S. HRG. 107–1031

THE SURFACE TRANSPORTATION BOARD'S NEW MERGER RULES

HEARING

BEFORE THE

SUBCOMMITTEE ON SURFACE TRANSPORTATION AND MERCHANT MARINE

OF THE

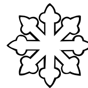
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION UNITED STATES SENATE

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

JUNE 28, 2001

Printed for the use of the Committee on Commerce, Science, and Transportation



U.S. GOVERNMENT PRINTING OFFICE

88–970 PDF WASHINGTON : 2004

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2250 Mail: Stop SSOP, Washington, DC 20402–0001

COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

ONE HUNDRED SEVENTH CONGRESS

FIRST SESSION

ERNEST F. HOLLINGS, South Carolina, *Chairman*

DANIEL K. INOUYE, Hawaii
JOHN D. ROCKEFELLER IV, West Virginia
JOHN F. KERRY, Massachusetts
JOHN B. BREAUX, Louisiana
BYRON L. DORGAN, North Dakota
RON WYDEN, Oregon
MAX CLELAND, Georgia
BARBARA BOXER, California
JOHN EDWARDS, North Carolina
JEAN CARNAHAN, Missouri
BILL NELSON, Florida

JOHN McCAIN, Arizona
TED STEVENS, Alaska
CONRAD BURNS, Montana
TRENT LOTT, Mississippi
KAY BAILEY HUTCHISON, Texas
OLYMPIA J. SNOWE, Maine
SAM BROWNBACK, Kansas
GORDON SMITH, Oregon
PETER G. FITZGERALD, Illinois
JOHN ENSIGN, Nevada
GEORGE ALLEN, Virginia

KEVIN D. KAYES, *Democratic Staff Director*
MOSES BOYD, *Democratic Chief Counsel*
MARK BUSE, *Republican Staff Director*
ANN CHOINIERE, *Republican General Counsel*

SUBCOMMITTEE ON SURFACE TRANSPORTATION AND MERCHANT MARINE

JOHN B. BREAUX, Louisiana, *Chairman*

DANIEL K. INOUYE, Hawaii
JOHN D. ROCKEFELLER IV, West Virginia
JOHN F. KERRY, Massachusetts
BYRON L. DORGAN, North Dakota
RON WYDEN, Oregon
MAX CLELAND, Georgia
BARBARA BOXER, California
JEAN CARNAHAN, Missouri
JOHN EDWARDS, North Carolina

GORDON SMITH, Oregon
TED STEVENS, Alaska
CONRAD BURNS, Montana
TRENT LOTT, Mississippi
KAY BAILEY HUTCHISON, Texas
OLYMPIA J. SNOWE, Maine
SAM BROWNBACK, Kansas
PETER G. FITZGERALD, Illinois
JOHN ENSIGN, Nevada

C O N T E N T S

	Page
Hearing held on Thursday, June 28, 2001	1
Statement of Senator Breaux	1
Statement of Senator Smith	3
Statement of Senator Carnahan	4

WITNESSES

Gebo, William L., Manager of Rail Services, Dow Chemical Company, accompanied by George Marshall, Director of Supply Cycle, Albemarle Corporation	40
Prepared statement	41
Haverty, Michael R., Chairman, President, and CEO, Kansas City Southern Railway Company	30
Prepared statement	31
Howells, Claudia L., Rail Division Manager, Oregon Department of Transportation	44
Prepared statement	46
Morgan, Hon. Linda J., Chairman, Surface Transportation Board, accompanied by Commissioners Wayne Burkes and William Clyburn	4
Prepared statement	6
Snow, John W., Chairman, President, and CEO, CSX Corporation	23
Prepared statement	24
Tellier, Paul M., President and CEO, Canadian National Railway Company	26
Prepared statement	28

APPENDIX

Lott, Hon. Trent, U.S. Senator from Mississippi, prepared statement	59
Hamberger, Edward R., President and Chief Executive Officer, Association of American Railroads, prepared statement	60
Marshall, George, Director of Supply Cycle, Albemarle Corporation, prepared statement	61
American Chemistry Council, prepared statement	43
American Forest Resource Council, prepared statement	63
Response to written questions submitted by Senator Dorgan to:	
Linda Morgan	66
Response to written questions submitted by Senator McCain to:	
Wayne O. Burkes	77
William Clyburn, Jr.	74
William Gebo	88
Michael Haverty	89
Claudia L. Howells	86
Linda Morgan	68
John W. Snow	80
Paul M. Tellier	81
Response to written questions submitted by Senator Specter to:	
Linda Morgan	70
Response to written questions submitted by Senator Smith to:	
Linda Morgan	72
John W. Snow	81
Paul M. Tellier	84
Response to written questions submitted by Senator Rockefeller to:	
Linda Morgan	73

THE SURFACE TRANSPORTATION BOARD'S NEW MERGER RULES

THURSDAY, JUNE 28, 2001

U.S. SENATE,
SUBCOMMITTEE ON SURFACE TRANSPORTATION AND MERCHANT MARINE,
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION,
Washington, DC.

The Subcommittee met, pursuant to notice, at 2:34 p.m., in room SR–253, Russell Senate Office Building, Hon. John B. Breaux, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF HON. JOHN BREAUX, U.S. SENATOR FROM LOUISIANA

Senator BREAUX. The hearing will please come to order. Good afternoon. Thank you all for being with us this afternoon.

I want to, first of all, say how pleased I am that we begin this hearing with my good friend and colleague, Senator Gordon Smith, who is now on this side of the middle. Last time you were on this side of the middle. I am not sure why you are over here this time, but we are delighted you are here and look forward to a long and fruitful relationship as Ranking Member and Chairman of this Subcommittee. I think we have an opportunity to do a lot of things that are very, very important for this country in the area of transportation and also maritime affairs.

Let me just say that when we look at the issue that is the subject of the hearing this afternoon, which deals with railroad mergers and the work of the Surface Transportation Board, I take the opinion that it seems to me that more and more we have less and less. What I mean by that is it seems that more and more in this country, we have less and less of companies that are engaged in competition with each other, because more and more, we have mergers and consolidations, and the end result is that we have few competitors.

If you look at what has happened in the airline industry, we have fewer airlines. If you look at what has happened in the telecommunications industry, we have fewer telephone companies. If you look at what has happened in the energy production area, we have fewer oil companies. And we certainly have fewer railroads than we used to.

For those of us who believe in competition as the way to have a society that serves consumers and also allows businesses to prosper, in this country it is fundamentally based on competition and not by regulation of those industries. It is apparent, however, to me

and I think to most Americans, that you cannot compete if you have no competitors. And if you do not have sufficient competitors to allow the free market and the competitive marketplace to work, then you end up with additional regulation, a result that I am not in favor of.

If we end up with two railroads or two airlines or one oil company or one phone company, then the Federal Government is going to regulate everything they do. We will regulate where they can go, who they can serve and how much they can charge. That is not something I want. That is not something I would expect anyone in this room would want. I would certainly think that my colleague, Senator Smith, would agree with that premise.

So, today the purpose of this hearing is to listen to the Surface Transportation Chairwoman and the Board members about their recent decisions to remove the previous hold that they had on any mergers, the freeze, and to discuss with the Board members and with some of our other witnesses the effect of those rules, the intent of those rules as well.

I would commend the Board for the so-called timeout that they took when they had a freeze on any future mergers. I think that it was important to allow for a freeze to occur, to step back and look at the big picture. I am a little concerned about whether that may have been too late.

I think that this is obviously a very difficult issue to come up with something that is fair for everyone. Every merger in every industry has pros and every merger in every industry has a lot of cons. There are good and bad in all of these activities.

But I do think that we can all agree that we need a strong and a vibrant railroad industry in America, and we are committed to doing everything we can to work with our Administration officials to see that that happens.

The new merger rules, as I understand them, will clearly require that merger applicants demonstrate with greater specificity even than what the old rules required before a merger can be shown to benefit the public, and I think that is good.

The new rules would require the Board and future Boards to evaluate a wider range of merger related activity. I think that is good.

I am particularly pleased to see that the merger applicants now will have to file a plan on how they intend to provide compliance with the promised levels of service as a result of the merger. I am interested to know more about the effect of that plan. Is it a guideline? Is it a contract? Is it a wish list? Is it enforceable? And questions of that nature.

I know in Louisiana some of our shippers have been required to suffer the consequences and pay the extra costs associated with mergers that did not work as they were intended to work certainly or as soon as they were intended to work.

The final note. I was somewhat surprised to read, in reading this new rule by the Surface Transportation Board, about the distinct treatment afforded one railroad, Kansas City Southern, in particular. I look forward to hearing from the Board as to why that decision was made, what was the justification for it, and was that

the only way to accomplish what the Board said that they were attempting to do.

We have only seven independent Class I railroads left in this country, and if you exempt one of them from the merger rules and they engage in a merger with another Class I railroad, then you are, in effect, exempting one-third of the Class I railroads from the new rules. Is that good public policy? Does that make sense? Those questions need to be not only asked, they need to be answered. And that is the purpose of this hearing.

With that, I would recognize my good friend, Senator Smith, for any comments he might have.

STATEMENT OF HON. GORDON SMITH, U.S. SENATOR FROM OREGON

Senator SMITH. Thank you, Mr. Chairman. I am very pleased to be here with you and with our witnesses today.

Before the recent fate of the Republican Party, I occupied your chair and I know we are in very good hands in this Subcommittee, but it was my purpose to begin a series of hearings on a wide range of rail transportation issues. The first we held in March was with Linda Morgan here, where we focused on the Surface Transportation Board and its ongoing efforts to carry out its statutory responsibilities and to explore the Board's merger rulemaking procedure that was then pending and is now the subject of this hearing today. I note that the Board's rules include a few items which we did not discuss at the hearing, including the exemption of those rules for one specific Class I carrier, and I am interested in exploring that exemption.

Also, we had a second hearing in May, Mr. Chairman, on the state of the rail industry, including its current financial condition, capacity constraints, and long-term capital investment needs.

I know, Mr. Chairman, of your willingness to pick up on the agenda that we had set to hold a hearing to consider rail shipper concerns, including service, reliability rates, and competition. I think this is a good place to air out these issues. So, I know we are in very good hands, Mr. Chairman.

I want to especially welcome Ms. Claudia Howells from the Oregon Department of Transportation Rail Division. I appreciate that she would come back here to share her views and those of our State on these merger rules and their application on Oregon and the Nation's rail transportation system.

So, I welcome you, sir, and congratulate you and look forward to working in every constructive way with you.

Senator BREAUX. Thank you very much, Gordon. I did want to also say and to recognize, under your leadership, that this is an effort that was started previously. You had already started looking at shipping interests and railroad interests. I know you want to do some more hearings on the question of shipper protection, and we are going to certainly be cooperative in that regard and hopefully, come up with something that will make sense because you started this and we just hope to continue in a cooperative fashion with you.

For any comments that you might have, Senator Carnahan.

STATEMENT OF HON. JEAN CARNAHAN, U.S. SENATOR FROM MISSOURI

Senator CARNAHAN. Thank you, Mr. Chairman.

Unfortunately, I will not be able to stay at this hearing very long today but I did want to take the opportunity to acknowledge one of the witnesses here today.

Michael Haverty is the President and Chief Executive Officer of Kansas City Southern Railway and the Chairman of Kansas City Southern Industries. He is a fourth generation railroader who started out as a Missouri Pacific brakeman at the age of 19. In 1970, he moved over to the Santa Fe Railroad and ultimately became the President and Chief Operating Officer of that company in 1989.

In 1995, he came to Kansas City and was appointed President and Chief Executive Officer of Kansas City Southern Railway. In large part, because of Kansas City Southern's successful acquisition of Mexico's Northeast Railway, *Railway Age* magazine named Mike Haverty Railroader of the Year. All of us in Missouri are proud to have Kansas City Southern as an exemplary corporate citizen in Kansas City, and I am pleased to welcome Mr. Haverty to this Subcommittee today.

While I will not be able to stay here to hear the witness, I am very interested in the subject matter at hand. The various consolidations over the past decade have raised serious concerns about the status of competition in the rail industry.

With these concerns in mind, the Surface Transportation Board recently adopted new merger rules that placed additional burdens on applicants to demonstrate that proposed mergers will actually enhance competition instead of simply preserving it. I look forward to examining these new rules and reviewing the testimony of today's witnesses.

Thank you very much, Mr. Chairman.

Senator BREAUX. Thank you, Senator Carnahan.

I would just say to all of our guests that it is a terribly busy day on the floor. Everybody is looking toward the Fourth of July recess, so we are trying to get everything done in one day, and it has been very, very difficult. But this hearing is also very important.

I would like to invite as our first witness who the Chair of the Surface Transportation Board, the Honorable Linda Morgan, but I also want to ask Commissioner Wayne Burkes and Commissioner William Clyburn to please come and take their seats at the witness table too. This Board does not operate in a vacuum. It operates with all of its members and I want them all there. We will have a statement and then we will proceed to questions of our Chair, Linda Morgan. Welcome back.

STATEMENT OF HON. LINDA J. MORGAN, CHAIRMAN, SURFACE TRANSPORTATION BOARD; ACCOMPANIED BY COMMISSIONERS WAYNE BURKES AND WILLIAM CLYBURN

Ms. MORGAN. Thank you. I am appearing here today at the request of the Subcommittee to discuss the Board's new major rail merger rules. I will make my oral remarks brief. I have submitted written testimony and I ask unanimous consent that it be included in the record in its entirety.

Senator BREAUX. Without objection, it will be included.

Ms. MORGAN. My written testimony reviews the Board's new merger rules in some detail. My written testimony demonstrates that the Board has acted affirmatively and appropriately by significantly raising the bar for future merger approvals. By raising the bar, our final rules address issues that have been presented about railroad consolidation.

Concerns have been raised about the level of competition in the rail industry. We expect that, because our new rules view enhanced competition as a clear benefit that will tip the scales in favor of the public interest, mergers approved in the future will add competition.

