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signals and traffic control on its entire distance. It is a high-speed 60 mph route (79 mph for passenger) that has seen substantial investment. By contrast, Conrail has downgraded the PRR route systematically since the mid-1980's. The line is single track with passing sidings, and many of those sidings have been removed. For example, there is only one passing siding in the now NS-owned segment from Fort Wayne to Hobart, IN, 115 miles. Conrail has removed 235 miles of signals on the line from Bucyrus to near Chicago, effectively reducing maximum speeds to 49 mph. Amtrak diverted its passenger trains off the line in 1990, citing low speeds. Most of the rail is jointed rail, unsuitable for major increases in tonnage without replacement or upgrading. Conrail recently attempted to abandon much of the line because of the lack of on-line business and lack of need for a through route, but portions of the line were retained only by sale to NS (Fort Wayne - Hobart, IN) and by usage by daily Triple Crown RoadRailer trains (east of Fort Wayne). Thus, from a capacity and running time standpoint, the "PRR" route is clearly incapable of substituting for the current Conrail routing via Cleveland.

Second, If the "PRR" route were to be fully allocated to NS as a Cleveland bypass, NS would then control three of the four New-York Chicago routes across Ohio, leading to a potential competitive imbalance resulting from the transaction.

#### **W&LE route from Orrville to Bellevue.**

In theory, this route could be used in combination with the PRR route discussed above from Alliance to Orrville, OH, and then via what would be a new connection to the W&LE route from Orrville to Bellevue, and thence west on existing NS routes from Bellevue

to Chicago, avoiding Cleveland. This could provide an alternate route for some PRR line traffic to the West to bypass Cleveland.

I address the deficiencies of this route fully in this Statement in my response to a similar suggestion by the W&LE for NS use of this route. To summarize those arguments: First, the route is not owned by either NS, CSX or Conrail, so use would need to be negotiated with an outside party. Second, the line is not currently in a condition to be usable as a mainline route. There is no usable connection at Orrville, OH. The line lacks sufficient sidings (one 40- mile segments has no sidings), and part of the signal system has been removed. The rail on the line, while welded, is approximately 50 years old and would require replacement if substantial tonnage were to be routed over the line. The line is currently suitable for 40 mph speeds, but would need major upgrading to support the 60 mph speeds comparable to the NS route via Cleveland.

#### **Other Alternatives**

No other suitable alternatives exist. The next nearest NS east-west lines pass through West Virginia or Tennessee. Use of these routes for Northeast-Midwest service would result in higher costs, poor service, and thus massive diversions of traffic to trucks. This would undermine the public benefits to be derived from the transaction.

## West Virginia Secondary Line

Commenters such as the West Virginia State Rail Authority ("WVSRA") and the West Virginia Association for Economic Development through the Joint Use of Conrail Tracks by Norfolk Southern and CSX ("WVED") propose that CSX be given trackage rights over the West Virginia Secondary line that is to be operated by Norfolk Southern. This is another variation on the theme that because some shared assets areas have been created, other ones should be as well.

Neither trackage rights nor any other form of additional two carrier service or shared assets should be imposed on the West Virginia Secondary line.

Applicants are addressing the requests for expansion of or creation of new shared asset areas generally in their narrative response to issues. That general response will apply to the West Virginia Secondary line, as well. The following comments deal specifically with the West Virginia Secondary line and comments asking that it receive shared asset or other dual status.

The WVED states that 4,000 miles of Conrail tracks are to receive joint access by NS and CSX. The actual number of miles with joint local access is much smaller. There are to be three shared asset areas, the definitions of which are summarized in Volume 1 of the Application, pages 46-49, and equal access usage by CSX to the former Monongahela Railway lines to be operated by NS. The North Jersey Shared Assets Area includes approximately 189 route miles of track. The South Jersey/Philadelphia Shared Assets Area includes approximately 240 route miles of track. The Detroit Shared Assets Area includes



approximately 85 route miles of track. In addition, Conrail lines formerly a part of the Monongahela Railway will be operated by NS, but CSX will have equal access. The Monongahela is defined in the Monongahela Usage Agreement (Volume 8C, page 715 of the Application) to include 191.9 miles of line.

The CSX and NS Operating Plans in Volumes 3A and 3B of the Application and the related agreements indicate that other trackage rights agreements relate to overhead traffic, or overhead access to "2-to-1" points that would otherwise be created as part of the transaction.

Despite comments that imply that points along the West Virginia Secondary will suffer a reduction in service, the transaction will not reduce the number of rail carriers serving points along the West Virginia Secondary line. Only one rail carrier, Conrail, currently generally serves points on the line. NS will be substituted for Conrail as the operator of the line. NS currently only serves one point -- Alloy, WV -- along the line, and generally does not serve the section of the State served by the line. Thus, the commenters seeking two-carrier service along this line are not seeking to fix any adverse effects of the transaction, such as reduction in the number of carriers serving locations on the line.

There is no local service on this line. Companies that became rail service customers located along the line with the knowledge they would be served by only one railroad. NS and CSX have pledged to maintain reciprocal switch access to the companies in the area that currently enjoy such service.

Because CSX maintains a parallel line on the opposite riverbank for almost the entire distance of the line, the area has a choice of rail service providers. There are few barriers to

transload and intermodal competition -- indeed many coal operators in the area often truck their coal to CR, CSX or use the river depending on who provides the most efficient transportation option.

Only one chemical shipper has joined in the WVED filing despite the location of several major chemical companies along the West Virginia Secondary line, and WVED's contention of harm to those companies. This may be due to a number of factors, including: (a) the companies' realization that NS service will be as good or better than current service, (b) the chemical plants in West Virginia have other transportation options, including barge and motor carrier service, (c) chemical plants in West Virginia may not produce the same products as those produced in New Jersey, and (d) many of the chemical manufacturers or users can negotiate volume discounts in rates based on their use of rail service at other locations.

Moreover, NS' sole operation of the West Virginia Secondary will result in new investments and service improvements on the line and on the connecting NS Deepwater, WV-Elmore WV line ("Deepwater line") to the south that will enhance the competitive circumstances of shippers located on the West Virginia Secondary line even without dual operation of the line. No rail customers in West Virginia will face a loss of competitive rail options. In fact, rail customers on the West Virginia Secondary line will have the advantage of direct, single-line service to a much larger territory than they do now.

NS' commitment to the area is shown by its willingness to invest over \$10 million dollars in its Deepwater line to the south of Charleston, WV in order to provide shippers on

the West Virginia Secondary and Deepwater lines with efficient service over new or shorter routes to both the south and east. The new NS single-line route to the south will shorten shipment distances between Charleston, WV and Atlanta, GA from the current 802 miles over the joint Conrail-NS route to 601 miles over a single-line NS route. Similarly, the new single-line NS route between Charleston, WV and Baltimore, MD via the Deepwater line will be 492 miles as contrasted to 810 miles over the current Conrail line between these two points.

WVED's assertions concerning possible future neglect of this line if it is served by one carrier are belied by the fact that NS will immediately invest substantial sums in order to serve the line and to grow traffic on what will be NS' sole line in this part of the State. NS operation of this line will better balance the competition between NS and CSX in this part of the State

NS lease and operation of the West Virginia Secondary line is expected to spur coal development along the line because coal producers along the line will have new single-line routes to new and existing markets, such as export markets over Norfolk, VA and electric utility markets in the southern United States. Currently, development of these coal markets on Conrail is limited due to its circuitous route to eastern markets.

Contrary to WVED's suggestion, some reciprocal switching now exists between the CSX's partially parallel line on the other side of the Kanawha River from the West Virginia Secondary line. (Also, CSX already has access to one of the listed members of WVED, Elkem Metals at Alloy, W V.) Many of the large shippers on the line also have access to

competitive barge service.

For all these reasons, and the general reasons stated in the narrative, requests of parties for local trackage rights over or shared asset area status for the West Virginia Secondary line should be rejected.

### **Chicago Metra**

I have reviewed the delay data supplied by Chicago Metra in conjunction with Metra's demand that CP 518 be dispatched as to avoid any potential of freight delay to Metra trains.

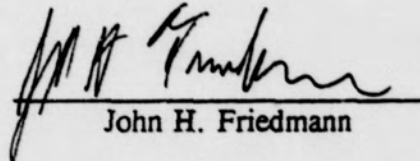
First, this is a pre-existing condition, and Metra has shown no evidence that the delays will be worsened by NS' assumption of Conrail's role at CP 518. Second, the delays mentioned by Metra at CP 518 are hardly significant when viewed in the context of the overall number of Metra trains passing through CP 518.

In 1996, the last full year for which data is available, Metra ran 3234 trains through CP 518. According to Metra, those trains incurred 43 delays totaling 363 minutes in the entire year 1996. This works out to a delay of about one in 75 trains, or one delay every six working days. Averaged among all the Metra trains traversing CP 518, the amount of delay totals just over one-tenth of a minute per train, or about seven seconds.

For Metra to compile such a record, especially through a corridor that has volumes of both parallel and crossing freight train activity, Conrail must have been according Metra the appropriate high priority as dictated in the 1989 CR/Metra agreement.

## VERIFICATION

John H. Friedmann, states under penalty of perjury, that he is Director, Strategic Planning, Norfolk Southern Corporation, Norfolk, Virginia, that he is authorized to file and verify the foregoing verified statement in STB Finance Docket No. 33388 on behalf of the applicants, that he has carefully examined all the statements in the foregoing verified statement, that he has knowledge of the facts and matters stated therein, and that all representations set forth therein are true and correct to the best of his knowledge, information and belief.



John H. Friedmann





**Paints**

Norfolk Southern Corp.

DEC 10 1997

December 8, 1997

Strategic Planning  
ICI Paints North America

925 Euclid Avenue  
Cleveland  
Ohio 44115 U S A

Telephone (216) 344-8000  
Fax (216) 344-8900

Mr. Vernon A. Williams  
Secretary  
Surface Transportation Board  
1925 K Street, N.W.  
Washington, DC 20423

Dear Mr. Williams:

RE: CSX/NS Conrail Transaction, STB Finance Docket No. 33388  
Cleveland Comments

My name is Gerald E. Brown and I am Corporate Transportation Manager for ICI Paints with Cleveland area facilities located at 925 Euclid Avenue, Cleveland OH 44115. My Company had previously submitted a letter of support for the joint application of CSX and NS to acquire Conrail and had urged the STB to approve the transaction giving my Company greater market penetration through single-line service and competitive pricing to, from and within the eastern United States.

The purpose of this letter is to strongly reiterate that support. It has come to my attention that the City of Cleveland and the Honorable Mayor White have expressed serious concerns over the impact of increased frequencies of trains through certain neighborhoods of Cleveland. Furthermore, the City and Mayor White have stated that the City of Cleveland, its residents and businesses, will not see any noticeable benefits from this transaction. While I appreciate the City's concerns for the impact on local neighborhoods, I believe the NS plans offer enormous economic benefits to the City, its residents and businesses. As most of this new traffic is intermodal, the expected increased train traffic will be far less disruptive to local neighborhoods than more trucks traversing roads in Cleveland and northern Ohio.

My Company employs 1500 Cleveland area residents. For this facility to stay competitive in the face of a global economy, Cleveland area businesses need a variable, strong rail network that the transaction will produce. Competitive rail service offers my Company and others the opportunity to expand and enhance employment prospects for Cleveland residents.

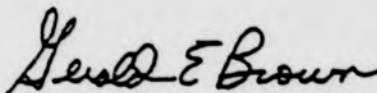
I have serious reservations about suggestions that NS restructure or alter a solid operating plan. These suggestions lack economic or transportation justification. I expressed support for the transaction because I believe that those plans, if implemented, would translate into significant advantages to my Company. Deviations from that plan could place my and other Cleveland businesses dependent on rail service at a competitive disadvantage vis-a-vis other industrial Midwestern cities. I cannot stress enough that in order to grow and employ more residents, we cannot jeopardize the efficient, cost-effective rail service this plan represents. Using alternative trucking is more expensive and affects my Company's ability to compete successfully. Besides, trucks pollute far more than rail. They damage our roads, and increase the tax burden on citizens and businesses. These types of costs determine whether businesses locate or expand in Cleveland.

NS has an excellent safety record. Its safety program serves as a model for other carriers. I know firsthand that NS takes its commitment to safety seriously, and so do we. I know that NS has pledged to work with Cleveland officials to improve safe rail operations.

The City of Cleveland should not view this transaction as a threat or blight to local communities, but as an opportunity. Cleveland has an opportunity to prosper again as an industrial giant. The joint NS/CSX transaction is a necessary component in attaining that goal.

Sincerely,

ICI PAINTS



Gerald E. Brown  
Manager-Transportation

rg:GB120801



# Handl-it INC.

Warehousing & Distribution Services

December 8, 1997

Vernon A. Williams  
Secretary  
Surface Transportation Board  
1925 K. Street N.W.  
Washington, DC 20423

RE: CSX/NS Conrail Transaction: STB Finance Docket No. 33388 Cleveland Comments

Dear Mr. Williams:

My name is Jerry Peters and I am the President for Handl-it, Inc. with several Cleveland area facilities. My company had previously submitted a letter of support for the joint application of CSX and NS to acquire Conrail and had urged the STB to approve the transaction giving my company greater market penetration through single-line service and competitive pricing to, from and within the eastern United States.

The purpose of this letter is to strongly reiterate that support. It has come to my attention that the City of Cleveland and the Honorable Mayor White have expressed serious concerns over the impact of increases frequencies of trains through certain neighborhoods of Cleveland. Furthermore, the City and Mayor White have stated that the City of Cleveland, its residents and businesses, will not see any noticeable benefits from this transaction. While I appreciate the City's concerns for the impact on local neighborhoods, I believe the NS plans offer enormous economic benefits to the city, its residents and businesses. As most of this new traffic is intermodal, the expected increased train traffic will be far less disruptive to local neighborhoods than more trucks traversing roads in Cleveland and Northern Ohio.

My company employs 160 Cleveland area residents. For this facility to stay competitive in the face of a global economy, Cleveland area businesses need a viable, strong rail network that the transaction will produce. Competitive rail service offers my company and others the opportunity to expand and enhance employment prospects for Cleveland residents.

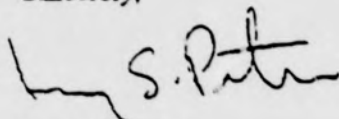
I have serious reservations about suggestions that NS restructure or alter a solid operating plan. These suggestions lack economic or transportation justification. I expressed support for the transaction because I believed that those plans, if implemented, would translate into significant

advantages to my company. Deviations from that plan could place my and other Cleveland businesses dependent on rail service at a competitive disadvantage vis-a-vis other industrial Midwestern cities. I cannot stress enough that in order to grow and employ more residents, we cannot jeopardize the efficient, cost-effective rail service this plan represents. Using alternative trucking is more expensive and affects my company's ability to compete successfully. Besides, trucks pollute far more than rail. They damage our roads, and increase the tax burden on citizens and businesses. These types of costs determine whether businesses locate or expand in Cleveland.

NS has an excellent safety record. Its safety program serves as a model for other carriers. I know firsthand that NS takes its commitment to safety seriously, and so do we. I know that NS has pledged to work with Cleveland officials to improve safe rail operations.

The City of Cleveland should not view this transaction as a threat or blight to local communities, but as an opportunity. Cleveland has an opportunity to prosper again as an industrial giant. The joint NS/CSX transaction is a necessary component in attaining that goal.

Sincerely,

A handwritten signature in dark ink, appearing to read "Jerry S. Peters". The signature is fluid and cursive, with the first name "Jerry" and last name "Peters" clearly distinguishable.

Jerry S. Peters  
President

JSP/mjc

Fleet Supplies, Inc.  
250 Mahoning Avenue  
Cleveland, Ohio 44113

Vernon A. Williams  
Secretary  
Surface Transportation Board  
1925 K Street, N.W.  
Washington, DC 20423

RE: CSX/NS Conrail Transaction: STB Finance Docket No.  
33368 Cleveland Comments

Dear Mr. Williams;

My name is Mary Tatarko and I am Corporate Traffic Manager for Fleet Supplies, Inc. with Cleveland facilities at 250 Mahoning Ave.. Our company had previously submitted a letter of support for the joint application of CSX and NS to acquire Conrail and has urged the STB to approve the transaction giving my company greater market penetration through single-line service and competitive pricing to from and within the eastern United States.

We strongly support this effort. It has come to my attention the the City of Cleveland and the Honorable Mayor White have expressed serious concern over the impact of increased frequencies of trains through certain neighborhoods of Cleveland.

While I appreciate the City's concerns for the impact on local neighborhoods, I believe the NS plans offer enormous economic benefits to the city, its residents and businesses. It is also a much more efficient and less taxing mode of transportation.

Our company employs 16 Cleveland area residents. For this facility to stay competitive, we need a reliable rail service. We feel the alteration of rail service would be disruptive to our business and other area businesses, and would restrict further growth at our facility.

NS has a very strict commitment to safety which we are asked to participate in. We know firsthand that NS takes its commitment to safety seriously. I know that NS has pledged to work with Cleveland Officials to improve safe rail operations.

Very truly yours,  
*Mary Tatarko*  
Mary Tatarko  
Fleet Supplies, Inc.



## Blue Circle Cement

250 Jefferson Avenue  
Cleveland, OH 44113-2525  
Telephone (216) 579-1911  
Fax (216) 579-0625

December 8, 1997

Vernon A. Williams  
Secretary  
Surface Transportation Board  
1925 K Street, N.W.  
Washington, DC 20423

RE: CSX/NS Conrail Transaction, STB Finance Docket No. 33388  
Cleveland Comments

Dear Mr. Williams:

My name is David Lumsden and I am Regional Distribution Manager for Blue Circle Cement with Cleveland area facilities located at 250 Jefferson, Cleveland. My company had previously submitted a letter of support for the joint application of CSX and NS to acquire Conrail and had urged the STB to approve the transaction giving my company greater market penetration through single-line service and competitive pricing to, from and within the eastern United States.

The purpose of this letter is to strongly reiterate that support. It has come to my attention that the City of Cleveland and the Honorable Mayor White have expressed serious concerns over the impact of increased frequencies of trains through certain neighborhoods of Cleveland. Furthermore, the City and Mayor White have stated that the City of Cleveland, its residents and businesses, will not see any noticeable benefits from this transaction. While I appreciate the City's concerns for the impact on local neighborhoods, I believe the NS plans offer enormous economic benefits to the city, its residents and businesses. As most of this new traffic is intermodal, the expected increased train traffic will be far less disruptive to local neighborhoods than more trucks traversing roads in Cleveland and northern Ohio.

My company employs seven Cleveland area residents. For this facility to stay competitive in the face of a global economy, Cleveland area businesses need a viable, strong rail

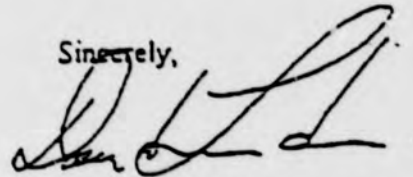
network that the transaction will produce. Competitive rail service offers my company and others the opportunity to expand and enhance employment prospects for Cleveland residents.

I have serious reservations about suggestions that NS restructure or alter a solid operating plan. These suggestions lack economic or transportation justification. I expressed support for the transaction because I believe that those plans, if implemented, would translate into significant advantages to my company. Deviations from that plan could place my and other Cleveland businesses dependent on rail service at a competitive disadvantage vis-à-vis other industrial Midwestern cities. I cannot stress enough that in order to grow and employ more residents, we cannot jeopardize the efficient, cost-effective rail service this plan represents. Using alternative trucking is more expensive and affects my company's ability to compete successfully. Besides, trucks pollute far more than rail. They damage our roads, and increase the tax burden on citizens and businesses. These types of costs determine whether businesses locate or expand in Cleveland.

NS has an excellent safety record. Its safety program serves as a model for other carriers. I know firsthand that NS takes its commitment to safety seriously, and so do we. I know that NS has pledged to work with Cleveland officials to improve safe rail operations.

The City of Cleveland should not view this transaction as a threat or blight to local communities, but as an opportunity. Cleveland has an opportunity to prosper again as an industrial giant. The joint NS/CSX transaction is a necessary component in attaining that goal.

Sincerely,

A handwritten signature in dark ink, appearing to read 'David Lumsden', with a stylized, flowing script.

David Lumsden  
Regional Distribution Manager





December 8, 1997

Vernon A. Williams  
Secretary, Surface Transportation Board  
1925 K Street, N. W.  
Washington, D. C. 20423

Patrick J. Gorbett  
Gateway Cold Storage  
3725 Croton Ave.  
Cleveland, Ohio 44115

Re: CSX/NS Conrail Transaction: STB Finance Docket No. 333X8  
Cleveland Comments

Dear Mr. Williams,

As President of Gateway Cold Storage I currently operate 2 facilities in the Cleveland area. Both are located in the downtown Cleveland area and are rail served. My company had previously submitted a letter of support for the joint application of CSX and NS to acquire Conrail and had urged the STB to approve the transaction giving my company greater market penetration through single-line service and competitive pricing to, from and within the eastern United States.

The purpose of this letter is to strongly reiterate that support. I have recently read in the newspaper and seen on television that Congressman Dennis Kucinich is stating that the increased traffic is going to have a negative impact on the Greater Cleveland area. While I do believe the impact will be felt on the areas that have many train crossings, I can't help but think that it would not be any more traffic than there was during the rail heydays of 40 or 50 years ago.

My company employs approximately 25 greater Clevelanders. For this facility to remain competitive in the global economy we will need to have a strong rail presence that is run in an efficient manner.

Norfolk Southern has an excellent safety record. In talking to their employees it seems that their safety program could act as a model for other rail carriers. They have also stated that NS has pledged to work with local government officials to improve safe rail operations.

Mr. Williams, if you have any questions or concerns please don't hesitate to call me.

Sincerely,

Patrick J. Gorbett  
President

Gateway Cold Storage  
3725 Croton Avenue ♦ Cleveland, OH 44115  
(216) 361-6200 ♦ FAX (216) 361-1993 ♦ TOLL FREE (888) 361-9333

# HARRY ROCK & COMPANY

FERROUS AND NON-FERROUS SCRAP

4100 WOODLAND AVE.

P.O. BOX 93628

CLEVELAND, OHIO 44101

December 3, 1997

Surface Transportation Board  
1925 K Street, N.W.  
Washington, DC 20423

Re: CSX/NS Conrail Transaction: STB Finance Docket No. 33388  
Cleveland Comments

Attn: Mr. Vernon A. Williams, Secretary

Dear Mr. Williams,

My name is James Hubach and I am Corporate Traffic Manager for Harry Rock & Company with Cleveland area facilities located at 4900 Woodland Ave. My company had previously submitted a letter of support for the joint application of CSX and NS to acquire Conrail and had urged the STB to approve the transaction giving my company greater market penetration through single-line service and competitive pricing to, from, and within the eastern United States.

The purpose of this letter is to strongly reiterate that support. It has come to my attention that the City of Cleveland and the Honorable Mayor White have expressed serious concerns over the impact of increased frequencies of trains through certain neighborhoods of Cleveland. Furthermore, the City and Mayor White have stated that the City of Cleveland, its residents and businesses, will not see any noticeable benefits from this transaction. While I appreciate the City's concerns for the impact on local neighborhoods, I believe the NS plans to offer enormous economic benefits to the city, its residents and businesses. As most of this new traffic is intermodal, the expected increased train traffic will be far less disruptive to local neighborhoods than more trucks traversing roads in Cleveland and northern Ohio.

My company employs 50 Cleveland area residents. For this facility to stay competitive in the face of a global economy, Cleveland area businesses need a viable, strong rail network that the transaction will produce. Competitive rail service offers my company, and others, the opportunity to expand and enhance employment prospects for Cleveland residents.



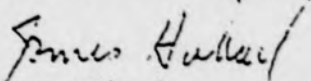
I have serious reservations about suggestions that NS restructure or alter a solid operating plan. These suggestions lack economic or transportation justification. I expressed support for the transaction because I believed that those plans, if implemented, would translate into significant advantages to my company. Deviations from that plan could place my and other Cleveland businesses dependent on rail service at a competitive disadvantage vis-a-vis other industrial Midwestern cities. I cannot stress enough that in order to grow and employ more residents, we cannot jeopardize the efficient, cost-effective rail service this plan represents. Using alternative trucking is more expensive and affects my company's ability to compete successfully. Besides, trucks pollute far more than rail. They damage our roads and increase the tax burden on citizens and businesses. These types of costs determine whether businesses locate or expand in Cleveland.

NS has an excellent safety record. Its safety program serves as a model for other carriers. I know firsthand that NS takes its commitment to safety seriously, and so do we. I know that NS had pledged to work with Cleveland officials to improve safe rail operations.

The City of Cleveland should not view this transaction as a threat or blight to local communities, but as an opportunity. Cleveland has an opportunity to prosper again as an industrial giant. The joint NS/CSX transaction is a necessary component in attaining that goal.

Sincerely,

HARRY ROCK & COMPANY

  
James Hubach  
Vice President

JH/kat



December 2, 1997

Vernon A. Williams  
Secretary  
Surface Transportation Board  
1925 K Street, N.W.  
Washington, DC 20423

Re: CSX/NS Conrail Transaction: STB Finance Docket No. 33388  
Cleveland Comments

Dear Mr. Williams:

My name is John Brunskole and I am Corporate Traffic Manager for Columbia Iron & Metal Company with Cleveland area facilities located at 6600 Grant Avenue. My company had previously submitted a letter of support for the joint application of CSX and NS to acquire Conrail and had urged the STB to approve the transaction giving my company greater market penetration through single-line service and competitive pricing to, from and within the eastern United States.

The purpose of this letter is to strongly reiterate that support. It has come to my attention that the City of Cleveland and the Honorable Mayor White have expressed serious concerns over the impact of increased frequencies of trains through certain neighborhoods of Cleveland. Furthermore, the City and Mayor White have stated that the City of Cleveland, its residents and businesses, will not see any noticeable benefits from this transaction. While I appreciate the City's concerns for the impact on local neighborhoods, I believe the NS plans offer enormous economic benefits to the city, its residents and businesses. As most of this new traffic is intermodal, the expected increased train traffic will be far less disruptive to local neighborhoods than more trucks traversing roads in Cleveland and northern Ohio.

My company employs ten Cleveland area residents. For this facility to stay competitive in the face of a global economy, Cleveland area businesses need a viable, strong rail network that the transaction will produce. Competitive rail service offers my company and others the opportunity to expand and enhance employment prospects for Cleveland residents.

I have serious reservations about suggestions that NS restructure or alter a solid operating plan. These suggestions lack economic or transportation justification. I expressed support for the transaction because I believed that those plans, if implemented, would translate into significant advantages to my company. Deviations from that plan could place my and other Cleveland businesses dependent on rail service at a competitive disadvantage vis-à-vis other industrial Midwestern cities. I cannot stress enough that in order to grow and employ more residents, we cannot jeopardize the efficient, cost-effective rail service this plan represents. Using alternative trucking is more expensive and affects my company's ability to compete successfully. Besides, trucks pollute far more than rail. They damage our roads, and increase the tax burden on citizens and businesses. These types of costs determine whether businesses locate or expand in Cleveland.

NS has an excellent safety record. Its safety program serves as a model for other carriers. I know firsthand that NS takes its commitment to safety seriously, and so do we. I know that NS has pledged to work with Cleveland officials to improve safe rail operations.

The City of Cleveland should not view this transaction as a threat or blight to local communities, but as an opportunity. Cleveland has an opportunity to prosper again as an industrial giant. The joint NS/CSX transaction is a necessary component in attaining that goal.

Sincerely,

John Brunskole  
Corporate Traffic Manager

COLUMBIA COMPANIES 6600 GRANT AVENUE • CLEVELAND, OHIO 44105 (216) 883-4972 FAX: 216-341-8632

== TOTAL PAGE. 12 ==

VERIFIED STATEMENT  
OF  
JAMES W. HARTMAN, JR.  
CONRAIL ASSET UTILIZATION DIRECTOR

My name is James W. Hartman, Jr., and I hold the position of Director, Asset Utilization, for Consolidated Rail Corporation (Conrail). My responsibilities include the management of Conrail's Line Sale Program, pursuant to which active rail lines are sold to short line operators for continued rail operation. I was Conrail's chief negotiator for the sale of the Lehigh Cluster, in Carbon, Lackawanna, Luzerne and Wyoming Counties in Pennsylvania, to Reading, Blue Mountain & Northern Railroad Company (RBMN), a transaction that was completed in August, 1996.

A line sale differs substantially from the sale of an ordinary asset, as it often creates an on-going commercial relationship from which both parties -- the selling and purchasing railroads -- expect future benefits. Conrail generally sells active rail lines with the expectation that the new short line operator will be able to protect and grow rail business on the line, which will benefit both the short line operator and Conrail, which will participate in the continued and new business as a connecting carrier.

In most instances, the critical issue in negotiating a sale is the future earnings that will be derived from operation of the line. Two issues primarily affect the parties' future

revenue: the allowance or division of revenue to the short line operator, and each party's estimate of the traffic potential of the line. The up-front purchase price is driven by these issues. For instance, a potential purchaser may be able to pay more for a property if its revenue allowance or estimate of future growth is higher. Conversely, Conrail may be willing to sell a property for less if the revenue projected for the short line is lower, or if Conrail can have a great assurance that its estimate of the future traffic volume it will handle in interchange service is valid. Because Conrail's experience has been that short line carriers are often able to grow traffic more efficiently than Conrail itself can, the up-front purchase price may be (and often is) much less than the existing market value of the property. Conrail can justify such sales on the probability of future revenue growth from traffic handled in interchange with the new owner of the line. In effect, Conrail can accept a lower up-front price because of the deferred compensation it will receive in the form of continued line-haul revenues.

In situations where a new short line operator is able to interchange traffic to a carrier other than Conrail, Conrail's estimate of future interchange traffic becomes highly uncertain - because of the potential that what had been Conrail traffic on the line will be diverted to another carrier, and thus lost by Conrail. Conrail could compensate for the speculative nature of its estimate of future earnings by seeking a higher purchase price for the property. However, Conrail has found that the up-front price it must receive for a rail line to provide compensation for the potential loss of future revenue is so high that potential short-line purchasers are discouraged from proceeding with the sale. Thus, if Conrail required full up-front compensation in this circumstance, it would be unable to sell such properties, thereby

losing the many benefits produced by short line operators. Accordingly, Conrail developed a method to reduce the uncertainty of future interchange traffic and revenue, to allow properties with the potential for diversion to be marketed at a price that would be attractive to potential purchasers. Under this approach, the purchaser/operator agrees to pay Conrail a specified amount for each carload of traffic which it could interchange with Conrail, but which instead is interchanged by the short-line with another carrier. This amount is sometimes mistakenly referred to as a penalty amount, but is more properly called additional consideration, as it reflects the reduced up-front purchase price of the property, a price which Conrail is able to justify based on the assurance of future traffic.

The additional consideration amount does not impose an absolute prohibition against interchange of traffic with another carrier, and is designed to allow such interchange where the other carrier can offer a more efficient route. The amount of the additional consideration is set to approximate Conrail's net earnings from handling the traffic, considering its own costs. Thus, if interchange with another carrier allows use of a more efficient route, the participants in that route could pay the additional consideration to Conrail, and still benefit from handling the traffic to the extent the costs of that route are less than the costs via the Conrail route.

This approach was followed in the sale of Conrail's Lehigh Line to RBMN. The up-front purchase price agreed to for that line represents a small fraction of the value of the line. However, from prior experience with RBMN, Conrail knew it to be an efficient, well-run operator, which had demonstrated in the past its ability to satisfy its customers and to grow traffic on its lines. Thus, Conrail felt confident that it would benefit from future traffic



growth, if it could be assured that it would not lose revenue from diversion of the traffic to another carrier. The additional consideration clause provided this assurance. This clause works to preserve Conrail's participation in the traffic where the Conrail route is at least as equally efficient as a competing route, and to compensate Conrail where the traffic is actually diverted to a more efficient route.

I do not recall that there were any specific negotiations concerning whether or not an additional consideration provision was to be included in the terms of this transaction, as both parties understood that the transaction could not go forward without it. RBMN would not have been interested in the property at a price which would represent the value of the property to Conrail without the protection of future traffic.

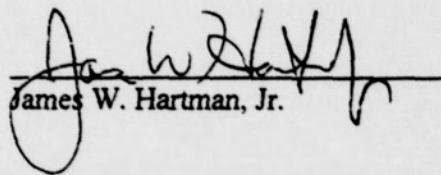
I have read the Verified Statement of Andrew M. Muller, Jr., attached to RBMN-5 filed herein. Conrail did not require RBMN to agree to pay a substantial penalty for traffic interchanged to another carrier. As explained above, the additional consideration provision was an integral part of the overall transaction.

I am not privy to Mr. Muller's Appendix HC-2 as it was filed as a highly-confidential document, but I believe it is not relevant to compare a short line's allowances with the additional consideration, which reflects Conrail's earnings from a proposed move. If a competing route is more efficient, there will be sufficient additional earnings available to compensate all the participating carriers in the route, including the short line.

