GPU and other captive shippers, who were merely innocent bystanders to CSX's and NS' Wall Street battle. Moreover, this penalty would be in addition to NS's enhanced ability to hide from Board scrutiny behind its "revenue inadequate" status should GPU successfully demonstrate that NS is market dominant vis-a-vis its coal traffic. In rate terms, the inflated variable cost means a multi-million (or billion) dollar subsidy of the Conrail acquisition by captive shippers which would be statutorily immune from Board scrutiny.

C. GPU And Other Captive Shippers Are
At Risk For Future Pricing Abuses.

As Mr. Stephens explains in his testimony, the Portland and Titus Stations are currently captive to Conrail for rail transportation; if the transaction is approved, the stations will be captive at destination to NS. See V.S. Stephens, at 3-4.

Upon expiration of its current coal transportation arrangements in 1998, GPU's principal avenue of protection from NS' pricing aspirations (assuming the transaction is approved) will be the Board's jurisdiction over maximum reasonable rates. The Board's protection at that time is paramount, because captive shippers are peculiarly susceptible to carrier attempts to extract the highest rate possible from their customers. Even Applicants' witnesses concur that railroads try to maximize their profits on individual movements. See Bryan Depo. Tr. at 140 ("[a]ll carriers are trying to get as much out of a market as they can"); Sharp Depo. Tr. at 43-44. Couple this predisposition with the motive -- or need -- produced by a multi-billion dollar investment recovery obligation, and the risk to captive coal traffic of rail pricing abuses becomes immediate and palpable.

If the Board does not act to exclude the acquisition premium from Applicants' net investment bases, the effect may be to severely limit the ability of GPU and other captive shippers to effectively enforce their statutory entitlement to maximum reasonable rate protection. Particularly given that the acquisition premium has virtually no connection to the railroads'

cost of providing service to these shippers, such a result is directly at odds with the NRTP. See 49 U.S.C. §10101 (6), (12).

D. Applicants Have Over-Estimated The Amount Of Revenues Expected From Post-Merger Diversions Of Motor Carrier Traffic.

Despite the enormity of the acquisition premium, CSX and NS confidently proclaim that most of the Conrail investment will be quickly recovered via new revenues from diverted intermodal traffic and operating cost savings. See Application, Volume 1, at 73-83; see also V.S. Bryan, Application, Volume 2A, at 250-56 (quantifying CSX's expected traffic diversion revenues). By implication, these sources allegedly will lift the burden from captive coal and other bulk traffic. As shown below, however, Applicants have seriously over-estimated the amount of revenues that the merger will generate.

The highly publicized and ongoing difficulties and system dislocations experienced by the Union Pacific in its effort to conclude its acquisition and integration of the Southern Pacific provide stark testimony to the fallacy of Applicants' claim that from "Day One," they will begin to realize the projected efficiencies and other benefits of their Conrail plan. This fact standing alone casts grave doubts on the veracity of Applicants' pre-acquisition, optimistic net revenue projections. However, even if the Board assumes that Applicants' estimates regarding future revenues are accurate, preliminary calculations still suggest the existence of a remaining shortfall of approximately \$ billion dollars -- the recovery of which has

not been addressed by Applicants. See V.S. Crowley, at 6-8; see also Application, Volume 1, at 73-83. GPU, and other captive shippers, are the most likely candidates for recovery of this shortfall.

Applicants' assumptions regarding the contribution of diverted motor carrier traffic to the projected net revenue increase cannot be considered accurate or reliable. In the first place, Applicants seem to assume away a competitive price response by motor carriers to an intermodal threat to their current business. Applicants' Witness Bryan, at his deposition, remarked that while some motor carriers may "try to compete on a cost basis with intermodal," he did not believe that they would be successful. See Bryan Depo. Tr. at 143-44. However, it is not logical to assume that the majority of motor carriers would stand idly by and suffer significant diversions of longstanding customers and revenues to rail.

At the heart of witness Bryan's unrealistic projection is his assumption that motor carriers will price their service no lower than levels that yield a 93.5% operating ratio is simply unrealistic. Mr. Bryan relies upon the average operating ratio of the most efficient truckers -- 93.5% -- to provide "the surrogate for truck price in the lane." V.S. Bryan, Application, Volume 2A, at 261 (Appendix A); see also Bryan Dep. Tr. (August 13, 1997), at 136-37. In other words, Mr. Bryan assumes that a motor carrier would rather let business divert to rail than set a rate that would produce an operating ratio higher than 93.5%. At

Mr. Bryan's deposition, this operating ratio was exposed as the weighted average of twelve (12) specific carriers. See Bryan Depo. Tr. at 137-38. As Mr. Bryan's workpapers indicate, however, of these twelve carriers, at least four (4) had operating ratios greater than 93.5% in 1995. See CSX 27 CO 000126. Thus, one-third of Mr. Bryan's sample are willing to conduct their businesses and compete with railroads at profit margins below the minimum levels assumed by Mr. Bryan -- in order to keep the business.⁹