There has been legitimate concern raised about the service problems associated with prior mergers. We have made sure by requiring, for the first time, the filing of a service assurance plan with a merger application, that new merger proposals demonstrate how service will be improved and how service problems will be dealt with.

There also has been concern raised about benefits claimed with past mergers that have not been realized. We have made sure that merger applicants are held more accountable for benefits claimed and that applicants address whether claimed benefits can be achieved by means other than merger.

We have made sure that downstream effects and cross-border issues associated with a final round of North American rail mergers are fully aired and considered. Also, our rules focus particular attention on the interests of smaller railroads, ports, and passenger and commuter operations, and we have addressed concerns raised about the impact of mergers on employees.

Some have said that the new rules do not really change anything, but the rules clearly reflect otherwise. For one thing, our old rules provided for the approval of a merger "unless," whereas our new rules provide for approval "only if." Our new rules clearly reflect a greater skepticism about the benefits of future mergers and a greater concern about the potential harm of further consolidation. And we have shifted the focus, imposed new requirements, and codified and expanded upon past practices in a number of areas. To me, all of that represents quite a change.

Some say that we have not gone far enough with respect to enhancing competition. We went as far as we could legally go in our decision, and I did not see the benefit in issuing rules that stood a very good chance of being thrown out in court. In any event, we clearly went further in this regard than our old rules provided for.

Without question, these rules have clearly changed the landscape for the future, reflecting the lessons learned from the past. And it is my hope that, in raising the bar, these rules will remind the railroads to take care of business with the systems they now have and to stop viewing mergers as the only way to go.

In this regard, I dissented on the waiver for Kansas City Southern from the new rules. These new rules are intended to address the final round of major rail mergers. Exempting a strategically important carrier in a transaction that could be expected to begin the final round and putting KCS customers under a different set of

rules from other customers seems inconsistent and inappropriate to me.

In closing, I know that regardless of how much we have done in these rules and elsewhere and how much we do in the future, there are those who will say that we have done nothing of substance unless we somehow guarantee the opportunity for every shipper to be served by at least two railroads. To me, belittling the progress that has been made is just not constructive.

I believe that the Board has acted responsively and responsibly to address, in a manner consistent with the statute, concerns that have been raised about the rail sector and to drive change that has moved the industry in a positive direction. These new major merger rules are no exception. Our rules recognize that a final round of major rail mergers will draw the map for the North American rail network of the future, and that if we go down that path, we had better take great care to get it right.

I will be happy to answer any questions that you might have.

[The prepared statement of Ms. Morgan follows:]

PREPARED STATEMENT OF HON. LINDA J. MORGAN, CHAIRMAN OF THE SURFACE TRANSPORTATION BOARD

My name is Linda J. Morgan, and I am Chairman of the Surface Transportation Board (Board). I am appearing today at the Subcommittee's request to review the Board's new rules governing mergers of large railroads adopted in *Major Rail Consolidation Procedures* STB Ex Parte No. 582 (Sub-No. 1).

The Board's decision adopting new major rail merger policies and rules, which was issued on schedule on June 11, 2001, after a 15-month period of extensive notice and comment, significantly raises the bar for approval of a major merger. Merger applicants must clearly show that a merger is in the public interest by demonstrating that public benefits, such as improved service and enhanced competition, outweigh any negative effects, such as potential service disruptions and harm that cannot be mitigated. In particular, the Board indicated that it will be looking for merger proposals to add competition, and the new rules suggest ways in which that objective could be met in the original proposal filed with the Board or by way of conditions imposed by the Board. The rules also require that any merger application must include specific details about the service that would be provided, how service will be improved, and how service problems will be addressed. And in the decision, the Board stated that it will take a more skeptical view of claims of merger benefits, that it will hold applicants more accountable for those claims if a merger is approved, and that applicants will be required to address whether claimed benefits can be achieved by means other than a merger.

EVENTS LEADING TO ISSUANCE OF NEW RULES

In recent years, the railroad industry in the United States has consolidated substantially. With those mergers came severe service disruptions and concerns about further concentration in the industry. Thus, the announcement in late December 1999 that the Burlington Northern Santa Fe (BNSF) rail system would seek to merge with the Canadian National Railway Company (CN), one of the two large Canadian railroads, drew strong expressions of concern from many quarters.

The Board, concerned that the BNSF/CN merger proposal would trigger another (and quite likely final) round of merger proposals, began a proceeding in January 2000 to elicit public comment on the future structure of the rail industry in the United States and the role of mergers today. The Board received well over 400 written comments. And during 4 days of hearings in March, the Board heard oral testimony from about 125 parties, including Senators and Congressmen, the Departments of Agriculture, Defense and Transportation, several ports, large and small railroads, numerous shipper associations, individual shippers of all sizes from every major industry, and the financial community.

The overwhelming message at the hearing was that the Board's then-existing merger policies and procedures—as reflected in its rules, policies, and precedents—were inadequate to deal with any new merger proposals, and that fundamental changes to that body of law were required to address any further mergers. Most wit-

nesses also expressed the concern, which the Board shared based on its own experience with rail mergers over the previous 5 years, that additional mergers at that time would have disrupted the Nation's rail transportation network and disserved the public interest.

After evaluating these extensive comments, the Board agreed that a broad reexamination of the agency's merger policies was required, and concluded that the existing rules and policies were not adequate to address what could be the final round of consolidation in the rail industry leading to two transcontinental railroads. Accordingly, on March 17, 2000, the Board imposed a 15-month moratorium on the filing of major merger applications so that it could reexamine and revise its merger policies and procedures before considering any new merger proposals, including the anticipated BNSF/CN proposal (for which an application had not yet been filed). The Board's moratorium, about which I testified before this Subcommittee last year, was upheld in court.

THE NEW RULES

So that final rules could be in place by June 2001, in accordance with the moratorium period, the Board promptly initiated a rulemaking proceeding. In the proceeding, the Board issued an advance notice of proposed rulemaking, a notice of proposed rulemaking with a proposed set of rules, and a set of final rules. The final rules increase significantly the burden on major merger applicants. The new rules require applicants to demonstrate that, among other things, a proposed transaction would enhance competition where necessary to offset negative effects of the transaction, such as competitive harm, and to address fully the impact of the transaction on service, including plans for service reliability.

Overall Approach

The new rules reflect a significant change in the way the Board will apply the statutory public interest test to any major rail merger application. The Board stated that, because of the small number of remaining large railroads, the fact that rail mergers are no longer needed to address excess capacity in the rail industry, and the transitional service problems that have accompanied recent rail mergers, future merger applicants will be required to bear a heavier burden to show that a major rail combination is consistent with the public interest. This shift in policy, the Board noted, will place greater emphasis in the public interest assessment on enhancing competition, while ensuring a stable, balanced, and reliable rail transportation system in a way that accounts for smaller railroads, ports, and passenger and commuter services.

Enhancement of Competition

The new rules reflect the Board's intent to offset, through the adoption of proposals made by merger applicants and as necessary through adoption of conditions for competitive enhancements, merger-related harms that cannot be directly or effectively mitigated. The Board indicated that such competitive enhancements could include, but would not be limited to, reciprocal switching arrangements, trackage rights, and efforts to eliminate restrictions on interchanges by shortline railroads. The Board also indicated that the quantity and quality of competitive enhancements that would be required relative to a particular transaction would depend upon a variety of factors, such as merger-related competitive harms for which feasible and effective remedies could not be devised, and the amount of public benefits that could be expected to flow from a particular transaction.

Benefit Assessment

The new rules also reflect the Board's view that, because the realization of benefits in recent mergers has been delayed or frustrated by transitional service problems, future merger proposals should be met with a more skeptical, "show me" attitude toward claims of merger benefits and toward claims that transitional service problems will not occur. The Board said that it will also consider the extent to which various claimed merger benefits can be achieved, short of merger, through cooperative agreements among railroads. The Board further indicated that, given the size of the transactions that may be proposed in the future, and, given the dangers involved should such transactions fail, the benefits claimed by future merger applicants will be very closely scrutinized.

Service Assurance Plans

The Board's new rules require merger applicants to submit a Service Assurance Plan with their initial application and operating plan. The Board stated that, given the importance of service to shippers and that implementation of any merger plan

necessarily has an element of uncertainty, applicants' Service Assurance Plan for each major merger proposal must provide certain essential information, such as plans to deal with any potential adverse service effects during implementation and plans to accommodate such less-than-optimum operations. The Board indicated that, in particular, a Service Assurance Plan must include information about proposed operational integration, training, information technology systems, customer service, freight and passenger operations coordination, yard and terminal operations management, service disruption contingency plans, how traffic-level changes or increases will be accommodated by the combined system, infrastructure improvement, labor issues, service benchmarking, and timetables for the completion of implementation activities, as appropriate. The Board stated further that the Service Assurance Plan must provide for the establishment of problem resolution teams and describe specific procedures to be used toward problem resolution.

Downstream Effects

The new rules reflect the Board's determination to "look down the road" to ascertain whether approving not just the immediate proposal that may be before the Board, but also others that are expected to flow from it, would ultimately result in a rail industry structure that would continue to provide at least the existing level of competitive options for shippers. The Board stated that merger applicants will not be required to present alternative benefit calculations based on specific alternative possible responses that could be filed by other railroads; yet, merger applicants will be required to initiate a commentary, to which other parties may respond, that would give the Board the information needed to rule on what would likely be the first step in an end-game situation in which only two transcontinental railroads would remain in North America. The Board made clear that it is also prepared to use its power to apply conditions to a transaction to repair conditions previously imposed on rail mergers that might be substantially impaired by a new major rail merger.

Employee Concerns

The Board indicated that it is extremely pleased with the privately negotiated "historic settlement agreement" on the issue of collective bargaining agreement (CBA) overrides recently signed by most of the larger railroads and by unions representing most rail employees. The Board stated that, to the extent there is still any live issue relative to CBA overrides, the new rules, which reaffirm that the Board supports negotiated agreements wherever possible, respects the sanctity of CBAs, and looks with disfavor on overrides, properly implement the Board's statutory mandate concerning overrides.

Transnational Issues

The Board stated that, because future major transnational mergers are likely to raise novel jurisdictional, national interest, and public interest issues, it will be necessary to gather information about relevant facts, laws, and policies important to an accurate and comprehensive understanding of such merger applications. The new rules therefore provide that, in addition to full-system competitive analyses and operating plans required of applicants with transnational operations, all applicants will be required to address any ownership restrictions (by law or corporate initiative) and any pertinent governmental restrictions or preferences.

Oversight and Monitoring

The new rules codify the Board's recent practice of formal oversight for a period of no fewer than 5 years following each merger. With respect to operational monitoring, the Board noted that, because its monitoring of previous transactions has proven vital to identifying and correcting operating deficiencies during implementation, the new rules also provide for expanded post-approval monitoring of the implementation of mergers to help ensure that adequate service is provided during the crucial transitional period, and beyond. The Board further indicated that, if substantial service disruptions occur as the result of a merger's implementation, the Board will consider alternative service arrangements.

Kansas City Southern

Finally, a majority of the Board granted a waiver to KCS from the application of the new major rail merger rules. The majority indicated that parties could attempt to show in a particular case that this waiver should not be allowed. I dissented to this aspect of the decision. I do not believe that KCS adequately demonstrated why it should have been given special treatment. Also, I am concerned that, given KCS' strategic position, any merger involving KCS and another large railroad will likely trigger the final round of consolidations leading to only two sys-

tems of large North American railroads. It seems incongruous to me to exempt a carrier transaction that could trigger the final round from the very rules that have been promulgated to address the final round and the interests of rail customers and other parties affected by further consolidation.

SUMMARY

Overall, the Board's new rules for major rail mergers will make merger approval more difficult, reflecting a greater skepticism about the benefits of more consolidation and a greater concern about the potential harm of more consolidation. The rules make clear in this regard that in order for the scales to be clearly tipped in favor of a merger proposal, that proposal will have to offer competitive enhancements. And any proposal will have to have been subjected to significant pre-filing analysis and planning as to the type of service to be provided and the actions to be taken in the event of service failures. Given the risks and finality associated with what could be a final round of consolidation leading to two transcontinental railroads, the final rules ensure that any further consolidation will be approved only if it is truly in the public interest.

I would be pleased to answer any questions that you might have.

Senator BREAUX. Thank you very much, Ms. Morgan, for your presentation on behalf of the Board.

Let me talk in the beginning about a plan that you are requiring, as I understand it, with the new rules, that a plan be submitted. That is different from the old rules?

Ms. MORGAN. Exactly, yes.

Senator BREAUX. What is the purpose of the plan? What should it constitute and what is the effect of it?

Ms. MORGAN. Well, the service assurance plan is new, and the purpose of that plan is to make sure that applicants focus on service in advance of filing their application.

Senator BREAUX. Why is that any different from what previously was required, or how is it different?

Ms. MORGAN. It is different because we did not previously require a specific plan that focused on how the operating plan will be implemented in the context of service to customers. So, this plan will focus on what service levels will be provided and how those levels will be provided. It envisions that the applicants will get with customers in advance to discuss service needs so that the plan that is filed with us will obviously reflect the needs of the customer community. And then throughout the process of reviewing the merger application, that plan will be before us and a record will be developed on the aspects of that plan. So, the benefit is that service is being discussed up front in a way that it has never been discussed before.

Senator BREAUX. Is the purpose of the plan to be something that is considered prior to the merger, or is it some document that is supposed to have an effect after the merger is completed?

Ms. MORGAN. It will have an effect after the merger is completed, but the plan is to be put together before the filing so that, when the filing comes to us, it will include this service assurance plan. So, whatever planning needs to be done has to be done in advance of the filing.

Senator BREAUX. Is there any legal effect that the plan brings to the table? In other words, suppose you have a plan which the Board agrees to and then a year after the merger there are significant areas of the plan that have not been considered or requirements met. Is the plan worth anything, or is it just a guideline? Can you enforce the plan, or is it just a good idea?