**VERIFICATION**

I, James W. Hartman, Jr., verify under penalty of perjury that I am Director, Asset Utilization, Consolidated Rail Corporation, that I have read the foregoing document and know its contents, and that the same is true and correct to the best of my knowledge and belief.

Executed on December 8, 1997.

  
James W. Hartman, Jr.



## REBUTTAL VERIFIED STATEMENT OF THOMAS G. HOBACK

My name is Thomas G. Hoback and I am Chairman, President and Chief Executive Officer of The Indiana Rail Road Company ("INRD"), which is based in Indianapolis. I founded INRD with a group of investors in March 1986, and have managed INRD ever since. My role is to oversee all aspects of INRD's performance and I have sole responsibility for INRD's bottom-line results.

I hold a Bachelor of Science degree in Transportation and Economics from Golden Gate University, San Francisco. Prior to founding INRD, I was Director of Marketing from 1983-85 for TECO Transport and Trade in Tampa, FL. From 1978-82, I was Director of Coal Marketing for Illinois Central Gulf Railroad in Chicago. I began my railroad career with Western Pacific Railroad in San Francisco as a Cost Analyst and have been involved in transportation continuously since that time.

The purpose of my Verified Statement is to provide INRD's perspective on the current coal delivery operations and options for Indianapolis Power & Light Company's ("IP&L") coal movements into the Perry K and Stout plants, both of which are located in Indianapolis. I also discuss how IP&L has used those options to its advantage. More specifically, I demonstrate how IP&L has used the threat of truck competition throughout INRD's corporate existence to receive favorable rate treatment.

I. INRD's Coal Movements on Behalf of IP&L

A. Stout Plant

INRD provides rail transportation to IP&L's Stout plant. INRD moves coal by rail from several Indiana mines including Black Beauty's Miller Creek Mine (INRD origin); Triad Mining's Switz City Mine (INRD origin); Black Beauty's Farmersburg Mine (CP Rail System ("CPRS")); and from time to time, spot coal from other mines. CPRS (a former Soo Line) interchanges certain coal to INRD at Linton, IN for final delivery to the Stout plant.

In addition to line-haul movements, INRD also moves coal to the Stout plant from an interchange with Conrail at Indianapolis. This coal has originated from Black Beauty's former Shand Mine at Carbon, IN, and from Peabody's Hawthorn Mine near Sandborn, IN, and is interchanged from Indiana Southern Railroad to Conrail before being transported by INRD to the Stout plant. [[['

]]]

B. Perry K

From time to time, INRD also has moved coal for delivery to IP&L's Perry K plant. INRD delivers that coal to the Stout plant where it is unloaded and then trucked to the Perry K plant.

In the past, INRD coal also has been unloaded at the Senate Avenue Terminal, INRD's principal switching yard in Indianapolis, and trucked about one mile to the Perry K plant. That

coal was handled through INRD's distribution center for several months in the early 1990s while IP&L was rebuilding its rail unloading facilities at the Perry K plant.

## II. Impact of Truck Competition

As evidence of IP&L's ability to take advantage of rail-truck competition, tours of the Stout plant begin with an orientation film that describes the plant's ability to take coal by truck or by rail. For a number of years IP&L has used truck competition -- or the threat of truck competition -- to constrain rail rates to the Stout plant.

### A. Reduction in Rail Rates

The following example demonstrates how effective IP&L has been in using the threat of truck competition to garner rail rate concessions.

Last year, IP&L entered into a coal supply agreement with Black Beauty Coal's new Farmersburg, IN mine. The agreement provides for the delivery of approximately 500,000 tons of coal annually from the Farmersburg mine to the Stout plant over a period of several years, beginning in early 1997. An all-rail movement would originate at the Farmersburg mine on CPRS and be interchanged with INRD at Linton, IN.

IP&L began rate discussions with INRD in 1995 for this new movement. At that time, INRD had in place two published rates that covered movements for IP&L: one for movements from the Amax Minnehaha mine; and a second one for movements from mines at Switz City, IN and from the interchange at Linton with CPRS. Due to a previous threat of truck competition, those rates remained unchanged during the period 1990-97.

During negotiations for this new movement, IP&L's Vice President for Fuel Procurement, Don Knight, informed me that if INRD did not reduce its existing rail rate from

Linton by approximately [[[ ]]]%, IP&L would truck coal from the new Farmersburg mine to the Stout plant. IP&L had worked out an arrangement with Black Beauty that would have allowed Black Beauty to truck coal to the Stout plant using Black Beauty's own truck fleet. Black Beauty is the largest coal producer in Indiana and operator of the largest fleet of coal trucks in Indiana. As evidence that truck competition was a viable option, Mr. Knight explained how Black Beauty would use 20 sets of double-bottom trailers operating in two 10-hour shifts per day to move the required tonnage to the Stout plant. Farmersburg mine is located just southeast of Terre Haute and is about 76 miles from the Stout plant, with most of the distance traversed by Interstate Highway (I-70 and I-465). Because Black Beauty would have had complete control over both coal production and transportation, Black Beauty had flexibility in how to price the delivered coal.

In addition, by trucking coal to the Stout plant, IP&L would have been able to unload coal directly onto its stockpile. This operation would have avoided the need to unload coal at IP&L's car dumper and move it on an extensive belting system to the stockpile, thereby resulting in an additional cost advantage for trucks. It also would have eliminated the need to use IP&L's rail car thaw shed during the winter months.

In mid-1996, INRD confirmed IP&L's trucking economies with RDI of Boulder, CO, a coal consulting firm, and with Mr. Jeffrey Stoops, President and CEO of Stoops Freightliner of Indianapolis, the largest dealer of Freightliner trucks in the United States.

In response to IP&L's threat to shift significant tonnage to truck, in January 1997 -- after a seven-year freeze on IP&L's rail rates -- INRD reduced its rates for coal deliveries to the Stout plant by approximately [[[ ]]]%. INRD made this rate reduction after CSX acquired financial

control of Midland United Corporation, INRD's parent, and after the announced division of the use and operation of Conrail's assets by CSX and NS.

B. Charges at Indianapolis

In addition to keeping rail rates low, IP&L also has used the threat of truck competition to constrain rail charges at Indianapolis. In the late 1970s, INRD's predecessor, Illinois Central Gulf (now Illinois Central) raised its charge for moving coal from Conrail's Indianapolis Belt Secondary Track to the Stout plant. IP&L protested and through protracted litigation and negotiation, a new, somewhat higher charge was agreed upon. That charge was approximately [[[ ]]] per car when INRD began operations in March 1986.

In contrast, the Conrail charge to move coal from INRD to the Perry K plant was [[[ ]]] per car. Conrail's charge at Indianapolis for most other traffic was about \$390 per car. CSX's charge was about \$230 per car. Thus, the [[[ ]]] charge was extremely low in relation to other charges in Indianapolis.

In 1987-88, INRD approached IP&L about its plans to raise INRD's charge to [[[ ]]] per car. Part of the justification for this higher charge was that IP&L accounted for the preponderance of traffic over INRD and there were no contractual commitments for any tonnage to move via line haul on INRD. In a meeting with Mr. Don Knight and IP&L Senior Vice President, Mr. Gerry Waltz, INRD was informed that if it raised its charge by any amount IP&L would immediately shift all of its coal tonnage from rail to truck. When I informed Messrs. Waltz and Knight that IP&L's action most assuredly would throw INRD into bankruptcy, they responded that INRD's financial success or failure was not their concern. At that time, IP&L traffic accounted for more than 80% of INRD's total revenue.



In the recent negotiations for moving Farmersburg coal to the Stout plant, IP&L again insisted that INRD maintain its [[[ ]]] charge with no escalation for the duration of the contract. Consequently, the contract for that movement maintains the [[[ ]]] charge.

### III. Access to Stout for NS Coal Deliveries

IP&L maintains that it needs the ability to move coal via NS to the Stout plant. See IPL-3, Weaver VS at 12. After the acquisition is consummated, INRD will have a direct interchange with NS at Hawthorne Yard. INRD is prepared to negotiate with IP&L an arrangement whereby IP&L could receive coal via NS, either through a separate INRD charge at competitive rates or through joint line NS/INRD service. To date, however IP&L has not requested a rate for coal movements on NS via INRD to the Stout plant. Nor has IP&L requested a separate charge for INRD to move coal from NS at Hawthorne Yard to the Stout plant.

### IV. Response to the Department of Justice

The Department of Justice's ("DOJ's") filed comments regarding coal movements to IP&L's Indianapolis plants are far fetched. DOJ witness Peter A. Woodward states that "competition between Conrail and INRD has significantly reduced transportation costs for IP&L." DOJ-1, Woodward VS at 18. However, Conrail has not been an effective competitor for coal in Indiana for some years. This is reinforced by the fact that in 1992 Conrail sold its Petersburg Secondary (which serves IP&L's Pritchard and Petersburg plants as well as several coal mines) to ISRR. Conrail's remaining east-west main line through central Indiana serves only one small mine (Shand Mine near Carbon, IN, which will be closed in December 1997)

and IP&L's Perry K steam plant. Therefore, Conrail has a minimal presence in Indiana coal movements.

Woodward further states, "[t]he Indiana Railroad matched Conrail's price and won 90 percent of the business, but the competition from Conrail reduced prices about \*\*\* percent below the truck price." *Id.* For Conrail to have been an effective competitor, coal would have to have moved via three railroads (CPRS, Conrail, and INRD) on a route through Terre Haute, IN versus only two railroads -- via CPRS and INRD, as the coal is presently moving. At no time did IP&L ever discuss with INRD the possibility of moving coal from Farmersburg via another rail carrier. Adding a third railroad to the route on a short haul movement of coal would have added inefficiencies and delays to the movement.

Moreover, INRD had no way of knowing that Conrail had been asked to bid on this coal movement. Even if INRD had known that Conrail was being asked to bid, INRD would have had no way of knowing what rates were being quoted by Conrail. IP&L only discussed with us the threat of truck competition, which we took seriously based upon our own studies.

#### V. Conclusion

IP&L historically has used the threat of truck competition and actually has used trucks to put pressure on coal transportation rates to both its Stout and Perry K plants. IP&L has done this by using the threat of trucking coal direct from the mine and of trucking from another rail carrier. Post-acquisition, the same trucking options will be available. Nothing will change. IP&L will continue to be able to truck coal from the mine to the Stout plant (as it threatened to do just last year from the Farmersburg Mine). IP&L's options at the Perry K plant are similarly unaffected.



The fact that IP&L is converting much of the Perry K capacity to natural gas, however, will eliminate in large part the requirement for coal transportation to Perry K. According to Coal Outlook, "[c]oke oven gas will displace half of the 250,000-tons/yr. burn at Indianapolis Power & Light's Perry K steam plant in downtown Indianapolis." See Exhibit 1. This displacement of coal stems from a 20-year contract signed in late 1996 under which IP&L will purchase gas from Citizens Gas & Coke. Id.

VERIFICATION

I, Thomas G. Hoback, declare under penalty of perjury  
that the foregoing is true and correct.

Further, I certify that I am qualified and authorized to

file this statement. Executed on December 4<sup>th</sup>, 1997.

Thomas G. Hoback  
Thomas G. Hoback

Citation	Rank(R)	Database
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1996 WL 13072710		

## Coal Outlook

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## Indianapolis turns to coke oven gas

Coke oven gas will displace half of the 250,000-tons/yr burn at Indianapolis Power & Light's **Perry K** steam plant in downtown Indianapolis.

IP&L and Citizens Gas & Coke Utility last week said they have signed a 20-year contract under which IP&L will buy the gas from Citizens' plant starting in November 1997. IP&L will convert three of **Perry K's** six boilers from coal to gas.

Triad Mining is believed to be the coal supplier to **Perry K**. In the 12-month period ending last June 30, Triad produced about 1.4 million tons of coal from its Freelandville mine in Knox County and its Switz City mine in Greene County. Triad also ships to other IP&L plants.

Citizens needed a customer for its manufactured gas because of a plan to convert its gas customers to 100% natural gas. At present about 5% of Citizens' distributed gas comes from the coke ovens.

Steam from **Perry K** is used to heat buildings.

## ---- INDEX REFERENCES ----

MARKET SECTOR: Energy (ENE)

INDUSTRY: Coal (COA)

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## VERIFIED STATEMENT OF RICHARD D. HUFFMAN

My name is Richard D. Huffman. I am Assistant Vice President-- Compensation and Benefits for Consolidated Rail Corporation ("Conrail"). I have held this position since May 1, 1994. Prior to that date, I held various positions in Conrail's human resources, passenger operations, and strategic planning departments, beginning in 1975 when I joined the newly created Conrail.

I make this verified statement, in conjunction with the verified statement of William McCain, Conrail's Assistant Vice President-Labor Relations, in response to certain comments filed by rail labor organizations in the Surface Transportation Board proceeding Finance Docket No. 33388, CSX Corporation and CSX Transportation, Inc. Norfolk Southern Corporation and Norfolk Southern Railway Co. - Control and Operating Leases/Agreements--Conrail Inc. and Consolidated Rail Corporation. Specifically, some of the labor commentators seem to contend that the Board should consider the benefits that Conrail's nonagreement employees reportedly are receiving as a result of the proposed transaction. This view is expressed most directly in the comments of Transportation Communications International Union ("TCU"), which purports to set forth the amounts of money that Conrail's nonagreement employees will receive in the form of "severance payments" and "dislocation allowances" and contends that "it is only equitable that comparable packages be made available

to Conrail's unionized workforce." TCU Comments at 6-7. TCU's description is not accurate. As I explain further below, most of the money that is being received by Conrail's nonagreement employees will come from the allocation of Conrail's Employee Stock Option Plan ("ESOP") to eligible participants of the plan. As Mr. McCain explains in his verified statement, Conrail's agreement employees rejected an offer to join the ESOP when it was established in 1990.

The proposed transaction is anticipated to result in the severance of a large number of Conrail's nonagreement employees. In order to ease the resulting financial impact on those employees, and to ensure a stable workforce pending the approval and the consummation of the transaction, Conrail will pay stay bonuses, and, where applicable, severance payments to eligible nonagreement employees, subject to certain conditions. For all but Conrail's senior executives, the amounts of the severance payments vary with the employees' length of service and compensation. For Conrail's senior executives (approximately 75 individuals) severance payments are governed by individual employment contracts.

In addition, eligible nonagreement employees are receiving allocations from the excess assets from Conrail's ESOP, a plan used to fund the corporate match embodied in the Conrail Matched Savings Plan, Conrail's 401(k) retirement savings plan. Conrail used its junior convertible preferred stock to match employees' cash contributions. Most of the money that will be received by



the vast majority of nonagreement employees (namely by those other than the aforementioned 75 executives) will come from the ESOP allocation.

Under the terms of the Conrail Matched Savings Plan/ESOP, which was established and funded in 1990, employee contributions were matched on a dollar-for-dollar basis up to 6% of salary with the preferred stock using a per-share value of \$28.84375, the valuation at the inception of the ESOP (adjusted for stock split).

The Conrail Matched Savings Plan/ESOP proved to be a very valuable investment for those who elected to participate, owing in part to the strong performance of Conrail's common stock, which increased the value of the convertible preferred to well above the \$28.84375 per share initial valuation, and which was eventually sold pursuant to the tender offers at nearly four times that amount. As Conrail terminates the ESOP in connection with the proposed transaction, it is allocating to eligible participants the proceeds from the previously unallocated ESOP shares, i.e. the cash received by the trustee for the tendered shares less the amount used to pay off the loan used to purchase the ESOP shares originally.

The aforementioned is also true for agreement employees who are eligible participants in the Conrail Matched Savings Plan/ESOP. As Mr. McCain explains in his verified statement, the Fraternal Order of Police, entered into a collective bargaining agreement whereby its members would be covered by Conrail's nonagreement compensation and benefits policies and practices.

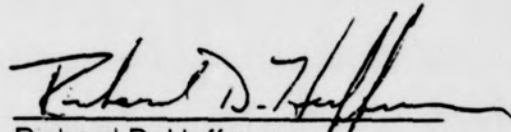
These benefits include eligibility to participate in the Conrail Matched Savings Plan/ESOP. (In the late 1970's, collective bargaining with the Transportation Communications Union led to certain of its members being designated as "Technically Covered" and thereby also covered by Conrail's nonagreement compensation and benefits policies and practices.) Accordingly, these union-represented employees, alone among Conrail's agreement employees, are also eligible to participate, and are participating, in the current ESOP allocation on the same basis as other eligible participants.

VERIFICATION

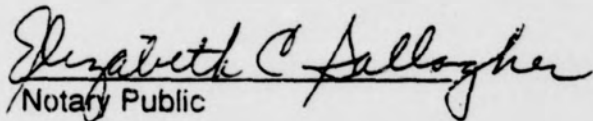
STATE OF PENNSYLVANIA )

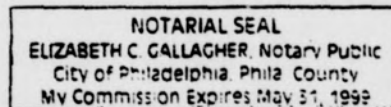
COUNTY OF PHILADELPHIA )

Richard D. Huffman, being duly sworn, deposes and says that he is Assistant Vice President-Compensation and Benefits of Consolidated Rail Corporation, that he is qualified and authorized to submit this Verified Statement, that he has read the foregoing statement and that he , knows the contents thereof, and that the same are true and correct.

  
Richard D. Huffman

Subscribed and sworn to before me by Richard D. Huffman this 9th day of December, 1997.

  
Notary Public



## **REBUTTAL VERIFIED STATEMENT OF CHRISTOPHER P. JENKINS**

My name is Christopher P. Jenkins. I am Vice President, Chemical Marketing for CSX Transportation. I previously submitted a verified statement as part of the June 23, 1997 Application in this proceeding. My background and work experience are described in that statement.

The purpose of this rebuttal verified statement is to address various commercial issues raised by commenting parties in the October 21, 1997 filings in this proceeding and to evaluate certain specific requests for conditions.

### **Commercial Issues Related to Implementation**

The Chemical Manufacturers Association and the Society of the Plastics Industry, Inc. (CMA/SPI) have asked the Board to impose two different conditions that involve the commercial implementation of the proposed Transaction. One of these deals with certain Conrail contracts involving movements to, from or within Shared Assets Areas. CMA/SPI want shippers to have an "open season" to test service from both carriers under these contracts. It wants the shippers to have the right to determine which carrier will ultimately assume the legal responsibility to perform the contract. And it wants each shipper to have the right to "reopen," i.e. get out of, its Conrail contracts involving movements to, from or within Shared Assets Areas.

The Applicants' proposal for the allocation of Conrail contracts, including

those involving movements to, from or within the Shared Assets Areas is the only feasible way of effecting a smooth commercial transition for contract movements currently performed by Conrail. First, it makes commercial sense for CSX and NS to know from the outset which of them will perform which contracts so they can plan to provide the service. The party who will perform the service must plan to have the crews and equipment in place to handle the traffic. A regime of sampling that allows the customer to switch back and forth would inhibit effective planning and could result in chaos. The CMA/SPI proposal is diametrically opposed to the smooth transition that CMA/SPI say they want. Shifting blocks of traffic back and forth between CSX and NS could be destabilizing. Such shifts of traffic from the initial carrier to the second carrier would place unanticipated demands on the second carrier which unexpectedly became obligated to handle traffic. The service problems created by the unexpected traffic could result in driving other traffic away from the second carrier. This traffic, in turn, might temporarily overload the first carrier, creating an unstable oscillation. I find it ironic that CMA/SPI, which is one of the commentators that repeatedly invokes the specter of UP's service failures, would make a proposal that poses serious risks of service problems.

CMA's proposal that Conrail shippers be able to terminate contracts at their option raises potential problems and inequities. The Applicants' basic approach for allocating Conrail contracts is for either NS or CSX to step into the shoes of Conrail for purposes of carrying out the commercial obligations that Conrail committed to perform. This guarantees that Conrail's customers will not lose the benefit of the bargains they made as the result of the Transaction. Capital investments made by Conrail that may



have made in reliance on the contracts will not be unfairly prejudiced by allowing customers to avoid their obligations.

There are additional potential complications that would result from the principle of voidability that CMA/SPI espouse. Some Conrail contracts undoubtedly cover multiple movements, some of which will be performed by CSX and some by NS. A decision by a customer to void the contracts as to certain movements but not as to others would create enormous confusion regarding the administration of these contracts.

CMA's suggestion that contracts should be voidable at the customer's option also strikes me as opportunistic and inequitable. Applicants are willing to incur whatever commercial obligations may be imposed on them under Conrail's contracts. It seems only logical and fair that they receive whatever commercial benefits the customers were willing to confer upon Conrail. Many of the customers will have the benefit of additional competition after the contracts expire. In the meantime, there will be stability in existing commercial relationships during the period that CSX and NS are implementing the Transaction.

Most rail transportation contracts are limited to arrangements on price, service and volume. However, some are part and parcel of broader transportation-related deals. The overall deal may also include capital investment by the carrier, up-front incentive payments to the shipper, concessions on disputes over performance by the shipper of earlier commitments, volume commitments in "out years," and so on. It is not unusual for the rate and volume commitments to be incorporated in the rail transportation contract, with the other arrangements included in other documents. Yet,

they are all part and parcel of the same business deal.

The shippers who are demanding the right to abrogate their rail transportation contracts at their sole option make no mention of related commercial arrangements forming part of the consideration for those contracts. Yet, allowing customers to walk away from long-term business commitments that compensated Conrail for investments made in consideration for those commitments is unjust. Allowing customers who made promises about future business -- perhaps several years into the future -- in exchange for current rate reductions would give an extra windfall to the abrogating customer. Customers who induced Conrail to waive breach of volume commitments in past contracts in exchange from promises of additional business in the future would be freed from their settlement arrangements. Industrial development deals which gave customers incentives to locate in exchange for customer commitments for the future would turn into economic giveaways. In short, giving any party a unilateral right to walk away from its part of a complex, structured bilateral deal would open the door to abuse and injustice.

From an administrative point of view, it is desirable to have the expiration of Conrail contracts spread out over time, as Applicants' proposal allows. The staggered expiration of the contracts in accordance with their own terms will allow for a smooth transition, rather than the discontinuity and administrative burden that would result if large numbers of contracts expired or were terminated at once.

A second commercial condition proposed by CMA/SPI would require Applicants to adopt all Conrail tariffs and circulars that were in effect when the

application was filed (June 23, 1997) and to publish supplements incorporating new routes. The proposal that all tariffs and circulars be maintained at June 23, 1997 rate levels ignores the fact that rates have in all likelihood been adjusted in the interim by Conrail as market conditions have changed. It would be impractical to reinstate rates that have changed in the interim and commercially foolish as well because rates that do not reflect current market conditions would impede the efficient movement of freight.

CSX anticipates that it will need to continue to adjust rates to reflect evolving market conditions. It would impede our ability to compete with NS and trucks if we have to lock in the old Conrail rate structure even for a short time.

CMA/SPI's proposal is also curious to the extent that it suggests that CMA/SPI believe that both CSX and NS should assess the same rates (i.e., former Conrail rates) between points that both of them serve. A major purpose of the Transaction is to bring rail competition to areas which did not have it before. I cannot believe that CMA/SPI really want CSX and NS to establish identical rates.

It would make no sense at all for CSX to have two separate rate structures following the Transaction -- one for the former CSX and one for the portion of Conrail to be operated by CXS -- which is what CMA/SPI's proposal would require. A dual rate structure would frustrate our customers' preference for having a rate structure that is comprehensive and easy to understand. It would be unnecessarily cumbersome. There would be enormous practical problems in modifying our rating and billing systems to accommodate two rate structures and in training our marketing personnel to administer both systems simultaneously.

In sum, both of CMA/SPI's proposed conditions regarding the commercial implementation of the Transaction are unnecessary, impractical and would be counterproductive.

### **The Transaction Will Result in Increased Competition**

In my opening verified statement, I emphasized that a principal benefit of the proposed Transaction would be the enhanced ability of CSX to compete with trucks. I sponsored a truck/barge-to-carload traffic diversion study that estimated the amount of general merchandise traffic that CSX could expect to capture from trucks and barges. I explained that the universe of traffic potentially available to CSX was actually much larger than the amount reflected in that study.

Nobody has seriously challenged the proposition that the proposed Transaction will allow CSX to compete more effectively with trucks and that this enhanced competition will benefit the shipping public. The prospect of more vigorous competition between railroads and trucks in the East would in itself be a substantial public benefit -- even if our proposal did not create increased rail-to-rail competition.

But of course the proposed Transaction does entail increased rail-to-rail competition. Many parties, including the National Industrial Transportation League acknowledge and welcome the enhanced competition that will result from the creation of the Shared Assets Areas. The claim made by some parties that the proposed Transaction will cause commercial harm by not including certain parties in the Shared Assets Areas is unfounded. In the first place, all shippers, not just those located in

Shared Assets Areas, benefit from access to the expanded CSX single-line network.

Moreover, the benefits that stem from the creation of the Shared Assets Areas will extend to all shippers, whether or not they are located in those areas.

A former Conrail shipper who will be outside the Shared Assets Areas and will be local on CSX will benefit from the Transaction because CSX has a strong interest in having that shipper move traffic by rail. CSX is the beneficiary of any traffic moving into or out of that shipper's facility. Therefore, we are vitally interested in the success of that shipper's business, whether that success is measured against the performance of competitors in the Shared Assets Areas or at locations on other railroads or overseas. Clearly, we will need to price our services so that the customer whose traffic CSX alone will enjoy has the incentive to move substantial volumes on us. If rates on traffic moving to and from Shared Assets Areas come down, as many shippers expect they will, that will put downward pressure on rates on CSX local traffic for industries that compete with those in Shared Assets Areas.

The suggestion made by the Erie-Niagara Rail Steering Committee that CSX would allow Niagara Frontier industries to shut down or relocate to Shared Assets Areas is simply unimaginable. Our incentives are diametrically opposite to those assumed by these commentators. If a customer closes down his Niagara Frontier facility and moves to a shared assets area, we will have only a fifty percent statistical chance of obtaining his rail traffic. If he is currently local on us and remains there, we will enjoy all his rail business, and the more the better. No party in this proceeding has cited a single instance where CSX has caused a locally served industry to close in favor of one in



a jointly served market.

There are numerous examples of customers today who are local to CSX who benefit because it is in our interest to keep our sole-served customers competitive in their markets. For example, we have a major producer of a key industrial acid at a sole-served CSX point. We move in all the raw material this customer needs in his manufacturing process and we carry out all the acid he produces that is shipped by rail -- the vast majority of his production. This customer competes against a wide range of other industrial acid producers, including some located at points on CSX where a competing railroad has access and some located on other rail carriers. In establishing rates for traffic moving in and out of this shipper's facility, we give full consideration to the viability of this producer and his ability to compete with manufacturers of industrial acid located at points with multiple transportation options.

Potential customers who are looking to build new rail-served facilities will also be able to exercise considerable leverage over CSX when making a decision about where to locate a new facility. For the reasons I have already discussed, CSX would much prefer to have a new facility located solely on us, where we will have the prospect of handling all the customer's rail traffic, rather than at a dual rail-served point where on average we will handle half the traffic. Having the customer commit to a local point on another carrier such as NS is the worst of the three outcomes for CSX. It is obvious that no customer will commit to having CSX as its sole rail option unless we make it worthwhile for him to do so. Thus, siting decisions and the negotiation of rail transportation contracts go hand-in-hand. We have a huge incentive to see that the

transportation proposal we make to the customer is the one that wins the business for CSX. Accordingly, I expect that there will be vigorous competition between CSX and NS throughout the former Conrail territory as well as in our existing service territories to attract new facilities to locate on one or the other of us.

The suggestion advanced by some parties that CSX and NS will be able to increase rail rates to cover the costs of Conrail is extremely naive. Our competition does not care what CSX paid for Conrail. The harsh reality of the marketplace is that we have to deliver a value package of price and service that beats the competition. Whatever we have paid for Conrail is a sunk cost. It has no bearing on what the marketplace will allow us to charge.

Furthermore, there is every reason to believe that Conrail, with its competent marketing staff, has already priced to the competitive market level. It seems highly unlikely to me that CSX or NS would be able to price at higher levels than Conrail has already established.

#### Switching Charges

Various parties have asked the Board to condition the Transaction by requiring CSX and NS to reduce the switch charges currently assessed by Conrail to some arbitrary figure, such as \$130 per car. I understand that the \$130 per car was a figure that Union Pacific and Burlington Northern Santa Fe agreed to and which was incorporated as part of a settlement agreement with CMA in the Union Pacific/Southern Pacific merger proceeding.

CSX and NS propose to step into Conrail's shoes and provide the switching

services that Conrail currently provides. We have no plan to curtail the switching services that Conrail offers and, speaking for CSX, no plan to increase the level of Conrail's switching charges. Therefore, there is nothing about the proposed Transaction that will produce a change in the status quo with respect to switching charges, much less any competitive harm that calls for the Board to impose a remedial condition.

Commenting parties seem to imply that reciprocal switching is a generic activity and that "one size fits all." That is not the case. Reciprocal switching charges are generally established bilaterally between pairs of rail carriers. The geographic scope of switching arrangements and the level of the charges is a function of the way in which the two carriers' systems overlap, the sorts of traffic that they handle, historical considerations and other factors. Accordingly, the level of switch charges established between one pair of carriers is likely different from the level of charges established by another pair of carriers. And the level of charges may differ from one location to another.

Generally, the establishment of switching charges reflects the notion that the party who owns the property, provides locomotives and crews and has constructed and maintained facilities to serve a customer is entitled to an appropriate return on its investment.

I understand that the switching charges established by Conrail are generally at the level of \$390 per car, although special circumstances may cause them to be higher or lower in certain areas. CSX switches for Conrail at the same rate of \$390 per car. CSX and NS, on the other hand, generally provide switching services for one another at

the rate of \$250 per car. From my perspective as a marketing officer, I view Conrail's switch charges as an effective commercial safety valve that permits traffic to move via a second carrier when there is a need for it to move. There are many examples where CSX purchases switching from Conrail or Conrail purchases switching from CSX at the \$390 level. One example of Conrail switching for CSX is the Joseph Smith & Sons scrap metal yard at Capital Heights, MD. In this case, CSX pays Conrail's \$390 per car switch charge, giving Smith access to CSX's superior fleet of gondolas and allowing CSX to enjoy the line-haul movement on some of Smith's traffic.

I am also aware of situations where Conrail has won the line-haul movement from CSX by incurring the switch charge at facilities served by CSX and switched for Conrail. Within the past 12 months, for example, for example, CSX lost two significant pieces of chemical business to Conrail at industries where CSX provides the switching service and assesses a charge of \$390 per car. Conrail was able to win the business because it offered a better overall package to the customer, notwithstanding the switch charge.

In short, I view the existing Conrail switching charges as playing a meaningful role in the market. They allow traffic to move on a second line-haul carrier when there is a real need for it to move and provide a competitive constraint on Conrail. CSX and NS are going to hold themselves out to provide the switching services that Conrail provides. There is no justification for the Board to reduce them by regulatory fiat to a level below that set in the marketplace, perhaps even to a level that is not compensatory to the owner of the facilities and that could subsidize inefficient

movements by a competitor. Conrail's switching service is not affected by the Transaction one way or another and the switching charges should not be adjusted by the Board.

**Traffic that Will Experience Joint-Line Service as a Result of the Transaction**

CSX and NS recognized in the Application that some traffic that moved in single-line service on Conrail prior to the proposed Transaction will receive joint-line service from CSX as a result of the Transaction. Certain shipper groups and individual shippers propose conditions to address this situation. NIT League and CMA/SPI, for example, both seek to impose a rate cap on this so-called "1-to-2" traffic. NIT League's rate cap would last five years. CMA/SPI's rate cap proposal appears to have no expiration date and presumably would go on forever. I believe that these proposed conditions are unduly restrictive and unwarranted.

To begin with, the creation of joint-line service where there formerly was single-line service cannot fairly be characterized as a reduction in rail competition. By definition, the local Conrail traffic that will become interline had one rail carrier (Conrail) at origin and destination prior to the Transaction and will have one rail carrier at both the origin and destination (albeit a different carrier at the two points) following the Transaction. These shippers simply will not experience the loss of an alternative service provider.

The volume of traffic that will receive joint-line service as a result of the Transaction is far exceeded by the volume that will be converted to single-line service. Shippers who will face joint-line service on certain historical movements will have new



single-line service on what were historically joint-line movements and, more important, will have the opportunity for new single-line movements in the future over the expanded CSX and NS networks. I want to emphasize that both CSX and NS will have the incentive to work with customers to develop single-line market opportunities that will result in increased volumes of traffic moving over the new networks. Thus, I would expect that over time the former Conrail local movements that become joint-line as a result of the Transaction will diminish in commercial significance. The new traffic patterns that emerge over time will reflect net gains in efficiency as customers take advantage of the enhanced single-line service provided by the Transaction.