Likewise, Applicants assume rail revenues based upon an average revenue to variable cost ratio of 130% for high volume traffic (such as coal traffic), to establish the projected rail rates and margins for new, post-acquisition intermodal rail traffic. See V.S. Bryan, Application, Volume 2A, at 261 (Appendix A). However, Mr. Bryan did not rely on any documented analysis to support the 130% ratio, and testified at his deposition that the 130% ratio was derived from Union Pacific Railroad Company movements in the western United States. See Bryan Depo. Tr. at 128. No explanation is offered as to why a ratio derived from western bulk movements presumptively can serve as a surrogate for eastern intermodal revenues. See UP/SP

⁹In the UP/SP merger, Mr. Bryan's firm sponsored a similar intermodal diversion analysis, which relied upon an operating ratio of 97% to establish "the surrogate for truck price in the market." See UP/SP Railroad Merger Application, Volume I (dated November 30, 1995), at 456. Had Mr. Bryan employed a 97% operating ratio for motor carrier traffic, Applicants' projected revenues would include significantly less revenues diverted from motor carriers.

Railroad Merger Application, Volume I (dated November 30, 1995), at 457; see also Bryan Depo. Tr. at 130, 133 (noting that no specific comparison of eastern and western lanes of rail traffic was performed). This lack of supporting analysis further undermines Applicants' rosy revenue projections, for intuitively, highly competitive eastern intermodal traffic would be expected to operate at lower margins than less demand-elastic western bulk traffic. Fewer urban centers, flatter terrain, different seasonal weather patterns and longer hauls likewise should raise a presumption that western ratios on average will be higher than their eastern counterparts.

F. Summary.

If the proposed acquisition is approved, GPU expects that as new revenues begin to fall short of the very rigorous estimates assumed in the Application, NS and CSX will turn to their captive rail traffic to extract higher rail rates in an effort to finance the initial investment. However, if captive shippers later attempt to challenge these increased rates, the effect of including the acquisition premium in Applicants' rate bases will block -- or at least severely impede -- their avenue to seek rate protection under 49 U.S.C. §10701 et seq. Such a result imposes a tremendous risk upon captive shippers for which they neither legally nor fairly can or should be accountable.

III. THE TRANSACTION SHOULD BE CONDITIONED UPON THE
EXCLUSION OF THE ACQUISITION PREMIUM FROM APPLICANTS'
NET INVESTMENT BASES

The Board imposes conditions on proposed consolidations where those conditions will ameliorate the harmful effects of the consolidation, will be operationally feasible, and will produce public benefits which outweigh any reduction to the public benefits produced by the consolidation. See BN/Santa Fe, supra, at 55-56, citing, UP/MP/WP, 366 I.C.C. at 562-65. Pursuant to 49 U.S.C. §11344(c), GPU requests that, if the proposed acquisition and division of Conrail is approved by the Board, the Board quantify the amount of the acquisition premium and direct that that amount be excluded from Applicants' net investment bases for regulatory costing purposes.

Exclusion of the acquisition premium from Applicants' will ameliorate the harmful effects of the consolidation by maintaining captive shippers existing protections from railroad pricing abuses, protections which likely will be more necessary as the Applicants consolidate their market power and strike out to recover their investment. The requested condition is narrowly tailored, however, and will only benefit those shippers who are able to demonstrate, in a regulatory context, that they are subject to rail market dominance and thus are entitled to regulatory protection.

Exclusion of the premium for Applicants' ratemaking purposes is also feasible. As Mr. Crowley explains, allocation of the value of the premium to a goodwill account (i.e., Account

80) is a simple matter for Applicants (see V.S. Crowley, at 19-22 and Exhibit____(TDC-6)), and would ensure that those monies do not infiltrate and inflate the costing process. See Docket No. 40581, Georgia Power Co., et al. v. Southern Ry. Co. and Norfolk Southern Corp., Decision served November 8, 1993, at 14 (Appendix A). The testimony of Applicants' witness Mr. Klick further supports this remedy. At his deposition, Mr. Klick referenced the complexity of the URCS analysis and the data upon which one relies for such an analysis. See Klick Depo. Tr. at 36-51. Mr. Klick confirmed that in developing URCS unit costs in a post-acquisition world, the acquisition price that Applicants paid for Conrail -- as distinguished from its book value -- was not relevant. Klick Depo. Tr. at 46-48.

Exclusion of the premium will produce public benefits with no reduction in the public benefits produced by the consolidation. It is well-recognized that the extraction of higher rates from shippers subject to railroad market power -- the only interest "adversely" affected by GPU's requested remedy -- is not a public benefit to be protected in evaluating consolidation conditions. See UP/CNW supra at 53. Finally, a decision by the Board at the present time to exclude the premium will not place an undue accounting or administrative burden upon Applicants. See V.S. Crowley, at 20, 22.

* * *

For all the reasons discussed herein, GPU respectfully requests that the proposed transaction be denied. Alternatively, if the Board approves the transaction, GPU requests that the acquisition premium exclusion condition described above be imposed upon Applicants.

Respectfully submitted,

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Dated: October 21, 1997

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CERTIFICATE OF SERVICE

I certify that I have this 21st day of October, 1997,
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I further certify that copies of the Public Version of
the foregoing Comments were served by first class mail, postage
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and upon all other parties of record in Finance Docket No. 33388.


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