Ms. MORGAN. Well, it is a good idea, but it also has, I think, some important ramifications. As part of the plan, we also ask of the applicants their plan for how they will address service problems, how they will address service failures, how they will address claims. So, as part of our review process, we will be looking at the adequacy of this plan not only in the context of the service levels, but also in the context of the procedure for resolving disputes. We will look at the plan in the context of whether it is a benefit that will go into our benefit box in determining whether a particular merger proposal is indeed in the public interest.

Senator BREAUX. Is a plan a document that both of the merger railroads would have to agree to?

Ms. MORGAN. Yes, because that would be part of the filing that would be made.

Senator BREAUX. I am trying to find out the effect. The plan you said is a good idea, but a good idea that is not enforceable is not necessarily a good idea if it cannot be enforced. I am trying to figure out what does the plan, which I agree is a good idea, because it clearly spells out what you are going to try to do in areas of service—but if it is not enforceable, what good is it?

Ms. MORGAN. Well, I think it is enforceable in the context that it is a plan that is filed with us, which then we will monitor after the merger is put into place. It is also a plan that will involve dialog between customer and railroad in terms of what the service needs will be. So, whatever legal ramifications of that will be represented in the plan. In addition, of course, the plan for resolving disputes will also cover whatever problems arise as a result of not meeting the plan. So, it has importance in that regard.

Senator BREAUX. How do people who utilize railroad services have input into the content of the plan, if at all?

Ms. MORGAN. Well, if a railroad is going to file an application and have with it a service assurance plan, we will be looking for whether that represents discussions with customers about their service needs, whether it will include some sort of service guarantees. So, we will be looking for what went into that plan. That will again be part of whether we view that plan as a good plan, as a beneficial plan, and whether it is good enough to go into the benefits box, if you will, in determining whether a particular proposal is in the public interest.

Senator BREAUX. Who is responsible for writing the plan?

Ms. MORGAN. Well, the applicants will be responsible for filing it with us, so they obviously, in the first instance, would have to be the ones reaching out to affected people in the context of the plan.

Senator BREAUX. I am not challenging that in particular, but if the two railroads are responsible for writing the plan, how do you guarantee that people who utilize railroad services, i.e., shippers, have had their input in the designing of the plan?

Ms. MORGAN. Well, you would hope that the railroads would get with the customers, because I do not know how you would write a service assurance plan without doing that. But let us assume they do not. Then it comes to us and then we begin to accumulate a record on that plan. If customers have not been involved in the discussion on that plan, then they will clearly file their comments

with us. So, we will know in that regard whether they have been involved and what their concerns might be with the plan.

The key here is, whereas before some of these issues would come to us as the proceeding evolved or perhaps after the merger has been approved, this plan forces these discussions in advance of the filing. Then it gives the opportunity for a record to be built on the plan so that by the time we get to the end of the process, we have a much better understanding of where everybody is and everybody has had the opportunity to have input into it.

Senator BREAUX. I understand that shippers, for instance, obviously can comment on merger applications and get their input before the Board makes a decision. But I take it there is no requirement of the Board. You said "hope to" have input from shippers, but there is no requirement that this plan is one that is achieved only after getting comments from users of the services.

Ms. MORGAN. Well, again, if you read the rules themselves and the text that goes with the rules on this particular section, I think it is pretty clear that the service assurance plan, which focuses on service levels and service needs, would need to involve a discussion with customers. And in our description of that particular rule, we emphasize the importance of that, of getting with the customers, and so we will be looking for that in the context of whether the plan has validity or not.

Senator BREAUX. So, you would recommend as chairperson of the Board that this plan obviously indicates that it has made contact with people other than just the two railroads.

Ms. MORGAN. Absolutely.

Senator BREAUX. Let me talk about previous consolidations and mergers which this rule obviously does not affect. Can you give the Subcommittee an update on some of the problems that we have had? Can you tell me how some of these previous mergers are doing now as opposed to in the past where we have had some difficulties?

Ms. MORGAN. Well, as you correctly stated, in the last round of rail mergers, we experienced some pretty significant service problems in the integration process, first in the West and then in the East.

We have obviously moved a great distance from where we were. Service is much better than it was during that period. Obviously, the West has been functioning better for longer than the East, but now the service in the East is much improved. Obviously, we continue to focus on further service improvements in both the West and the East.

Senator BREAUX. Things are better?

Ms. MORGAN. Yes.

Senator BREAUX. What areas are they not better in?

Ms. MORGAN. Well, in terms of service, I think we continue to hear about specific issues with particular customers, and we have a rail consumer assistance program that is specifically designed to interface with individual customers and other users of the rail network with respect to particular problems that arise. So clearly, we deal with those. We do not have an overwhelming number of problems coming in. We have a steady stream of individual issues, but we have been able to deal with them and move on. So, I would not

suggest that there is any particular area that continues to be a particular problem. I think we have moved beyond that. Now what we are doing is focusing on individual issues in particular areas of the country.

Senator BREAUX. Are conditions indicating adequate competition in these areas where we have had these previous mergers?

Ms. MORGAN. Well, as I have said before, this question does relate to how one would define adequate competition. There are those who feel that if a shipper is not served by two rail carriers, then there is not adequate competition. Obviously, there are customers out there who are not served by two rail carriers and have not been served by two rail carriers for a long time.

As far as the state of competition today, in terms of post-merger implementation, I think we are seeing vigorous competition both in the West and the East. There are rate wars going on between carriers, and that is an indication of competition. So, I think post-merger there is competition.

Senator BREAUX. I think that that will be something that the Subcommittee and I am sure the Full Committee under Senator Hollings' leadership will continue to look at as far as the pre-existing mergers and the continuation of adequate competition. I think that is obviously very, very important.

Let us talk about the KCS exemption and the rule. In looking at your dissent on the rule, you said that you disagree with the special treatment being afforded to KCS and the decision being issued today. You point out that, indeed, as the self-styled NAFTA railway with a substantial ownership interest in a Texas-Mexican railway company and the strategic importance—and I am paraphrasing here—that any merger between KCS and another Class I railroad could well trigger the next round of major rail mergers, resulting in two transcontinental railroad systems. Giving KCS the opportunity to pursue waiver requests on a case-by-case basis at the time it proposed a specific merger transaction would have seemed appropriate.

Do I understand the exemption correctly that if KCS, which is a Class I railroad, and another Class I railroad entered into a merger agreement, that they would not be required to meet the standards of the new rules?

Ms. MORGAN. Well, that would be the effect of the waiver in the first instance. Now, the majority voted also as part of that provision to allow parties to come in and dispute that. So, if a record were developed that that particular waiver would not be appropriate, then it might not apply. But it is a blanket waiver in the first instance.

Senator BREAUX. Where did this exemption come from? The reason why I ask that is because it was not included in the Board's proposed rulemaking.

Ms. MORGAN. No, it was not.

Senator BREAUX. And I want to ask Mr. Burkes and Mr. Clyburn the same question.

Ms. MORGAN. Well, KCS had a proposal originally that would have put it in a category other than the major rail merger category. That was proposed in response to the advance notice of proposed rulemaking.

Senator BREAUX. They did not ask for, at that time, an exemption from the new rules.

Ms. MORGAN. Not in so many words. Their proposal involved setting a threshold below which a railroad would not be considered to be part of the major rail merger pool, and it would go into another pool.

Senator BREAUX. It was my understanding that what they had requested was that if it was a friendly takeover or a friendly merger, they would be considered a significant merger as opposed to a major merger.

Ms. MORGAN. That is correct. If it was a hostile takeover, then they would want it to be considered a major merger.

Senator BREAUX. So, if that is what they proposed, how did it come out of the Board being something entirely different?

Mr. Burkes, would you comment on that?

Mr. BURKES. Thank you, Mr. Chairman. I will be delighted to comment on it.

First of all, as you know, there has been a long history under the Interstate Commerce Commission and the Surface Transportation Board of treating carriers differently based upon their size. I reviewed those records.

Senator BREAUX. I am sorry?

Mr. BURKES. I reviewed the records of those cases.

Senator BREAUX. You reviewed them?

Mr. BURKES. Yes.

Senator BREAUX. I just misunderstood what you said.

Mr. BURKES. Well, there is a long history of treating carriers differently based on the size of the carrier, whether it is under the Interstate Commerce Commission or the Surface Transportation Board, the successor of the Interstate Commerce Commission. As a result of that and based on the fact that Kansas City Southern at most of the public hearings and in their comments, their replies, and their rebuttals emphasized that they were not anywhere near in the class of the other Class I railroads.

Senator BREAUX. They are a Class I railroad, are they not?

Mr. BURKES. Yes, they are a Class I railroad based on their annual operating revenue exceeding $250 million. That puts them one-fifth the size of the next Class I above them.

Senator BREAUX. They are still a Class I railroad.

Mr. BURKES. I understand that, but we are dealing with the new rules for mergers of Class I railroads. They are one-twentieth the size of the largest carrier, and them being treated as a Class I railroad as a major combination, whereas the proposal that I made was that any carrier whose annual operating revenue was $1 billion or less—it would be treated as a significant transaction. Our general counsel's office looked at that. One reason I made that proposal is because Florida East Coast and Montana Rail Link will, after another year, it appears, become Class I railroads, but very small Class I railroads.

Senator BREAUX. So, is it correct, as I asked Chairman Morgan, that if they had another Class I railroad that merged with a Kansas City, another Class I railroad, that you would have both of them exempt from the rules? Is that not correct?

Mr. BURKES. Well, it depends. It depends on whether somebody filed a request that the waiver not apply. Another carrier has that——

Senator BREAUX. No, but the new rules, is it not correct, would allow two Class I railroads to merge without being susceptible to the new rules on merger? Is that not correct? Unless someone challenged it. They can always do that.

Mr. BURKES. Yes, that is correct so far as being treated as a major merger under the new rules. Now, they will still be treated as a major merger, but it will be under the current rules rather than the new rules.

Senator BREAUX. Well, my concern is obvious by my question. I do not understand where this came from. Can you shed some light? Because this was not requested by KCS when they did their proposed oral arguments before the Board. Who came up with the idea of just carving them out as a special exemption?

Mr. BURKES. No. They had requested through their public appearance before the Board, as well as in their comments, their replies, and their rebuttals that they not be treated like the other big Class I railroads.

Senator BREAUX. But they did not request an exemption, as I understand it, and Chairman Morgan said that they had requested that they be considered as a significant merger if it was a friendly merger and a major merger only if it was a hostile merger.

Mr. BURKES. Yes, they requested they be treated as a significant transaction.

Senator BREAUX. So, they did not request an exemption.

My question to you, sir, is where did the concept of just carving them with an exemption come from?

Mr. BURKES. The concept came from our general counsel's office that recommended it be treated as a waiver rather than it——

Senator BREAUX. It is not a waiver, Mr. Burkes. It is an exemption. It is an exemption that has the effect of law. It is not a waiver request. KCS does not have to ask for anything. They got it.

Mr. BURKES. It is a waiver, and they would be exempt unless somebody within that 10-day period requests that they not be waived.

Senator BREAUX. Is someone merely requesting that they not be exempt sufficient to prevent the exemption?

Mr. BURKES. Well, the Board would make that decision at that time, just the same as the Board would make the decision if they were included in the new rules as to whether or not to waive them under the new rules.

Senator BREAUX. Mr. Clyburn, where did this concept come from?

Mr. CLYBURN. Throughout the testimony and the submissions that came before the Board in the ANPR and the NPR, KCS was asking to have, I guess, two bites of the apple. If it were a friendly takeover, then it would be a significant transaction.

My concern is that approach would exempt them from possibly, arguably, the rules under Section 11324 of Title 49 where we have the criteria, even under the old rules, determining whether a proposed transaction is within the public interest or not. I did not want to just give an outright exemption, saying "Well, because you

are merging with KCS, you do not have to go through the rules and the criteria as Congress put forth for a major Class I transaction."

True enough, KCS is a Class I railroad. One of the issues that came out was that KCS is such a small Class I railroad, in terms of their trackage and their revenues, compared with the other railroads. KCS has approximately $575 million in operating revenues as opposed to BNSF with $9.1 billion or Norfolk Southern with $5.2 billion. So, the issue was raised.

There was a concern that KCS not be treated differently than Wisconsin Central per se which, with operating revenues of approximately $300 million, is closer in size to KCS. As you already know, the Board has deemed the Wisconsin Central/Canadian National merger proposal as neither major nor significant, but minor.

I have not proclaimed to be a soothsayer or prognosticator as to what will happen next year or 2 years from now. So I was concerned when the original proposal came through to carve out that outright exemption for KCS.

True enough, KCS is a very small Class I, and I would like to go back into the history of why the Board even has the Class I classification. The major policy purpose for the Class I classification is that railroads having major transportation significance must file certain financial reporting requirements.

In 1990, there was a proposal to change the Class I threshold from $50 million to $250 million. The rationale behind that change was that the agency did not see the need to have the smaller Class I's, at that time, submit certain financial requirements.

Since KCS is hovering around that threshold, particularly when compared with the larger Class I's, the issue was raised whether KCS should be treated differently.

My major concern was that KCS not get an outright exemption. The rebuttable presumption is relevant to whether KCS is deemed to be similarly situated as Wisconsin Central. If so, then let us not automatically say that KCS is not a major transaction and merely a significant one. Let us say we can deal with them within the old context of the rules for a major transaction.

However, because of the rebuttable presumption, I thought it was always important for the Board to stay in the game. We do not want to be onerous with our rules or our regulations. However, I have traveled all over the country and I have talked to shipper groups who are not too enamored with the Board. They feel that the Board's rules do not go far enough if we do not overturn the bottleneck decision, if we do not loosen the competitive access rules in Midtech I and II, or if we do not impose final offer arbitration.

Senator BREAUX. Let us get right to the point on this. You are saying you did not like the exemption that they were requesting for, but in essence, you voted for another exemption which was a blanket exemption. They do not have to comply if they are going to merge with another Class I railroad with the new rules. That is a blanket exemption. That is a more extensive exemption than what they were asking for before the Board.