In the interim, CSX and NS will work together to provide efficient joint-line service on former Conrail single-line movements that become joint-line as a result of the Transaction. While it is true that joint-line service is generally not as efficient as single-line service, it is also true that joint-line movements can meet customers' needs if the carriers cooperate to provide efficient service. Even on relatively low-value commodities such as aggregates, CSX has a substantial volume of traffic that moves in joint-line service. During the 12-month period from September 1996 through August 1997, more than 100,000 carloads of minerals, including aggregates and limestone, moved on CSX in joint-line service. We have worked well with NS in providing joint line service in the past, and I can see no reason why we will not be able to handle the former Conrail local traffic relatively efficiently on an interline basis.

With respect to rates on the joint-line traffic, I would note that the joint commitment of CSX and NS to perform existing Conrail contracts means that any

Conrail local traffic under contract that moves in joint-line service after the Transaction will continue to move at the contract rates until the expiration of the contract. Extended rate protection beyond the expiration of the contracts is not needed in my view. Nor is it necessary to protect rates on common carrier traffic that will move in joint-line service. There is no guarantee that Conrail would have held the rates on this traffic at existing levels for extended periods into the future. The requests by NIT League and CMA/SPI that rates on this joint-line traffic be capped for years into the future is simply opportunism; it would provide a one-way contract in favor of shippers who never gave Conrail a contractual commitment. And, to the extent that such rate caps might cause traffic to move at non-compensatory rates, they are contrary to the public interest. There is an opportunity cost associated with the equipment and labor that must be employed in hauling freight. Scarce equipment is better used on profitable movements where there is a prospect of earning a return that allows us to replace it than on non-compensatory movements.

#### Settlement Agreements

In this section of my testimony, I will summarize the settlement agreements recently negotiated between CSX and Canadian National Railway Company, Canadian Pacific Railway Company and Providence and Worcester Railroad Company, and describe how these settlement agreements will provide enhanced commercial opportunities east of the Hudson, in the Buffalo/Niagara area, and in New England.

In an effort to address the concerns of certain parties and to arrive at mutually beneficial arrangements that would further improve rail transportation in the

Northeast and Canada, CSX has entered into settlement agreements with several carriers. In August 1997, CSX and Canadian National Railway Company (CN) reached agreement on a settlement intended to improve each party's ability to recoup market share from trucks and maintain market-competitive alternatives for rail shipments between Canada and the U.S. Northeast. The CN-CSX agreement helps ensure the competitiveness of CN traffic and preserves CN's ability to participate in the continued expansion of Canadian-U.S. trade, while promoting additional rail competition in the Buffalo/Niagara area.

In October 1997, CSX and Canadian Pacific Railway (CP) came to an agreement that will provide effective access for many shippers in New York City on CSX and Philadelphia to CP through its subsidiary the Delaware and Hudson Railway (D&H).

In August 1997, CSX also came to an agreement with Providence and Worcester Railroad Company (P&W) that will result in significantly greater market reach and enhanced competitive alternatives for freight shipments moving between Long Island and the New England states.

#### **East of the Hudson**

Improved rail access to the area east of the Hudson will result from the recently negotiated agreements with CN and CP/D&H. Both Canadian carriers will now have increased commercial access to New York City. Shippers and receivers in New York City and on Long Island will be able to solicit bids from CN and CP/D&H for movements of general merchandise truckload business to and from Canadian points

served by CP/D&H and CN. CSX will handle the traffic for these other roads to and from its connections with these carriers -- Albany in the case of CP/D&H and Buffalo or Montreal in the case of CN. A similar agreement is in place with P&W, allowing them to use CSX's services between New Haven and an interchange with New York & Atlantic at New York City. The agreements allow these carriers to quote rates for movements via CSX without obtaining our prior consent.

These agreements permit these other railroads to offer to provide transportation services to shippers in New York City and Long Island for general merchandise truckload traffic, and are specifically designed to attract truck-competitive freight business off the roads and on to rail. The agreements permit shippers in New York City or Long Island, in many circumstances, to solicit independent competitive bids from at least two railroads. To ensure coordinated dispatching and other operational efficiencies, CSX will move the cars for the carrier selected.<sup>1</sup>

#### **Buffalo/Erie-Niagara**

The agreements with CN and CP/D&H will benefit shippers in the Buffalo/Niagara area by providing increased commercial access between the Niagara Frontier and Canadian markets for new truck-competitive traffic at mutually agreeable charges.

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<sup>1</sup>With respect to intermodal service to the east side of the Hudson, the final portion of the Oak Point Link has not yet been fully completed, and there is no intermodal rail terminal currently available at the Harlem Yard. Therefore the agreements with CN and CP/D&H roads do not at this time contain similar commercial access provision to that location. CSX will be willing to discuss modifications of its arrangements with other railroads to permit similar commercial access to any newly constructed intermodal terminal at Harlem Yard, for the marketing of new joint line intermodal service to that location.

Specifically, CSX's settlement agreement with CP provides that, through special traffic interchange and joint-line marketing arrangements, rail customers located in the Buffalo/Niagara area will receive effective access to and from CP- and D&H-served markets. The settlement agreement provides effective commercial access for traffic which will be diverted from motor carriers and for certain other categories of rail traffic as well. The CN agreement contains a similar provision to allow CN to convert traffic currently moving by truck to rail movements.

The benefits for Buffalo/Niagara area shippers flowing from the CN and CP settlement agreements are among the many reasons why the Erie-Niagara Rail Steering Committee is wrong in suggesting that Buffalo/Niagara area shippers will be harmed by the proposed Transaction. Just the opposite is true. I have already explained why the benefits of enhanced rail competition in the Shared Assets Areas are likely to carry over to customers located on CSX who compete in their businesses with rail shippers in the Shared Assets Areas. An additional benefit of the Transaction is the improved access that NS will have to Buffalo via the former Conrail Southern Tier route. Historically, NS has served Buffalo only from the West. Now it will have the opportunity to handle Buffalo/Niagara area traffic to and from the East and to compete with CSX on many such movements. The 1995 traffic data relied upon by Erie-Niagara's witness Fauth does not reflect NS's improved access to Buffalo following the Transaction.

#### **New England**

CSX's recent agreement with the P&W will benefit the New England area by allowing shippers using the P&W a rail option not previously available. The P&W



agreement permits P&W to independently establish and communicate rates to its customers for certain joint-line routes involving CSX without CSX concurrence. This arrangement will eliminate needless delays in establishing rates and result in more efficient service between New York City and New England. Equally important, the agreement signals a commitment by CSX to develop the New York to New England freight market and to divert traffic from trucks on the heavily congested I-95 corridor.

#### Comments Addressed to Specific Parties

Finally, I want to comment on aspects of the filings of two particular parties, the Philadelphia Belt Line Railroad and International Paper Company.

##### **Philadelphia Belt Line**

The Philadelphia Belt Line Railroad, a 16.3 mile line railroad within the City of Philadelphia, has asked for the imposition of "equitable" reciprocal switching rates for any carrier that might, in the future, obtain access to Philadelphia and for imposition of reciprocal switching rights on behalf of CP/D&H. (PEL-10)

Shippers on the Philadelphia Belt Line today have access to only one Class I carrier -- Conrail -- and post-Transaction will have access to both CSX and NS. In addition, CP, on whose behalf the Belt Line purports to act in its submission, will have commercial access to Philadelphia Belt Line shippers under the Settlement Agreement with CSX. Thus, the Philadelphia Belt Line's situation will be dramatically improved as a result of this Transaction, and there is no rationale for a Board-imposed remedy.

##### **International Paper**

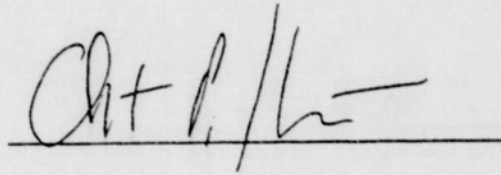
IP alleges that it currently enjoys single-line service via Conrail between its

facility at Lock Haven, PA and its paper mill in Erie, PA. IP expresses concern about the joint-line service it will receive following the Transaction. I understand from Conrail that the move is currently originated by a shortline railroad, the Nittany and Bald Eagle, which switches the IP facility at the Lock Haven end of the movement. We believe that the service to be provided by CSX and NS for IP will be similar, if not identical to, the service IP receives today over the existing route. I would also note that the proposed Transaction will give NS a single-line route for the Lock Haven/Erie movement. Traffic could move on NS from Lock Haven through Buffalo to Erie, and CSX would provide switching service at Erie.

VERIFICATION

I, Christopher P. Jenkins, 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 on December 8, 1997.

A handwritten signature, appearing to read "Ch + P. / Jenkins", is written over a horizontal line.

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**In the Matter of**

**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**

STB Finance Docket No. 33388

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**REBUTTAL VERIFIED STATEMENT  
OF  
JOSEPH P. KALT**

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**I. INTRODUCTION**

**I.A Introduction and Overview of Topics Covered**

My name is Joseph P. Kalt. I am the Ford Foundation Professor of International Political Economy and Faculty Chair of the Economics and Quantitative Methods Section at the John F. Kennedy School of Government, Harvard University, Cambridge, Massachusetts, 02138. In addition, I work as an economic consultant with The Economics Resource Group, Inc., One Mifflin Place, Cambridge, Massachusetts, 02138. I have previously filed a Verified Statement in this proceeding on behalf of Applicants CSX Corporation and CSX Transportation, Inc. (together referred to herein as "CSX"). My statement focused on the implications of the proposed transaction for the competitiveness and efficiency of the nation's railroad system. My previous statement also provided details regarding my qualifications and included my *curriculum vitae*.

I have now been asked by CSX and Norfolk Southern Corporation/Norfolk Southern Railway Company ("NS") to review and comment upon submissions made by a number of parties relating to the Application of CSX and NS for control of Conrail Inc. and Consolidated Rail Corporation ("Conrail"). This Rebuttal Verified Statement reports the results of my study and analysis of the submissions of selected parties that have raised economic issues regarding the proposed transaction. In particular, I address here analyses and arguments raised by various commentators in three primary areas:

- ***Asserted Harm Due to Expansions of Competition:*** A number of commentators express fears that the proposed transaction's enhancements of competition in certain high-volume traffic areas will adversely affect the competitive fortunes of certain shippers and/or railroads located outside of such areas. These commentators typically request that the pro-competitive nature of the CSX/NS acquisition and disposition of Conrail be extended further to include the commentators' territories.
- ***Supposed Harm Due to Vertical Integration and Expansions of Single-Line Service:*** Several commentators express concern that the vertical, end-to-end integration of Conrail into CSX and NS will adversely affect shippers by causing post-transaction rates to rise (apparently) in response to supposed adverse effects on competition or the expansion of single-line service. These parties seek conditions on the transaction that would compel the Applicants to either extend their pro-competitive Shared Assets Areas (SAAs) to unspecified broader areas, grant system access to intervening parties via trackage (or related) rights, or impose tighter regulatory limits of rates on "bottleneck" routes.
- ***Proper Interpretation and Regulatory Treatment of the Acquisition Cost:*** Multiple commentators express objections to the purchase price that NS and CSX have paid for control of Conrail, arguing that a so-called "acquisition premium" (measured in numerous and inconsistent ways) will adversely impact shippers by loosening regulatory oversight of CSX's and NS's rates and/or by putting CSX and NS under special financial pressure to raise rates. These parties typically request that the



difference between the purchase price of Conrail and Conrail's pre-transaction net book value be excluded for purposes of calculating applicable jurisdictional thresholds and making revenue adequacy determinations.

## **I.B Summary of Findings**

As discussed in my original verified statement, my analysis indicates that the competitive effects of the CSX/NS acquisition of Conrail are decidedly and demonstrably positive. The transaction would introduce dual service areas into a large portion of Conrail's otherwise solely rail-served territory, while adopting measures to ensure that multiple rail carriers will continue to compete where the CSX and NS integration of Conrail would otherwise eliminate multiple rail options for shippers. These competition-enhancing and competition-protecting terms of the Applicants' proposal are complemented by the very substantial cost savings and service improvements that the integration of Conrail's Northeast system into the CSX and NS networks portends. The evidence is compelling that the savings from this integration are on the order of hundreds of millions of dollars per year. The projected service improvements for shippers arise from expanded single-line operations, streamlined interchanging and handling, and enhanced equipment and yard utilization. Upon analysis of the issues noted above that commentators raise, I do not find the foregoing conclusions to be overturned. Specifically:

- *Implications of Enhanced Competition:* In any market, it is understandable that consumers of a good or service prefer more, rather than fewer, competitive options. It is also understandable that users of railroad services would seek to use the evident opportunity of a control proceeding to pursue such a preference. Nevertheless, from a public policy perspective, the extent of the proper scope of review is the *protection of competition relative to its pre-transaction status quo*. Complaints that other people and businesses will be made relatively better off by more rail-to-rail competition and

improved service are not grounds for denying or further conditioning a railroad control transaction. Even when the acquiring parties to a control transaction—NS and CSX in this case—put forth a proposal that offers to enhance competition relative to the *status quo*, sound policy is not compelled to then try to push the parties yet further. To do so would put railroad policy back into the losing game of trying to micro-manage the winners and losers in railroad markets. It would also make the outcome of control transactions more onerous and/or less certain. This would only discourage parties from seeking out cost-saving and service-improving transactions of the type at hand.

- *Purported "Vertical" Effects of the Transaction:* The integration of Conrail's assets into the CSX and NS systems portends substantial expansions of single-line service for traffic originating and terminating in the Northeast. Moreover, by introducing SAAs and related multiple-rail service settings, the transaction would eliminate a large number of high-volume bottlenecks otherwise attributable to Conrail's sole-service status in its territory. The arguments proffered by various commentators purporting to demonstrate that expansions of single-line service portend harm to competition and shippers do not weaken these conclusions. Where parties do offer evidence of prospective anti-competitive implications of the vertical integration of Conrail into CSX and NS, such evidence is seriously flawed and fails to support the commentators' contentions. In fact, such commentators' analyses pertain to situations in which *horizontal* competition (*i.e.*, between competitors at a common point) might be reduced. They do not pertain to bottleneck situations, nor do they support the requests for conditions sought.
- *The So-Called "Acquisition Premium":* There is considerable confusion among commentators concerning the definition and implications of asserted "acquisition premia." A "market acquisition premium," defined as the difference between an acquired firm's purchase price and its pre-transaction stock market value, is an expected and common occurrence. In the case at hand, the market acquisition premium does not plausibly reflect capitalization of expected market power somehow awaiting CSX/Conrail and NS/Conrail. The acquisition cost does reflect the best measure of the fair market value of Conrail given the opportunity to realize the cost savings and traffic gains that the transaction offers to the marketplace. With fair

market valuation of Conrail's assets in the transaction at issue here, this valuation provides a proper basis for measuring and regulating, if necessary, a railroad under revenue-adequacy and rate-reasonableness criteria. The use of a measure of value less than the fair market value would discourage parties from seeking out efficient and productive restructurings of the railroad system.

## **II. CONDITIONS RELATED TO THE *EXPANSION* OF COMPETITION UNDER THE TRANSACTION ARE UNWARRANTED AND POTENTIALLY HARMFUL**

The proposed joint acquisition of Conrail by CSX and NS will expand competitive railroad options for a very large number of shippers and a very large share of Conrail's otherwise solely-served traffic. Several commercially important areas (*i.e.*, North Jersey, South Jersey/Philadelphia, and Detroit) will be operated as Shared Assets Areas with *both* CSX and NS serving customers and/or facilities in those areas where previously Conrail was the only rail alternative. Similarly, substantial portions of the Monongahela coal region, as well as the Ashtabula Harbor facilities on Lake Erie, will be Joint-Use Areas in which customers will have access to both CSX and NS service. This will create competitive, single-line service to any point on the CSX or NS networks. For convenience, I will refer to the combination of both Shared Assets Areas and Joint-Use Areas as Shared Areas (or SAs).

Among commenting parties, there appears to be wide-spread recognition that the SAs portend substantial enhancement of competition where Conrail previously dominated. Numerous intervening parties echo the sentiment of the Erie Niagara Rail Steering Committee to the effect that: "[T]he businesses located in the Shared Assets Areas will obtain head-to-head rail competition between CSX and NS under the proposal, which expectedly would result in lower

transportation rates and costs for such businesses."<sup>1</sup> Moreover, a very large amount of traffic stands to benefit directly. As shown in Figure 1, more than one million units of the approximately two million units of traffic that receive rail service exclusively from Conrail will experience dual rail service under the CSX/NS proposal.

The improvements in competition and service promised by the SAs unambiguously promote the public's interest in an efficient and competitive railroad system. The prospect of these improvements in the nation's rail service, however, has led shippers and some railroads who are not located in the SAs to seek either similar improvements for themselves, or insulation from the marketplace effects of improvements realized by competitors located within SAs. As one commentator argues: "I know from experience that having a real choice of vendors leads directly to lower prices and better service. Under the [Applicants'] plan, I see these benefits going to our Market's competitors, but not to us, with the predictable result that their market shares will grow at our expense."<sup>2</sup> Commentors in this position request protection from this relative change in fortunes in the marketplace in the form of an STB-mandated extension of the Applicants' Shared Assets Areas' coverage,<sup>3</sup> or an STB-mandated expansion of Joint-Use

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<sup>1</sup> See Erie Niagara Rail Steering Committee (ENRS), "Comments, Evidence and Requests for Conditions," at 3. See also, New York State (NYS) and the New York City Economic Development Corporation (NYCEDC), *Robertson V. S.* at 7; *NYS, Pataki V.S.* at 3; *NYS, Banks V.S.* at 4; *NYS, D'Arrigo V.S.* at 3; *NYS, Firestone V.S.* at 2-3; *NYS, Christie V.S.* at 4.

<sup>2</sup> *NYS, D'Arrigo V.S.* at 3.

<sup>3</sup> See, e.g., the Erie Niagara Rail Steering Committee (ENRS), "Comments, Evidence and Requests for Conditions," at 6; Indianapolis Power and Light (IP&L), "Supplemental Comments, Evidence, and Request for Conditions," at 13; and in support of ENRS: *NYS, "Comments,"* at 5; *Niagara Mohawk Power Corporation (NIMO), "Comments, Evidence and Request for Conditions,"* at 2-3; *Atlantic City Electric Company and Indianapolis Power and Light (hereinafter ACE, et al.), "Joint Comments, Evidence, and Request for Conditions,"* at 5; and *Ace, et al./Consumer Energy Company, Kahn/Dunbar V.S.* at 21.

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**Figure 1**

**CONRAIL TRAFFIC IN SOLELY-SERVED POINTS THAT  
WILL RECOGNIZE DUAL RAIL OPTIONS POST-  
TRANSACTION**

	<b>Units (in Millions)</b>	<b>Percent</b>
<b>Total Conrail Traffic</b>	3.300	
<b>Total Pre-Transaction Conrail Traffic Solely Served</b>	2.204	66.8%
<b>Total "Solely-Served" Conrail Traffic Receiving Dual Options Post-Transaction</b>	1.038	47.1%

Note: "Units" represent railcars or intermodal trailers (as appropriate) measured as Conrail terminations and interline originations.

Source: 1995 STB Waybill Sample.

Areas.<sup>4</sup> Others argue that the protection should take the form of trackage or haulage rights to the Applicants' terminals or interconnections.<sup>5</sup>

The justifications for such STB interventions take differing forms. Some commentators, e.g., New York State, *et al.*, and the Erie Niagara Rail Steering Committee, argue that competition in the SAAs will drive down transportation rates for shippers in the SAAs, thereby harming the end-market competitors of those shippers located off the SAA lines.<sup>6</sup> Certain short-line railroads (e.g., the New England Central) argue that they will carry smaller volumes of traffic because improved efficiency and pricing will lead the marketplace to favor the Applicants' transloading facilities rather than those outside the expanded network.<sup>7</sup> One shipper group, the Erie Niagara Rail Steering Committee, argues that its region is comparable across commodity types, volumes, revenues, route miles, R/VC ratios, and numbers of freight stations to the areas that will be Shared Assets Areas, and therefore, the STB should condition the CSX/NS transaction upon the creation of a "Niagara Frontier Shared Assets Area" in order to "cure" the effect of greater competition.<sup>8</sup> A number of commentators assert that the current arrangement of railroads falls short of the intent of the USRA's 1975 Final System Plan (FSP), and therefore, the

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<sup>4</sup> E.g., PEPCO would like to have the Applicants' Monongahela Joint-Use Area extended to Rochester & Pittsburgh's Mine 84. Potomac Electric Power Company, "Comments and Request for Conditions," at 23.

<sup>5</sup> See, e.g., the New England Central Railroad, Inc. (NECR), "Responsive Application," at 2-3; the Housatonic Railroad Company Inc., "Request for Protective Conditions and Comments," at 21-22; NYS/NYCEDC, "Joint Responsive Application," at 1 (hereinafter, collectively New York State, *et al.*); and NIMO, at 4-5.

<sup>6</sup> NYS/NYCEDC, Robertson, at 7, 12; ENRS, "Comment," at 3.

<sup>7</sup> See, e.g., NECR, Carlstrom, V.S. at 5; Housatonic Railroad, "Request for Protective Conditions and Comments," at 13.

<sup>8</sup> ENRS, Fauth V.S. at 54.

STB should modify the transaction as proposed to more closely resemble the FSP.<sup>9</sup> Finally, certain commentators argue that, having opened the door to shared access to rail facilities, the Applicants lack any reason for not following through with more such areas (apparently to be chosen by commentators).<sup>10</sup>

## II.A Competition, Competitors, and Competition Policy

Writing on behalf of commenting electric utilities, Atlantic City Electric Company and Indianapolis Power and Light ("ACE", *et al.*) and Consumers Energy Company, Drs. Kahn and Dunbar assert that: "The Applicants, having endorsed the concept of equal access in various regions of their own choosing, are not in a position to argue the same concept should not be extended to other areas adversely affected by the acquisition."<sup>11</sup> This represents a rather gross misrepresentation of both the genesis and function of the Applicants' SAs, but serves to highlight the underlying premises of parties seeking expansions of the size and number of SAs.

As discussed at length in my Verified Statement,<sup>12</sup> the Shared Assets Areas have not been designed to remedy competition problems created by the transaction in "areas adversely affected by the acquisition" (*per* witnesses Kahn and Dunbar). Common and well-tested remedies such as those applied by the Applicants in this case to so-called 2-to-1 locales are found in trackage and related arrangements. The proposed Shared Assets Areas go far beyond such arrangements, introducing additional rail options for shippers over broad areas where sole-service by Conrail is

<sup>9</sup> See, e.g., NYS/NYCEDC, Argument of Counsel, at 7.

<sup>10</sup> See Kahn and Dunbar V.S. on behalf of ACE, *et al.*, and Consumers Energy Company, at 21.

<sup>11</sup> Kahn/Dunbar V.S. at 21.

<sup>12</sup> CSX/NS-19, Vol. 2A, Kalt V.S. at 7. 19-26.

otherwise the pre-transaction *status quo*. They have been designed by the Applicants as the product of business negotiations in which both CSX and NS have sought to establish their respective integration with Conrail's system so as to productively meld that system into their own by taking advantage of synergies and untapped efficiencies.

Consider, for example, the North Jersey Shared Assets Area affecting northern New Jersey and the southern portion of the New York City metropolitan area. This area was not "adversely affected by the acquisition"<sup>13</sup> absent designation as a Shared Assets Area. In fact, traffic in the New York City BEA was overwhelmingly solely served by Conrail.<sup>14</sup> Rather, the analysis of traffic flows and synergies described by the Applicants in their Application makes it clear that traffic originating and terminating in the North Jersey Shared Assets Area carries substantial market opportunity for integration into both the CSX and NS systems—and it is reasonable that both CSX and NS would seek such integration in order to make the acquisition and disposition of Conrail "work" for each Applicant. The result, as shown in Figure 2, is that a huge portion of the North Jersey/New York area (*i.e.*, the BEA) rail traffic by Conrail will see the introduction of dual rail service under the CSX/NS transaction.

The proposed Transaction represents the negotiated balancing of interests by the Applicants in order for them to undertake the rationalization of Conrail's integration into the nation's eastern rail network. As detailed at length in my Verified Statement, this rationalization is long overdue. Its delay since Conrail was born of political forces has demonstrably been the

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<sup>13</sup> As witnesses Kahn and Dunbar imply *per* the quoted passage above.

<sup>14</sup> CSX/NS-19, Vol. 2A, Kalt V.S. at 59.

Figure 2

## THE INTRODUCTION OF DUAL RAIL OPTIONS IN THE NEW YORK BEA

Pre-Transaction: Conrail Solely Served Traffic 732,602 Units

--- Of Which ---

Post-Transaction: Traffic w/ Dual Rail Options 94.5%

Note: "Units" represents railcars or intermodal trailers (as appropriate) measured as Conrail terminations and interline originations.  
Source: CSX/NS-19, Vol. 2A, Kalt V.S at 58.



source of impediments to productivity, insulation of Conrail from intramodal competition, and unrealized potential for service improvements.<sup>15</sup> The public is a direct beneficiary of the *pro*-competitive and cost-saving consequences of the Shared Assets Areas that the private sector negotiations of the Applicants has produced.

Public policy toward acquisitions should welcome and encourage the kinds of *pro*-competitive negotiations that have produced the SAs proposed by CSX and NS. For third, fourth and fifth parties to insert themselves into such negotiations, however, on the grounds that the Applicants should be required to deliver up even more of a good thing entails substantial risks to the public interest. These prospective errors are of at least two general types. First, injecting the private interests of third parties—parties who do not have their capital invested in an acquisition—into *pro*-competitive negotiations over, *e.g.*, the designation of shared assets, can only introduce a disharmony of interests and deter Applicants who do have their capital on the line. Second, the interjection of the private interests of third parties raises the risk that otherwise *pro*-competitive actions by Applicants will be sub-optimized, distorting Applicants' incentives to minimize costs and maximize their abilities to yield value for customers throughout their networks.

From the perspective of sound principles of public policy, the occasion of an acquisition should not be an excuse for the government to attempt to master-plan the nation's railroad network.<sup>16</sup> Oversight policy properly focuses on the protection of competition, seeing to it that

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<sup>15</sup> CSX/NS-19, Vol. 2A, *Kalt V.S.* at 17-19.

<sup>16</sup> A few commentators argue that the transaction deviates from the Final System Plan (FSP) issued by the USRA in 1975, and that public policy should require that the transaction more closely execute the FSP. (See, *e.g.*,

railroad control transactions do not diminish the force of competition relative to the pre-transaction *status quo*. Using the occasion of a control proceeding to address real or advocated problems that are not transaction-related inappropriately invites the policy process to become a venue for self-serving policy advocacy.<sup>17</sup> Raising of non-transaction-related issues, real or imagined, in a merger proceeding forces the policy maker to consider these issues within the analytic framework and information relevant to making decisions regarding competition, as opposed to those for considering broader transportation policy concerns.

None of this is to say, of course, that railroad control proceedings should be anything less than assiduously vigilant in protecting the public from transaction-related effects that are *anti-competitive*. The SAs, however, are not anti-competitive. They are the contrary. Indeed, this is the complaint of commentators seeking to compel CSX and NS to expand the scope of SAs and related provisions under their transactions.

#### II.A.1 Impacts on Shippers

As noted above, at the core of relevant commentators' desires for expansions of SAs and/or protection from the efficiency and pro-competitive consequences of the Applicants' SAs are

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Erie Niagara Rail Steering Committee's witness Fauth V.S. at 10; Livonia, Avon & Lakeville, "Responsive Application," at 10. Notwithstanding whatever merits commentators see in a 22-year-old recommendation for restructuring the rail industry, it is not relevant to this transaction. What is appropriate is to guard against competitive harm through reduced competition that may occur in this transaction, not to attempt to force this transaction to conform to a decades-old planning document.

<sup>17</sup> Two examples of this type of behavior come to mind. The Livonia, Avon, and Lakeville Railroad Corporation (LAL), for example, seeks to obtain new interchange rights with the R&S in a Conrail yard that will be operated by CSX post-transaction (LAL, "Responsive Application," at 12). Similarly, the IC seeks to force the sale of two miles of CSX track on the Leewood-Aulon Line near Memphis because it perceives CSX to be obstructing IC operations on these lines. Regardless of the merits of these claims, they are not related to the transaction nor are they concerned with any change in competition arising out of the transaction, and thus, are not appropriately addressed in the context of a transaction review.

concerns that improvement in the productivity and performance of competitors will adversely affect the relative competitive fortunes of such commentators. It would be wholly inappropriate and impossible, however, to hold competition policy to a standard of both protecting competition and promoting efficiency, on the one hand, and ensuring that successful transactions do not upset the pre-transaction marketplace positions of all shippers, on the other. It is unreasonable and unrealistic to expect that any significant merger or acquisition will affect all suppliers and consumers in the same manner. In fact, the complaints of commentators in this regard might just as well be lodged against any actions that their competitors or their competitors' suppliers around the world or the nation take which make such competitors more efficient and competitive. Such actions, whether they arise from improved railroad rates and services or, say, competitors' investment in new technologies, inherently have the potential to upset the relative fortunes of the different players in the marketplace. This is a description of the process of competition that properly links the fate of shippers across their national and international markets; and such upsetting of the balance of parties in a marketplace is a desirable force in a dynamic economy.

From a factual point of view, shippers raising complaints over the pro-competitive effects of the Applicants' SAs underestimate the degree to which shippers outside of the SAs will benefit from them. In particular, the "relevant markets" in which the positive influence of SAs will be felt are broader than the SAs themselves. Specifically, the boundaries of influence are extended to the extent that shippers outside the SAs are linked to SA rail service by truck (or other modes). That is, the competitive influence of increased rail options in a Shared Area is shared by, for example, shippers of at least truckable products when the reach of trucks is

enhanced. Moreover, end-product competition that links SA shippers and non-SA shippers disciplines transportation costs for the latter, and non-SA shippers and consumers who rely on goods shipped by SA shippers clearly are beneficiaries.

Consider, for example, claims of the New York City-area respondents located outside of the SAs.<sup>18</sup> New York State, *et al.*, claim that "shippers and receivers in New York City and on Long Island...and other areas of New York south of Albany and east of the Hudson River...will be disadvantaged relative to their counterparts on the west side of the Hudson."<sup>19</sup> They conclude that these shippers are deserving of trackage rights along the east side of the Hudson.<sup>20</sup>

Not only is the requested "remedy" inappropriate as a component of competition policy for the reasons discussed above, but the purported harm to non-SA shippers is misrepresented. The reasons for this are the close proximity of the bulk of purportedly-harmed shippers to the SAA in the New York metropolitan area and the ready accessibility of trucks to the bulk of the traffic of such shippers. Indeed, the bulk of all shippers east of the Hudson stand to benefit from SAA competition and efficiency. As shown in Figure 3, substantial traffic in the East-of-Hudson region is made up of goods that can be and/or are already trucked by trailer or container for part of their routing. Figure 3 shows that 42% of the 27,168 units of traffic terminating or originating in the 11-county region east of the Hudson and south of Albany are commodities that are

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<sup>18</sup> State of New York and the New York City Economic Development Commission.

<sup>19</sup> State of New York, *et al.*, Brief, at 4, Robertson V.S. at 2

<sup>20</sup> Brief, at 5.

Figure 3

## TRUCK OPPORTUNITIES IN THE EAST-OF-HUDSON REGION

Total Traffic (Units)	Truckable Traffic (Units)	Truckable Percent
27,168	11,500	42%

Note: "units" represent railcars or intermodal trailers (as appropriate) measured as Conrail terminations and interline originations.



generally "truckable," *i.e.*, they are commodities that can and do move intermodally.<sup>21</sup> Thus, for example, the East-of-Hudson shippers of white wines, or fruit and produce, cited by commentators would benefit from the introduction of competition in the North Jersey SAA because any threat to raise prices outside the immediate vicinity of SAA nodes could credibly be met with a threat to terminate rail moves in the SAA and then ship by truck to eastern New York.<sup>22</sup> In the presence of ample trucking alternatives, sole-serving carriers are constrained in their pricing behavior, and requests for dramatic policy interventions are not warranted.

End-market competition can also limit the ability of solely-serving carriers to raise prices for commodities that are not truckable. If Conrail's shippers are unable to compete successfully in their markets and greatly reduce or stop shipping products and raw materials, Conrail loses. Conrail currently has the incentive to keep the businesses it serves competitive in their respective end markets by offering attractive combinations of price and quality-of-service for the transportation services it provides. CSX and NS will be in the same position when they step into Conrail's shoes. To the extent that the pro-competitive introduction of new rail service in the SAs increases competition in the product markets for shippers not in the SAs, CSX and NS will have an incentive to lower rail rates in non-SA locations to those shippers affected by end-market competition in order to retain profitably such business. Thus, wherever companies outside the reach of the direct spill-over effects of SA *transportation* competition are competing

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<sup>21</sup> "Truckable" here is designated as traffic showing at least ten percent TOFC/COFC movement. This reflects a clear dividing line between heavy, bulk products that are poorly suited to trucking, and those kinds of products that can and do readily take advantage of truck services. Following the methods of New York State and NYCEDC's witness, Robertson, Figure 3 excludes from the Waybill data movements to and from the General Motors Tarrytown plant. See Robertson, V.S. at 9.

with shippers inside the SAs (as many commentators allege is happening),<sup>23</sup> CSX and NS will have the incentive to maintain or enhance the quality of service and attractiveness of pricing.<sup>24</sup>

Finally, commentators' analyses are limited by their exclusion of the effects of the Canadian Pacific Railway (CP) agreement on competitive rail options. Because the CP-NS-CSX agreement was announced on the same day as the respondents' filings, their analyses do not adequately capture the competitive options for rail service that they will have if the transaction is approved. As publicly announced, the agreement will introduce competitive options for shippers in eastern New York, in the Niagara Frontier, and in other regions across the Northeast. More specifically, the carriers have agreed to traffic interchange and interline marketing arrangements for shippers in New Jersey, Buffalo and the Niagara Frontier area, greater Philadelphia, and other areas in the Conrail territory. Shippers in the New York City area and Long Island will have effective access to the CP for traffic currently moving by truck. Similarly, shippers in Montreal will have access to CSX.<sup>25</sup> Thus, shippers affected by the CP agreement who are outside the SAs will witness more rail transportation options than in the pre-transaction *status quo*, and more than

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<sup>22</sup> See, e.g., Responses of State of New York to CSX's First Set of Interrogatories and Requests for Production of Documents, at 8-9 (Vol. 3).