Mr. CLYBURN. It actually may be more of a "blanket exemption" having a KCS merger deemed a significant transaction as opposed to deeming the transaction major under the old rules. Arguably, if the Board deemed a merger with KCS a major transaction, the ap-

plicants will have more requirements to satisfy, more work to do with the application, than if the transaction were deemed significant under any rules. The rebuttable presumption still allows the Board to protect the public interest.

Senator BREAUX. This is my last question. You do not disagree with Chairman Morgan that the effect of what the Board did was to allow two Class I railroads to merge, whether it is a friendly or a hostile merger, without meeting the requirements of the new rules.

Mr. CLYBURN. If the Board at that time deems that the rebuttable presumption is not met. The Board is still in the game, Senator.

Senator BREAUX. Only if someone comes in and challenges it.

Mr. CLYBURN. Often there are challenges. Even in the Wisconsin Central/Canadian National merger proposal which the Board deemed as minor, there were challenges.

Senator BREAUX. Then they have got to come prove that the exemption that you granted was incorrect in the first place.

Mr. CLYBURN. If someone believes a merger with KCS might trigger other mergers, even if a merger with KCS does not create a transcontinental, that party has the opportunity to file that concern with the Board after the prefiling notice is submitted, which occurs 3 to 6 months before the application is filed.

Senator BREAUX. Did any other railroads support the exemption?

Mr. CLYBURN. Well, there was a question in regards to whether other railroads actually supported it. There is a record of one or two railroads not opposing the outright exemption. But as I said before, I felt comfortable with the rebuttable presumption; that the Board would always be in the game.

Senator BREAUX. Ms. Morgan, do you agree with the response that any other railroads supported the exemption?

Ms. MORGAN. My recollection was that this particular issue was not expansively discussed in the record. There were a few comments along the way, but it was not a clear discussion one way or the other.

Senator BREAUX. It was not presented in oral arguments.

Ms. MORGAN. Not to my knowledge, no. Not to my recollection.

Senator BREAUX. Senator Dorgan.

Senator DORGAN. Mr. Chairman, thank you very much. I regret that I was not here during the initial presentations. I have read much of it.

Let me say, Mr. Chairman, that Senator Rockefeller and Senator Burns and I and some others have introduced the Rail Shipper Protection Act, and we look forward to working with you to get a hearing on that piece of legislation. I chair the Subcommittee dealing with consumer issues, and perhaps we can work with you on a hearing.

We are very concerned. You all have heard us describe our concerns—Senator Rockefeller and myself, Senator Burns—about what has happened with mergers and concentration in the rail industry.

I want to say first that I appreciate the courage it took for the Board to do what it did in creating the position you did where you stopped all of the potential merger activity and said, we are going to take a fresh look at this and create some rules and regulations.

I think that took some courage and it took some thinking outside the box. That moratorium was in the public interest.

It is not clear to me. I am not an expert and I have not spent enough time studying these new regulations to know whether they do what I would like them to do. I certainly think it is a step in the right direction.

I guess the first question I would ask about them is, Linda Morgan, you said that these new rules went as far as the statute would allow you to move to enhance competition and increase the burdens on major mergers. What kind of additional authority would you need to have moved further?

And do you think that it would be advisable to have additional authority that would allow you to move further in these circumstances?

Ms. MORGAN. Well, I think, first of all, with respect to your discussion of my oral testimony, the key is that we had to be very careful that we did not imply in our rules somehow that mergers were bad in the first instance and that every merger would be treated exactly the same in the context of what would come in and how we would deal with the particulars. That is something that we have to be cognizant of in a lot of the issues that are before us.

Having said that, what you are interested in is enhanced competition. My view of these rules is that if anybody brings an application to us and they want it approved, they had better have some sort of enhanced intramodal competition. And that is a message that I think is very clear throughout the rules. If you want your transaction approved and you want to make sure that you bring something that has a pretty good chance of getting approved, then if I were advising an individual, I would say you had best come in with some sort of enhanced intramodal competition.

Senator DORGAN. I do not understand that. Intramodal enhanced competition. It seems to me highly unlikely that anyone, given what has happened in recent years with the mergers, the megamergers, and ending up with really four behemoth enterprises dividing up the country, can come in and say, by the way, here is another merger application and we think it will "enhance competition." Are there circumstances where you think that will be the case?

Ms. MORGAN. Well, for example, just looking backwards, the Conrail transaction involved shared asset areas where there was added competition, where two carriers are now serving a particular area. That was part of the application that came to us. So, there are avenues for enhancing competition, whether it be trackage rights or whatever, that could be offered in the context of the application. I do not see that as a problem.

If they want to come in and they want to get some sort of approval, then I think the rules are pretty clear that we are a little more skeptical about benefits from further consolidation, we are concerned about harm from further consolidation. So, we will be looking very carefully at the benefits from future consolidation, and if you want to show us that the benefits box is fuller than the harm box, then enhanced competition should be what is brought to the Board.

Senator DORGAN. I think the phrase "benefits from further consolidation" is an oxymoron.

Ms. MORGAN. When I said it, I figured that is where you were.

Senator DORGAN. I cannot conceive of benefits from further consolidation being something that is even in our language here. When I speak of benefits, I think of the public interest. The Chairman just observed, well, it is going to benefit some people. That is quite clear.

[Laughter.]

Ms. MORGAN. But what we do look at is public benefits. We look at the public interest and we weigh the benefits against the harm in determining whether a merger approval would be in the public interest.

Senator DORGAN. Obviously, this Committee is interested in the public interest. I will not inquire further except to say this. We have introduced now for the third time——

Senator ROCKEFELLER. 35th.

Senator DORGAN [continuing]. The 35th time——

[Laughter.]

Senator DORGAN [continuing]. The Rail Shipper Protection Act. And they are being protected very slowly at this point. But we are determined this time to get a hearing, to get a markup, and move this legislation. So, the first step, of course, is with the cooperation of our colleague, Senator Breaux, to schedule it for a hearing. The second step is to have you show up and fully and without reservation support all provisions of it.

[Laughter.]

Senator DORGAN. And then we will mark it up, and it will become law. And I will be a much happier Senator.

Ms. MORGAN. And you will drug me before I come to that particular hearing.

Senator DORGAN. No. I think it is going to work out fine for you.

[Laughter.]

Senator DORGAN. But I want to say very seriously, Senator Rockefeller and myself and others, Senator Burns, have been very serious about this for a long while. It made almost no progress. We have drafted good legislation. But I was told 20 years ago, "you take on the railroad, you are not going to win. You are just sort of spinning your wheels." We learn these lessons the hard way I guess. But we think this is such important legislation that we must continue and we are determined to succeed.

So, again, let me just say that your moratorium took some courage. I do not know whether these regulations do what I want done, and I certainly cannot conceive of enhanced competition coming from further mergers. But I do know that passing a Rail Shipper Protection Act fits right in the glove of what we are talking about today, and it is critically necessary for the public interest.

Mr. Chairman, thank you for holding the hearing.

Senator BREAUX. Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman. We are going to be meeting on an easy matter in a little while.

Senator BREAUX. Yes.

Senator ROCKEFELLER. I wanted to say, Mr. Chairman, just as an opener that I do not know this to be a fact, but I have heard that

the railroads are going to Members of this Subcommittee asking them to sign a letter which would, in a sense, sort of discourage the introduction of the bill that Byron Dorgan was talking about. I do not know if that is true, but I would hope that that would not be true.

And I would hope that the processes of the Subcommittee would work so that a bill which has, in fact, been introduced for 15-16 years or whatever, and in the three names, there is even an advance, and I think our time will come that this will not happen.

I think it is terribly, terribly important that we do not have railroad companies going to Subcommittee Members telling them what letters they ought to write to our Chairman and whatever else. I am certainly not going to write such a letter and I hope that others do not either.

Ms. Morgan, I want to also commend you, as Byron Dorgan did, on the courage—I guess I can include all of you, but I know the best, so I am talking to you—on recognizing some potential harm and deferring some things and making some good decisions. And that was good. That really was. I do not say that because I am about to get into tougher questioning, which I am, but because I really mean it. If it was not a shift, it was an evolution and it was strong and it was good and it was meaningful and had a very good effect.

Now, I have not read your remarks because I have been swamped in the other work that John Breaux are doing all day.

But that does not prevent me—I know there is evidence that one requires for mergers. And pro-competitive evidence you have referred to in another way for the public benefit and all that kind of thing. But pro-competitive evidence is a technical term which is used and I think which is in that category. Is that the kind of thing that one would look for if there were future merger opportunities?

Ms. MORGAN. In line with my earlier discussion with Senator Dorgan, our rules definitely shift the focus toward enhanced competition in a way that the rules had not previously.

Senator ROCKEFELLER. I got that very clearly because I listened very clearly. But the pro-competitive evidence is just a bit sharper.

Ms. MORGAN. Well, we use the term “enhanced competition.” Procompetitive initiatives, as far as I am concerned, mean the same thing. I may be missing something, but we just use the term “enhanced competition.”

Senator ROCKEFELLER. But find no disagreement in the way I put it in particular.

Ms. MORGAN. No.

Senator ROCKEFELLER. It sort of seems like the same thing.

Ms. MORGAN. Right.

Senator ROCKEFELLER. I have been a Governor for 8 years and I have been doing this for some time. Like when John and I would have discussions on managed care, there is always what happens in the first couple of years and then what happens in the third, fourth, fifth, sixth, and seventh year. If you look at managed competition in health care, you can always say that it is going to save costs, but the major question is how long will it save costs. In other words, is there a period of 2 or 3 years where they can save costs and after that point they have pretty much saved the costs that

they are going to be able to and therefore, it sort of even outs and goes into what we would refer to as more fee-for-service like Medicare?

Now, having thoroughly engaged your interest on that——

[Laughter.]

Ms. MORGAN. I think I will switch to that issue.

Senator ROCKEFELLER. There has to be a follow-up on all of this was my point. The question is, how does the STB do a follow-up on enhanced competition or pro-competitive evidence or whatever the word is? One can say the conditions seem to be, but then a couple of years pass, and things could change.

So, how does one follow up on that? And how does one do that in the process of making a decision that you can only make once?

Ms. MORGAN. I presume we are discussing the merger process because that is where we are today.

Senator ROCKEFELLER. We are, right.

Ms. MORGAN. As you know, in the past round of mergers, we instituted an oversight and a monitoring process. That has become more and more refined. In our new merger rules, we have formalized our 5-year oversight process, and also we have formalized our operational and service monitoring process. So, we have built into the rules, from lessons of the past, a formalized oversight process for the implementation of the merger for conditions that are imposed and so forth. I believe that is what you are talking about.

Senator ROCKEFELLER. It is. Suppose you find it becomes deficient. There is not much you can do about, is there?

Ms. MORGAN. Well, in our new rules, we have a provision which formalizes our oversight and indicates what our oversight will be looking at. One of the things that our oversight will be looking at is the conditions that we have imposed and whether they are working as they were intended to work.

Senator ROCKEFELLER. If they do not?

Ms. MORGAN. Then we will step in and fix the problem.

Senator ROCKEFELLER. How?

Ms. MORGAN. Again, without having a particular proposal in front of me——

Senator ROCKEFELLER. I understand that.

Ms. MORGAN. But it would be coming up with a condition, another condition, that would serve the same purpose and effect as the original condition that we imposed was intended to have.

Senator ROCKEFELLER. What would be a way that you might—not hypothetically, but just thinking back in your experience when you say enhanced competition or I would say pro-competitive evidence—and we have agreed it is sort of the same. What would be an example of enhanced competition?

Ms. MORGAN. Well, I have used an example in the Conrail merger of the shared asset areas. That represents the creation of competition, in other words, having two carriers serving those shared asset areas, and that was part of the proposal that came to us. Trackage rights is another form of enhanced competition, which I discussed with Senator Dorgan earlier.

Senator ROCKEFELLER. Trackage rights gets interestingly close to bottleneck, does it not?

Ms. MORGAN. Well, obviously bottleneck is, I am sure, an issue that we are going to get to here in a minute.

[Laughter.]

Senator ROCKEFELLER. No, but I was not thinking about it.

Ms. MORGAN. I was waiting for you to lead right into that.

Senator ROCKEFELLER. Does that not fit under the definition of enhanced competition?

Ms. MORGAN. Yes, it can.

Senator ROCKEFELLER. You have heard me do this so much that you can sort of sip some water while I am saying it because you are so accustomed to it. Again, if I am taking a flight to Fargo, which I have done—I have not been invited back, but I did it once—and let us say I have to make a switch. I am told that the flight to Minneapolis or Chicago or whatever is such-and-such, but then the flight to Fargo is not listed, and I do not know what the cost is. Now, obviously within the airline industry, the public would rebel.

The FAA would step in. The President would declare a state of—it would be totally untenable. And they do not have the protection, of course, that railroads do.

Is that an example of the kind of thing that could be looked at in terms of prices that are not quoted on clearly and predictably to be used rail service lines?

Ms. MORGAN. Yes. May I elaborate on that answer? And maybe now you may hear some of the prior discussion that we have had.

As you know, the Board issued a decision on bottlenecks that was affirmed. So, in the context of the future direction of the Board, we could not undo that decision because obviously that decision, we felt, was based on the statute, and it was upheld.

Now, having said that, in the context of a merger, given what I have said earlier, if applicants were interested in seeing their application approved, they, as I said, should think about bringing us enhanced competition. Some sort of additional bottleneck relief other than what the Board has provided clearly could be initiated by the parties in the first instance.

Senator ROCKEFELLER. I am trying to think if I understand that.

Senator DORGAN. Her answer was yes.

[Laughter.]

Senator ROCKEFELLER. That is what I thought. I think you are going in that direction, but it was not clear to me.

Let me put it negatively. If in the questioning that you did in a proposed, hypothetical future merger, one of the commissioners—it might be yourself; it might be one of your colleagues—posed that question and the answer came back, "no, we do not really intend to do that because we do not have to, because we have protections that others do not." Would that negatively affect the way you looked upon an enhanced competition?

Ms. MORGAN. Well, again, if we are outside the merger context, then as you and I have discussed previously—and I know you do not like the decision we issued on bottleneck—obviously, there is only so much relief in a generic sense that can be provided under our current decision as upheld in court in accordance with the statute.

Now, in the merger context——

Senator ROCKEFELLER. Now, is that a way of saying that until we change the law, you are stuck?

Ms. MORGAN. Well, we have had that conversation before.

Yes.

Senator ROCKEFELLER. We certainly have.

Ms. MORGAN. But in the merger context, again if someone wants to get approval for their transaction, they must figure out a way to bring us what we comfortably feel is enhanced intramodal competition, which will help us to feel better about the benefits of a particular transaction. So, in the merger context, that is one avenue that could be pursued. There are other avenues that could be pursued to enhance intramodal competition as well.

Senator ROCKEFELLER. Let me just end with this, Mr. Chairman, I apologize and I thank you, as I always do, and apologize to you as I often do.

Everything you are saying, your body language, the word "intramodal" which caused confusion for a moment—but everything you seem to be saying is really affirming an answer to a question that I gave to you. I do not think you want to come out in a Committee hearing and create an insoluble problem for yourself or create unnecessary ruckus. But I think you are saying that, yes, that is something we would look at. Yes, that has to do with enhanced competition, and yes, intramodal means things of that sort, that defines things of that sort. So, I would take it that you would look at that carefully.

Ms. MORGAN. In the context of a merger review, yes.

Senator ROCKEFELLER. In the context of the merger, yes. I would not be wrong, right, in saying that?

Ms. MORGAN. No.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

Senator BREAUX. I want to thank the panel.

Mr. BURKES. Mr. Chairman, may I make one comment in response to the question you asked about others supporting KCS's position? Obviously, the U.S. Department of Transportation supported it. Wisconsin Central supported it. CSX did not use the exact language, but in several areas they referred to it on January 20th. The fact is there are only six major railroads left in North America. If the proponents of the combination that did not involve two of the big six carriers could demonstrate that there was no reason to apply the rules, then presumably after comment, the Board could grant the waiver. So, they supported a theory but not the exact language.

Now, Dr. John Snow is here. He will be testifying. He can respond to that as well as Mr. Haverty.

Senator BREAUX. Have any of the Class I railroads ever requested not to be considered a Class I railroad before?

Ms. MORGAN. Not to my knowledge, no.

Mr. BURKES. Not to my knowledge. Obviously, six of them would not because they so far exceed the limits.

Senator BREAUX. But KCS has never requested that they be not considered because of their smaller size?

Mr. BURKES. No. They just requested in all the comments and the public hearings that they not be held to the standards of——

Senator BREAUX. But they never requested changing what was a requirement to be considered a Class I railroad.

Mr. BURKES. No. They requested the threshold be raised.

Senator BREAUX. I understand.

We want to stay in touch with the Board on this decision and work with you on future things that you are going to involved with and do so very closely. Thank you for being with us.

We would like to welcome up our next panel, which will be a panel consisting of Mr. John Snow, who is Chairman and President and CEO of CSX Corporation; Mr. Paul Tellier, who is President and CEO of the Canadian National Railway Company; Mr. Mike Haverty, who is Chairman and President and CEO of the Kansas City Southern Industries; Mr. William Gebo, who is Manager of Rail Services for Dow Chemical, who will be accompanied by Mr. George Marshall, who is Director of Supply Cycle for Albemarle Corporation in Louisiana, a chemical company; also Ms. Claudia Howells with the Oregon Department of Transportation. We look forward to receiving their testimony.

Let us see. We have got three good railroad men there and look forward to hearing their testimony.

John, we have you listed first. We welcome you to the Subcommittee and are pleased to hear your testimony.

STATEMENT OF JOHN W. SNOW, CHAIRMAN, PRESIDENT, AND CEO, CSX CORPORATION

Mr. SNOW. Mr. Chairman, thank you very much. Senator Rockefeller. I am delighted to be here today. I have submitted a statement and I will make some brief comments now and look forward to your questions.

CSX is in broad and basic support of the rules that have been propounded by the agency with respect to future mergers.

We think they are timely. They meet the requirements of the situation, which is really a product of recent history, because recent history, as you all well know, of railroad mergers has not been a completely happy story. In fact, it has, in many ways, been quite an unhappy story. These rules are designed, I think, to deal with the unique circumstances of the current environment. I think they adopt the right approach. They raise the bar. They make future mergers more difficult. They put added requirements on railroads going forward, as you have heard the Chairman of the STB testify.

At the same time, I think we are in a period where further rail mergers are clearly inadvisable. This is a time when railroads ought to be focusing on serving customers better, on reducing their costs, on improving their balance sheets, on improving earning power, on winning back the confidence of both shippers and investors.

I must say the process of the last 4 or 5 years with the mergers has shattered, in many respects, that confidence of shippers and Wall Street. We are now in the process of rebuilding that confidence. I think we need some more time to complete that process and do it right. I am confident that we will.

CSX is a fundamentally different and better railroad today because of the opportunity we have had to focus on improving our performance than we were a year ago. I think if we had been

caught up in a merger movement 18 months ago or so, it would have been hard for us to have made the clear progress that we have made in the East.

Finally, I would say that I do not see any need for mergers at this time. I do not see any sentiment for mergers at this time. If there are to be mergers in the future, they should come at a time when the shipping public and the investing public really express a need and a desire for them. So, for the next 3, 5, 7—I do not know—some considerable number of years going forward, I do not see mergers. I see railroads, rather, focusing on the things I mentioned to improve their performance.

One important path to improving their performance will be these alliances and joint ventures that have been talked about.

So, I think we are in a new era in railroading, Mr. Chairman. We are in an era where we will consolidate the benefits of prior mergers rather than seek future consolidations for now.

I thank you very much.

[The prepared statement of Mr. Snow follows:]

PREPARED STATEMENT OF JOHN W. SNOW, CHAIRMAN, PRESIDENT AND CEO OF CSX CORPORATION

Good afternoon, Chairman Breaux and Members of the Subcommittee. I am John W. Snow, Chairman, President and Chief Executive Officer of CSX Corporation (CSX). CSX operates the largest freight railroad in the eastern half of the United States, serving 23 states, the District of Columbia and the Provinces of Quebec and Ontario. I appreciate the opportunity to appear before you today to present CSX's views on the new merger rules issued by the Surface Transportation Board (STB).

All of us with a stake in the industry—rail customers, labor, management, short lines and the financial markets—have followed closely the lengthy proceeding that produced these rules, and have anxiously awaited the Board's ruling on the many complex issues that were raised. Many of us have different interests. I believe, however, that a broad consensus of interested parties agrees that the Board's process was timely, open, professional, and fair in every respect. Indeed, this has been our experience with the STB since its formation. While we have disagreed with certain decisions, we have found that under Chairman Linda Morgan the STB has functioned thoughtfully, carefully, productively and efficiently.

CSX and the other major carriers are all products of consolidations. Over many decades, mergers have produced substantial economies and efficiencies. Shippers have shared in these benefits, enjoying an inflation-adjusted rate reduction of more than 50 percent since 1980. Now, with only seven major carriers left, however, the Board has recognized the need to pause to identify the key issues for study in future mergers which would result in a smaller major carrier universe.

When the STB inaugurated this process, rail customers and investors in the industry were experiencing the impact of service difficulties following recent mergers, including the absorption of Conrail lines by CSX and Norfolk Southern. It was a rough time for all of us—a time when the industry was single-mindedly focused on re-building service. We were determined to win back the confidence we had earned in preceding years.

Recognizing the paramount importance of industry recovery, the Board believed that another merger could trigger a final industry restructuring at the wrong time. We agreed. Such destabilization could have wreaked havoc in the economy and produced long-term problems. Clearly, the decision to institute the moratorium and rulemaking was well-timed and sound policy.

Given 15 months of breathing room, I am pleased to tell you that CSX today is running better than ever. The critical operating metrics we use as performance indicators—freight car dwell time in yards, velocity, and cars on line—are exceeding goals. Customers have noted the improvement: Complaints have plummeted and we are recapturing business. Daily, we are becoming more responsive to our customers' needs in our expanded service territory. While we recognize the need for continuous improvement, CSX today is well staffed, well equipped, running smoothly, and beginning to reap the considerable benefits of the single-line service provided through the Conrail acquisition. We are moving traffic from the highways onto the rails. We are moving coal to our nation's utilities and industries in record amounts. My sense

is that other roads are experiencing similar improvements and are back on a solid operational footing. The Board was prescient in deciding to institute a moratorium on mergers, thereby giving the industry a critical opportunity to stabilize and earn back the confidence of its various constituent interests.

But I believe this rulemaking also sends the rail industry a clear signal. It tells me that future Class I rail mergers will be much harder to accomplish, which is as it should be given the industry's recent history and current circumstances. It tells me that customers and other constituencies have convinced the Board that more time must pass to complete and verify industry recovery. I see this as a prudent approach—the right approach for these times—which will be followed to keep the rail industry on the main line to full recovery.

The Board's new rules focus on two key issues. First, how a proposed merger affects competition in the surface freight industry; and second, the need to thoroughly plan and implement well all the many steps involved with any new merger initiative. We agree with the Board that the need for increased focus on safety, service plans and communications with employees, customers and affected communities are appropriate elements for consideration in future merger proceedings.

On competition, the Board's decision confirms sound agency policy against using its jurisdiction in ways that would re-regulate the industry and, in short order, return to the regrettable pre-Staggers days of regulated rates and services that virtually crippled the industry. I can assure you that re-regulation of our industry with its extremely competitive marketplace would ultimately deprive our customers of the significant benefits they secured under the Staggers Act, and would severely limit our ability to fund the necessary, substantial costs of our infrastructure. This is a very important point. We are one of the most capital-intensive industries in America. This year alone CSX will invest nearly $900 million in infrastructure and equipment. Re-regulation would be a stranglehold, constraining our ability to generate these funds internally or secure outside financing to even maintain our railroad in sound condition.

I am concerned, however, about the interpretation of competitive standards in the future. There was considerable debate during the proceeding over the roles of intermodal and intramodal competition in future consolidations. While I believe that the final rules reflect a recognition of the role of single-system service and intermodal competition in delivering benefits to the nation's shippers, I'm concerned that the Board in interpreting the new rules may focus too much attention on intramodal competition without enough credit being accorded intermodal, geographic and product competition—all of which are key drivers in the rail marketplace.

In terms of the general rules for mergers, the bar has been set higher, and winning approval of future mergers will be more difficult. That result makes good sense for now and for the foreseeable future, as railroads need to focus on securing the benefits of past mergers and not on initiating new mergers. But as industry efficiency improves further and we regain customer confidence with steadily rising service reliability, there may come a time in the future when shippers seek the benefits of mergers and when our shareholders' interests are enhanced by a restructuring. These opportunities should not be permanently foreclosed. But let me emphasize that for now, and for perhaps even 5 years from now, the message and effect of these new rules are not only sound and appropriate, they are an imperative.

As I have indicated, we are in a time when railroads must continue to demonstrate the benefits of prior mergers. As I see it, there is little or no sentiment for additional major mergers among the rails themselves, from our customers, or from our investors. For our part at CSX, we have absolutely no plan, intentions, or inclination to initiate any restructuring and would be opposed to such action by anyone else as well until our recent history has become a much more distant memory. In fact, the very existence of these new, more stringent standards encourages us not only to continue improving our railroad in traditional ways, but also to look for innovative, creative alternatives to mergers. With our operations substantially improved and our railroad running smoothly, we at CSX have turned our attention to using the technological and marketing tools available to develop alliances with other railroads to improve service and capture more business from the highways.

Here are some examples: Just last month, CSX Intermodal and Canadian National introduced a range of new intermodal services connecting major Canadian and U.S. markets. The CN-CSXI marketing agreement offers shippers highly competitive service for coast-to-coast intermodal traffic moving between Vancouver, B.C. and New York; between Toronto and Florida; and Toronto and New York. We are working with Norfolk Southern on many projects, including an arrangement to improve service in the critical Cincinnati gateway. With Union Pacific, we have introduced "Express Lane" service which is moving fruits and vegetables and even wine from the West Coast to New York City and Boston on a greatly accelerated schedule

that is 94 percent on time. We also are running a NAFTA express with UP to get vehicle parts from Michigan to Mexico. We estimate that 45,000 loads have been taken off the highway and put on the rails as a result of this service alone. And we are developing what we call a "watershed" business opportunity using simplified routings with Western roads to connect target markets that are generally 200-250 miles on either side of the Mississippi. Our goal is to capture business that currently is moving almost exclusively over the highways between these relatively short distances.

Last week we announced a partnership between CSX Intermodal and Burlington Northern Santa Fe to provide service for temperature-controlled products from San Bernardino, California to Little Ferry, New Jersey. The schedule meets midnight delivery times and is a seamless service that is a highly competitive alternative to over-the-road transportation. In addition to our activities with other major railroads, we are, of course, working with our friends in the short line industry. There are a variety of alliances and marketing initiatives underway between other railroads, and I anticipate even more emphasis on these types of approaches now and in the future. I sense a real "sea change" in the railroads' willingness to cooperate with each other.

In conclusion, the challenge ahead of us is not to quickly formulate a merger to meet the new requirements. The challenge is to develop and test ways to reap many of the benefits of consolidations without precipitously plunging down the merger track.

I appreciate having had this opportunity today and will be pleased to answer any questions you may have.

Senator BREAUX. Thank you very much, John. We appreciate it. Monsieur Tellier. [French spoken.]

STATEMENT OF PAUL M. TELLIER, PRESIDENT AND CEO, CANADIAN NATIONAL RAILWAY COMPANY

Mr. TELLIER. Merci.

Mr. Chairman, Senator Rockefeller, I am delighted to have this opportunity to talk about these new rules.

By way of background, just a couple of words about Canadian National. We are the only transcontinental railroad in North America from the East Coast, Halifax, to the West Coast, Vancouver, and also, as you know very well, Mr. Chairman, to the Gulf Coast to New Orleans.