<sup>23</sup> New York State/NYCEDC, "Joint Responsive Application," at 8-9; Erie Niagara Rail Steering Committee, "Comments," at 3. See also CSX/NS-19, Vol. 2A, Jenkins V.S. at 40: "I expect that the discretionary business in the shared areas where both CSX and Norfolk Southern will operate will constitute a powerful bargaining chip for our customers, allowing them not only to negotiate attractive rates from the shared areas but also giving them leverage to negotiate attractive rates on traffic outside the shared areas."

<sup>24</sup> Indeed, a profit-seeking railroad would, if necessary, be willing to price down to full incremental cost rather than see all its traffic from that shipper or location disappear. A railroad cannot be expected to do more, since further reductions in price amount to a subsidy to such shippers.

<sup>25</sup> CSX, "CPR Reaches Commercial Access Settlements with Both NSC and CSX Prior to STB Filing Deadline," CSX Press Release, 10/21/97. Note also that the Canadian National Railway and CSX agreed to "new arrangements at Buffalo, NY, which will enable CN and CSX to better compete for new business in the region." Burke, Jack, "CN, CSX Cut Deal: Canadian National now supporting Conrail breakup plan; CP still talking," *Traffic World*, 9/1/97, at 23.

those analyzed by intervening commentators who complain of the pro-competitive effects of the SAs in the Northeast.

## **II.B Summary**

The joint acquisition by CSX and NS represents the balancing of myriad business judgments. The predominant impact of the transaction is to enhance competition and efficiency through the creation of the Shared Areas and the introduction of improved single-line service. Many of the commentators' requests to the STB to rewrite the business relationship among the railroads in the transaction arise from what amount to complaints about *improved* rail efficiency and competition. These commentators have not had their rail options reduced, and they generally do not claim that the transaction reduces competition. The commentators' concern is that the benefits of the CSX/NS transaction accrue relatively more, or entirely, to the commentators' competitors.

Competition policy is properly focused on making sure that transactions are in the public interest and do not harm competition. Preventing harm from reduced competition is a proper goal of merger policy and an appropriate rationale for intervention that restricts and modifies the options of merging parties. The types of claims discussed above, however, are not valid claims stemming from reductions in competition resulting from the CSX/NS transaction. Providing "relief" from greater competition would be inconsistent with the economics underlying sound merger policy and would run substantial risk of distorting and limiting the pro-competitive and cost saving effects of the CSX/NS acquisition of Conrail.

### III. ISSUES OF VERTICAL INTEGRATION

#### III.A Overview

Several commentators in this proceeding have raised concerns regarding the proposed transaction resulting from changes in the vertical relationships between CSX, NS, and Conrail. These concerns fall into three fundamentally inconsistent categories:

- First are concerns that arise from the loss of single-line service for certain movements on the Conrail system that will become interline CSX-NS moves following the transaction.<sup>26</sup>
- Second are concerns primarily expressed by railroads that interconnect with Conrail regarding the loss of neutral gateways and carriers due to the operational control provided to CSX and NS from the transaction.<sup>27</sup>
- Third are concerns raised by several utilities regarding the potential competitive harm arising from increased vertical integration and the provision of new single-line service on moves that are currently interlined.<sup>28</sup> These concerns are expressed in terms of competitive harm caused by the loss of origin competition due to increased vertical integration. The evidence and argument, however, are as much concerned with pure end-to-end vertical joining or with horizontal issues.<sup>29</sup>

The overwhelming impact of the merger runs counter to the claims of these parties. One of the primary benefits of the joint acquisition of control is to introduce new single-line service on a broad scale where none was possible before and to provide the benefits of a larger, more integrated rail network to all shippers on the current Conrail system.<sup>30</sup> Single-line service results in improved reliability, reduced delay, lower transactions costs for shippers, and reduced damage

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<sup>26</sup> See, e.g., ENRS, "Comments," at 23; CMA/SPI, "Comments," at 24-25.

<sup>27</sup> See, e.g., NECR, "Responsive Application," at 7; ASLRA, "Comments," at 4; IC, Skeiton V.S. at 6-7; CMA/SPI, "Joint Comments," at 26-7.

<sup>28</sup> See, e.g., ACE, *et al.*, "Joint Comments," at 32; CEC, "Comments," at 3.

<sup>29</sup> See, e.g., ACE, *et al.*, Crowley, Kahn/Dunbar.

<sup>30</sup> CSX/NS-18, Vol. 1, McClellan V.S. at 511.



and loss.<sup>31</sup> As such, single-line service is one of the main benefits of the transaction.<sup>32</sup> By integrating the operations of the Conrail system with the CSX and NS rail systems, shippers on the Conrail system will benefit from enhanced single-line service to many locations that currently require interline movements.

Another main effect of the merger is to introduce intramodal rail competition into areas which were previously served by one railroad. The extension of both CSX and NS into the Shared Areas (SAs) provides competitive benefits, in part, through the elimination of vertical "bottlenecks." Nearly half of the current Conrail traffic from solely served origins will receive dual rail options which will result in the elimination of bottlenecks at these locations.<sup>33</sup> The removal of the bottleneck carrier from the Conrail locations dramatically reduces bottlenecks located anywhere on a move from these locations. For example, the transaction will eliminate bottlenecks, as determined at the BEA level, on 95% of the traffic originating or terminating in the New York BEA.<sup>34</sup> The introduction of dual-service options in a number of high-traffic areas has the overwhelming effect of reducing bottlenecks and increasing competition in the U.S. rail system.

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<sup>31</sup> CSX/NS-19, Vol. 2A, Kalt V.S. at 28-39; Interstate Commerce Commission, *Burlington Northern Inc. and Burlington Northern Railroad Company—Control and Merger—Santa Fe Pacific Corporation and the Atchison, Topeka and Santa Fe Railway Company*, Finance Docket 32549, Decision No. 38, August 16, 1995, (hereinafter *BN/Santa Fe Decision*) at 64; CSX/NS-21, Vol. 4B, Claxton Poultry Farms at 632; CSX/NS-21, Vol. 4C, Duferco Limited at 114; CSX/NS-21, Vol. 4D, Magotteaux, at 278.

<sup>32</sup> CSX/NS-18, Vol. 1, McClellan at 511.

<sup>33</sup> See Figure 1.

<sup>34</sup> CSX/NS-19, Vol. 2A, Kalt V.S. at 58, Figure 8.



The introduction of two carriers into the SAs should eliminate all plausible concerns of harm from vertical effects for those areas. The local bottleneck carrier has been eliminated. With shipper access to each system, it would be impossible for either railroad to foreclose the other, even if it were to wish to engage in such foreclosure despite being against its own interest to do so. Neither CSX nor NS will be able to foreclose each other; each railroad can serve these shippers through single-line movements to all locations on each of their systems. Only under the implausible assumption that single-line service is inherently worse than interline service can the new competition between CSX and NS be viewed as causing harm.

### **III.B Single-Line to Interline Service**

Single-line service is one of the primary public benefits to shippers of this transaction as well as other railroad mergers.<sup>35</sup> Single-line service increases efficiency, reduces transit times and delays, reduces damage and breakage, and in general makes rail transportation more valuable to shippers and more competitive with other modes of transportation.<sup>36</sup> The overwhelming net effect of the merger is to create new single-line service with benefits for the affected shippers.

As the CSX and NS transaction rationalizes the operation of the Conrail system, however, certain movements that are currently single-line Conrail movements will become interline

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<sup>35</sup> CSX/NS-19, Vol. 2A, Kalt V.S. at 31, CSX/NS-18, Vol. 1, McClellan at 511; *BN/Santa Fe Decision*, at 64; CSX/NS-21, Vol. 4B, Claxton Poultry Farms at 632, CSX/NS-21, Vol. 4C, Duferco Limited at 114; CSX/NS-21, Vol. 4D, Magotteaux, Vol. 4D at 278; Surface Transportation Board, *Union Pacific Corporation, Union Pacific Railroad Company, and Missouri Pacific Railroad Company -- Control and Merger -- Southern Pacific Rail Corporation, Southern Pacific Transportation Company, St. Louis, Southwestern Railway Company, SPCSL Corp., and the Denver and Rio Grande Western Railroad Company*, Finance Docket 32760, Decision No. 44, August 6, 1996, (hereinafter *UP/SP Decision*), at 113.

<sup>36</sup> CSX/NS-18, Vol. 1, McClellan at 511; ICC *BN/Santa Fe Decision*, at 64; CSX/NS-21, Vol. 4B, Claxton Poultry Farms at 632; CSX/NS-21, Vol. 4C, Duferco Limited at 114; CSX/NS-21, Vol. 4D, Magotteaux, Vol. 4D at 278.

moves. Some commentators complain about the loss of single-line service for some routes.<sup>37</sup> A shift from single-line to interline occurs only in the specific circumstance where a move: a) originates and terminates on the existing Conrail system; b) will not originate or terminate in any of the Shared Areas; and c) where the control of the originating and terminating locations will be divided between NS and CSX. Regardless of the frequency of such changes, the shift from single-line to interline service does not represent a harm to competition nor does it portend an exercise of market power by the Applicants.

Overall, the quantity of traffic that goes from single-line to interline service is a small portion of the traffic affected by the transaction. As discussed in the V.S. of NS witness McClellan, the amount of new single-line service created by the transaction is more than six times the amount of single-line service lost.<sup>38</sup> Even for commentators who specifically fall into the category of losing some amount of single-line service, the effect is modest. The submission on behalf of the Erie-Niagara, for example, states that the dollar amount of traffic losing single-line exceeds that gaining single-line.<sup>39</sup> The impact in that region, however, is less than an [[[ ]]] percent net shift in existing Conrail traffic that will become interline. That is, the percentage of existing Conrail traffic that is interline goes from [[[ ]]], while the percentage of single-line traffic goes from [[[ ]]].<sup>40</sup> The submission by the CMA/SPI complaining about the loss of single-line service explicitly recognizes that the represented

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<sup>37</sup> See e.g., ENRS, "Comments," at 23; Chemical Manufacturers Association/Society of the Plastic Industry (CMA/SPI), "Joint Comments," at 24.

<sup>38</sup> CSX/NS-18, Vol. 1, McClellan at 550.

<sup>39</sup> ENRS, "Comments," at 24.

shippers actually gain new single-line service on more than twice as much traffic as where single-line service is lost (13,000 carloads versus 6,000 carloads).<sup>41</sup> As is pointed out in the Application, the overall effect of the CSX/NS transaction is a very large net increase in single-line service.

### III.C Economics of Vertical Integration and Bottlenecks

Despite the fact that the overwhelming effect of this merger is to remove bottlenecks, it is not surprising that commentators on this transaction would raise bottleneck claims similar to those raised in other proceedings.<sup>42</sup> Those who describe situations that may be true instances of vertical integration in "bottleneck" settings—*i.e.*, where a sole carrier to a location merges with one of several possibly competing upstream, connecting carriers—have not offered evidence that this transaction would engender any anti-competitive effects to themselves or others through the elimination of vertical competition.

Those who purport to offer evidence of the anti-competitive effects of vertical integration arising from the transaction provide evidence that is not applicable to evaluating those claims. As discussed below, the evidence is, at best, useful for evaluating the relative performance of interline and single-line service and the economic operations of the U.S. coal market and does

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<sup>40</sup> Derived from ENRS, *Fauth V.S.* at 31. Note: [[[ ]]]% of Fauth's uncategorized traffic post-transaction is treated as single-line.

<sup>41</sup> *CMA/SPI, Grocki V.S.* at 15-16.

<sup>42</sup> *E.g.*, in Surface Transportation Board, *Central Power & Light Company v. Southern Pacific Transportation Company*; *Pennsylvania Power & Light Company v. Consolidated Rail Corporation*; and *Midamerican Energy Company v. Union Pacific Railroad Company and Chicago and North Western Railway Company*. Decided: December 27, 1996, or in ICC, *BN/Santa Fe*.

not serve to suggest harm resulting from vertical foreclosure.<sup>43</sup> Moreover, I am unaware of any commentators who provide specific evidence demonstrating that they will suffer competitive harm from a change in the vertical organization of the rail system resulting from this transaction. For example, the coal consuming power-plants of Atlantic City Electric served by Conrail are in a Shared Assets Area and will now have two competing carriers; for the reasons indicated above, such a circumstance provides no reasonable possibility for competitive harm from vertical changes arising from this transaction.

### **III.C.1 The "One-Lump" or "Neutrality" Result**

Assertions of harm raised by the commentators regarding vertical issues echo those heard and rejected in other proceedings. Commentors theorize that when a rail carrier that is the sole carrier serving a destination (or an origin) merges with one of multiple upstream carriers in an end-to-end transaction, this combination can cause the shipper to lose the benefits of upstream (or downstream) competition. The merging downstream railroad is then alleged to foreclose inefficiently the non-integrated upstream railroads from competing for movements, causing the shipper to lose the benefits of upstream competition.

The Board has examined similar claims many times before in other settings and has concluded, based on the economic evidence available to it, that such an outcome is inconsistent with the economics of the railroad industry.<sup>44</sup> The economics of the "one-lump," or "neutrality," result demonstrate that, if upstream competition is sufficient, the sole destination (or origin) rail carrier

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<sup>43</sup> See, for example, Crowley; Kahn/Dunbar on behalf of ACE, *et al.*

has the incentive and the ability to capture all of the profit available from market power in the vertical chain, both before and after vertical integration with one of the upstream competitors.<sup>45</sup> More generally, even if upstream competition is imperfect, and the upstream carrier is able to capture some of the "lump" available in rates above the competitive level, a vertical merger will not create any additional ability to raise prices to the detriment of the shipper.<sup>46</sup>

Figure 4 shows the classic "rat-tail" case of vertical integration. Initially, a single bottleneck carrier connects with two upstream carriers that serve the same origin. After a vertical-integration transaction, the downstream bottleneck carrier merges with one of the upstream carriers. Thus, after the transaction the integrated carrier must now decide whether to provide upstream carriage itself or, effectively, to purchase such carriage, *i.e.*, whether to "make" or "buy" upstream transportation. A vertically-integrated, profit-seeking rail carrier has every incentive to make an efficient "make-or-buy" decision. The vertically-integrated carrier will remain properly neutral in deciding whether to provide carriage itself or to use carriage provided by the competing carrier. If the competing upstream railroad can provide carriage at a price less than what it costs the vertically-integrated carrier to provide the same service, then it has every economic incentive to use the competitor. By inefficiently choosing to provide upstream carriage at an incremental cost greater than what it could "buy" from the upstream competitor, the vertically-integrated carrier reduces the size of the lump of profits that it can earn. There is

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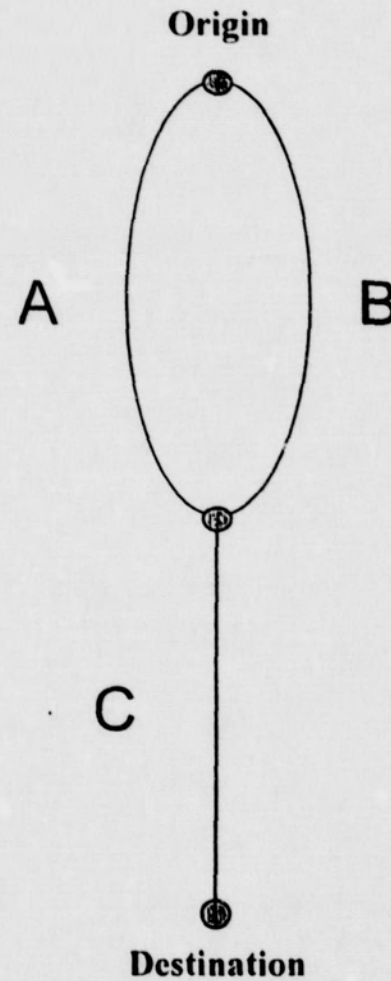
<sup>44</sup> *BN/Santa Fe Decision*, at 74; see also *Kalt Rebuttal V.S. on behalf of BN/Santa Fe in ICC Finance Docket 32548* (redacted).

<sup>45</sup> While the discussion is generally framed in terms of single downstream carrier with multiple upstream competitors, the principles also apply if competition occurs downstream and there is only a single upstream carrier. Also, the term "profits" is used here in the economic sense of returns in excess of the full incremental cost of providing the service.



Figure 4

**VERTICAL INTEGRATION AND BOTTLENECK CARRIERS:**  
The "Rat-Tail" Rail System



no incentive for a profit-seeking, vertically-integrated carrier to harm or inefficiently foreclose the competing carrier from carrying traffic.

Finally, to the extent that the incremental cost of the upstream movement to the vertically-integrated carrier, whether provided internally or by the competing upstream carrier, is reduced, the vertically-integrated carrier has the incentive to reduce rates to the shipper. Even if it has market power at the destination, the vertically-integrated carrier that receives the benefits of lower upstream costs has the incentive, thereby, to obtain additional profitable business by lowering rates to the shipper. Thus, shippers benefit in the form of lower through rates resulting from competition-driven reductions in upstream carriage costs, even when served by a vertically-integrated downstream bottleneck carrier.

### **III.C.2 Implications and Extension of the One-Lump Result**

The one-lump result is broadly applicable to a variety of market conditions. The classic rat-tail example of the one-lump result can be extended, with proper modifications, to situations where: (i) there are different but competing originations, (ii) there are upstream carriers with different incremental costs of service, or (iii) commodities with varying supply and demand conditions are transported between the same origin and destination. While some of the subsidiary implications of the one-lump result vary in these more complicated situations, the fundamental implications for merger policy remain: The profit-seeking, vertically-integrated carrier has the incentive to choose efficiently whether to "make or buy" with regard to upstream transportation, and the shipper is not harmed by the vertical integration of the upstream and downstream carriers.

*Information requirements.* Contrary to the assertions of Kahn/Dunbar, the "one-lump" outcome does not rely on stringent, unrealistic assumptions about information in the market or available to the carriers. Kahn/Dunbar specifically mention four types of perfect information they argue is necessary for the "one-lump" result to hold:

- 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.<sup>47</sup>

None of these requirements is generally necessary for the one-lump result to hold. In the face of uncertainties such as those described by Kahn/Dunbar, a profit-seeking railroad makes the best, rational decision it can based on information about the shipper, the markets for the commodity shipped, carrier costs and regulatory constraints. The decision may not be identical to that which would occur in the presence of perfect information, but that does not invalidate the one-lump result. The presence of less-than-perfect information merely means that the railroad will sometimes make "errors" by establishing transportation rates above and below the levels at which they would be set in the presence of perfect information. In none of the cases identified by Kahn/Dunbar, however, is there a reason to believe that the railroad will make errors consistently in one direction, that is, there is no reason to believe that the resulting outcome will be biased from the basic one-lump result. Just as it would in a market with many competitors, the

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<sup>47</sup> ACE, *et al.*, Kahn/Dunbar V.S. at 8.

vertically-integrated carrier makes decisions in the face of uncertainty regarding what customers are willing to pay; and just as it would in non-bottleneck markets, the seller of a good or service may try to set a price above or below that which would be set in the presence of perfect information. The important point is that there is no reason to believe that the vertically-integrated bottleneck carrier will make systematic errors. As in other markets, there is no reason to believe that less-than-perfect information will cause the profit-seeking railroad to behave in ways that lead to sustained, substantial and biased deviations from the one-lump result.<sup>48</sup>

**Bottlenecks, horizontal mergers, and build-outs.** The economics of the one-lump also do not invalidate the standard analysis of horizontal competitive impacts. Kahn/Dunbar argue that the one-lump result requires 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."<sup>49</sup> This is not quite right. As I discuss in more detail below, the size of the "lump" depends greatly on supply and demand conditions in various markets and the available alternatives to the shipper. A bottleneck carrier will always be subject to limitations on market power from source competition, potential new entrants, and transportation alternatives that limit the shipper's willingness to pay. It is true that in some very specific cases, the

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<sup>48</sup> The ICC has, in previous rail merger proceedings, been faced with similar claims regarding the dependence of the one-lump result on particular assumptions and has concluded, based on economics and other evidence, that these assumptions are not necessary for the one-lump result to prevail. For example, when faced with a long list of purported requirements for the one-lump result to hold, including "the bottleneck carrier must have perfect information regarding all aspects of pricing," the ICC concluded that "We do not think the one-lump theory requires the series of perfect conditions the utilities claim must be present for the theory to accurately represent the coal transportation markets at issue here. Our focus is on *substantial* harm to competition....The fact that a bottleneck carrier might not have perfect information to execute a perfect price squeeze or to extract the last penny of economic profits does not mean that *substantial* benefits to shipper will be lost when the bottleneck carrier merges with a connecting carrier." *BN/Santa Fe Decision*, at 74.

<sup>49</sup> ACE, *et al.*, Kahn/Dunbar V.S. at 7.

*horizontal* merger of railroads can have competitive effects on the bottleneck carrier's ability to exercise its market power. However, rather than being in contradiction with the one-lump result, such effects turn out to be a straightforward application of that result.

In their appendix, Kahn/Dunbar present an example in which the horizontal merger of two carriers can present competitive harm. The essentials of their argument are reproduced in Figure 5. In this example, there is a vertically-integrated carrier with a downstream bottleneck (Railroad A), an independent upstream carrier (Railroad B), and a potential entrant on the downstream leg in the form of a potential "build-out" to connect with the independent upstream carrier.<sup>50</sup> It is important to note that the build-out option has a full incremental cost greater than that of the downstream portion of the vertically-integrated carrier. A credible threat of the build-out, however, can, by raising the possibility of an independent route from origin to destination over the build-out link and the independent upstream carrier, constrain the price charged by the apparent bottleneck carrier.

What happens if the upstream carrier merges with the vertically-integrated carrier in a horizontal merger, so that the number of independent carriers upstream goes from 2 to 1? In this case, in the absence of an independent upstream carrier, the ability of the potential downstream build-out option to constrain the price charged by the vertically-integrated bottleneck carrier is eliminated. This effect is consistent with the one-lump result. The horizontal merger between the two upstream carriers creates a sole-carrier bottleneck at the upstream end. The potential

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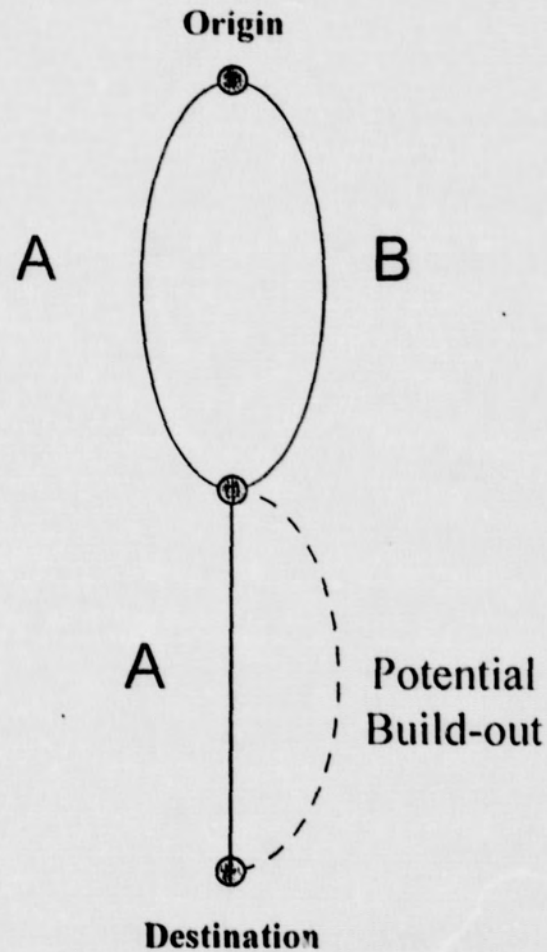
<sup>50</sup> I use the term "build-out" to refer to the construction of a new rail link that connects, in this example, the destination location with an upstream carrier. It is not relevant for this discussion whether it is "built-out" by the shipper or "built-in" by an independent upstream or other railroad.



Figure 5

## THE KAHN AND DUNBAR EXAMPLE

How a Horizontal Merger Can Harm Competition in the Presence of a Potential Build-out



build-out acts as a competing carrier on the downstream leg, with an incremental cost above that of the existing downstream carrier.<sup>51</sup> The newly-merged upstream bottleneck carrier has the ability now to extract the full lump of profit, unconstrained by the threat of an independent routing that includes the build-out and an independent upstream carrier.<sup>52</sup> In short, the horizontal merger of railroads A and B eliminates competition from the railroad B build-out alternative to the single-line railroad A route.

A number of conclusions can be drawn the hypothetical build-out case provided by Kahn/Dunbar. First, the one-lump result applies to situations in which build-outs may occur; it merely requires recognizing that viable threats of build-out can represent a form of horizontal competition. Second, the reduction or elimination of horizontal competition ought to be scrutinized to ensure that competitive harm does not occur. Neither implication is inconsistent with the one-lump result, proper merger policy, or Board precedent. The Board's predecessor has previously found, when presented with credible evidence that fits the Kahn/Dunbar example, that a horizontal merger can create competitive harm in the presence of a viable build-out opportunity, and has granted protections in an effort to mitigate such harm.<sup>53</sup> The possibility proposed by Kahn/Dunbar does warrant close scrutiny in particular circumstances, but it does not

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<sup>51</sup> If the build-out had a lower full incremental cost than the existing downstream segment, it would be built and utilized regardless of whether there were one or two upstream carriers. Indeed, that is an implication of both competition and the one-lump result.

<sup>52</sup> The lower-cost build-out route might, however, lead to a lower rail rate for the shipper. In the presence of reduced through costs, the vertically-integrated carrier may adjust its transportation pricing downward to account for its lower costs and to attract more profitable business.

<sup>53</sup> The ICC granted protections to Oklahoma Gas & Electric in circumstances analogous to the example in the Kahn/Dunbar appendix. *BN/Santa Fe Decision*, at 68. Similarly, in the UP/SP merger decision, the STB made provisions intended to protect shippers with build-out threats from competitive harm due to the elimination of horizontal competition between UP and SP, STB, *UP/SP Decision*, at 106.

invalidate the one-lump result. Neither Kahn/Dunbar nor others have provided evidence that the horizontal aspects of this transaction will lead to substantial harm to competition through the elimination of build-out opportunities

**Upstream competition and cost structures.** The one-lump result can, quite naturally, be extended beyond the simplest rat-tail setting laid out in Figure 4. As a descriptive device, it is common to assume that the two competing upstream segments have the same incremental cost and that they compete against each other to drive price down to incremental cost. Neither assumption is required for the basic result that vertical integration by the bottleneck carrier harms neither competition nor shippers; but other implications of the simplest form of the one-lump result need to be revised. First, if the two unintegrated upstream segments do not compete vigorously enough to drive the price of upstream carriage down to incremental cost, some of the lump may be retained by the upstream carriers. This does not invalidate the one-lump result. In fact, in this case, the vertical integration will tend to reduce rates to shippers by eliminating the "double marginalization" that occurs when the upstream leg is priced above incremental cost.<sup>34</sup>

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<sup>34</sup> When more than one link in a vertical chain attempts to maximize profits by charging above marginal cost, then double marginalization occurs. In this case, the upstream leg is priced above marginal cost by the (imperfectly) competing upstream carriers. The downstream bottleneck carrier treats that upstream price in excess of marginal cost as the cost the downstream carrier faces for that portion of the move, and it marks up that price in order to maximize its profits. The result is that a margin is placed on the upstream move by both the downstream and upstream carriers which results in a through-price greater, or at best no lower, than a price that would be charged by an integrated carrier.

Double marginalization will also occur when there is both a destination and an origin monopolist. Each tries to capture as much of the "lump" as possible, resulting in both parties trying to mark-up price above incremental cost. Vertical integration in that case will also result in rates to shippers that are the same or reduced. The concept is set forth in economics textbooks: see, e.g., McCloskey, D.N. *The Applied Theory of Price* (New York: Macmillan, Publishing Co., 1982), at 378-39.

In another extension of the simple rat-tail example, the two upstream legs may have different incremental costs, say \$8 and \$10 respectively. To secure the upstream traffic the low-cost provider need not price its service less than the cost of the high-cost competing carrier. In my example, the \$8-cost carrier can price its carriage at up to \$10, earning \$2 above its incremental cost. Thus, if the incremental costs of competing upstream carriers differ, there is no reason to believe that competing upstream carriers will earn no contribution above incremental costs. This is true even if the bottleneck carrier integrates with the high-cost upstream carrier. The competing carrier will try to price to just match the revenue that the integrated carrier needs to cover its incremental costs; in this example, \$10. With vertical integration, the competing upstream carrier will earn a contribution (or rent) above its incremental cost due to its cost advantage. If the bottleneck carrier were integrated with the low-cost carrier, we would not expect to see the high-cost carrier win the traffic, as the vertically-integrated carrier will internalize the lower (\$8) cost for the upstream carriage into its pricing decisions. This is the case where it might appear that a competing option is not being used after a vertical merger, but only because the vertically-integrated carrier is the low-cost, efficient provider of the service.

The application of both extensions to the simplest rat-tail case, in which upstream competitors compete imperfectly and have different incremental costs, implies that carriers on the non-bottleneck segment will earn economic profits above incremental cost. Due to the historical accident of the current route system and the high-cost and rarity of entry through the construction of new rail routes, it is reasonable to expect that competing rail routes will

frequently have cost differences which may be quite large.<sup>55</sup> This straightforward extension of the one-lump example demonstrates that the hypothesis constructed by Kahn/Dunbar stating that "on such routes [*i.e.*, routes where there is a bottleneck but potential interline competition at the origin], the competitive origin carrier should make zero profit" is not, in fact, an implication of the one-lump result.<sup>56</sup> As I discuss below in more detail, the results of the purported tests by Crowley and Kahn/Dunbar—tests based simply on whether non-bottleneck carriers on bottleneck routes earn zero profit—fail to provide useful economic evidence on the applicability of the one-lump result.<sup>57</sup>

*Origin and product competition and the size of the "lump."* Commentor witnesses Crowley and Kahn/Dunbar have proposed tests of the one-lump result using comparisons of the size and distribution of rates and lumps across varying origins, destinations, and goods. It is important, therefore, to understand the implications of the one-lump result across such dimensions. The simple rat-tail diagram in Figure 4 may also be used to extend the one-lump result to account for multiple commodities and competing origins. To do so, however, requires more careful consideration of what makes up the "lump" of profit on a move. The bottleneck carrier's ability to extract revenue in excess of its cost depends on the degree of market power it has in the range in which rail revenue exceeds the cost of transportation. The ability of the

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<sup>55</sup> In many industries, sustained differences in costs between competitors are assumed to disappear over time with the entry of new competitors who are capable of replicating or improving on the cost structure of existing competitors. Entry is difficult in the rail industry due to the high cost of creating new rail routes compared to the cost of expanding or improving existing ones by incumbent carriers and compared to the revenue opportunities available in most locations following entry.

<sup>56</sup> Kahn/Dunbar V.S. at 10-11.



bottleneck carrier to establish rates for the move depends on the difference between what the purchaser of the commodity is willing to pay for delivery and what the supplier of that commodity is willing to accept at the origin for its commodity. The purchaser's willingness to pay will depend on the options it has to purchase the same commodity from other sources, the response in the product markets to increases in product prices, the extent of substitutes for the purchased commodity, and so on. Similarly, the seller's willingness to sell depends on the options it has to sell through other outlets, the degree of competition it faces in such markets, its cost structure, the alternatives to produce other goods, and so on. All of these factors, which can be summarized in the difference between the demand for the commodity delivered by the railroad to the destination shipper and the supply of the commodity delivered to the railroad by the originator, affect the potential size of the "lump."