We are very much a North American company. The reason I say this is that 52 percent of our revenues are derived either from carrying freight in the U.S. or in cross-border traffic. We are also a North American company because 65 percent of my shareholders are on this side of the border. We are a $3.5 billion company in terms of revenues, real dollars, U.S. dollars.

[Laughter.]

Mr. TELLIER. And 22,000 employees. We are the fifth largest railroad, but we never describe ourselves in that fashion. We prefer to describe ourselves as the largest of the small guys.

Mr. Chairman, if I may say so, we offer quite a unique perspective for the simple reason that we are the most efficient railroad in North America, bar none. Six or seven years ago, we were the last in the class. And today we are at the top of the class. Whichever way you look at it, in terms of operating ratio, in terms of quality of service, in terms of the way we run our trains on a scheduled basis, we are at the top of the class.

We are committed to shipper service. I can relate very well, Senator Rockefeller, to your concern. As a matter of fact, I stood in front of a group of shippers some years ago proposing a bill of

rights for customers or shippers. So, therefore, our perspective is quite unique.

As you are very much aware, Mr. Chairman, in 1998 we acquired the Illinois Central, and we integrated these two companies without any service disruption. It was a successful merger.

Later on that same year, we did a marketing alliance with KCS, and since then we have embarked on a number of alliances, for instance, very recently with our friend here at CSX providing the best intermodal service from the West Coast to the East Coast.

So, from that perspective, let me make some very brief comments on the rules.

First of all, Canadian National is very pleased that the STB has raised the bar for these future mergers if they do take place.

Second, we are very pleased that our arguments were heard and that the STB has come out saying that in transnational mergers involving a U.S. railroad and either a Canadian railroad or a Mexican railroad, the same rules should apply. We are very, very pleased about that.

Third, we had expressed some concerns about the Board's proposal on identifying the downstream effects of a future merger. But we think that the new rules have addressed our concern and have addressed the issue of enhanced competition and, therefore, we are very comfortable with that.

My last comment on the rules. We may not agree with every aspect of these rules, but Canadian National is quite confident that the industry can live with these rules and we can operate effectively within that framework.

A word before closing, Mr. Chairman, about the future of the industry. It is difficult to predict. It is possible that we will end up with only two transcontinental railroads, but this is not a certainty. Some will say it is not even a probability. It is certain that the industry will continue to evolve. For instance, NAFTA over 10 years since it was signed between Canada and the U.S.—the two largest trading partners in the world—and Mexico has influenced a lot the evolution of the structure of the rail industry, and I am sure that is going to continue to be the case.

In conclusion, Mr. Chairman, what I would say to you and to your colleague, Senator Rockefeller, really matters for us, CN, is the quality of service. The quality of service has to continue to improve.

Second, we are going to continue to improve the quality of service. We, the Class I's, have to work better with one another. The number of us is shrinking and therefore we must work better together. If we cannot provide single line service as a result of a merger, we should be able to provide single line-like service as a result of good alliances.

At this point in time, we do not plan to merge with any carrier. You may be aware, Mr. Chairman, that we announced at the beginning of this year the acquisition of Wisconsin Central, a Class II railroad. This application is currently before the Surface Transportation Board. We are hopeful that it is going to be approved by early fall and we will be able to put these two companies together without any traffic disruption by the end of the year.

Therefore, my very last point, Mr. Chairman, CN is not a defender of the status quo. We know that our industry must evolve. The truckers have been eating our lunch every day of the week. We have got to be more conscious than ever that the customers, the shippers, are paying our salaries. Therefore, we at CN have been trying to provide leadership in this. On the basis of our scheduled service, which means that we have a trip plan for every car, year to date our service has been 92 percent on time. So, we think that by working better together with our colleagues, the other Class I's, we could meet your objective, Senator Rockefeller, and continue to provide better service.

Thank you.

[The prepared statement of Mr. Tellier follows:]

PREPARED STATEMENT OF PAUL M. TELLIER, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CANADIAN NATIONAL RAILWAY COMPANY

Mr. Chairman and Members of the Subcommittee: On behalf of Canadian National Railway Company (CN) and its affiliates, I appreciate the opportunity to present our views on the new rules governing railroad mergers that were issued on June 11 by the Surface Transportation Board (STB) in STB Ex Parte No. 582 (Sub-No. 1), *Major Rail Consolidation Procedures*.

By way of background, CN spans Canada and mid-America, from the Atlantic and Pacific Oceans, to the Gulf of Mexico. With extensive operations in Canada, as well as our activities in the U.S. and our reach into Mexico by virtue of our marketing alliance with the Kansas City Southern (KCS), we have a North American focus. We operate 15,500 route miles of track and we are the fifth largest of the seven Class I railroads operating in the United States, with annual operating revenues of approximately US$3.5 billion.

CN appears before you today with a unique perspective on these merger rules. We are the most efficient railroad, with the best operating ratio of all Class I railroads. Our objective since CN was privatized in 1995 has been to become the best railroad in North America by delivering high-quality service to our customers. We are committed to more efficient service and faster transit times for our customers, and we are committed to moving more freight, more quickly, with fewer assets. We are always seeking new ways to compete in the very dynamic transportation market.

To this end, we have undertaken a number of important initiatives. To capitalize on the rapidly expanding market for north-south trade that has arisen as a result of the North American Free Trade Agreement (NAFTA), we merged with the Illinois Central Railroad (IC) in 1999 with no serious integration problems. We have undertaken alliances and entered into marketing agreements with other rail carriers. And, CN announced earlier this year our intent to merge with the Wisconsin Central Transportation Corporation (WC). All of these efforts make CN a stronger railroad and a more effective competitor, which in turn benefits our customers.[1]

CN'S POSITION ON THE NEW MERGER RULES

We are pleased that the rules adopted by the Board will raise the bar for the quality of customer service in future railroad mergers. The Board has said it will closely scrutinize claims of benefits made by future merger applicants and has imposed requirements intended to ensure that railroad customers receive the service envisioned by merger applicants. CN had urged the Board to adopt such an approach last year.

We also are particularly gratified that the Board appears to have heard the concerns raised by CN, Canadian Pacific, and the Government of Canada regarding the

[1] One initiative on which we were not successful was our attempt last year to combine the operations of CN with those of the Burlington Northern Santa Fe (BNSF) in a new company, North American Railways, Inc. We saw this essentially end-to-end transaction as good for shippers, competition, the economy, and the shareholders of CN and BNSF. However, the Board's review of our proposed combination was suspended with the STB's imposition in March 2000 of a 15-month moratorium on activity related to mergers of Class I rail carriers. CN and BNSF appealed the Board's decision to the U.S. Court of Appeals for the District of Columbia Circuit, but the Court denied our appeal. On July 20, 2000, CN and BNSF announced that we were abandoning plans for our combination. To this day, we have not revived those plans.

Board's proposed requirements related to transnational mergers. In the final rules, the Board now plans to apply higher public interest standards for mergers equally to all applicants—both domestic U.S. companies and foreign-headquartered corporations. If the goal of treating U.S. and foreign-headquartered railroads equally is met in the implementation of the rules, that will help stimulate competition in our industry.

In our comments during the Board's proceeding, we had expressed concerns about the Board's proposal that merger applicants identify "downstream" effects of a merger and the Board's proposed requirement that future mergers enhance competition. The new rules have taken steps to allay our concerns in these areas, but the implementation of these rules will be of vital importance. These rules should be a mechanism to promote efficiency and service, not a way to induce artificial, economically unsustainable competition or to protect some carriers from competition with others.

It is also important to note that the enhanced competition that the Board seeks can also come through more efficient competition. One of the best actions carriers can take for their customers is to reduce costs and improve service. Mergers may still have an important role to play in helping the industry achieve that goal.

While we may not agree with all aspects of the new merger rules, CN believes that, if the rules are properly implemented, the rail industry will be able to operate effectively and will have the opportunity to bring good merger cases before the agency and receive a fair hearing.

FUTURE RAILROAD INDUSTRY STRUCTURE

In its new merger rules, the Board appropriately emphasizes the importance of a renewed emphasis on improved customer service, which is essential if the railroad industry is to survive. How the industry will respond to new service challenges—and the new merger rules—is the subject of considerable speculation.

It is important to note that no particular industry structure is inevitable. It is, of course, possible that two major North American railroads will emerge, but that possibility is neither a certainty nor even a probability. Nor is there any reason to believe that the industry structure will ever become static. CN believes the railroad industry will continue its long history of changing along with the economy at large, which is the only way rail can remain a competitive mode.

In recent years, we have seen the rail industry change dramatically with the economy. For example, short lines have re-emerged as an important rail sector. Similarly, NAFTA has increased the importance of improved north-south routes, which was one of the factors behind the Board's approval of the CN/IC merger in 1999. Other new forms of competition will undoubtedly emerge to meet future market needs. Similarly, new capabilities may emerge that will allow old structures to become effective in ways that are not yet possible.

CN believes that railroad customers can be the beneficiaries of a new railroad paradigm that emphasizes responsible growth and responsive customer service. Our industry will stagnate and deteriorate if it does not continue to grow by providing more and better services to our customers so that rail will always be an attractive alternative in this dynamic, multi-dimensional economy. For customers who rely entirely on railroads, we have to provide service that keeps them competitive in the global marketplace. For the vast majority of our customers, who have a choice between railroads and other modes, we have to make rail a better choice of transportation than the other modes. We also need to capture a part of the share of other modes, which have the largest share of the freight transportation market—if we are to stay in business.

With respect to CN, we of course are always looking to the future and seeking new ways to improve our performance and enhance our customer service. However, we have no plans at this time to merge with another rail carrier. We are currently focusing solely on our proposed merger with Wisconsin Central and the ongoing regulatory review process at the STB surrounding that transaction.

Mr. Chairman, thank you again for the opportunity to appear before the Subcommittee on this important subject. I would be happy to answer any questions you might have.

Senator BREAUX. Merci, Monsieur Tellier. It is nice to hear someone who does not have an accent testify.

[Laughter.]

Senator BREAUX. Michael Haverty.

STATEMENT OF MICHAEL R. HAVERTY, CHAIRMAN, PRESIDENT, AND CEO, KANSAS CITY SOUTHERN RAILWAY COMPANY

Mr. HAVERTY. Good afternoon, Mr. Chairman and Senator Rockefeller. It is a pleasure to be here today.

A little brief history on the Kansas City Southern. It was founded back in 1887, primarily a North-South railroad intended to move goods from the Midwest down to the Gulf Coast. When I showed up in 1995, it was a mid-sized regional railroad. The very month that I showed up, in May 1995, the Union Pacific/Chicago & North Western merger was approved. Three months later, the Burlington Northern/Santa Fe merger was approved. The next month, the Union Pacific/Southern Pacific merger was announced.

So, that meant that Kansas City Southern was clearly at a crossroads in its history. If the merger was approved between Union Pacific and Southern Pacific, which ultimately it was, it meant that 90 percent of all of the rail traffic west of the Mississippi River would be controlled by two railroads.

Inasmuch as we were west of the Mississippi River, that did not bode well for our future.

But we looked at what courses of action we had. Number one, we said we can shrink the railroad, which meant if we did that, we probably would not be here today. Or second, we could aggressively try and capitalize on the NAFTA trade agreement that had just been passed in 1994 and through a series of acquisitions, investments, and marketing alliances try and capitalize on that traffic. And that is exactly what we did, and in three-and-a-half years, we put together a NAFTA rail network.

But I would like to point out that we did it by only purchasing 450 miles of track. The rest of it was through marketing alliances or investments where we are not the controlling shareholder. We went from 2,700 miles in the United States to 3,150. We are by far the smallest carrier, 3,150 miles compared to Burlington Northern and Union Pacific that are close to 33,000 miles. So, even though we have been able to survive with this strategy, we are still the smallest and we have limited market access.

A year ago when the moratorium was proposed, we supported the moratorium. We said that you needed a breather from major railroad mergers. When the advance notice of proposed rulemaking took place simultaneously, we participated in that, and in fact, we proposed seven rules, none of which were accepted in totality. But we have publicly supported the rules that have just come out by the Surface Transportation Board.

Let me just briefly address some of the concerns that you have, Senator, about the so-called exemption that Kansas City Southern got.

First of all, it has been no secret that for a period of 15 months we have said that we think that Kansas City Southern needs to be treated differently. I understand the Class I rules, but to say a Class I is a Class I is a Class I certainly is not the case. When I go out to compete with a railroad that is 10 times our size and has 17 times more revenue for the same customer in your State of Louisiana that produces paper, there is absolutely no way that the two of us are the same. It is very, very difficult to compete. In fact,

many of the major railroads today have argued that they had to merge in response to other mergers because they did not want to be smaller. Well, here we are, much, much smaller than any other carrier.

I think that a lot of the concern about this new rule is really too much concern. Again, as was pointed out, the grandfathering of the Kansas City Southern under the previous rules—and that is the way I look at it, not an exemption, but grandfathering—is appropriate, and there is a rebuttable presumption. So, if someone thinks that we should not be exempted or we should not be grandfathered, then they certainly have the right to file for that.

Also, grandfathering KCS does not mean an exemption from merger rules. All we are saying is that we be guided by the same rules that the other mega-mergers were guided by when they put together their 30,000-miles-plus systems. Again, we are one-tenth the size of them.

We were somewhat surprised by Chairman Morgan's dissent. A couple of months ago, Mr. Tellier's railroad here was granted a right to move forward with the Wisconsin Central purchase. It was considered a minor transaction, which means it can be completed in basically 6 months under very lenient rules.

Kansas City Southern is very much closer to being the size of Wisconsin Central than it is of the other Class I carriers. We are at around $565 million and Wisconsin Central, in the United States, was a little less than $400 million. Kansas City Southern owns 3,150 miles of track; Wisconsin Central was 2,750.

Also, we were a little bit surprised when the comments were made that Kansas City Southern might trigger the eventual move to two railroads. Here we are, again 3,150 miles, yet Canadian National bought WC (Wisconsin Central), which is similar in size, and yet there are no strategic implications of the kind that have been suggested for KCS? A Canadian railroad [CN] and a U.S. railroad [WC] that owns trackage in Canada? There really has been no protest by any other railroads or by shippers about the WC transaction. Therefore, I did not understand the claim that if we were involved in a transaction, as a 3,150-mile railroad, we would trigger a major merger.