The size of the potential profit to the bottleneck railroad (*i.e.*, the "lump") will depend on myriad factors specific to each commodity and set of shippers. In the simplest rat-tail diagram, the one-lump result is explained in terms of a single origin and commodity with a fixed amount of available profit. There is no requirement, however, that the lump be constant across rates or shippers. For example, coal shipped to baseload power plants may have very different demand characteristics depending on whether the volumes shipped represent baseload or incremental volumes. Hence, the market power and profit opportunity available to a bottleneck railroad will depend both upon whether the coal is needed for baseload or incremental volumes and upon the alternatives available to the power plant in terms of other coal sources, source competition from

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<sup>57</sup> ACE, *et al.*, Crowley V.S. at 19-24 gives other examples in which the competing upstream carrier appears to earn positive profits. For the reasons discussed above, such examples are not necessarily an invalidation of the

other plants possibly using other types of fuel, and competitive alternatives in the power market. Thus, the "lump" may not be constant even for the identical commodity moved from a single producer at one location to a single consumer at one destination. This fact does not alter the fundamental conclusions of the one-lump theorem that vertical integration by the bottleneck carrier does not harm competition or shippers.

Figure 4 shows the upstream carriers serving the same origin. When multiple origins and producers of goods are considered, the one-lump analysis remains the same, but specific numerical predictions are harder to make. The size of the profit opportunity will be the same across the two origins only if competing producers at different origins have identical supply alternatives and cost structures at the margin, the consuming shipper considers the commodities produced by the two producers perfect substitutes, and the apparent upstream cost to the bottleneck carrier is identical. Differences in each of these characteristics—the costs of production, the willingness to pay of the buyer, and the incremental costs of the movements—will lead to differences in the lump available to the downstream carrier. Thus, for example, one origin may be served by several carriers that compete vigorously, while another origin for the bottleneck carrier may be served by two carriers who compete less vigorously. All else equal, the former origin will leave a better profit—a bigger "lump"—than the latter. Higher-cost producers, lower-quality commodities, and higher incremental-cost of upstream movements all reduce the lump available to the bottleneck railroad. As the differences across origins get larger,

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one-lump result.

the differences in the size of the available lump increase, and the degree of effective competition across the origins and commodities declines.

None of these sources of variation in the size of the "lump" changes the reasoning underlying the one-lump result and the impact of vertical integration on competition and shippers. It does mean, however, that as commodities and origins become less perfect sources of competition, the precision with which the one-lump result can say where rates will be highest or lowest is reduced. A single carrier serving New York, for example, may have a bottleneck with respect to coal from West Virginia and wine from California. In the absence of an enormous amount of other information and knowledge, however, it is not possible to predict which commodity will pay the highest rate per unit or yield the largest lump for the bottleneck carrier.

This observation has implications for empirical testing of the one-lump result. In making predictions about the behavior of bottleneck railroads and rail rates for the purpose of testing the one-lump result, it is imperative that such factors as differences in origins, upstream costs of movements, cost structures and supply alternatives of producers, quality and substitutability of commodities, destination purchasers' willingness to pay, and sources of substitution and competitive discipline be properly taken into account. Small differences in these factors can lead to significant numerical differences in rates, "lumps," and test results. Failure to account carefully for such factors can render any empirical test of the one-lump result invalid. As I discuss in more detail below, Crowley and Kahn/Dunbar fail to properly account for this danger.

Kahn/Dunbar propose three hypotheses, the first of which is implicitly reflected in a test attempted by Crowley:

- 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 competition at origin, the bottleneck carrier should make the same "profit" regardless of whether it handles traffic for the whole route or only for the bottleneck portion;
- the existence or extent of origin competition should not tend to reduce prices for the local service.<sup>58</sup>

I now turn to an examination of the Crowley and Kahn/Dunbar test of these hypotheses.

### **III.D Alleged "Evidence" Regarding the One-Lump Result and Impacts of Vertical Integration**

There is almost no attempt by the commentators, apart from bald assertion, to demonstrate that the proposed transaction will cause competitive harm through vertical integration. Only the verified statements of Crowley and Kahn/Dunbar purport to provide evidence that vertical integration is harmful. They attempt to do this primarily by looking at differences in prices and contributions for disparate categories of traffic and arguing that implications of the one-lump result have been violated. As I point out above, the implications that Crowley and Kahn/Dunbar assert follow from the one-lump result are not necessary implications and certainly should not be expected to hold in the data and tests they perform.

#### **III.D.1 Analysis of MGA-Originated Coal Movements**

Both Crowley and Kahn/Dunbar examine patterns in coal transportation prices. In particular, they both attempt to look at the change in rail transportation rates between 1991 and

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<sup>58</sup> ACE, *et al.*, Kahn/Dunbar V.S. (ACE) at 10-11.

1995 for coal originating on what was once the Monongahela Railway (MGA) compared to rates from other sets of coal originations, both of which terminated at Conrail destinations.<sup>59</sup> They state that Conrail merged with the MGA in 1991 and thus the change between 1991 and 1995 can show the effects of the merger of an origin with a destination railroad. The difference in the status of the MGA they claim represents the elimination of origin competition for Conrail destinations receiving MGA coal. [[[

]]] They conclude that this proves the one-lump result does not hold. Such a conclusion is justified given the facts, the data and controls they use, and the conditions they study in the coal markets.

The flaws in their "before and after" analyses are myriad. Any one of these errors would be sufficient to invalidate their conclusions. Together, these errors render their findings simply uninformative about what they claim to be testing. The more significant errors include:<sup>60</sup>

- There is no "before" in the Crowley and Kahn/Dunbar "before and after" tests. Conrail already owned the MGA in 1991. Conrail had acquired ownership of all of the stock in the MGA in 1990.<sup>61</sup> In most instances, economists consider complete ownership sufficient to provide the incentive to control the types of decisions, such as

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<sup>60</sup> In the case of Kahn/Dunbar there were a series of what appear to be errors in data handling. Kahn/Dunbar drew their information from a large set of observations created by Crowley. We were unable to obtain workpapers from Kahn/Dunbar on how the data provided by Crowley was processed to get their smaller samples they used in their analysis; we were told that there were no such workpapers as the data was processed "by hand." Whatever process was used introduced a number of errors, such as one major movement that was apparently inadvertently re-coded from 8 million tons to 8 thousand tons, multiple instances in which revenues from the wrong year were used, inclusion of data that did not meet the stated screening criteria, and exclusion of data that appear to meet their stated criteria.

<sup>61</sup> 1990 Conrail Annual Report, at 3, 5.



pricing, service quality, and interchanges, that control vertical rail relationships. In the specific case of the MGA, the ICC agreed: "...whatever incentive it [Conrail] might have to do so [i.e., alter existing interchange relationships with connecting railroads] results from its control of MGA and is not affected in any discernible way by this [1991] merger transaction."<sup>62</sup> To the extent that ownership of the MGA provided Conrail the ability, if it chose, to adjust pricing behavior, there was no relevant change in the vertical structure of the MGA during the period Crowley and Kahn/Dunbar examined. As such, the analyses performed by Crowley and Kahn/Dunbar cannot qualify as a test for price changes resulting from vertical integration.

- Crowley and Kahn/Dunbar fail to test the one-lump hypothesis. Specifically, they do not restrict themselves to looking at bottleneck destinations. Over 17% of the destinations examined are competitively served by another railroad.<sup>63</sup> Moreover, no attempt has been made to control for competition from other sources, such as water-carried coal.
- The MGA was the sole originating railroad providing service for most of the mines on its system. Thus, both before and after the acquisition of the MGA by Conrail, the origins on the MGA lacked origin rail competition. It is incorrect to treat the merger of the MGA with Conrail as reflecting the reduction in origin rail competition for the MGA mines. It was, in fact, a pure end-to-end merger in which Conrail integrated with an upstream carrier. Thus, if the relevant product is MGA-produced coal for delivery to Conrail coal destinations, the merger is more accurately viewed as the vertical integration of two carriers that could not have eliminated origin competition. In this case, vertical foreclosure is not a possibility. If instead, Crowley and Kahn/Dunbar intend to imply that the relevant product is all coal delivered to Conrail-served destinations, then the logic of their test would require that they control for all of the supply and demand factors that affected U.S. coal markets between 1991 and 1995. In that case, as I discuss further below, their failure to control for any of the factors that influenced changes in coal demand and supply invalidates the tests.
- The sampling and calculation methods produce spurious changes in calculated prices unrelated to any change to the underlying rail rates. They look at the average of all deliveries from non-MGA coal originations to any Conrail destinations. Thus they are comparing, for example, MGA moves to Baltimore for export with Conrail moves

<sup>62</sup> ICC *Consolidated Rail Corporation Merger Monongahela Railway Co.* October 4, 1991. Mr. Crowley appears to come to a different conclusion regarding the importance of 100% ownership for testing changes in vertical relationships, arguing that ownership is not relevant, but corporate form is. Crowley Deposition Transcript at 7-13. It is also typical in analyzing waybill data to treat 100%-owned railroads as part of a single railroad family for analyzing waybill traffic. For example, see Crowley electronic work papers: t\_grp.prq.

<sup>63</sup> [[

of Illinois coal to Indiana. Far worse, neither Crowley nor Kahn/Dunbar make any attempt to control for the source or distribution of coal transported over time. For example, they incorrectly treat the fact, as reported in their sample, [[

]]. Also, to the extent that the volumes shifted from distant high-rail-cost sources to closer low-rail-cost sources, this shift in purchasing patterns is treated as a decline in transportation rates. Even if the rail rate on *every origin-destination move* was unchanged between 1991 and 1995, changes in the pattern of coal purchasing combined with the sampling and calculation methods used by Crowley and Kahn/Dunbar would spuriously produce a change in rail rates.

To investigate the impact of this conceptual error, I restrict the sample of movements used by Kahn/Dunbar and Crowley to movements that had the same origination and destination in both 1991 and 1995. Using only movements with the same origin and destination in both years, so as to remove the spurious, direct effect of changing geographic patterns of coal purchasing on measured average transportation costs demonstrates that the error leads to biased results. [[

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- Mr. Crowley based his analysis on the inference of masking factors; Kahn/Dunbar relied on Crowley for their data. The revenue information for contract moves in the STB Waybill sample is masked to prevent the release of highly confidential information. Crowley attempted to de-mask the revenue.<sup>64</sup> The reliability of his calculations depend on the reliability of his derived masking factors. Crowley assumed that all Conrail coal movements have the same masking factor and, using information from the 100% 1995 Conrail waybill database, he calculated a single masking factor and applied it to all Conrail terminations in 1991 and 1995.

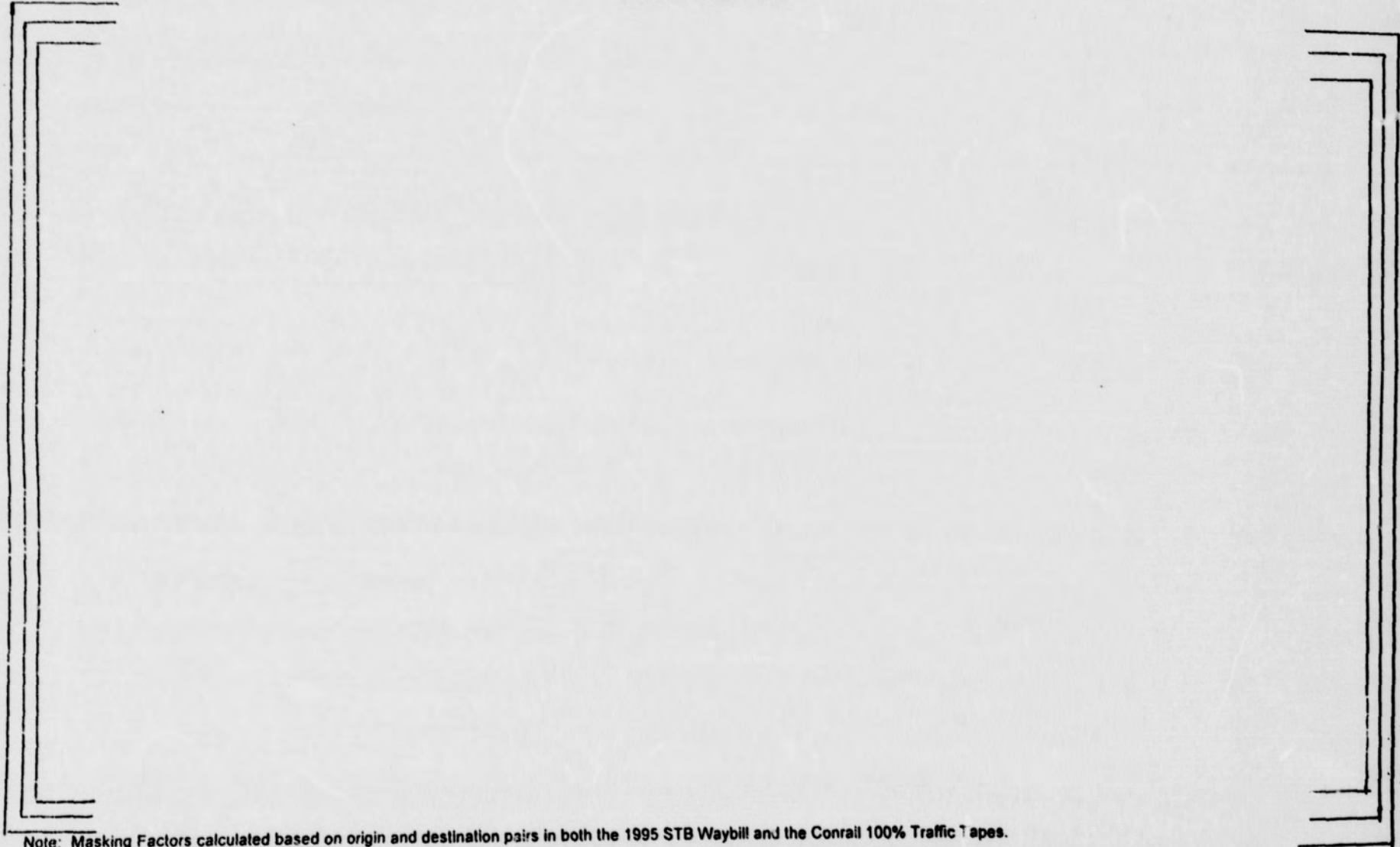
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<sup>64</sup> Crowley's analysis only uses the de-masking factor for Conrail terminations. The data he provided to Kahn/Dunbar required masking factors for CSX and NS as well.

Figure 6

## DISTRIBUTION OF CONRAIL SINGLE LINE VS. INTERLINE DERIVED MASKING FACTORS



Note: Masking Factors calculated based on origin and destination pairs in both the 1995 STB Waybill and the Conrail 100% Traffic Tapes.

Source: 1995 STB Waybill Sample; Conrail 1995 100% Traffic Tapes.

<sup>65</sup>]]] Neither I nor Crowley know what the actual rail revenues are for movements in 1991, nor how the rates have changed over time. Thus, there is no reliable "before" measurement that could be employed in the Crowley and Kahn/Dunbar "before and after" test.

- Neither Crowley nor Kahn/Dunbar attempt to control for changes in the coal markets—either in the producing regions, mines or from consumers of coal—between 1991 and 1995. They are implicitly assuming that the net average effect of changes in the coal markets, as these changes affect the willingness to supply and purchase coal, are the same for MGA-originating mines as for all other mines in the U.S.—from the Illinois and Powder River Basins and all others. Their approach also assumes that the demand factors from utilities for high and low sulfur, high and low Btu coal are the same regardless of whether the coal is for export and consumption in Michigan or Indiana or New York. Also, they must implicitly be assuming that the relative costs of rail transportation from all origins and destinations move together. As none of these assumptions can simply be assumed and are unlikely to be true, their tests have no power to inform regarding the one-lump result.

### III.D.2 What Do the Crowley/Kahn/Dunbar Results Reveal?

Once the Crowley and Kahn/Dunbar analyses have been corrected for obvious problems, an interesting insight can be gained from the exercise. It is not an insight into possible competitive harm from vertical integration as they purport, since the analysis provides no meaningful refutation of the economic principle of vertical integration. Rather, the data can be used to provide a glimpse into the evolution of the eastern coal and rail transportation markets.

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<sup>66</sup> Looking at the sample of matched origin-destination moves that occur in 1991 and 1995, I calculated that the MGA originations showed a change in rates of [[[ ]]] and non-MGA moves [[[

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The Crowley and Kahn/Dunbar analyses compare MGA originations versus all others terminating on Conrail. Figure 7 takes this one step further and shows the [[

]] Figure 7 also shows the change in production for each coal-producing area over the same time period. The price of rail transportation from the MGA area [[ across the coal regions serving Conrail destinations, [[

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The change in MGA rail rates over 1991 to 1995 fits in a pattern of rising and falling rates across various regions. This pattern does not correspond to the participation of the MGA and acquisition of the MGA by Conrail. Thus, for example, [[

]] "after" Crowley's and Kahn/Dunbar's (mis)identified date of Conrail's acquisition of the MGA. Obviously, the purported acquisition does not explain the [[ for regions such as West Virginia and Maryland. The conclusion to be drawn is that other marketplace factors must be responsible for [[ in West Virginia and Maryland rates. Since Crowley and Kahn/Dunbar have no means of isolating such marketplace factors, they cannot properly claim to have isolated the effect of Conrail's acquisition of the MGA.

Closer examination of Figure 7 indicates a pattern in which relative changes in supply and demand factors shed more light on changes in rail rates than Conrail's acquisition of the MGA. In particular, the pattern of rail coal transportation prices reflects changes in the supply



Figure 7

**PERCENTAGE CHANGES IN RAIL TRANSPORTATION RATES AND  
PRODUCTION BY COAL PRODUCING REGION, 1991-1995**

Coal Region	Percentage Change in Rail Transportation Rates <sup>1</sup>	Percentage Change in Coal Production, 1991-1995 <sup>7</sup>
MGA (Monongahela) <sup>2</sup>	[[[ ]]]	12%
West Virginia	[[[ ]]]	-5%
Maryland	[[[ ]]]	-3%
Powder River Basin <sup>3</sup>	[[[ ]]]	35%
Non-MGA Pennsylvania <sup>4</sup>	[[[ ]]]	-29%
Central Appalachia <sup>5</sup>	[[[ ]]]	2%
Illinois Basin <sup>6</sup>	[[[ ]]]	-18%
Ohio	[[[ ]]]	-15%
Average Non-MGA <sup>8</sup>	[[[ ]]]	-13%

1. Weighted by total tons/movements.

2. Sample includes only moves originating in Fayette and Greene counties of Pennsylvania, and Monongalia and Marion counties of West Virginia, areas served by the former MGA.

3. "Powder River Basin" origin and destination pairs include moves from Chicago Union Station to Michigan destinations.

4. Not including MGA counties (see note 2).

5. Central Appalachia is defined as eastern Kentucky and northwestern West Virginia.

6. "Illinois Basin" includes western Kentucky and all of Illinois and Indiana.

7. Source: EIA Form 7A (2,584 observations removed: prep plants/tipples without production, missing production or missing county assignments).

8. Weighted by total tons moved in 1991 and 1995 by region.

Note: Sample defined as Conrail terminations with origin and destination pairs occurring in both 1991 and 1995.

and demand for coal arising from the differentiation of coal across regions. The largest drops in rail transportation rates for coal come out of the Ohio and Illinois supply areas. These are both relatively high-sulfur, high-cost production areas in which the demand for that coal and its production has been dropping. On the other hand, coal produced in the Monongahela region, the heart of which is served by the MGA, demonstrates a variety of desirable characteristics that have incited a growing demand for the region's coal production since the early 1980's. The coal is primarily low- to mid-sulfur, and high-Btu. The large mines in the area use longwall mining techniques that have led to low and falling costs of production. In the 1980's, much of this expansion came from the creation of a high-volume export market for the mid-sulfur coal.<sup>67</sup>

The passage of the Clean Air Act Amendments of 1990 forced many electric utilities to reevaluate their coal supply sources and influenced coal purchasing decisions that, on net, favored coal produced from the Monongahela region. Sulfur emission restrictions that went into effect in 1995, restricting emissions to 2.5% by weight, combined with anticipation of the stricter regulations scheduled for enactment in 2000, enhanced demand for compliance coal. Compliance coal, defined by the year 2000 standards as having less than 1.2% sulfur by weight, is found primarily in portions of West Virginia and the Powder River Basin (PRB). These two regions show increases in coal transportation rates in Figure 7. The Clear Air Act Amendments greatly reduced the demand for high-sulfur coal, such as that supplied from Ohio, Illinois,

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<sup>67</sup> Exports continue to play an important role in the demand for Monongahela coal even today. Metzroth, Larry, "The Outlook for the U.S. coal industry: Moderate Demand Growth and Soft Prices," *Coal*, May 1996 (Vol. 3).

Indiana and Central Pennsylvania.<sup>68</sup> The high-Btu, mid-sulfur coal from the Monongahela area, while in demand for the export market is also valuable for use in combination with emission credits, and for use in blending with low-sulfur, low-Btu PRB coal.<sup>69</sup> The result has been an increase in Monongahela coal production to meet demand due to its favorable shifts in production costs, while many other regions have seen production declines. Monongahela's expansions have been supported by ongoing commitments and significant investments by the MGA railroad to improve service performance and capacity. Consistent with those changes, Mr. Crowley reports that coal originating on the MGA lines increased over 60% in the four years between 1991 and 1995.<sup>70</sup>

What are the implications for rail rates? In short, railroads have more flexibility to increase prices in the face of rising demand and falling costs of coal production. By contrast, in coal regions in which production costs are not keeping up with competition and declining demand, railroads will need to reduce rates to retain traffic. Figure 7 shows that changes in coal transportation rates on the Conrail system have broadly tracked the changes in the coal market. Overall, Figure 7 shows rail rates rising in the Monongahela-MGA region as demand continues to grow, while average rates for the other regions are falling as demand and average production falls. While this behavior is completely consistent with the one-lump result, a careful test of the result, in the form proposed by Crowley and Kahn/Dunbar, would have required highly detailed

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<sup>68</sup> 1.0% sulfur emission requirements have effectively been in place in Michigan since January 1, 1980 for plants with capacity greater than 500,000 lb. steam per hour (State of Michigan Department of Environmental Quality, Air Quality Division, Rule 401, 1/18/80).

<sup>69</sup> CSX/NS-19, Vol. 2A, Sansom V.S. at 21-25.

<sup>70</sup> ACE, *et al.*, Crowley V.S. at 14.

controls for changes in demand for different types of coal by each purchaser, and for changes in costs and supply alternatives for each producer of coal (not to mention the change in rail transportation costs between different locations). The proper interpretation of the MGA findings is not that they represent a test that invalidates the one-lump result of vertical integration economics, but rather, consistent with the one-lump result, that they give some glimpse into the operation of the coal market and the market factors to which rail rates respond. In short, the purported tests of Crowley and Kahn/Dunbar using the MGA changes are incapable of proving or disproving the one-lump result and cannot be relied on to demonstrate that vertical integration harms competition or shippers.

### III.D.3 Other Purported Tests Of The One-Lump Result

Kahn/Dunbar claim to perform additional tests related to their incorrect hypotheses (see above) regarding the implication of the one-lump result. As I discuss below, the last three of the four hypotheses should not be expected to hold in general and certainly not in the manner in which Kahn/Dunbar construct their empirical tests. These hypotheses by Kahn/Dunbar hold that the one-lump result requires:

- **Equal profits to the bottleneck carrier regardless of whether a move is single-line or inter-line move.** Kahn/Dunbar attempt to test this by calculating the contribution, estimated revenues minus variable costs, earned by the destination carrier for inter-line and single-line moves of coal going to the same destination in a year regardless of origin for moves to CSX, NS, and Conrail coal destinations. Kahn/Dunbar calculate the average contributions for the destination carrier separately for the inter-line and single-line moves. They then average separately for inter-line and single-line over all years and destinations and then compare the average contribution for the destination carrier on the inter-line moves to the average contribution earned on the single-line moves.

- **No profits earned by the origin carrier in a inter-line move.** Using the same calculations as for the above test, Kahn/Dunbar look to see if the average contribution for origin carriers on inter-line coal moves is zero.
- **No effect of competing origins on the size of the contribution or the rail rates.** For all moves to CSX, NS, and Conrail coal destinations, Kahn/Dunbar aggregate separately all single-line moves and all inter-line moves to each destination in each year across all origins. They regress the rail rate (and separately, the contribution earned by the destination shipper) on indicators of origin competition, which they define as the presence (or proportion) of inter-line moves to a destination in a year.

Regardless of the errors in the specific implementation of the tests, the tests themselves are incapable of refuting the one-lump result.

These three tests draw on a similar set of data, sampling and calculation methods, and are prone to many of the errors I have discussed above. I will not review them all, but each of these three tests suffers from the following flaws:

- Both bottleneck and non-bottleneck destinations are included. Of the 166 destinations used in these last three tests, 32, or 19% of the destinations, are not bottleneck locations, according to the tabulation of rail carriers serving each destination tabulated by Mr. Crowley.<sup>71</sup> In fact, the manner in which the sample is constructed is such that over 24% of the observations used to test hypotheses two and three are competitive destinations.<sup>72</sup> These two tests explicitly claim to measure the "Average Contribution for Bottleneck Carrier" on single-line and inter-line hauls, as well as the "Average Contribution for Competitive Origin Carrier."<sup>73</sup> The one-lump result has no implication for how revenues are to be split for competitive locations.<sup>74</sup>

<sup>71</sup> Based on ACE, *et al.*, Crowley V.S. at TDC-2.

<sup>72</sup> Based on ACE, *et al.*, Crowley V.S. at TDC-2 and replication of Kahn/Dunbar data.

<sup>73</sup> Kahn/Dunbar V.S. at 13.

<sup>74</sup> Kahn/Dunbar report the average contribution for single-line hauls is [[[ ]]]; the sum of the average contributions for the upstream and downstream legs of the double-line haul is [[[ ]]]. (Kahn/Dunbar, V.S. at 13.) This result, taken on face value, argues that vertically-integrated carriage earns [[[ ]]

]]]. For all the reasons stated above, however, no weight should be given to the test results for this or any other interpretation.



- As in the MGA test, non-comparability in sampling and calculation exists such that changes in the pattern of coal purchases between 1988 and 1995 will change both the rates and the size of the "lumps" that are available. They appear, for example, to include single-line movements by competing railroads that are not party to this transaction.
- The calculation of "contribution" is measured as the difference between unmasked revenue and the variable cost measure on the costed waybill sample. Both revenues and variable costs, however, are measured with error. Revenues are subject to the flaws of Mr. Crowley's de-masking method as described above. The costing method applied to the waybill is quite general and cannot be expected to capture the true incremental cost appropriate for each coal move. Moreover, to the extent that the contribution is the difference between revenues and costs, errors in either variable, particularly systematic errors in the unmasking of revenue, will lead to errors and likely biases in the results.
- In not one of the three tests has any attempt been made to control for the factors that affect the size of the profit opportunities, or "lump" available to the railroad. Even more significantly, in these tests there is no attempt to control for any factor that affects demand and supply. As the analysis of Figure 7, above, indicates, rail rates, and contributions, are likely to be sensitive to supply and demand factors relating to products, origins, and destinations. The degree of aggregation across all originating areas, whether it be the Powder River Basin or Pennsylvania, makes these results inherently unreliable. Another indicator of the failure to control for any reasonable factor affecting the demand for rail transportation on any route is the inclusion, possibly unintentional, of some amount of anthracite coal movement.<sup>75</sup> While the demand and supply forces for different types and origins of bituminous coal will vary over time and by purchaser, the demand and supply factors for anthracite are unlikely to be the same since the products are so different.

Any or all of these errors are sufficient to invalidate the results reported by Kahn/Dunbar.

In the absence of detailed and accurate modeling of the factors affecting the demand for rail transportation of coal on an origin-to-destination basis, which certainly cannot be done using information in the waybill sample alone, the implications that Crowley and Kahn/Dunbar purport to be implications of the one-lump result are not. As such, they have provided no useful

<sup>75</sup> ACE, *et al.*, 1-HC0079; Crowley indicated he only provided information on bituminous coal, but the analysis of the data and workpapers indicate otherwise.

information by which to evaluate the validity of the one-lump result or the impact of vertical integration.

### III.E Other Evidence on Vertical Impacts of the Transaction

The Crowley and Kahn/Dunbar V.S. provide no evidence that *this* transaction will harm any of the complaining shippers.<sup>76</sup> I am unaware of any specific evidence provided by shippers concerning how the vertical integration of the carriers resulting from the Conrail transaction will harm them on specific routes or movements. The ACE coal facilities are in a Shared Asset Area and receive increased, not lessened, competitive options from this transaction. Indeed, as discussed above, other shippers base their claims for relief on the fact that shippers, such as ACE, that are in the Shared Area, will receive a competitive advantage. ACE's requests for relief cannot be related to the harm identified. The request for equal access to all coal shippers requesting it would introduce dual service where currently they are served only by one carrier. This request, as with ACE's request, in the alternative, for bottleneck rate caps signals clearly that the objective has more to do with another attempt to convince the Board to revise its basic regulatory structure, than with addressing any specific claim arising from the transaction

<sup>76</sup> Kahn/Dunbar do cite a study by C. M. Grimm, C. Winston, and C.A. Evans ("Foreclosure of Railroad Markets: A Test of Chicago Leverage Theory," *Journal of Law and Economics*, October 1992) as supporting their conclusions. This study, however, provides no useful information on the matters at hand. It is based on pre-Staggers Act data (at 308), and its key statistical procedures do not include data for the coal sector. (Sample construction is discussed more thoroughly in Winston, *et. al.*, *The Economic Effects of Surface Freight Deregulation* [Washington: Brookings Institution 1990], at 17.) Most disappointing, the study does not test the one-lump result in rat-tail settings. While it asks the question how much through-rates in general change when more competitors are present at one stage of vertical linkages, it does not ask the question of how through-rates change when more competitors are present at one vertical stage for a given number of carriers at the most bottlenecked stage. In particular, the study does not ask the rat-tail question of whether through-rates change when more competitors are present at one stage and there is a single carrier at another stage. Technically, the econometric specification in the study fails to include interaction terms, or other approaches, that would address the question of the marginal contribution of additional upstream (downstream) competition when the number of downstream (upstream) carriers is one.

Similarly, IP&L's claim, despite the statements of Crowley and Kahn/Dunbar, is focused on horizontal issues, not on the impacts of vertical changes from the transaction.<sup>77</sup>

The overall impact of this transaction is to eliminate sole-service bottlenecks and introduce competition on the Conrail system where none previously existed. Over 30% of the existing traffic that is solely-served at both ends of the move where one end is currently served by Conrail will gain the introduction of a new, competing carrier at least one end of the move.<sup>78</sup> Thus, if—as Crowley and Kahn/Dunbar assert—the introduction of new origin or destination competition that eliminates a bottleneck at one end or the other of a move is viewed as a benefit from the vertical restructuring of the rail industry, then the transaction generates vertical benefits for many shippers.

### **III.F Neutral Gateways and Vertical Foreclosure**

Several parties have raised concerns regarding the loss of Conrail as a neutral gateway carrier<sup>79</sup> or about re-routings of traffic to different gateways following the transaction,<sup>80</sup> or the asserted need for widespread conditions intended to freeze existing vertical relationships.<sup>81</sup> These concerns arise directly from a view that CSX and NS, once they step into the shoes of

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<sup>77</sup> IP&L does make a request for continued oversight regarding gateways. I address issues of gateways below.

<sup>78</sup> Based on the 1995 STB Waybill sample. Whether the origination or destination is solely-served is determined by examining traffic in the sample at the 6-digit SPLC level.

<sup>79</sup> NECR, "Responsive Application," at 7-8.

<sup>80</sup> CMA/SPL at 26-27.

<sup>81</sup> IC, Skelton V.S. at 7; Joint Comments of William E. Loftus, American Short Line Railroad Assn. and Peter Gilbertson, Regional Railroads of America (Shortline Associations) at 3.

Conrail at certain locations, will use their positions to either foreclose or inefficiently divert traffic in a manner that will harm existing shippers and other railroads.

Consider the claims, for example, of the NECR. This intervenor fears that the loss of Conrail as a "neutral" gateway. NECR's position is analogous to that of a shipper concerned about vertical integration of a downstream bottleneck carrier with an upstream carrier. In fact, however, acquisition of control of Conrail's lines in New England will allow CSX to provide enhanced single-line service over a broader network, and thus make it more competitive for traffic in competition with NECR. Indeed, the diversion studies provided in the Application suggest that the NECR could lose some business due to the enhanced competition provided by CSX. There is no evidence, or reason to expect, however, that CSX will inefficiently divert traffic from NECR, that it will foreclose NECR from competing for business, or that it will prevent NECR from interchanging in an economically appropriate manner. Finally, no reliable evidence demonstrates that NECR will be put in jeopardy or that there will be the loss of any essential service as a result of the enhancements to the competitiveness of CSX.