True, we have investments in Mexico. We also have investments in Panama. But we are either an equal investor or a minority investor, and we do not control the railroad down in Mexico.

Thank you very much.

[The prepared statement of Mr. Haverty follows:]

PREPARED STATEMENT OF MICHAEL R. HAVERTY, CHAIRMAN, PRESIDENT AND CEO, KANSAS SOUTHERN RAILWAY CO.

Good afternoon Mr. Chairman, members of the Committee. My name is Michael R. Haverty. I am Chairman, President, and Chief Executive Officer of The Kansas City Southern Railway Company. I am pleased to appear before you today, and I thank you for the opportunity to discuss KCS's thoughts on the recently released final rules for major rail mergers and their impact on the country's railroad system.

I would like to begin my comments by explaining the role that KCS plays in the national railroad system. KCS is the smallest of the Class I railroads. See Exhibit A. Using 1999 annual operating revenues available from AAR, KCS's revenues were approximately $564 million dollars. In comparison, the next largest Class I carrier, Canadian Pacific Railway ("CP") (including its U.S. subsidiary, Soo Line Railroad), had annual operating revenues of approximately $2.4 billion dollars. The largest Class I carrier, Union Pacific Railroad ("UP"), is over 17 times the size of KCS with

annual operating revenues of approximately $10 billion dollars. In comparison, KCS is much closer in size to Wisconsin Central's U.S. rail operations, that include a Class II railroad, and had combined annual operating revenues around $400 million dollars. A quick look at the miles of road operated by each Class I carrier reveals the same story of disparate size differences. KCS's miles of road operated (including Gateway Western Railway) in 1999 was 3,158; CP's miles (including the Soo Line) were 14,358; UP's miles were 33,341 and WC's miles were 2,756. See Exhibit B. Notably, WC would have become a Class I railroad under existing criteria on January 1, 2002 if the recently announced acquisition by the Canadian National Railway had not occurred. Also, notably, the Surface Transportation Board (STB or the Board) determined this transaction would be treated as minor, the most lenient treatment available for proposed rail mergers.

KCS was founded in the 1880s by a visionary that sought to connect America's heartland to the Gulf of Mexico to move Midwest agricultural products by rail to southern states and by ship to other countries. KCS's main lines ran from Kansas City to Lake Charles, Louisiana and Port Arthur, Texas. In the 1930s, a line between Dallas and New Orleans via Shreveport, Louisiana was added to the KCS network. In 1993, KCS purchased a strategic line from Shreveport to Meridian, Mississippi via Vicksburg and Jackson. KCS's rail network remained in this configuration as a regional railroad until 1995.

In 1995, the Union Pacific/Chicago & North Western and the Burlington Northern/Santa Fe mergers were approved by the Interstate Commerce Commission (ICC), completing another wave of major rail mergers. See Exhibit C. That same year, the proposed Union Pacific/Southern Pacific merger was announced, and it was subsequently approved by the STB, the successor to the ICC. As a result, KCS found itself facing the possibility of extinction as two major rail carriers were created that would control 90 percent of the traffic west of the Mississippi River.

In an entrepreneurial reaction, KCS, in a span of about three and one-half years, became part of a "NAFTA Railway" network, spanning from Canada to Mexico. This network was created through a series of acquisitions, investments and strategic marketing alliances. The interesting thing to note is that KCS added only about 450 miles of rail ownership to the company that it controls. The rest of the network was created through minority investments and strategic alliances. KCS is one-tenth of the size of the two major railroads it competes against in the west, Burlington Northern Santa Fe (BNSF) and Union Pacific because Kansas City Southern does not actually own controlling interest in trackage beyond its 3,158 miles compared, for example, to Union Pacific's actual ownership of over 33,000 miles of trackage and BNSF ownership of over 33,000 miles of trackage as well.

Subsequent to the two major rail mergers approved in the west, two major rail carriers were also created in the east when the CSX and Norfolk Southern purchase of Conrail was approved by the STB. As a result of these major rail transactions, two giant rail carriers dominated traffic in the west and two dominated traffic in the east. Besides these four major rail carriers in the United States, there are two major railroads in Canada and two in Mexico. (KCS owns a minority position in one of the two Mexican systems.) Because previous STB decisions have established that two carriers are adequate competition in the United States and there are only two major rail carriers today in Canada and Mexico, the likelihood of eventually seeing only two major rail companies in all of North America is strong. However, the premise that KCS would be the catalyst of triggering a move to the final end game of mergers, with ownership control of only 3,158 miles of track in a 100,000 plus mile major rail network in North America, is, in my opinion, unrealistic.

The mergers and other changes that have taken place in the rail industry over the past two decades have in part been the result of the major merger regulations enforced by the ICC, and (since 1996) by the STB. Shortly after the enactment of the Staggers Rail Act of 1980, the ICC modified its merger regulations to place a premium on the reduction of excess capacity which was deemed to be choking the large railroads. Under these merger regulations, consolidation was encouraged as long as it was not deemed to unacceptably reduce competition. Along with the liberalization of abandonment rules and, perhaps most significantly, the reduction in government regulation of ratemaking and other service issues, the merger regulations implementing the Staggers Act helped to return the railroad industry from the brink of financial ruin.

The railroad industry that we see today is largely the result of the ICC's and STB's interpretation of the post-Staggers merger standards. However, it has now been determined that the reduction of excess capacity should not be the primary goal of future rail mergers. KCS supports that concept and supported the STB's 15-month merger moratorium imposed in March 2000, and we were pleased when the moratorium withstood a challenge in court.

The purpose for imposing the moratorium, according to the Board, was to allow the Board time to re-write the merger regulations, to better address the competitive and service issues which would now arise from a round of final combinations. KCS also supported the Board in its pursuit of these goals. However, I would like to make it clear that KCS has not been, and is not, part of the "mega-carrier" problem that the STB sought to address in its new regulations.

KCS actively participated in the STB's review of its merger rules—a process which spanned 15 months. At each step in the proceeding, KCS filed comments proposing modest changes which we believed could put the merger regulations more in tune with the modern rail industry. See Exhibit D. KCS's written comments were contained in hundreds of pages of text, all of which reflected views on improving the rail system as a whole. We were also represented by our regulatory counsel at an oral hearing conducted by the STB to facilitate a dialog on the Board's revision of the merger rules.

At each step in the Board's review proceeding, KCS urged the Board to consider seven specific proposals for improving its regulation of major rail mergers. Those seven points were as follows: 1. Rail Service Options Should Be Preserved In Merger Proceedings; 2. Service Restrictions Contained In Marketing, Haulage And Trackage Rights Agreements Imposed As Merger Conditions Should Be Disclosed And Justified; 3. Benefits Claimed From Prior Mergers Should Be Preserved; 4. Applicants Should Be Required To Disclose And Discuss The Impact Of Related Negotiated Agreements In Merger Proceedings; 5. Recent Cancellations Of Reciprocal Switching Access Should be Disclosed and Discussed; 6. The Definition of "Major" Merger Transactions Should Be Limited To Mergers Involving Only The Largest Railroads; 7. Merger Applicants Should Be Required To Disclose And Discuss Paper And Steel Barriers Applicable To Their Shortline Interchange Connections.

KCS was pleased that our seven modest proposals generated a significant amount of discussion in the merger rule proceeding. Although none were adopted in totality, other railroads, government agencies, and shippers all made comments directly or indirectly supporting or opposing the suggestions made by KCS. KCS has supported the STB's new rules.

Since I assumed the Presidency of KCS in 1995, we have been actively involved in all of the major rail mergers, urging the STB and the ICC before it to maintain as a guiding principle the preservation of rail competition. Railroading involves enormous capital expenses. Unlike the trucking industry, for example, where underserved markets can be remedied with the purchase of some trucks, railroads must pay for their own infrastructure, meaning that it is virtually impossible for any new rail systems to be built. In short, the rail systems we see today are likely all we will have to work with for many years to come. For that reason, we have repeatedly asked the Board to make sure that rail mergers do not reduce competitive options to shippers in major transactions.

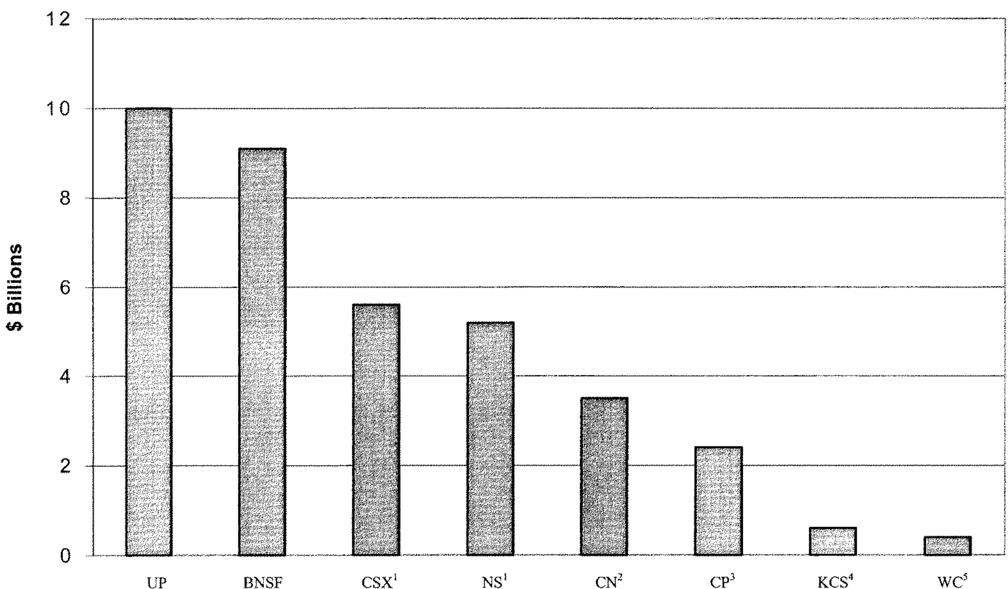
Over the last few weeks, some have questioned the majority of the Board's approval of a regulation grandfathering any potential merger of KCS and another Class I carrier under the Board's former regulations governing major rail mergers. The final regulation is different than the proposal put forth by KCS, which was that such a merger be reviewed as a "significant" transaction, not a major one, under the new merger regulations. The Board's rule is different from what we proposed but is based on the same facts that spurred our original proposal 15 months ago: KCS's limited market reach simply cannot support the types of concern over service and competitive issues which will dominate future mergers of the other Class I carriers. The "grandfathering" of KCS, under the previous rule, which is fair and appropriate, is a rebuttable presumption that could be challenged by a concerned party if they desired to do so.

I would like to conclude my comments with a few observations on KCS's independence. Many parties have been speculating that the recent adoption of the STB's major merger regulations is nothing short of a "For Sale" sign on KCS. The people making that speculation have simply not watched us over the past few years. KCS has worked diligently to maintain its independence while entering alliance and marketing agreements to extend its reach and better serve our customers. We have worked hard to develop on-line business opportunities, and to work with our connecting carriers to better serve our shippers. We are currently involved in the construction of a new headquarters building in downtown Kansas City, an action that we would not be taking if we were looking to exit the market as an independent carrier. It is true that we are a publicly traded company, and thus in some sense our future rests in the hands of those who invest in our stock. Additionally, we must protect the interest of not only our shareholders but our customers and employees as well. But a railroad so dwarfed by major carriers around it with limited geographic reach may well prove to be in no one's best interest. But, in the meantime,

we will continue to focus our energies on keeping KCS a strong, reliable carrier, one with a proud heritage and a challenging future.

Again, I want to thank the Subcommittee for giving me the opportunity to testify today. I would be pleased to answer any questions you might have.

EXHIBIT A



All figures are 1999 data from AAR's Railroad Facts, 2000 Ed., unless noted otherwise.

[1] CSX and NS began operating most of Conrail's lines on June 1, 1999. CSX and NS data includes only the final seven months of Conrail's 1999 data.

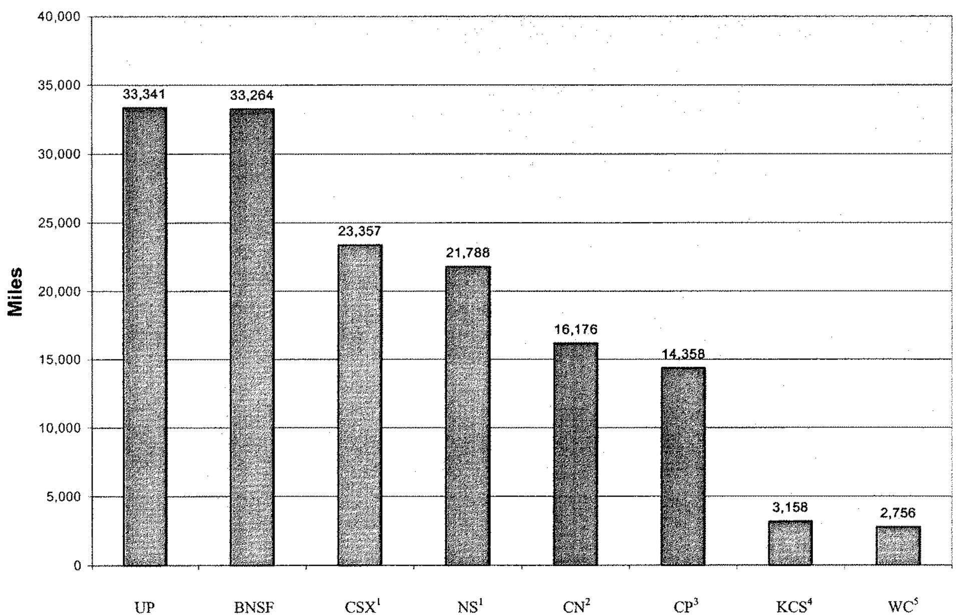
[2] CN merged with IC on July 1, 1999. CN data includes consolidated U.S. and Canadian operations, including IC for all of 1999. Financial figures have been converted to U.S. dollars.