Illinois Central submits an application requesting that CSX be required to establish joint rates through several gateways and to establish rate requirements on CSX's divisions. The Shortline Associations also urge the Board to require existing gateway and rate relationships to be maintained until changed by mutual consent. Gateway and rate requirements arise from the basic concern that CSX will re-route traffic at the IC's expense, or else alter the rates it charges across gateways. There is nothing about the proposed transaction, in particular, that suggests that CSX or NS will behave in an inefficient fashion with regard to either the IC or the shortlines



Moreover, the proposed remedies are out of proportion to any purported harm. Indeed, the request to freeze gateway relationships and establish fixed-rate relations could easily be worse than any harm it is intended to cure. The removal of the flexibility of in routing and rate-making locks railroads into operations and pricing that are inflexible and bound to generate inefficiencies as market conditions change. Such conditions deny railroads the opportunity to respond actively and competitively to changes in market conditions. The IC proposal to return to old-style, regulation-imposed rate divisions is clearly a step backwards. Such an approach is just the kind of approach that the rail industry had to shake off to become a more flexible, dynamic, and efficient national transportation system. Imposed and rigid rate and gateway restrictions prevent rail carriers from adapting to change and implementing and benefiting from innovations in service. These types of regulatory handcuffs should be avoided.

#### **IV. ANALYSIS OF ASSERTED "ACQUISITION PREMIUM"**

##### **IV.A Overview and Summary of the Issues**

The Applicants in this proceeding reached agreement with Conrail to purchase the latter for \$9.895 billion. This figure exceeded the pre-transaction stock market value of Conrail that prevailed immediately prior to the announcement of acquisition attempts aimed at Conrail. The Applicants' purchase price also exceeded the historic net book value of Conrail's plant, property, and equipment assets as recorded on Conrail's books. Based variously on these observations, a number of commentators assert that CSX and NS "paid an excessive "acquisition premium"



for Conrail, and that this "premium" poses the threat of substantial merger-related harm to shippers.<sup>82</sup>

According to those commenting parties, the asserted "acquisition premium" is purported or insinuated to represent the capitalization of expected future profits attributable to merger-related enhancements of market power. These enhancements of market power are asserted to arise from the vertical integration of Conrail into the CSX and NS networks (*e.g.*, *per* the arguments reviewed above of Messrs. Crowley, Kahn, and Dunbar) and/or a "fatal circularity" under which inclusion of the so-called "premium" in determinations of the statutory 180% revenue/variable cost ("R/VC") regulatory threshold for STB maximum rate jurisdiction and in revenue adequacy findings eases pre-merger regulatory ceilings that otherwise cap CSX, NS, or Conrail rates in market dominance settings.<sup>83</sup> In the view of certain commentators, the "acquisition premium" portends post-transaction increases in rates either through the realization of unleashed market power or simply through pressure on CSX and NS to pay for Conrail.<sup>84</sup> To prevent rate increases attributable to the asserted "acquisition premium," the concerned parties request that CSX and NS be prevented from recording their shares of the full acquisition cost of Conrail as increments to their asset bases for regulatory purposes. Instead, argue the commentators, only the pre-transaction net (historic, depreciated) book value of Conrail's assets should be allowed to be

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<sup>82</sup> See, *e.g.*, statements of Kahn/Dunbar V.S. at 18; CMA/SPI "Join: Comments," at 7; NITL/CPTA/TFI "Comments," at 21; PEPCO Felton V.S. at 24.

<sup>83</sup> Kahn/Dunbar V.S. at 16-18.

<sup>84</sup> See, for example, ENRS, "Comments," at 25-28.

recorded in accounts that influence either R/VC jurisdictional threshold or revenue adequacy findings.<sup>85</sup>

The commentators who put forth these arguments have offered no support for their claims that withstands the scrutiny of economic principles, relevant evidence, and simple logic.

- As reviewed extensively above, notwithstanding repetition, claims of undetected enhancements of market power are unfounded and bereft of evidentiary support. Commentors' "acquisition premium" arguments systematically ignore the demonstrable competition-enhancing provisions of the proposed transaction, as well as the oversight role of the STB itself.
- The *market* acquisition premium—the difference between the purchase price of Conrail and pre-transaction market value of Conrail's outstanding publicly-traded stock—is a normal and expected aspect of corporate mergers and acquisitions. In the case at hand, the observed market acquisition premium is more than accounted for by the cost-savings attributable to the proposed transaction. There is no portion of the premium that requires enhancement of market power as its explanation.
- Commentors requesting restrictions on the treatment of the asserted "acquisition premia" inexcusably ignore the cost savings and traffic increases attributable to the CSX/NS integration of Conrail into their networks. This leads to misrepresentation of the implications of purported "premia" for R/VC jurisdictional threshold and revenue adequacy determinations. Merger-engendered cost savings and traffic increases, which go unchallenged by the most vociferous of the relevant commentators,<sup>86</sup> would have the effect of reducing variable costs and jurisdictional levels for particular traffic movements and improving the carriers' rates of return for revenue adequacy purposes.
- The requested "remedy" of excluding the "premium" above net book value is not only unjustified on the merits, but carries with it extremely poor policy implications. The proffered "remedy" would distort investment decisions and set counterproductive precedent for future efficiency-enhancing reallocations of railroad ownership and control.

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<sup>85</sup> Kahn/Dunbar V.S. at 20; ACE, *et al.*, Crowley V.S. at 26-27, 36-39.

<sup>86</sup> See ACE, *et al.* "Comments," at 11.

#### IV.B The Economics of Acquisition "Premia"

Intervening shippers seeking "protections" from inclusion of the "acquisition premium" in the relevant property accounts of CSX and NS for regulatory purposes have variously and inconsistently defined the asserted "premium" as the amount by which the acquisition cost of Conrail exceeds some pre-transaction measure of Conrail's historic existing book asset value, or as the pre-announcement market value of Conrail's outstanding equity. Commentors' definitions of the asserted "premium" include:

- the excess of the acquisition price over the net book value of Conrail's assets;<sup>87</sup>
- the excess of the "consideration given" over the book value of Conrail's ownership shares;<sup>88</sup>
- the excess of the appraised value of the acquired assets of Conrail over the assets' historical gross book value;<sup>89</sup>
- the excess of the appraised value of Conrail's assets over the pre-transaction net book value of those assets;<sup>90</sup>
- the excess of the purchase price over the historical book value of Conrail;<sup>91</sup>
- the excess of the purchase price over the "original cost";<sup>92</sup> and
- the difference between the per-share purchase price paid by CSX and NS and the single-share value of Conrail's outstanding publicly-traded stock immediately prior to the announced merger (*i.e.*, the market acquisition premium).<sup>93</sup>

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<sup>87</sup> Kahn/Dunbar V.S. at 17-18.

<sup>88</sup> ACE, *et al.*, Crowley V.S. at 27.

<sup>89</sup> ACE, *et al.*, Crowley V.S. at 25.

<sup>90</sup> Kahn/Dunbar V.S. at 16.

<sup>91</sup> ACE, *et al.*, Crowley V.S. at 26.

<sup>92</sup> Kahn/Dunbar V.S. at 17.

<sup>93</sup> Kahn/Dunbar V.S. at 18.

Corresponding to each of these definitions are specific accounting and valuation issues, as described by Mr. Whitehurst in his Rebuttal Verified Statement (Rebuttal V.S.) on behalf of CSX and NS. For perspective, and reflecting the heart of commentators' views, the first and last of the foregoing versions of a "premium" are measured by commentators to be \$9,113 million and \$3,755 million, respectively.<sup>94</sup>

To the extent that intervening shippers concerned about the "acquisition premium" suggest that such a "premium" is inappropriate because it reflects an excessively high price for Conrail, such a suggestion overlooks the functioning of the capital market in which the acquisition of Conrail is taking place. The purchase price of Conrail's equity is an arm's-length value arrived at by well-informed and sophisticated parties seeking their own rational self-interests. As such, the purchase price properly stands as a measure of the market value of ownership of Conrail *acquired for the purposes of deploying Conrail to the uses the buyers intend*. The arm's-length market price of Conrail's equity that the parties' negotiations have produced is the best evidence of the current value of control of Conrail. By contrast, for reasons I discuss more fully below, the pre-transaction net book value—with its dependence, for example, on historical authorized depreciation schedules and the cost of asset acquisitions from many years earlier—is not a measure of current value.

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<sup>94</sup> Kahn/Dunbar V.S. at 17-18; ACE, *et al.*, Crowley V.S. at 25 and Exhibit TDC-11.

A market acquisition premium is a common and predicted result in corporate acquisitions.<sup>95</sup> Such a premium arises because mergers and acquisitions occur when the net present value of expected future net cash flows arising out of the combination of two (or more) separate firms under common ownership exceeds the expected discounted future net cash flows from those same business units retained under separate ownership.<sup>96</sup> An acquiring firm does not rationally invest resources in merger activity unless it believes that bringing the acquired entity under its control will generate more value than the market indicates the acquired firm can generate as a stand-alone enterprise. Under such circumstances, market acquisition premia arise as the price that current owners can realize in exchange for turning over control so that the acquiring firm can have the opportunity to generate more value with the acquired firm.

Proposed acquisitions and mergers undergo the explicit or implicit screening and scrutiny for potential competitive harms arising from increases in market power by agents such as the Federal Trade Commission and the United States Department of Justice. Observed premia in consummated transactions that have survived such scrutiny are large and range upwards of 100 percent. In the presence of such scrutiny by the appropriate regulatory authorities, the size of the market acquisition premium, in general, cannot then be attributed to the capitalization of market power. Furthermore, competition among bidders for an acquisition target greatly impacts the market acquisition premium. Economic research indicates that the presence of cash offers

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<sup>95</sup> See, for example, Alexander Slusky and Richard Caves, "Synergy, Agency, and the Determinants of Premia Paid in Mergers," *Journal of Industrial Economics*, March 1991, at 277-296; and David J. Ravenscraft and F.M. Scherer, *Mergers, Sell-offs and Economics* (Washington, D.C: Brookings, 1987), see Vol. 3.

<sup>96</sup> That is, mergers arise when the expected  $NPV(a+b) > \text{expected } NPV(a) + \text{expected } NPV(b)$ , where NPV represents the expected future discounted cash flows and "a" and "b" represent two pre-merger firms.



and rival bidders—as in the case of the CSX/NS competition for Conrail—leads to, on average, market acquisition premia more than 45 percentage points higher than otherwise would be the case.<sup>97</sup> The experience of market acquisition premiums in the market for corporate control does not lead to the conclusion that the market acquisition premium in the Conrail transaction represents a capitalization of unleashed, transaction-related market power.

The acquiring firm's willingness to pay a market acquisition premium for control of an acquisition target can, in general, reside in multiple factors. These may include, for example, anticipated cost-saving economies of scale or scope or other synergies stemming from the coordination and integration of business assets, as well as opportunities to generate additional revenue by providing more and/or higher quality service to consumers. The gains from a merger can also arise out of the elimination of managerial, labor, or other inefficiencies on the part of the acquired firm. Whatever the source of the gains from integration of two firms into one, the pre-acquisition business units are expected to generate higher net cash flow under single ownership. The opportunity to do this is what is sold at a market premium by the acquired firm's owners. Such a premium, however, does *not* imply a purchase price *above* market value—as Kahn/Dunbar imply.<sup>98</sup> The source of the market acquisition premia that are so prevalent is the difference in valuation that exists between the acquiring firm's assessment of market value and the assessment of those in the market that would keep the acquired firm independent. The resulting transaction price in such a setting is a fair market price struck between parties risking their own money for their own reward.

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<sup>97</sup> *Op cit.* Slusky and Caves, (1991) at 291, 292 and Table 2.

In theory, of course, a possible source of a market acquisition premium, apart from the value that can be generated by merger-related cost-savings and service improvements, is the expectation of enhanced post-transaction market power leading to higher post-transaction profits. This is the fear that certain commentators raise and assert. I turn now to consideration of what the Conrail market acquisition premium might represent.

#### **IV.C The Conrail Market Acquisition Premium**

If an acquiring firm (or firms) anticipated that acquisition of another firm could lead to lower cost operations for the combined entity or improved capacity to attract customers with lower prices and/or better service offerings, a successful drive for acquisition could well yield a sizable market acquisition premium. In effect, the projected merger-related cost-savings and service improvements would "pay for" the market acquisition premium. That is, such types of post-merger value would be the source of the differences between the *status quo* market value of the acquired firm and the value perceived by the acquiring firm. This raises the question of whether the efficiencies and productivity improvements that CSX and NS document in their Applications are sufficient to explain why the Applicants would have been willing to pay the noted market acquisition premium.

The transaction-related cost-savings, productivity improvements, and incremental traffic gains that CSX and NS represent as the bases of their interest in acquisition of their respective portions of Conrail are discussed at length and in detail in the Application; and I have accumulated and analyzed the dollar amount of these merger-related benefits in the case of CSX

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<sup>98</sup> Kahn/Dunbar V.S. at 18.

in my earlier verified statement. The evident and documented benefits to the acquiring carriers include cost savings of both an overhead and an operating nature, improved utilization of equipment and yards, and synergies associated with expanded single-line operations. Similar cost savings are described for NS. In addition, both Applicants see the transaction as yielding additions to traffic, and, hence revenue, primarily as a result of improved competitiveness vis-à-vis trucks. Together, the two acquiring railroads project cost savings and incremental revenue gains in the hundreds of millions annually. How do these transaction-related benefits to the Applicants compare to the market acquisition premium?

The cost-savings on existing traffic and revenue gains (net of costs) on additional traffic attributable to the transaction are a source of increased, transaction-related net cash flow for CSX and NS. Designating such transaction-related additional net cash flow "benefits," Figure 8 compares the expected net present value of this improved net cash flow to the market acquisition premium (\$3,755 million) as calculated by witness Crowley on behalf of Atlantic City Electric and Indianapolis Power & Light (and cited widely by other commentators).<sup>99</sup> When the present value of the benefits of the transaction—the net new cash flow—exceeds the acquisition premium, it is rational to pay and finance the acquisition premium.

As Figure 8 shows, expressed in present value terms, the anticipated merger-related benefits to CSX and NS total over \$5.5 billion. Hence, the measured benefits in Figure 8 substantially outweigh the asserted market acquisition premium of \$3.755 billion. Stated alternatively, the efficiencies and traffic to be gained from the merger more than "pay for" the

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<sup>99</sup> ACE, *et al.*, Crowley V.S. at 25.

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Figure 8

**DO PRIVATE BENEFITS "PAY FOR" THE  
MARKET ACQUISITION PREMIUM?**

(Private Savings vs. Purchase Price Less Pre-Transaction Market Value)

		Net Present Value (\$ in millions)
<b>Total Private Benefits</b>		<b>\$ 5,518</b>
<b>Private Benefits to CSX</b>	<b>\$ 2,414</b>	
<b>Private Benefits to NS</b>	<b>\$ 3,104</b>	
<b>Market Acquisition Premium</b>		<b>\$ 3,755</b>
<b>Net Private Benefits</b>		<b>\$ 1,763</b>

Sources: Applicants' Pro Forma Income and Cash Flow Statements, Crowley V.S., STB Ex Parte 558.  
Analysis based on 30-year life discounted using STB's 1996 railroad industry cost of capital.



market acquisition premium. From a business perspective, they provide the basis upon which rational parties would pay the market acquisition premium to acquire Conrail. In particular, no additional expected benefits from merger-related enhancements of market power are needed to explain the Conrail market acquisition premium. As corroboration, Mr. Whitehurst finds that cash generated by the transaction for CSX and NS more than covers their costs of financing the acquisition of Conrail.<sup>100</sup>

In light of these findings, is it plausible that the market acquisition premium reflected anticipation by CSX and NS that the acquisition of Conrail would enable them to garner incremental profits from an unleashing of market power? Importantly, no commentators have offered evidence that would reverse the conclusion from Figure 8 that the proposed transaction's cost-savings and incremental revenue gains justify the market acquisition premium. Kahn/Dunbar, for example, explain that "we believe the acquisition will increase market power," but indicate that "[w]e are not in a position to assess the relative contributions of [possible efficiencies and enhanced market power] to the overall premium paid for the Conrail assets."<sup>101</sup> Neither ACE, *et al.*, nor its witness Crowley adds to this empty set of analyses by commentators challenging the "acquisition premium." Indeed, ACE, *et al.*, state bluntly that they are not challenging CSX's and NS's projection of benefits.<sup>102</sup>

Assertions and insinuations that the market acquisition premium for Conrail represents the capitalization of merger-related enhancements of market power do not constitute evidence.

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<sup>100</sup> Whitehurst Rebuttal V.S.

<sup>101</sup> Kahn/Dunbar V.S. at 19.

Even if one accepts the flawed analyses of competitive issues set forth by shipper witnesses Crowley and Kahn/Dunbar at face value, it is not plausible that the competitive "problems" they claim exist would provide an explanation of the Conrail market acquisition premium. When turning to the application of their "results" to the case of the CSX/NS acquisition of control of Conrail, Kahn/Dunbar argue that merger-related market power enhancement is so pervasive that "remedy is required for all destinations that will be served henceforth by either or both of the acquiring carriers...where competition, actual or potential, is eliminated or lessened at either origin or destination as a result of the acquisition of Conrail."<sup>103</sup> Kahn/Dunbar describe no such situations, but aver that "[e]xamples of such instances are discussed by Mr. Crowley."<sup>104</sup> Examination of Mr. Crowley's "examples,"<sup>105</sup> however, finds that he presents three examples which he asserts demonstrate that railroads do not maximize profits, but which are not verified as fitting the Kahn/Dunbar criteria. He offers but two more examples,<sup>106</sup> both intended to illustrate that destination sole-serve railroads leave origin railroads with no profits, under the mistaken impression that this is an implication of the neutrality, or "one lump," theory (see above). These five examples provide no foundation for concluding that the proposed transaction enables CSX and NS to capture an acquisition premium made up of more than \$3.7 billion in present-valued unleashed market power.

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<sup>102</sup> ACE, *et al.*, "Comments" at 11.

<sup>103</sup> Kahn/Dunbar V.S. at 20.

<sup>104</sup> Kahn/Dunbar V.S. at 20-21.

<sup>105</sup> ACE, *et al.*, Crowley V.S. at 19-20.

<sup>106</sup> ACE, *et al.*, Crowley V.S. at 22-23.

In fact, the proponents of the view that post-transaction enhancements of market power will be rampant offer no quantitative assessment as to how there would be so much harm to competition as to generate the "acquisition premia" about which they complain, or how such harm would outweigh the pro-competitive effects of the immense and measurable introduction of dual rail competition into the Conrail solely-served areas described in Figure 1.. Apart from shippers that seek to use this proceeding to revisit the bottleneck issue and to introduce two rail carriers where pre-transaction service was by a single carrier, the core complaint of shippers has not been that Conrail fails to maximize profits. Rather, they see the competitive problem as the lack of competition Conrail faces as a sole-serve carrier at so many destinations and origins.<sup>107</sup> Such shippers stand to benefit from the CSX/NS transactions.

Finally, the Board's well-established precedents for eliminating and conditioning any prospective harm to competition emanating from a rail merger contradict the interpretation of the market acquisition premium as the capitalization of market power. Given the regulatory authority and historical precedent for robust competitive review on the part of the STB (and the ICC), it is not reasonable to think that the capital markets would rationally support any expectation that the STB would fail to condition this transaction so as to rid it of any potential competitive harm. The Santa Fe/Southern Pacific, BNSF, and UP/SP experiences have clearly established strong pro-competitive precedent that parties seeking approval of rail mergers and

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<sup>107</sup> See, e.g., CSX/NS-21, Vol. 4B, Alger Farms, Inc., p.61; CSX/NS-21, Vol. 4B, BOC Gases, p.369; CSX/NS-21, Vol. 4D, Jenkins Brick Company, p.50; CSX/NS-21, Vol. 4B, American Honda Motor Co., p.114; CSX/NS-21, Vol.4D, Mazda Motor of America, Inc., p.331; CSX/NS-21, Vol. 4C, Griffin Pipe Products Co., p.429; CSX/NS-21, Vol. 4D, Ogihara America Corporation, p.613; CSX/NS-21, Vol.4B, Carbonic Industries Corporation, p.496; CSX/NS-21, Vol. 4B, Cabot Corporation, 458; and CSX/NS-21, Vol. 4D, Hercules, Inc., p.528.

acquisitions are now so cognizant of such precedent that they recognize the need to cure competitive problems as part of their applications—just as CSX and NS have done in this instance.

#### **IV.D Regulatory Implications**

It would be logically contradictory for the Board to approve a merger on the grounds that it does not pose the threat of substantial merger-related harm to competition, but to then find that an "acquisition premium" represents capitalization of returns to incremental market power. Notwithstanding this contradiction, several intervenors advise that any excess of the purchase price of Conrail over its net book value be excluded from the carriers' accounts for the purposes of jurisdictional threshold and revenue adequacy determinations. These recommendations are inconsistent with both the evidence on the composition of Conrail's market acquisition premium discussed above, and with sound design of regulatory policies that seek to promote a dynamic and efficient railroad system.

##### **IV.D.1 The Alleged "Burden" of an Acquisition Premium**

Commentors allege that, as a result of the cost of the acquisition as struck by CSX/NS and Conrail in an open, arm's-length negotiation, shippers "captive" to the acquiring railroads will suffer competitive harm. Specifically, it is asserted that the agreed-upon purchase price reflects, in their estimation, an excessive "premium," where premium has been variously defined as the cost of acquisition over the historic book value or the difference between the pre-acquisition market value and purchase price of Conrail's outstanding stock. Commentors thus imply that the expected efficiencies and projected revenue growth detailed in the pro-forma

financial statements will be insufficient to cover the agreed-upon transaction price, and in order to recover the unrealized incremental costs, the Applicants will be forced to raise rates, particularly on "captive" shippers.<sup>108</sup>

This argument is flawed at the level of basic economic principles of profit-maximizing decisions by a railroad. The "acquisition premium" is a sunk cost as CSX and NS go forward. As such, even if realization of the projected merger benefits that underlie the Applicants' rational willingness to incur the market acquisition premium were to be blocked, it would not make sense for CSX or NS to therefore try to price at higher levels in order to somehow "pay for" the acquisition premium. Under any circumstances, the best way for them to ensure that they can finance their purchase of Conrail on a going-forward basis is to ignore the burden of the chase price. Net income available to pay off (finance) the acquisition price of Conrail will be maximized by pricing and providing service so long as additional sales bring in more revenue than the (non-fixed) marginal costs of making such sales. This basic rule of profit maximization holds whether or not a railroad is trying to pay off a sunk obligation.<sup>109</sup>

#### IV.D.2 Regulatory Pricing Limits

Beyond the foregoing argument, commentators allege that—barring action on the part of the STB—the acquisition cost of Conrail will "distort" regulatory protections afforded shippers. Unless the STB intervenes to prevent the inclusion of the difference between the acquisition

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<sup>108</sup> See, for example, CMA/SPI "Joint Comments," at 7; NITL/CPTA/TFI "Comments," at 22; PEPCO, Felton V.S. at 24; ACE, *et al*, "Joint Comments," at 11.

<sup>109</sup> As demonstrated above, the Applicants' Pro Forma Income and Cash Flow Statements, which assume no overall rate increase on the part of the Applicants, show that the transaction-related benefits more than "pay for" the market acquisition premium.



price and the pre-merger net book value of Conrail's assets as used in regulatory rate determinations, it is asserted that CSX and NS will be afforded the opportunity to pass through the predicted rate increases without scrutiny as the accounting treatment of the acquisition cost will increase the jurisdictional threshold (via an increase in system-average variable costs) for particular traffic movements, and will reduce the carriers' net return on investment for purposes of revenue adequacy determinations. The net effect, it is asserted, is to raise the level of regulatory restraints on rail rates, freeing up CSX/Conrail and NS/Conrail to realize otherwise unexercisable market power and impose rates that would otherwise exceed a maximum reasonable level.

Various parties term the foregoing argument the "fatal circularity." This claim holds that permitting the firm with market power, which has its prices constrained to some function of its costs, to raise its costs and, subsequently, its regulatory rate ceiling by incurring an acquisition premium is fatally circular insofar as it implies that the capitalization of such freed up market power provides the cost-basis for capturing such freed up market power in subsequent rate setting. This argument, however, rests on flawed analogies to regulated utilities that are subject to pervasive cost-of-service controls on their prices.

The Board has previously recognized the inapplicability of the argument put forth by the commentators:

For public utilities, use of acquisition costs would result in a circular downward rate spiral [where the acquisition cost was less than the predecessor cost]; rates would be based on lower acquisition costs which, in turn, would produce lower rates. In the case of railroads, however, ...a larger share of revenues is determined by competitive markets and not by regulation. [The Revenue Accounting

Principles Board] concluded that the issue of circularity was, therefore, not applicable to the railroad industry.<sup>110</sup>

The railroad industry is not appropriately analogized to electric, gas, or other public utilities. With few exceptions, railroads do not operate at cost-based price caps. Instead, rail rates are established by market forces, free of maximum constraint.<sup>111</sup> In the case of Conrail, for example, most traffic is either exempt from such regulations—i.e., movements based on contracted rates—or movements that would be below the regulatory threshold. In either case, the rates are not set on the basis of regulation but by prevailing market conditions and negotiations. I understand that even the number of ICC/STB rate challenges faced by Conrail over the past ten years has been minimal. It is simply not the case that there is a “circle” to be closed.

Assuming *arguendo* that the fatal circularity argument applied with force to the carriers at hand, intervening shippers’ analyses of the implications are flawed in a fundamental fashion. Inexcusably, commentators’ calculations of the impact of various asserted “premia” on the jurisdictional threshold and revenue adequacy ignore the hundreds of millions of dollars of annual cost savings and incremental traffic and revenue gains that the CSX/NS transaction entails. As Mr. Whitehurst explains in his Rebuttal V.S. on behalf of CSX and NS, Mr. Crowley purports to show that the inclusion of an “acquisition premium” would raise jurisdictional thresholds and lower rates of return for revenue adequacy purposes.<sup>112</sup> In addition to various

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<sup>110</sup> *Ex Parte 483*, Railroad Revenue Adequacy - 1988 Determination, 6 ICC2d, at 938.

<sup>111</sup> *Ex Parte 483*, *supra*, 6 I.C.C.2d at 941; *Railroad Cost Recovery Procedures – Productivity Adjustment*, 5 I.C.C.2d 434, 447 (1989), *aff’d sub nom. Edison Electric Institute v. ICC*, 969 F.2d 1221 (D.C.Cir. 1992); *Coal Rates Guidelines*, *supra*, 11 I.C.C.2d at 521-522.

<sup>112</sup> *ACE, et al., Crowley V.S.* at 25-39.

technical and computational errors discussed by Mr. Whitehurst, this analysis takes no account of the transaction's documented capacity to yield cost savings and incremental traffic. Yet, the merger-related benefits of cost savings and traffic gains would directly offset the impacts of an "acquisition premium" in raising regulatory rate "ceilings" in the manner described by Mr. Crowley. As Mr. Whitehurst reports, taking the transaction's cost savings into account reveals that CSX/Conrail and NS/Conrail will both have the ability to finance an "acquisition premium" out of cost savings and revenue gains while maintaining adequate overall returns, and the use of the full acquisition cost of Conrail for regulatory purposes (as existing accounting rules and precedent require) would not significantly increase regulatory rate "ceilings" in the manner claimed by Mr. Crowley.<sup>113</sup>

As a "fix" to the purported problems that an "acquisition premium" purportedly poses for the regulatory threshold and revenue adequacy, a number of intervenors propose allowing no more than historic depreciated, or "net," book value of Conrail's assets (*i.e.* predecessor cost rather than acquisition cost) in jurisdictional threshold and revenue adequacy calculations.<sup>114</sup> This "fix" is wholly unjustified on the basis of the evidence and basic economic principles applicable to the railroad industry. In the absence of capitalization of merger-related enhancement of market power (for which there is not evidence in this case), the proper measure of the value of Conrail is its *current* value. The current value of a firm is the sum of the value of the holdings of shareholders (*i.e.*, those with claims on the residual, post-debt earnings of the

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<sup>113</sup> Whitehurst Rebuttal V.S.

<sup>114</sup> See, for example, Kahn/Dunbar V.S. at 20; ACE, *et al.*, Crowley V.S. (ACE, *et al.*) at 36-39; NITL/CPTA/TFI, "Joint Filing," at 42.

firm) and debtholders (*i.e.*, those to whom liabilities are owed).<sup>115</sup> Together, the value of these claims represent the value of all of the assets and financial returns of the firm. Therefore, as applied to Conrail, the proper measure of the value of the thing called "Conrail" is the sum of the current value of the equity of Conrail (as reflected in the Applicants' arm's-length purchase price of that equity) and the value of the Conrail's liabilities. As leading experts in the economics of corporate finance explain:

"Note that the values of debt and equity add up to the firm value...and that the firm value equals the asset value. (These figures are *market* values, not *book* values: The market value of the firm's equity is often substantially different from its book value.)"<sup>116</sup>

The central justification for relying on current value, as opposed to net book value, when measuring the value of a railroad lies in the fact that it is its current value on which debt and equity investors must be able to earn returns. If investors do not have the reasonable expectation of being able to earn returns at least commensurate with those available elsewhere in the economy, they will lack the incentive to make new investments in, or even to keep their capital in, the firm. In industries where firms are not regulated as public utilities and market forces and competition are given rein to establish marketplace prices, outputs, and investments, the current value of an ongoing firm will tend to reflect the current cost of replacing that firm with an equivalent alternative, depending on the waxing and waning of supply and demand conditions at any point in time. It generally will not, or only by happenstance will it, equal book value.

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<sup>115</sup> Richard Brealey and Stewart Meyers, *Principles of Corporate Finance*, Fourth Edition (McGraw-Hill; 1991) at 190.

<sup>116</sup> *Ibid.* at 190.

A tendency toward current firm values that correspond to replacement cost in markets governed by competition, rather than utility regulation, arises from the long-run need for the marketplace, particularly in growing markets, to sustain prices that are high enough to attract new supplies to meet demand. These new supplies come in at (or anticipating to recover) their costs (*i.e.*, current replacement costs). Thus, for example, a house built in 1900 for \$10,000 will readily sell for, say, \$500,000 when it costs \$500,000 to replace it in the marketplace with an equivalent asset. The sales price – the current value – of this old house need bear no particular relationship to its historical cost or its depreciated net book value.

The book value or net book value fails as a measure of the fair market value of a firm because, fundamentally, book value reflects the valuation of assets and investments in *past* marketplace conditions. Thus, particularly for long-lived assets like railroads, small and large changes in market conditions, inflation, and regulatory regimes can combine to leave depreciated net book values with little or no relationship to current market value. This is especially evident in the case of Conrail. As Mr. Whitehurst details, Conrail's net book value reflects the legacy of investments and memorable bankruptcy resolutions that, themselves, cannot be asserted to have even reflected original cost at the time they occurred.<sup>117</sup> Even in the absence of regulation, inflation, technological change, and changes in demand conditions, differences between economic depreciation and accounting depreciation can result in large deviations between current market value and depreciated net book value.<sup>118</sup>

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<sup>117</sup> Whitehurst Rebuttal V.S.

<sup>118</sup> It is particularly surprising that the "net book value" recommendation would be embraced by Kahn/Dunbar. Their formulation of "acquisition premium" recognizes that, if prospective enhancement of market power is being capitalized into an "acquisition premium," it is the *market* acquisition premium that reflects this. The



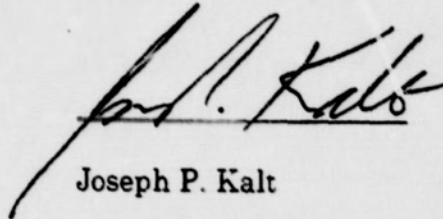
The distortions of book-value-based accounting and (potentially) ratemaking arise from its "heads I win, tails you lose" character. For the railroad that is considering an efficient, pro-competitive acquisition, for example, book value treatment of its asset value generally would tighten jurisdictional thresholds and impinge on revenue adequacy. That is, a railroad looking to undertake a cost-saving acquisition would find itself faced with the prospect that cost-savings would pull down regulatory caps toward the point of being binding, and the incentive to bid for the control of an otherwise efficiency-enhancing merger partner would be dampened. The proper signals to such a party would be sent by providing for acquisition cost treatment of its post-acquisition asset value. It is that value, after all, that is the motivation for efficiency enhancing restructurings of the rail system of the type proposed by CSX and NS.

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pre-announcement market value of Conrail to equity and debt investors would reasonably be viewed as reflecting pre-transaction market power of whatever force. Any post-merger increases in market power would then be reflected in the market acquisition premium in the Kahn/Dunbar framework. If the goal is to remove the capitalization of purported merger-related market power from the post-transaction cost base, it is the market premium that would have to be dismissed. As discussed at length above, there is no foundation in this case for the dismissal of the market acquisition premium.

VERIFICATION

I, Joseph P. Kalt, verify 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 on December 11, 1997.

  
Joseph P. Kalt

## REBUTTAL VERIFIED STATEMENT OF THOMAS E. KUHN

My name is Thomas E. Kuhn. I am Managing Director of TRAX Engineering & Associates, Inc. I am a registered professional engineer whose duties include the design, analysis and rating of railroad structures; bridge inspection; repair and rehabilitation recommendations; and the design and inspection of track work projects. My resume is attached as Exhibit 1.

The purpose of my statement is to provide a review and analysis of the build out route and estimate proposed by Indianapolis Power & Light Company ("IP&L") witness John E. Porter. IPL-3, Porter VS. My testimony provides a narrative description of the proposed build out route and identifies areas of concern that likely will have a significant impact on the cost estimate provided by Mr. Porter. Those items of concern are alphabetically designated to correspond to the locations shown on IP&L's conceptual plan, which is provided as Exhibit 2. At the end of this statement is a series of photographs to assist in visualizing the proposed site and the possible problems enumerated below. The photographs also are alphabetically designated to correspond to the locations shown on IP&L's conceptual plan.

- A. The proposed turnout to the new track is to be located in the vicinity of the existing turnout to the storage track at the north side of the power plant. An existing concrete culvert structure just west of the existing turnout can accommodate only one track. There is not room to the west of the existing turnout to install a new turnout. Therefore, it appears that a new culvert structure, or an addition to the existing culvert structure, is required to carry the new track over the existing ditch. No provision was made in the cost estimate for this structure. See IPL 1-HC0002 & IPL 1-HC0003 (in Volume 3). [[[  
]]]
- B. According to the conceptual plan provided, the track is to run to the northwest across a piece of land immediately to the north of the Stout Plant. This piece of land is the property of IP&L but does contain a building and some other facilities. For the track to cross this land as proposed, some of the facilities on this property would have to be

demolished, relocated or treated in some manner to clear a way for the track. It does not appear that there is any provision in the estimate for demolition of existing facilities. See IPL 1-HC0002 & IPL 1-HC0003. [[[

]]] However, aerial photographs of the property show facilities that run nearly the full length of the property and it does not appear possible to cross the property at an angle and miss all of the facilities on the property. [[[

]]] However, because this particular piece of property is already IP&L property, it would not appear that this would be included in land to be acquired and some provision for demolition, relocation or removal of the existing facilities should be made. This could add \$100,000 or more to the cost of the project depending on whether the facilities are to be done away with or will have to be relocated or reconstructed.

C. The crossing over the White River is proposed [[[

]]] Based on available aerial photographs of the area, it appears that a bridge which spans from the east bank of the White River across the river and across the levee on the west bank of the river would be required. [[[

]]] Scaling the distance along the line of the proposed centerline of track from the east bank of the river across the levee on the west bank, it appears that the length of the bridge would have to be more on the order of 1000 feet. [[[

]]]

D. [[[

]]] It would appear to be impossible to construct a bridge over the levee without having to excavate into the top of the levee and leave an opening lower than the existing top of the levee or, in effect, breaching the levee. Further, there is a gate at the north end of the levee which is marked for service vehicles only. This indicates that service vehicles will, from time to time, use the road on the top of the levee to perform necessary maintenance. If the bridge has to be constructed at an elevation which would provide room under the bridge for service vehicles, [[[

]]] Raising the elevation of the top of rail at the bridge would require additional embankment on both the east and west sides of the river and would add approximately 30,000 Cubic Yards of embankment to the amount provided for in the estimate. This would add \$155,000 to the estimate.

- E. There is an existing overhead power line (reported to be 136 kV) that runs parallel to the levee in the vicinity of the proposed crossing of the White River and continues to parallel the levee all the way to West Raymond Street. [[[

]]] This clearance would be a minimum of 24.7 feet (8.1 meters). There does not appear to be any provision for any adjustments to the overhead power line. IPL 1-HC0002 & IPL 1-HC0003. It may be that, since this is IP&L's line, any adjustments to the power line were considered to be an in-house matter not to be included in the estimate. However, there needs to be some cost associated with these adjustments. This would add \$100,000 to the estimate. There is no photograph associated with this item.

- F. After crossing the river, the proposed track alignment turns more or less parallel to the levee and the power line. The property to the west of the proposed alignment at the south end is an active landfill. As the line goes north from the levee, the landfill embankment moves to the east and at one point, there is the landfill boundary, a service road, a ditch and the overhead power line all in a very constricted area. There does not appear to be anywhere to build the railroad track except on top of the service road. The elevation of the railroad track at this location would appear to require that the slopes infringe on the landfill boundary and the ditch. There does not appear to be any provision for adjusting the landfill's monitoring wells and other facilities that would be covered up by the railroad embankment. IPL 1-HC0002 & IPL 1-HC0003. Nor does there appear to be any provision in the estimate for necessary adjustment to the overhead power line to provide the necessary lateral clearance in accordance with the National Electrical Safety Code. There is some question whether the embankment would be allowed to infringe on the landfill property since its operation is governed by license requirements. If the embankment is allowed to infringe on the landfill property, adjustments to the landfill's monitoring wells and other facilities could add \$150,000 to the estimate.



G. The map provided shows the proposed track to cross or come very near to two small ponds of water in the vicinity of the Indiana Grain property. It does not appear that any provision has been made for any additional fill or special handling to fill in these ponds. Filling a pond and constructing a railroad grade over the area will require draining the pond and taking special steps to achieve the proper moisture content in the ground in the bottom of the pond prior to construction of the fill. This could add \$50,000 to the estimate.

H. [[[

]]] There is no provision in the estimate for removal and reconstruction of any fencing. Further, there is an existing electric service line that parallels the existing fence from Kentucky Street to the south and then turns east to serve a building. Relocation and raising of this line will be required to permit construction of the proposed track. [[[

]]] The necessary fence work could add \$20,000 to the estimate.

I. [[[

]]]. At the present time, there does not appear to be any service off the Conrail track west of the switch which serves Indiana Grain. This means that any trains that presently bring cars to Indiana Grain or any other industry located south of Indiana Grain would consist of only ten or fifteen cars based on what was on hand at the time of our observation. Initiating unit train service to IP&L would involve bringing trains consisting of 100 or more cars and several locomotives across the Kentucky Avenue crossing on a regular basis. At the present time, the crossing is not equipped with crossing gates or cantilever signals. This is a four lane road and appears to carry a lot of traffic into and out of Indianapolis. It would seem likely that more comprehensive protection to vehicular traffic would be required by the city/state at this location. This could add \$250,000 to the estimate.

J. The Conrail track from Kentucky Avenue to the Indianapolis Union Railway was observed to determine its condition and attempt to assess its capability to handle the increased traffic that it would carry if unit coal train traffic were to be moved to the IP&L connection. This track consists primarily of 100 pound rail with some 130

pound and 133 pound rail. The heavier rail appears to have been installed as part of grade crossing reconstruction projects. The track condition is marginally adequate for the light traffic that the track now carries but it is doubtful that it would hold up under increased traffic loading that would be imposed by unit coal train traffic. This track would require heavy upgrading to be able to carry unit train loading. No estimate of cost for rehabilitating this track was made.

- K. Of particular concern on the Conrail track from Kentucky Avenue to the Indianapolis Union Railway connection is the bridge over Eagle Creek. This bridge consists of a pony truss and a through truss bridge on masonry piers and abutments. The through truss span appears to be of light construction and a thorough rating of the bridge should be done to ensure that it is structurally capable of carrying the loads that would be imposed by unit coal train traffic. The pony truss span is severely corroded to the extent that there are holes in the flanges of the floor beams and at least one floor beam web is completely corroded through. This span should also be thoroughly analyzed to ensure that it is structurally capable of carrying the loads that would be imposed by unit train traffic. The track profile across this bridge indicates that one of the abutments may have settled creating a dip in the track at one end of the bridge. This condition would be exacerbated by unit coal train traffic. [[[

]]]

In sum, additional work not included in the IP&L study could add:

- A. \$ 350,000 for structure at the plant turnout to the new track
- B. \$ 100,000 for facility relocation, removal, demolition
- C. \$2,200,000 for additional length of bridge to cross levee
- D. \$ 155,000 for additional fill to provide service road clearance at levee
- E. \$ 100,000 to raise power line at levee for clearance over track
- F. \$ 150,000 to adjust landfill monitoring wells and service road
- G. \$ 50,000 for special handling to drain and fill existing ponds
- H. \$ 20,000 for fence relocation on property east of Indiana Grain

or a total of \$3,125,000 to the estimated cost for the project from the Stout Plant to the connection at Indiana Grain. This does not include any additional cost for upgrading the

grade crossing protection at Kentucky Avenue, upgrading the Conrail track to permit safe and reliable operation of unit coal trains over the line or reconstruction of the existing bridge over Eagle Creek on the Conrail track. These three items could add \$4,000,000 or more to the total cost to provide safe and reliable rail service to the Stout Plant. [[[

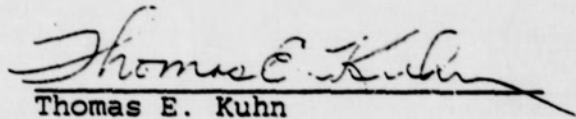
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While the actual operating factors of the proposed build-out were not in the scope of our study, it was noted that a 100 car train would occupy every grade crossing on the Conrail track between Kentucky Avenue and the Indianapolis Union Railway connection. It is our understanding that there is a state law that a crossing may not be occupied for more than 10 minutes. If a 6,000 foot train moved from a standstill to 10 MPH, it would take more than 10 minutes for the entire train to pass one point. Therefore, it may not be possible to serve the power plant without violating state laws.

VERIFICATION

I, Thomas E. Kuhn, declare under penalty of perjury that the foregoing is true and correct.

Further, I certify that I am qualified and authorized to file this statement. Executed on December 5, 1997.

  
Thomas E. Kuhn

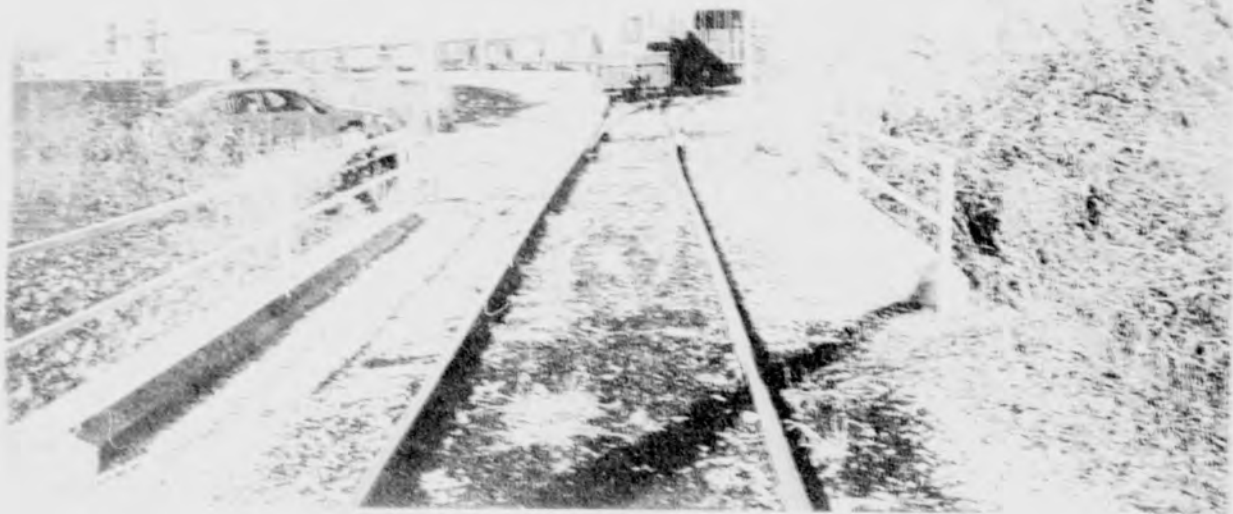




Photo C - View of White River in vicinity of proposed bridge. Note height of levee to the right of the picture. Fill would restrict the waterway. Bridge should span from the east bank over the levee on the west bank.



Photo D - View in the vicinity of the end of the bridge. Note the overhead power line to the right of the picture. Overhead power line would have to be adjusted to provide adequate vertical clearance for the track over the levee.



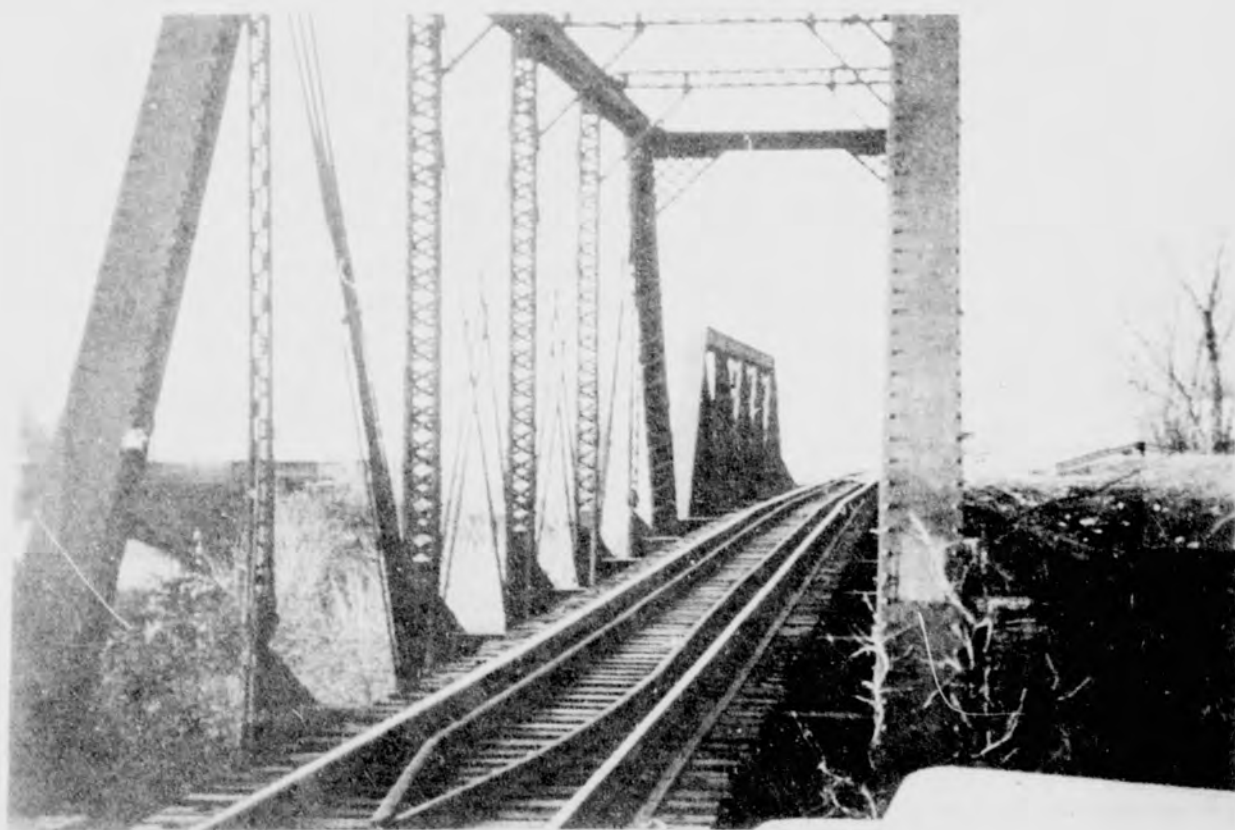


Photo H - View at the south end of Indiana Grain. Proposed track would be to the right of the fence. Fence would have to be reconstructed to the right of the proposed track.



Photo I - View at Kentucky Street grade crossing. Note that crossing is not protected by crossing gates and that the flashing lights are not on cantilevers. Crossing would have to be upgraded if railroad traffic is to increase.







**PROFESSIONAL RESUME OF THOMAS E. KUHN****EXPERIENCE:**

- Present: Managing Director, TRAX Engineering & Associates, Inc. Duties include: Bridge inspection and repair and rehabilitation recommendations. Design, analysis and rating of railroad structures. Design and inspection of trackwork projects as required.
- 1986-95: Principal of consulting firm of Design Nine, Inc., which specializes in railroad related projects. Duties included: Bridge inspection and repair and rehabilitation recommendations. Design, analysis and rating of railroad structures. Design and inspection of trackwork projects as required. Administrative duties included maintaining corporate financial records, computerized accounting and consultation with accountant as well as general administrative duties involved in running a business.
- 1984-86: Bridge Construction Engineer (Missouri Pacific Railroad Co.) Duties included: Supervision of bridge construction gangs in construction of steel and prestressed concrete railroad trestles and repairs to existing steel railroad bridges. Supervision of plant in manufacture of prestressed concrete piles and girders. Coordinated schedules for casting and construction. Supervision of emergency repairs to bridges damaged by derailment, fire, etc.
- 1978-84: Engineer-Special Projects (MoPac) Duties included: Inspection of railroad bridges, training district bridge inspectors, developing maintenance and repair recommendations. Preparation and administration of contract documents for bridge construction and repair projects. Supervision of emergency repairs to bridges damaged by derailment, fire, etc.
- 1976-78: Bridge & Building Superintendent (MoPac) Duties included: Supervision of district personnel in maintenance and repair of bridges, buildings and structures. Inspection of structures to develop maintenance, repair and replacement programs. Development and control of maintenance programs and budgets.
- 1975-76: Bridge Design Engineer (MoPac) Duties included: Analysis of design of railroad bridges and structures. Preparation of plans and estimates for construction and repair projects. Preparation of contract specifications and documents.
- 1974-75: Bridge Inspector (MoPac) Duties included: Inspection of railroad bridges and other structures to develop maintenance and repair



requirements for programs.

- 1972-74: Civil Engineer (MoPac) Duties included: Preparation of detailed drawings, specifications estimates and contract documents for repair and construction of railroad bridges and structures. Analysis and design of steel, concrete and timber bridges.
- 1971-72: Civil Engineer Assistant (US Army) Originated, evaluated and inspected projects in construction, highway, structural, hydraulic and sanitary engineering.

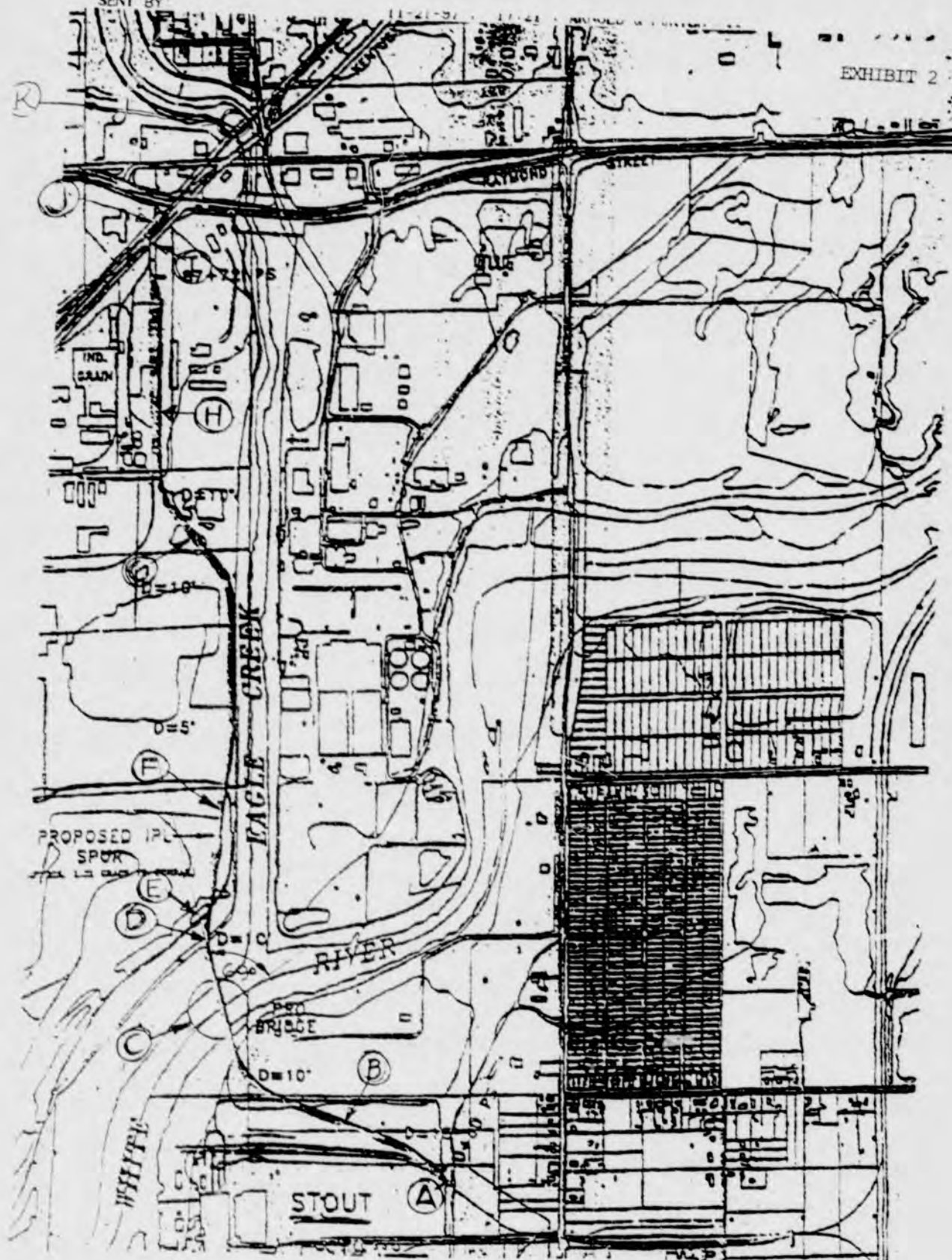
EDUCATION: B.S. Civil Engineering, 1970, University of Missouri-Rolla

ACTIVITIES AND ORGANIZATIONS:

Professional Engineer - Missouri #17486  
- Kansas #9065

American Railway Engineering Association (Committee 18 - Light Density and Short Line Railways)

American Railway Bridge and Building Assn  
(Director 1982-85)



REBUTTAL VERIFIED STATEMENT

OF

E. J. MARTIN

NORFOLK SOUTHERN MARKETING MANAGER  
OF GRAIN AND GRAIN PRODUCTS

My name is E.J. Martin. My business address is 110 Franklin Road, SE, Roanoke, Virginia 24042-0041. I am Marketing Manager of Grain and Grain Products with Norfolk Southern. I have held my present position since May 1, 1990. My position is responsible for planning and direction of pricing negotiations, contractual development and marketing activities involving grain and grain products.

I have reviewed the public, but not the confidential, comments filed by the U.S. Department of Agriculture. While I cannot comment on the economic studies that, according to USDA, show some minimal adverse impact on agricultural shippers in the Conrail service territory, I can comment on the importance NS places on the agricultural markets in its territories, the incentives it has put into place to develop those markets, and the extraordinary benefits I believe the agricultural marketplace will reap from the Transaction.

I know that both CSX and NS view agricultural markets as important growth markets, and both are very aggressive about going after the agricultural business. NS, for example, has invested heavily in developing agricultural markets and in providing customers in these markets with the necessary equipment to efficiently handle their traffic. Agricultural shippers on NS do not experience the same car supply and unit train size problems often identified with other railroads.

NS maintains a fleet of 8,300 jumbo and super jumbo covered hopper cars, a majority

of which are dedicated to grain service. Many of these cars (1,600) are in 50-car unit train service, but many more (3,860) are in single-car service. Conrail, by contrast, has downsized its covered hopper fleet due to its different marketing philosophy and differing needs of its customers.

The 50-car unit train service is an example of NS' emphasis on the agricultural market, and is significant from a shipper's cost savings perspective. NS' 50-car unit train program includes privately-owned as well as NS-owned cars. This unit train program, with its reduced rates, is available for all types of agricultural markets: export markets, southeastern feed markets, corn and soybean markets, and flour mill markets. NS also works in partnership with shippers in the agricultural marketplace to develop new facilities and expand present facilities to enable those facilities to take advantage of NS' 50-car unit train program.

NS must be continuously aggressive in developing its agricultural market share to avoid losing out to the combined competition of CSX (NS has very few moves where Conrail is a direct competitor) and trucks.

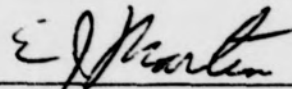
USDA's comments fail to recognize the significant favorable effect of the transaction on certain large agricultural markets. Elevators and processors located on Conrail in the Midwest will enjoy new single line service to the Southeastern feed market. This is the fastest growing and largest agricultural market served by NS and represents about 38% of NS' carload grain traffic -- nearly 65,000 carloads per year. Having this added source of supply will benefit end users in the Southeast and will provide new business for elevators and processors located on Conrail, which previously had limited single-line destination markets. Another area that will experience a direct benefit from the Transaction is the Delmarva feed

market, which will be open to the NS 50-car unit train program and expansion incentives for the first time.



## VERIFICATION

E. J. Martin, makes oath and says that he is Marketing Manager, Grain and Grain Products, Norfolk Southern Corporation, Roanoke, Virginia, that he is authorized to file and verify the foregoing verified statement in STB Finance Docket No. 33388 on behalf of the applicants, that he has carefully examined all the statements in the foregoing verified statement, that he has knowledge of the facts and matters stated therein, and that all representations set forth therein are true and correct to the best of his knowledge, information and belief.

  
\_\_\_\_\_  
E. J. Martin

COMMONWEALTH OF VIRGINIA

CITY OF ROANOKE

Subscribed and sworn to before me  
This 3<sup>rd</sup> day of December, 1997.

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

My commission expires February 29, 2000.

## VERIFIED STATEMENT

OF

WILLIAM M. McCAIN

My name is William M. McCain. I am Assistant Vice President-Labor Relations for Consolidated Rail Corporation ("Conrail"). I have held this position since April 1, 1994. Prior to that date, I held various positions in the Conrail Labor Relations Department, beginning in 1976, when I joined the newly-established Conrail. I began my career in railway labor relations in 1974 with the Lehigh Valley Railroad, one of Conrail's predecessors.

Based on my work experience, I am very familiar with the history of Conrail's labor relations, beginning with Conrail's inception in 1976. I make this declaration in order to respond to certain comments filed by rail labor in the Surface Transportation Board proceeding captioned 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. Specifically, several commentators have urged the Board to disapprove the proposed transaction, citing the asserted "sacrifices" made by rail labor in connection with the creation and operation of Conrail. This contention is expressed generally in the declarations submitted by the Allied Rail Unions (e.g., Scheer Decl. ¶3). An individual, R. D. Chamberlain, who identifies himself as a Conrail employee, filed a letter urging the Board to disapprove the proposed transaction, and asserting that Conrail employees "gave up all our money making agreements and crew sizes to make this company a profitable railroad." The Transportation Communications International Union ("TCU") urges the Board to grant agreement employees "a level of protection which is commensurate with their contribution to Conrail's value" (TCU-6 at 3-7), and purports to buttress its case with the verified statement of Thomas Roth ("Roth V.S."). Mr. Roth presents what he

terms a "report on Conrail's recovery and return to profitability" (Roth V.S. at 1), in which he contends that rail labor made "the greatest contribution toward Conrail's recovery" (*i.d.* at 2). As I explain below, Mr. Roth's report omits key facts and provides a misleading account of the history it purports to relate.

A contention that Conrail's current employees deserve special protection on account of their prior sacrifices is just wrong. TCU rests its contention principally on the substantial number of employees whose jobs were abolished (or were transferred to commuter railroads) in the effort to transform Conrail's bankrupt predecessors into a profitable railroad. The number of employees whose jobs were abolished in the past has no logical bearing on the level of protection that is appropriate for the current Conrail employees who may be affected by the proposed transaction. By definition, current Conrail employees did not lose their employment in the effort to build Conrail; they are the ones who kept their jobs.

Likewise, I disagree with TCU's contention that enhanced employee protection should be imposed because Conrail employees agreed to defer wage increases in 1981 in order to help the railroad achieve profitability. Mr. Roth's description of the 1981 wage increase deferral is incomplete and misleading.

A wage increase deferral by Conrail employees was one of the statutory "goals" expressed by Congress in the Northeast Rail Service Act ("NERSA"), Pub. L. No. 97-35, 95 Stat. 643 (1981) ("NERSA"), which adopted various measures designed to help Conrail achieve profitability. Section 1134(4)(A) of NERSA provided that Conrail "should enter into collective bargaining agreements with its employees which would reduce Conrail's costs in an amount equal to \$200,000,000 a year, beginning April 1, 1981, adjusted annually to reflect inflation." Pursuant to §1134(D), the \$200 million annual savings goal was to be measured based upon the total labor costs that Conrail otherwise would incur under nationally negotiated collective bargaining agreements. In accordance with the NERSA directive, Conrail and the labor organizations entered into a wage increase deferral agreement entitled "Agreement Between Conrail and Certain

the 1981 Agreement provided that Conrail employees would receive no wage increases until the wage rates negotiated on the national level exceeded Conrail wages by 12 percent, a gap that was achieved in 1982.

Mr. Roth refers to the wage increase deferral as having been "contributed by rail labor" (V.S. Roth at 6), thereby erroneously implying that the 1981 wage increase deferral was limited to Conrail's agreement employees. This assertion is made notwithstanding the fact that his estimation of wage increase deferral savings includes nonagreement as well as agreement employees employed by Conrail in the relevant time frame (V.S. Roth Att. 1). One of the terms of the 1981 Agreement and one of the other express "goals" of NERSA required Conrail's nonagreement personnel to forego proportionally equivalent wage increases. The 1981 Agreement and another "goal" of NERSA also required Conrail to reduce the size of its nonagreement workforce in proportion to reductions in agreement positions.<sup>1</sup>

Conrail has long since restored its employees' wages to national levels. By agreement dated February 14, 1985, Conrail agreed to adopt national wage levels for all agreement employees. The wage increase restoration was effective July 1, 1984, and Conrail has maintained wages at national levels ever since.

The 1981 Agreement failed to achieve the \$200 million annual savings targeted under NERSA. Indisputably, however, the agreement yielded hundreds of millions of dollars in savings. Mr. Roth contends that those savings reached nearly \$500 million. V.S. Roth Att. 1. Our records show that Conrail saved slightly less than \$400 million

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<sup>1</sup> NERSA § 1134(1) provided:

(1) NONAGREEMENT PERSONNEL. --(A) Employees who are not subject to collective bargaining agreements (hereafter in this section referred to as "nonagreement personnel") should forego wage increases and benefits in an amount proportionately equivalent to the amount foregone by agreement employees pursuant to paragraph (4) of this section, adjusted annually to reflect inflation.

(B) After May 1, 1981, the number of nonagreement personnel should be reduced proportionately to any reduction in agreement employees (excluding reductions pursuant to the termination program under Section 702 of the Regional Rail Reorganization Act of 1973).

(over the period April 1, 1981 through June 30, 1984), including wage increases deferred by nonagreement as well as agreement employees, and also including employer tax savings. In any event, the precise extent of the savings is irrelevant.

Whether the wage increase deferral saved Conrail \$400 million or \$500 million, the pertinent fact is that Conrail compensated the employees affected by the wage increase deferral. In 1985, Conrail entered into an agreement (the "Definitive Agreement of September 17, 1985 By and Between Conrail and the Undersigned Representatives of Conrail's Agreement Employees" (hereinafter, "Definitive Agreement")), under which Conrail agreed to compensate employees for their previous wage increase deferrals through a number of means, including cash payments totaling \$200 million, the distribution of stock, and the assumption of certain employee protection obligations. The \$200 million was allocated to affected employees based on their relative earnings in the period covered by the wage increase deferral (April 1, 1981 through June 30, 1984). The stock payment took the form of an accelerated distribution of shares (amounting to 15 percent of Conrail's common stock) to an Employee Stock Ownership Plan ("ESOP"). We intended and expected those provisions to yield affected employees more money than they would have received if their wage increases had not been deferred.

The Definitive Agreement's principal terms were mandated by Congress in the Conrail Privatization Act, Pub. L. No. 99-509, 100 Stat. 1893 (1986). Among the legislative findings in support of the Act, Congress found that Conrail's employees

contributed significantly to the turnaround in the Corporation's financial performance and [that] they should share in the Corporation's success through a settlement of their claims for reimbursement for wages below industry standard, and a share in the common equity of the Corporation.

Id. § 4002(9).

Thus, § 4024 of the Privatization Act provided:



## PROVISIONS FOR EMPLOYEES.

...

(e) COMPENSATION FOR WAGES BELOW INDUSTRY STANDARD. --- The Corporation shall pay \$200,000,000 to present and former employees subject to collective bargaining agreements, in accordance with the terms and conditions in the Definitive Agreement referred to in subsection (d)(1), or as otherwise agreed between the parties.

In addition, pursuant to § 4024(f) of the Privatization Act, Conrail was required to honor the provisions of the Definitive Agreement entitling employees to accelerated distribution of stock under the ESOP. Section 4038 of the Privatization Act expressly provided that the § 4024 cash and stock benefits were to constitute complete and final resolution of "all claims to pay entitlements arising out of the pay increase deferrals by present and former employees of [Conrail] under the [1981 Agreement]."

TCU purports to explain what Conrail's nonagreement employees will receive in the form of "severance payments" and "dislocation allowances" and contends that "it is only equitable that comparable packages be made available to Conrail's unionized workforce." TCU-6 at 7. As explained in the Verified Statement of Richard D. Huffman, most of the money that individual employees will receive in connection with the proposed transaction represents allocation of Conrail's current ESOP. Under this ESOP, which was established and funded in 1990, employees' retirement contributions were matched with Conrail stock.

Conrail's agreement employees were offered an opportunity to participate in the ESOP in 1989. All of the unions representing Conrail's agreement employees rejected the offer. Since then, a single union, the Fraternal Order of Police ("FOP"), made an agreement to join the ESOP. (We reached an agreement on the ESOP with the United Railway Supervisors' Association, but the agreement was rejected by that union's membership.) Thus, Conrail's FOP-represented employees will participate in the ESOP allocation on the same terms as Conrail's nonagreement employees.

Mr. Chamberlain's assertions also are without merit. His contention that Conrail employees "gave up all our money making agreements" presumably is a reference to the 1981 wage increase deferral. As I have explained, Conrail employees were compensated for the wage increase deferral years ago. Mr. Chamberlain's contention that Conrail employees "gave up...crew sizes" presumably refers to the various crew consist agreements that Conrail has entered into with the United Transportation Union. These agreements provide additional monetary benefits to employees who work in smaller crews. In any event, Conrail's crew consist agreements are generally comparable to agreements on other Class I railroads, and do not constitute a reason to treat Conrail employees differently in this proceeding.

#### VERIFICATION

STATE OF PENNSYLVANIA

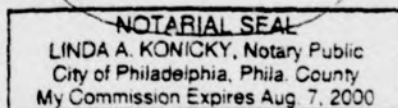
COUNTY OF PHILADELPHIA

William M. McCain, being duly sworn, deposes and says that he is Assistant Vice President-Labor Relations for Consolidated Rail Corporation, that he is qualified and authorized to submit this Verified Statement, and that he has read the foregoing statement, knows the contents thereof, and that the same is true and correct.

William M. McCain  
William M. McCain

Subscribed and sworn to before me  
by William M. McCain, this 8th day of  
December, 1997.

Linda A. Konicky  
Notary Public



The SP situation was compounded by a huge growth in traffic, largely unsupported by corresponding revenues or profits. In the period 1987 through 1996, revenue ton-miles on SP grew 71% whereas revenues grew only 18%. Such growth puts tremendous pressure on the facilities of a railroad which simply did not have the infrastructure necessary to accommodate that growth. SP was (and is) a largely single track railroad, which puts severe constraints on capacity when compared to multiple track railroads. Further, SP did not and could not generate enough operating income to support needed capital investment needed to support growth.

SP was a fragile operation and any sudden shock to the system, such as a surge in traffic or unexpected weather, would cause serious problems. Indeed, SP suffered "gridlock" similar to the current UP problems in 1979. In my judgment, UP is absolutely correct in saying that much of the current UP-SP problems can be traced to the condition of SP. By contrast, Conrail's growth has been far less; revenue ton-miles increased 16.9% for the ten year period (revenues increased 13.1%). Conrail had further advantages; its mainlines are largely double tracked and CR's infrastructure continues to benefit from substantial government investment in the period 1976-1980, followed by a continuous and healthy internal capital investment program.

Conrail, by contrast, is in excellent condition. Its financial performance continues to improve and customers rate its service quality as good to excellent.

**NS AND CSX HAVE BEEN MORE FOCUSED ON CONRAIL THAN UP WAS ON SOUTHERN PACIFIC.**

UP enjoyed a good reputation before the SP merger. Yet UP was also wrestling with huge traffic; revenue-ton-miles grew 71% in the ten year period 1987-1996. Of special importance to later events was the substantial growth in traffic to/from Texas and Mexico, an area where UP lines were largely single tracked. This rapid growth put a strain on UP's fixed plant and motive power fleet.

In the past five years, UP also managed significant changes to its system. UP reduced route miles from 26,752 in 1990 to 22,266 in 1996. It acquired the Chicago and NorthWestern. It was confronted with a proposed BN-SF merger; it countered with a hostile takeover bid for the Santa Fe. It lost that bid and was then confronted with the emergence of a new competitor, BNSF. Faced with a complete change in the balance of power in the West, UP put together and obtained approval of the SP transaction in record time. Concurrently, UP was involved in a effort to make major expansions into the Mexican market.

Inevitably, all of this activity had to divert management focus from SP's problems.

The eastern situation is fundamentally different. Traffic growth has been relatively modest; in the ten year period revenue ton-miles grew 37.7% on NS and 11.5% on CSX. Both CSX and NS completed most of their downsizing activities prior to 1990, and both are growing their workforces. Conrail was the dominant rail merger item on the management agenda at both NS and CSX for many years. In that process both CSX and NS learned a lot about Conrail.

# REBUTTAL VERIFIED STATEMENT

OF

JAMES W. MCCLELLAN

## NORFOLK SOUTHERN VICE PRESIDENT STRATEGIC PLANNING

My name is James W. McClellan. I am the same James W. McClellan who submitted a verified statement contained in the primary application submitted on June 23, 1997 in Finance Docket No. 33388 (See Volume I, pages 501 to 554).

I am submitting this statement for two purposes: (1) To respond to the numerous questions raised concerning the ability of Norfolk Southern and CSX to acquire Conrail, separate that company into two components and then efficiently manage the integration of those segments into NS and CSX, respectively; and (2) to provide information and rebuttal to certain statements and claims made in the Responsive Application of the Wheeling and Lake Erie Railway Company (W&LE-4).

### **I. INTEGRATION OF CONRAIL BY NS AND CSX**

Concerns about the integration of Conrail appear to be largely driven by the significant service failures that have occurred on the Union Pacific-Southern Pacific system, some of which may be ascribed to the merger and some of which have their roots outside of that merger itself, as I will explain.

In making this statement, I draw upon widespread press reports of the UP-SP situation, certain studies undertaken on behalf of NS's Strategic Planning Department by Mike Mohan of the Kingsley Group (a former President and before that, Vice President-Operations, of Southern Pacific), and my own knowledge of the railroad



industry that spans three decades. Further, in my job as Vice-President Strategic Planning and various jobs preceding my current assignment, I have had the responsibility of following, interpreting and acting on various industry events and trends for Norfolk Southern. I have also discussed the UP-SP situation with a large number of industry officials and observers.

It is my judgment that the Conrail transaction is significantly different from the UP-SP situation and will not experience the same difficulties that have plagued that transaction. It is also my judgment that far too little emphasis has been placed on the serious problems that existed at both Southern Pacific and Union Pacific prior to the time of their merger.

To simply assume, as some have done, that the Conrail restructuring will turn out badly because the UP-SP has had problems is no more rational than to have concluded that the railroad merger movement should have stopped after the Penn Central debacle.

#### **CONRAIL IS IN FAR BETTER CONDITION THAN SOUTHERN PACIFIC**

Conrail is a solid performer, financially and operationally. In the period 1987 through 1996, the operating ratio of the Southern Pacific averaged 99% and never dipped below 92%. By contrast, the average operating ratio at Conrail was a full 14.5% points lower, averaging 84.5% and reaching a low of 79.7% in 1995. The operating income for the two carriers over the decade is billions of dollars in favor of Conrail. Conrail not only is a profitable company, the trends have been positive.

Further, Conrail has been a "partner" for both NS and CSX. This strong interline relationship has helped us increase our understanding of Northeastern markets and operations over a long period of time. By contrast, UP and SP always were aggressive competitors rather than partners.

#### **NS AND CSX WILL MANAGE THE IMPLEMENTATION BETTER.**

NS and CSX have understood the complexity of dividing Conrail since they considered the matter in detail in 1995. No one ever split a railroad the size of Conrail before and we anticipated major questions about feasibility. Long before there were UP-SP problems, indeed long before there was even a UP-SP deal, we were wrestling with the complexity of a Conrail deal. Extraordinary measures are underway and will continue to be taken to assure a smooth transaction. I will touch upon some of them.

**1. Reliance on Conrail knowledge.** Our Conrail activities over time made us aware of how much we did not know. As a result, NS relied on knowledgeable former Conrail personnel, including Gordon Kuhn, former chief commercial officer and Bob Hatton, former AVP-Transportation to aid us in various decisions. Currently, we have a good working relationship with Conrail and are using as much of their expertise as is possible within legal bounds. CSX has already hired two senior Conrail executives who occupy senior management positions at CSX. NS has picked a Conrail executive to head Triple Crown, and will shortly announce several more appointments of Conrail executives to senior posts at NS.

**2. Significant planning was accomplished pre-application.** The split

of Conrail itself required an immense amount of planning, a knowledge of Conrail and how Conrail's parts would be operated. It is significant that no party submitted evidence to show that the split is not operationally feasible (though some would like the boundaries redrawn for commercial or other reasons).

Further, the attention given to issues of on-going Conrail management, including the structuring of incentives to keep management in place, shows the type of detailed planning that has already been accomplished. The continued smooth functioning of Conrail during a very difficult time for its management is unprecedented and reflects the appreciation of CR, NS and CSX of the complexity of these transaction issues and of the importance of proper implementation.

**3. Longer timetable for implementation.** Not only have NS and CSX been studying Conrail for years, the longer timetable at the STB gives both carriers substantially more time to refine their plans and prepare for implementation. In the UP-SP case, the STB approved the merger 255 days after the application was filed. In this case, the STB's final decision will not be issued until at least 395 days after the applications was filed--140 days longer than in UP-SP. As indicated in the statements of Nancy Fleischman, NS's Vice President in charge of transition planning, and her CSX counterpart, Michael Ward, while NS and CSX did not seek that additional time, both of us are using it to engage in an extraordinarily detailed and comprehensive planning for the implementation of the transaction, and will continue to do so.

At the same time there is a tradeoff between planning and doing. An unduly

long implementation timetable runs the risk of creating uncertainty in the transportation marketplace, creates uncertainty among the managements of NS, CSX and CR, and imposes a substantial financial cost that drains resources from NS, CSX and the rail industry.

Planning is never a substitute for doing. As thorough as the current planning process is, unexpected events will occur. A lesson from UP-SP is that as a situation changes, you must have a flexible plan and you must take corrective action quickly. I believe that our management culture and processes and our flexible implementation plans will permit NS to respond quickly and effectively to the inevitable unforeseen developments.

**4. Pro-Competitive Nature of the eastern transaction will promote better service.** The Conrail transaction offers more new rail-to-rail competition than did UP-SP. The entire transaction is designed around this competitive structure. This is in marked contrast to UP-SP where many of the pro-competitive adjustments were "added-on" by the applicants later after customer complaints mounted. The STB then approved the merger based on those adjustments.

The far more competitive eastern structure means that two asset-owning railroads will be vying for the privilege of handling customers' traffic in a significant number of markets. In these markets, customers will have the choice should one carrier or the other experience difficulties in the implementing process. And because NS and CSX have their own routes to major markets, the ability of shippers to shift traffic between one carrier and another is greatly enhanced. In the case of UP-SP,

the ability of other competitors to gain traffic from UP-SP has been severely constrained by the fact that the these competitors use to move that traffic are controlled by UP-SP and are already severely congested.

NS and CSX, knowing that customers have real choices, will pay considerable attention to doing the job right lest their competitive positions be compromised. And customers, because the competitive structure has been designed from the start, will have effective leverage over the carriers and real operating alternatives.

Consider the Shared Assets Areas SAAs), which were designed long before the UP-SP problems became known. The CSAO will have control of all of the railyard facilities in the area. The dispatching will be local and neutral. CSX and NS will make certain that the CSAO takes no action that would compromise each of their competitive position. Superior service, not elimination of "redundant" facilities, will be the primary mission for the CSAO. In addition, Each railroad will have not one, but multiple mainline routes to/from each SAA. The new structure in the East provides inherent flexibility and ability to adapt to unexpected circumstances.

From the outset, the NS and CSX plan for Conrail sets up the essential infrastructure (including management) needed for competition at the offset.

## CONCLUSION

No one at NS or CSX ever thought that acquiring Conrail, splitting it into logical components, and providing for enhanced competition was going to be an easy task. Long before there were problems on UP-SP, NS and CSX were systematically identifying issues, reaching decisions and moving forward. The infrastructure was



about divestitures. NS was prepared to divest the W&LE along with the much healthier mainline of the former "Nickel Plate" to Guilford Transportation, Inc. (GTI). As will be shown, that divestiture was included in a larger package not to solve a competitive problem but rather because the recipient of the divestitures wanted those lines as part of the deal.

When NS sought Conrail from the government, it concluded that NS's proposal would never pass regulatory muster unless competition was provided between Northern New Jersey and Chicago. The creation of Conrail had essentially left that carrier in total control of all of the tracks into Northern New Jersey. One carrier, Guilford Transportation Inc. (GTI) operated the former Delaware and Hudson route between Northern New Jersey and Buffalo using trackage rights on Conrail, and thus became the natural carrier to complete a competing New York - Chicago route.

To create effective competition, NS negotiated a deal with GTI to divest the Southern Tier line as well as the NS's "Nickel Plate Line" between Buffalo and Chicago. This divestiture would have created two single system routes, each owning their own routes, in what was and still is one of the busiest rail routes in the United States.

The lines of the future W&LE connected with the lines to be divested at Bellevue, OH, a major operating hub of the former Nickel Plate. GTI wanted access to markets other than Northern New Jersey in order to flesh out its system. Had NS acquired Conrail, the Pittsburgh market would still have been served by NS and CSX,

which was all the rail competition that was required. The added inclusion of the future W&LE was done because GTI wanted the routes and the future W&LE routes were of little value to NS given the fact that the Nickel Plate mainline was to be divested. This was a business, not political decision, though NS and GTI did correctly say that competition would be enhanced by the overall divestitures.

When the Conrail acquisition failed, NS turned its attention to strengthening its own internal performance. In its 1987 five year plan (prepared at that time by P.A. Dieffenbach, AVP-Corporate Planning and Development), NS projected a deterioration of operating income due largely to continued declines in average yields caused by the growing competition unleashed by the Staggers Act and truck deregulation. In a series of high level meetings, it was decided to bring costs in line with expected revenues through a substantial downsizing of both NS's route structure and its personnel (especially non-agreement personnel). An early retirement/buyout program was implemented in the Fall of 1988 and resulted in a reduction of more than 2000 jobs.

As Chairman of the Light Density Line Committee, I identified over 2500 route-miles that should be sold or abandoned. This program was approved by senior management and the process begun. Concurrently, Corporate Planning was identifying additional lines to be divested. The W&LE properties were included in this additional set of lines.

The reasons for selling the lines that are now the W&LE had nothing to do with Conrail. Rather, the W&LE properties simply did not fit NS' own strategic

split. The price was split. Protocols were established for the continued operation of Conrail, including proper incentives. Complex economic and political issues were addressed. In spite of being two fierce competitors, both parties recognize that the future of their companies and the future of railroad industry in the U.S. depends on how well we implement the Conrail transaction. We have made a lot of progress and have shown both an understanding of changes as they occur and an ability and willingness to deal with those changes. I am certain we will complete the task just as successfully.

## **II. WHEELING AND LAKE ERIE RAILWAY COMPANY**

My rebuttal statement with respect to W&LE's Responsive Application is based on my review and analysis of the comments filed by the W&LE, my knowledge of the specific decisions made by NS when it divested the W&LE properties and my knowledge of the Eastern rail network and the prospective role of the W&LE in that network in the past, present and future.

My essential message is that the W&LE's problems are long term, structural in nature, and not related to the Conrail transaction. The W&LE is simply being opportunistic in claiming harm. Because the W&LE cannot support its obligations from income from railroad operations, they have concocted an interesting set of reasons why they should be granted extraordinary relief by the STB. The reasons have little to do with the facts.

### **NS SOLD THE W&LE AS PART OF AN OVERALL DOWNSIZING EFFORT BETWEEN 1987 AND 1990, NOT AS PART OF A COMPETITIVE SOLUTION ANTICIPATING A FUTURE ACQUISITION OF CONRAIL.**

The W&LE states (see V.S. of Larry R. Parsons) that the W&LE was founded in 1990 in order to preserve competition with a then-to-be-formed Norfolk Southern/Conrail combination. This is revisionist history of the worst and most self serving kind.

NS's efforts to acquire Conrail from the U.S. Government ended in 1987. The NS Strategic Planning Department (then the Corporate Planning and Development Department) was heavily involved in that activity, especially in terms of decisions

objectives. The route had once been a through route in conjunction with the Western Maryland Railroad. That through route withered after Western Maryland was acquired by Chessie System (which went on to become CSX). The W&LE properties never provided significant access to industry in the Pittsburgh market; it was built late as a through route and stayed on the hilltops, whereas most of the traffic was down in the valleys (and much of that industry has gone away in recent years). The W&LE had no eastern anchor, and its only eastern connection to the NS system was via 170 miles of trackage rights over a mainline of NS' arch-competitor CSX. NS was the third, and weakest, carrier in most of the markets that W&LE now serves. Though in good condition when sold, the W&LE lines were facing reinvestment. In short, NS was in a downsizing mode and had to focus on our core markets and our core routes, and the W&LE properties did not meet criteria for reinvestment.

The W&LE properties, like most the other lines abandoned or divested during this downsizing effort, did not have enough potential from NS' perspective to warrant retention. Better, we thought, to sell it to a lower cost operator who might find value in the property as a regional carrier and expand the business base.

#### **THE W&LE HAS LONG TERM STRUCTURAL PROBLEMS.**

Many of the lines spun off from Class I carriers have been successful. Some have not. These lines almost always represent a gamble that the underlying conditions, high costs or low traffic volume or a combination of both, that led to their being divestiture candidates, can be reversed. The W&LE lines had been a marginal producer for NS or they would not have been sold. They also offered an opportunity



for others, as John Williams attests in his Rebuttal Verified Statement.

The W&LE has been successful in reducing its costs as compared to costs under the NS operation. But anticipated traffic growth did not occur, and W&LE continues to be a low volume railroad, trying to support a substantial debt load (a debt sized to the traffic base it was trying to achieve rather than the traffic base it ended up with). For example, W&LE revenue per route mile (a key indicator of railroad density and strength) is only about \$60,000 a mile vs. the Class I average of \$258,000 a mile. Faced with such numbers, W&LE is faced with a problem: either the system must be more closely sized to its existing revenue base or there must be a substantial increase in the revenue base.

Throughout its existence, the W&LE has always hoped for better traffic levels and has avoided any efforts to rationalize its network. Now, W&LE is pursuing an opportunistic strategy of seeking a "quick fix" of new revenue from the proposed Eastern restructuring. In my opinion there is no justification in penalizing NS, CSX and rail customers to fix a long standing W&LE revenue problem.

From my experience in railroad restructuring, the right answer for the W&LE is to downsize its system, protecting and promoting those markets where it has a significant presence (such as Akron and Canton, where it is the second, not third, carrier in terms of market share) while shedding the relatively hopeless parts of its system.

I can only speculate on why the W&LE has failed to downsize. It may well be that the debt load--W&LE is still servicing \$17 million in debt and has another \$20

million in "inactive debt" that will only be serviced if certain lines in the Pittsburgh area are sold--means that downsizing would force financial restructuring. But a reluctance to take that hard action is no reason for the STB to reward W&LE with undeserved rewards from the NS and CSX acquisition of Conrail.

Downsizing could be relatively easily achieved if the W&LE had the willpower to pursue such a course of action. The territory it serves is crisscrossed with other carriers. When faced with similar situations here at NS, and where NS did not want to exit the market for whatever reasons, we have been successful in using the tracks of other carriers to protect our market access without the burden of track ownership. In contrast, it is my sense that the W&LE is stubbornly sticking to a single strategy directed at revenue infusion. There are a lot of things a railroad can do when faced with light density problems than simply sit around and hope that the market improves (whether by regulatory fiat or otherwise).

### **C. THE W&LE IS NOT AN ESSENTIAL FACILITY.**

Part of the reason for W&LE's lack of success is that most of the W&LE's major customers are served by other, stronger railroads. These jointly served customers do not seem concerned about the future of W&LE or their transportation options. Indeed, USX, W&LE's largest customer, supports the transaction. That is hardly the action of a customer concerned about the loss of essential service.

Because W&LE serves very few facilities on an exclusive basis, the W&LE is generally not an essential facility. If the W&LE fails, it is my judgment that virtually all of the essential services would be protected by other carriers. Even rail

competition could be maintained; those markets that would go from "two to one" status could be protected through direct access, trackage rights or ownership, depending on the volume and economics of each. None of the W&LE's load centers are very far from other railroads, and it would be relatively easy for such carriers to step in and serve these markets. My staff and outside consultants have estimated that of the 864 miles of W&LE trackage and rights, less than 220 miles, or 25%, are required to maintain rail service by one carrier to all W&LE rail customers. If the requirement were reduced to provide rail service to all stations with 1000 cars or more per year, less than an estimated 140 miles (16%) of W&LE trackage would need to be retained.

The W&LE reminds me of the situation that existed with the Rock Island, another financially-weak, low density railroad with too much mileage that chased too little traffic in competition with other, stronger carriers. Given the other railroads serving the same markets or in close proximity, protecting service was relatively easy. The same solutions would work for W&LE customers.

Fundamental restructuring of the W&LE, whether it remains as a corporate entity or not, is the right answer for the long term viability of the Eastern rail network. A forced expansion of the W&LE's network, in an attempt to bail out an already sinking enterprise, would be misguided.

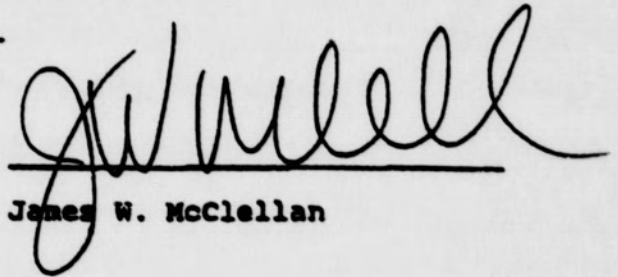
#### **NS HAS BEEN MORE THAN FAIR IN ITS DEALINGS WITH W&LE.**

NS has consistently gone the extra mile to help the W&LE, even though it had no legal reason to do so. The business deal made for the 1990 sale was an arms

**VERIFICATION**

I, James W. McClellan, verify under penalty of perjury that I am Vice President - Strategic Planning of Norfolk Southern Corporation, that I have read the foregoing rebuttal verified statement and know its contents, and that the same is true and correct to the best of my knowledge and belief.

Executed on December 3, 1997.

A handwritten signature in dark ink, appearing to read 'J. W. McClellan', is written over a horizontal line. The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent. The line underneath the signature is a simple horizontal stroke.

James W. McClellan

REBUTTAL VERIFIED STATEMENT  
OF  
A.J. MCGEE

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FINANCE DOCKET 33388

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My name is A.J. McGee. I am an employee of Railroad Publication Services ("RPS") of Atlanta, GA. My office is at the headquarters of Consolidated Rail Corporation ("Conrail"), at 2001 Market Street, Philadelphia, PA. In my current position, I have been asked by Conrail to continue to perform certain tariff information and publication services, which is similar to the work that I had performed in prior years as a Conrail employee.

I began my railroad career in 1967 as a clerk in the tariff distribution area for the Pennsylvania Railroad. Over the years, I continued to work for the Pennsylvania and its successors, the Penn Central and Conrail. Throughout this time, I always worked in the tariff bureau. I worked on the "quote desk" reading tariffs and supplying quotations to shippers, the Divisions section, helping to publish the "divisions" of joint rates, and the distribution desk. I was made Manager - Tariff Publications in 1990 and Manager - Tariff Publications and Divisions in 1991. In 1995, I also became responsible for keeping Conrail's rail transportation contracts.

In 1996, I elected to participate in Conrail's Voluntary Separation Program, a program that enabled me to retire. My separation was made effective on April 30, 1997. At that time I was hired by RPS, an independent firm that acts as the tariff publication agent for many rail carriers, including Conrail. I was asked to continue to operate out of Philadelphia.



length transaction in a highly competitive bidding process. The winners were bidding against numerous other interested buyers. They had total access to all of the customers and were free to make their own assessment of the business potential and risk. In retrospect, the purchasers may have overpaid for the property, but they did so of their own free will, as explained in Mr. Williams' Rebuttal Verified Statement.

Still, when W&LE ran into financial problems, which it did almost at inception, NS worked with W&LE to help it expand its revenue base, and relieve it of some of its financial obligations. For example, NS relieved W&LE of some equipment lease obligations in October, 1990, only five months after W&LE started operations. In 1991, NS granted W&LE access to Central Soya at Bellevue, OH in an attempt to increase W&LE revenues. In 1992, NS allowed W&LE to return most equipment that W&LE had leased from NS. And NS gave W&LE access to Huron Dock through a lease in 1994 to allow W&LE to compete for new ore traffic. Significantly, NS also participated in a 1994 "work-out" of W&LE finances in which NS wrote off approximately \$4 million in W&LE obligations to NS.

Going forward, NS has agreed to assume certain charges by W&LE as well, including a portion of the \$915,000 per year lease on the Pittsburgh and West Virginia Railway, which W&LE operates under sublease. Despite this, W&LE is in arrears in Huron Dock lease payments and in arrears on its portion of the P&WV lease payments, which NS is paying in lieu of the W&LE.

Most importantly, NS made multiple attempts at a fair and reasonable settlement offer with W&LE. The principal items we offered were expanded access

to certain markets, protection of W&LE lake presence, and forgiveness of future P&WV lease payments. But W&LE rebuffed the NS offer, claiming instead the need for conditions plus cash. (Among the more outrageous of the requested conditions is the request for access to Weirton Steel, Conrail's fifth largest shipper. Weirton Steel not only does not join in W&LE's request, but actually supports the NS/CSX transaction.) In addition to non-transaction related conditions, W&LE asks for an additional \$25 million cash payment to pay off W&LE's debt load and give the carrier working capital with which to compete with CSX and NS.

### CONCLUSION

The Conrail acquisition is a large, financially costly undertaking by both CSX and NS. There is a temptation for smaller carriers such as W&LE to want to solve their pre-existing problems, real and imagined, and whether caused by this transaction or not, on the theory that what they seek is really is not that expensive for NS or CSX given the overall size of this transaction. In the case of the W&LE, no valid public policy goal is achieved by rewarding a carrier that simply has failed to manage its business in a prudent fashion and now seeks undeserved rewards as the "price of peace" in this restructuring.

The matters about which I will testify, however, all occurred during the time that I was a Conrail employee.

I have been asked to respond to certain assertions made by Witness Gerald W. Fauth III on behalf of the Erie-Niagara Rail Steering Committee. In his testimony, Witness Fauth alleges that Conrail cancelled reciprocal switching to 89 shippers in Buffalo in November, 1996 and intimates that this cancellation was the result of Conrail's agreement to merge with CSX in October, 1996. Witness Fauth also complains that Conrail cancelled switching to shippers in Niagara Falls in 1996. V.S. Fauth, at 29.

Conrail did cancel reciprocal switching to certain Buffalo shippers in November, 1996, but it was merely as part of a "housekeeping" project to clean up the existing Conrail Tariff 8001-D. This work was done under my direction beginning in the spring of 1996. The goal of the project was to organize and modernize Tariff 8001-D, which covered switching and other services. We approached the task alphabetically; that is, examining application of the tariff to shippers in an alphabetical listing of locations. Thus, Buffalo was one of the first locations analyzed.

We began by making sure that the shippers who were listed in each switch district actually existed at the locations referenced in the tariff. To do this, we looked for evidence of rail traffic moving to or from that shipper and determining whether that shipper had a "customer profile" on file at Conrail. (A customer profile gives the customer service center some basic information about the shipper for ready reference.) We also checked with the Customer Service department to verify that the shipper was not active if no traffic or profile was found. If evidence of continuing actual or potential shipping activity by any specific

shipper was found, the tariff was not changed as to that shipper. If the shipper could not be located and there was no shipping activity, Conrail canceled the switching as to those shippers determined to be inactive.

Had any active shipper affected by the cancellation voiced concern about the cancellation, Conrail would have put the shipper back in the tariff, since the entire point of the exercise was to clean up the tariff by deleting references to shippers who were out of business at that location, not to remove switching from any active shippers. To my knowledge, no shippers complained or sought reinstatement of switching, either informally at Conrail or formally through the Surface Transportation Board.

As to Witness Fauth's assertion that the cancellation was, in some way, linked to Conrail's announced merger with CSX, I can categorically state that was not the case. The project began in the spring of 1996 and was exclusively focused on tariff simplification and rationalization. In fact, the project was suspended shortly after the merger was announced.

Witness Fauth also complains that Conrail cancelled reciprocal switching in Niagara Falls. This complaint is highly misleading. CSX rerouted its traffic so that it no longer travelled through Niagara Falls and, as a result of that, the switching charges would no longer apply to CSX.

Prior to 1995 and for as long as I can recall, CSX operated via Niagara Falls on its way to and from Canada. Its operations were over the CN in Canada, then at Niagara Falls it operated over Conrail to Buffalo. Its traffic then operated over a former CSX line (now owned by the Buffalo and Pittsburgh Railroad) and then connected to CSX itself. Some time in 1995 or 1996, CSX decided to route the Canada traffic via CN. That is, CN would bring

the traffic over Buffalo into Conrail's Frontier Yard at Buffalo. So, CSX gave up its rights to operate on Conrail between Niagara Falls and Buffalo.

Inasmuch as CSX no longer went to Niagara Falls, Conrail would not offer switching for it at Niagara Falls. (No one performs switching for carriers that do not actually travel to the switch district.) Therefore, Conrail did note in the switch tariff under "Niagara Falls" on April 1, 1996 that "There is no reciprocal switching between CR and CSXT." But there was no effort by Conrail to eliminate switching for the shippers in Niagara Falls. Instead, CSXT simply stopped operating at Niagara Falls and the switching tariff was thereby moot. Again, Conrail received no formal or informal complaints to my knowledge.

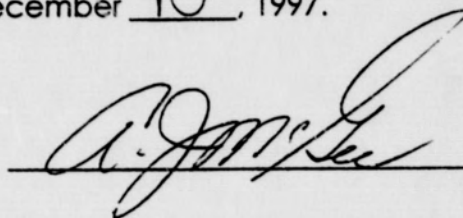
As to CP's access to Niagara Falls, CP, through its purchase of the Delaware & Hudson Railroad Company's rail assets (D&H) in the early 1990's, acquired access to Niagara Falls through switching from Buffalo. CP, therefore, may obtain a switch from Conrail via Buffalo to and from the former D&H trackage rights that end in Buffalo according to a switch agreement between Conrail and D&H (now CP). That agreement is reflected in the tariff note that states,

"Carload Freight Traffic arriving at or departing from Buffalo, NY over CPRS via routes that do not pass through Niagara Falls, NY may be handled by CONRAIL in switch service to or from industries listed in this item, subject to the provisions of an agreement between CPRS and CONRAIL."



**VERIFICATION**

I, A. J. McGee, 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 on December 10, 1997.

A handwritten signature in cursive script, appearing to read "A. J. McGee", is written over a horizontal line.

with the existing high capacity, service sensitive route of Conrail/NS to the Chicago Gateway. It is my conclusion that by no means will AA routing choices to the Chicago Gateway be restricted as a result of the Transaction. On the contrary, they will be enhanced.

#### CN Trackage Rights over AA

As discussed in the verified statement of Evert O. Erickson, the CN has trackage rights over AA from Diann, MI to Toledo, OH. These rights provide a "shortcut" for CN traffic between its Flat Rock, MI yard and Toledo. If CN did not have these rights, it would be forced to route this Flat Rock traffic to Toledo via Detroit, MI and via the current CN route from Detroit to Toledo, which would be much more circuitous.

AA states that the Applicants "may" settle with the CN and offer CN trackage rights from Detroit to Toledo over the current Conrail route, which parallels a CN route. AA fears that CN would then route its Flat Rock traffic over these rights and discontinue its rights over AA, costing AA approximately \$300,000 in annual trackage rights revenue.

CN currently has trackage rights over Conrail's Detroit to Toledo line for one train per day. It utilizes these rights in conjunction with its own parallel Detroit to Toledo line. Applicants have not entered into any arrangement with the CN to modify these rights. In the future, however, if CN rerouted any traffic currently moving over AA via either its own Detroit to Toledo line or the Conrail Detroit to

Toledo line, it would do so only as the result of operational needs or marketplace conditions. Any such changes initiated by the CN would not be a result of the Transaction. In fact, if CN rerouted this traffic, it would contradict the very reason it has trackage rights over AA in the first place: namely, to provide a "shortcut" for its traffic between Flat Rock, MI and Toledo.

#### Yuma, MI Sand Traffic

Evert O. Erickson, in his verified statement, explains that AA currently ships sand from Yuma, MI to Cleveland, OH, routed TSBY-AA-CR, generating approximately \$500,000 in annual revenue for AA. The consignee (receiver) for this move is currently served only by Conrail; however, it will be served by both Applicants in the future if the Transaction is approved. According to Mr. Erickson, AA fears that because CSXT has a direct connection with the TSBY, the traffic "may move" via TSBY and CSXT in the future, thus eliminating AA from the route.

Today, Conrail does not have a direct connection with the TSBY and thus relies on AA to provide overhead services for this sand traffic. As discussed in more detail in the Rebuttal Verified Statement of John H. Williams, the Transaction does not harm the competitive position of AA since NS is only "stepping into Conrail's shoes" with respect to this traffic. Moreover, NS has a strong commercial incentive to do everything it can to retain this traffic for AA and NS, as NS is replacing Conrail in the routing.

In reality, the Transaction actually will provide a competitive benefit with