[3] CP data includes consolidated U.S. and Canadian operations. Financial figures have been converted to U.S. dollars.

[4] Consolidated figures for KCS and Gateway Western Railway. Gateway figures from KCS website.

[5] Figures reflect 2000 data from WC website. Consolidated figures for Wisconsin Central Ltd., Fox Valley & Western Ltd., Algoma Central Railway Inc., and Sault Ste. Marie Bridge Company.

EXHIBIT B



All figures are 1999 data from AAR's Railroad Facts, 2000 Ed., unless noted otherwise.

[1] CSX and NS began operating most of Conrail's lines on June 1, 1999. CSX and NS data includes only the final seven months of Conrail's 1999 data.

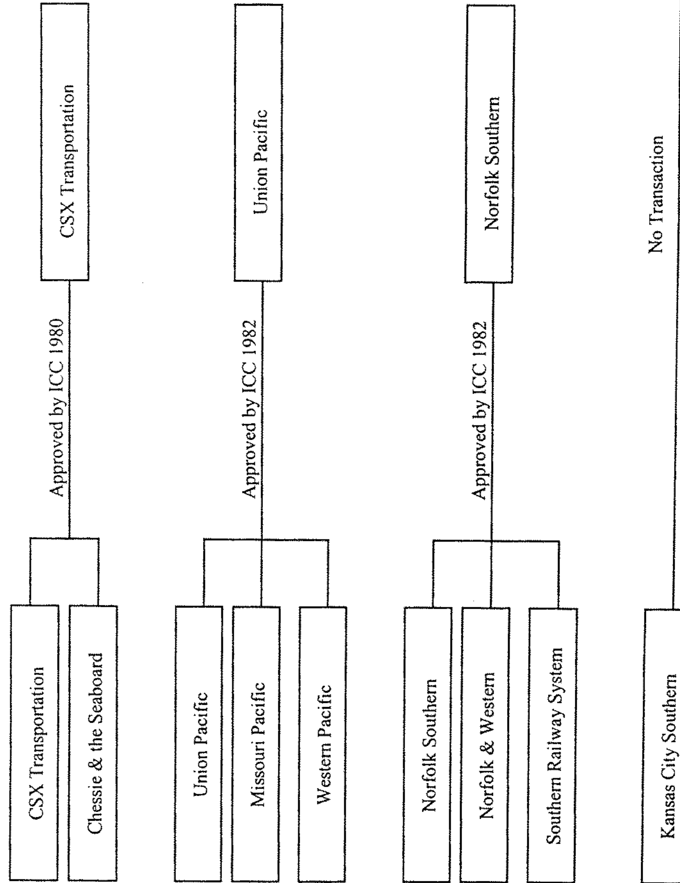
[2] CN merged with IC on July 1, 1999. CN data includes consolidated U.S. and Canadian operations, including IC for all of 1999. Financial figures have been converted to U.S. dollars.

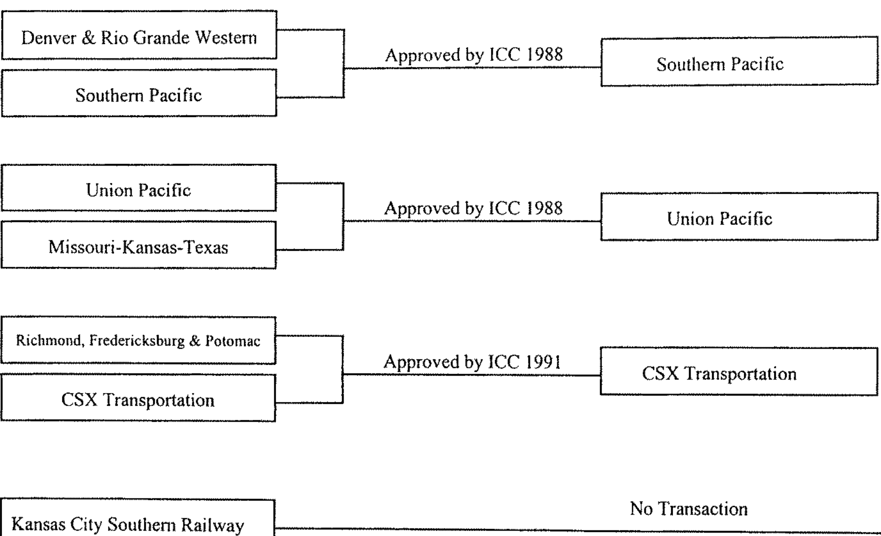
[3] CP data includes consolidated U.S. and Canadian operations. Financial figures have been converted to U.S. dollars.

[4] Consolidated figures for KCS and Gateway Western Railway. Gateway figures from KCS website.

[5] Figures reflect 2000 data from WC website. Consolidated figures for Wisconsin Central Ltd., Fox Valley & Western Ltd., Algoma Central Railway Inc., and Sault Ste. Marie Bridge Company.

EXHIBIT C




(late 1980's)
Denver & Rio Grande Western
Southern Pacific
Approved by ICC 1988
Southern Pacific
Union Pacific
Missouri-Kansas-Texas
Approved by ICC 1988
Union Pacific
Richmond, Fredericksburg & Potomac
CSX Transportation
Approved by ICC 1991
CSX Transportation
Kansas City Southern Railway
No Transaction

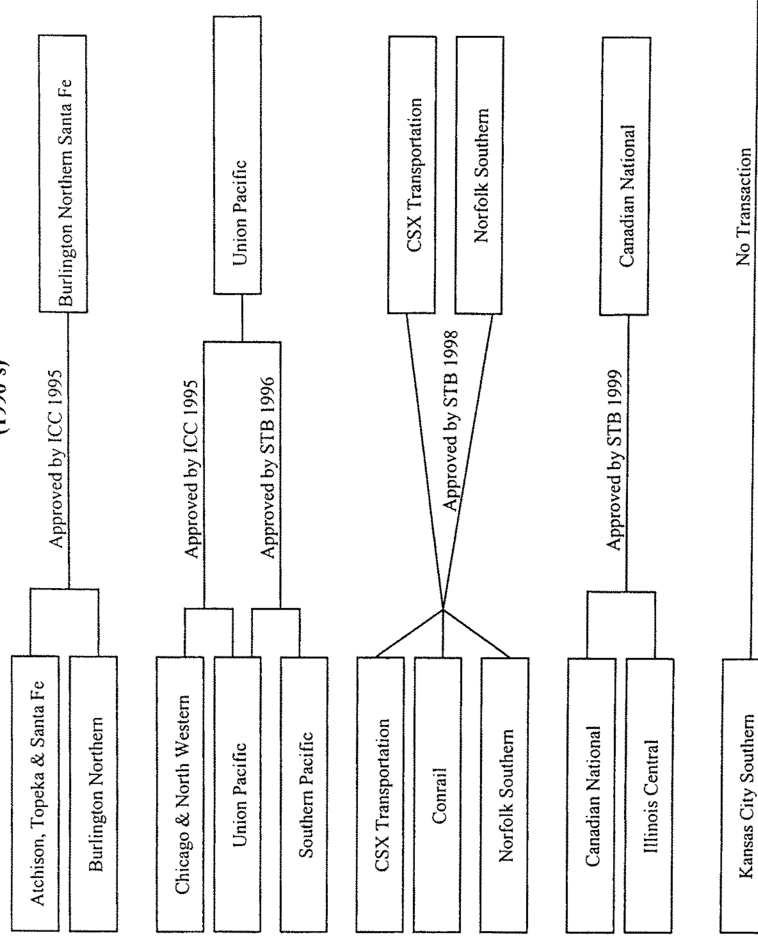

MAJOR RAIL MERGERS - WAVE 3
(1990's)
Atchison, Topeka & Santa Fe
Burlington Northern
Approved by ICC 1995
Burlington Northern Santa Fe
Chicago & North Western
Union Pacific
Southern Pacific
Approved by ICC 1995
Approved by STB 1996
Union Pacific
CSX Transportation
Conrail
Norfolk Southern
Approved by STB 1998
CSX Transportation
Norfolk Southern
Canadian National
Illinois Central
Approved by STB 1999
Canadian National
Kansas City Southern
No Transaction

Exhibit D—Debate Timeline On KCS Proposal

Date	Event	What Happened
March 11, 2000	STB imposes 15 month moratorium on major rail mergers.	
March 21, 2000	STB issues Advanced Notice of Proposed Rulemaking (“ANPR”); seeks public comments.	
May 16, 2000	Comments on the ANPR due	Over 100 parties filed Comments KCS asks any future KCS-Class I merger to be “significant,” not “major” WCL supports the same idea in KCS’s proposal
June 5, 2000	Reply Comments on the ANPR due.	Approximately 60 parties filed Reply Comments KCS again urges differences between large and small Class I railroads BNSF, UP, EEI and SPI oppose KCS’s request WCL and CSX indicate support for KCS’s proposal
October 3, 2000	STB issues Notice of Proposed Rulemaking (“NPR”).	1No distinction to “major” merger definition included
November 17, 2000	Comments on NPR due	Over 100 parties filed Comments KCS urges reconsideration of its proposal WCL supports KCS’s request and USDOT agreed with the same concept of KCS’s request
December 18, 2000	Reply Comments on NPR due	Approximately 50 parties filed Reply Comments KCS continues to seek distinction in “major” merger regulation IMPACT and UP oppose KCS’s proposal WCL and USDOT indicate support for KCS’s request
January 11, 2001	Rebuttal Comments on NPR due	Approximately 40 parties filed Rebuttal Comments KCS’s final written justification for amendment to “major” merger classification
April 5, 2001	STB conducts oral argument	Approximately 40 parties participate in oral argument KCS appears before STB to answer questions about proposal
June 11, 2001	STB issues final major merger regulations.	Regulations include rebuttable presumption that KCS-Class I merger to be reviewed under existing “major” merger standards

Senator BREAUX. Thank you, Mike.
Mr. Gebo.

STATEMENT OF WILLIAM L. GEBO, MANAGER OF RAIL SERVICES, DOW CHEMICAL COMPANY; ACCOMPANIED BY GEORGE MARSHALL, DIRECTOR OF SUPPLY CYCLE, ALBEMARLE CORPORATION

Mr. GEBO. Yes, Mr. Chairman, Senator Rockefeller. My name is William Gebo, and I am the Manager of Rail Services Purchasing for Dow Chemical Company. It is an honor to appear here today on behalf of the American Chemistry Council.

Dow Chemical is one of the Council’s largest shipping members. We operate a fleet of 29,000 rail cars with a replacement value of $2 billion. We initiate over 145,000 rail shipments per year, and we spend in excess of $450 million a year on rail freight in North America.

For several years, coinciding with the recent wave of rail mergers, the Council and its member companies have been increasingly concerned about the lack of direct head-to-head competition among railroads. For the Council’s membership as a whole, two-thirds of all rail-served chemical plants are restricted to service by a single railroad. These captive plants have no opportunity to obtain com-

petitive price quotations or service options. This is not acceptable to us as an industry.

Throughout the recent 15-month merger moratorium and rulemaking process, the Council took part in every phase of the STB policy review. Our industry took those STB proceedings very seriously, but we were fairly disappointed with the outcome. STB had the opportunity to establish clear rules for the next round of rail mergers. Now that there are only two major Class I's in the East and two major Class I's in the West, the next round of mergers will be the last round.

The Council believes that within a few years there will only be two North American railroads. With our members already subject to monopoly conditions at almost two-thirds of their rail-dependent facilities, we are worried that there will be even more concentration and even fewer routing options for captive customers.

In the rulemaking docket, the Council asked the STB to make competition the centerpiece of its new merger guidelines. While the STB did appear to change its emphasis regarding competition, unfortunately it declined to lay out specific guidelines to enhance rail-to-rail competition.

Therefore, the American Chemistry Council makes the following recommendations to the Subcommittee.

One, elevate the involvement of the Department of Justice in rail mergers.

Two, direct the STB to examine marketing alliances and other cooperative arrangements between the railroads that have the potential to further limit competition without the benefit of meaningful Federal scrutiny.

Three, direct the STB to establish more precise merger guidelines for enhancing rail-to-rail competition.

Under these merger rules, there is no requirement to enhance rail-to-rail competition in the future consolidations, and moreover, there is no attempt to restore competition that was lost from previous mergers.

Merger rules aside, the overall implementation of rail policy so limits the opportunity for competitive market forces to work, it is clear that Congress must intervene. Therefore, we urge this Subcommittee—and I guess as far as Senator Rockefeller is concerned, I am preaching to the choir—to consider legislation such as S. 1103 that would promote rail-to-rail competition as originally envisioned by the Staggers Rail Act.

Thank you very much.

[The prepared statement of Mr. Gebo follows:]

PREPARED STATEMENT OF WILLIAM L. GEBO, MANAGER OF RAIL SERVICES, DOW CHEMICAL COMPANY, ON BEHALF OF THE AMERICAN CHEMISTRY COUNCIL

Good afternoon Mr. Chairman and members of the Subcommittee. My name is William L. Gebo and I am Manager of Rail Services for the Dow Chemical Company. I am appearing here today on behalf of the American Chemistry Council.

The American Chemistry Council ("the Council") represents the leading companies engaged in the business of chemistry. Council members apply the science of chemistry to make innovative products and services that make people's lives better, healthier and safer. The Council is committed to improved environmental, health and safety performance through Responsible Care, common sense advocacy designed to address major public policy issues, and health and environmental research and product testing. The business of chemistry is a $460 billion enterprise and a key

element of the nation's economy. It is the nation's largest exporter, accounting for ten cents out of every dollar in U.S. exports. Chemistry companies invest more in research and development than any other business sector.

Safe and efficient rail service is crucial for the member companies of the American Chemistry Council. The business of chemistry is second only to the nation's electric utilities in terms of its dependence on railroads and the size of its freight bill. Chemicals and plastics annually account for 150 million tons of rail traffic, which provides our rail service providers with $5 billion in revenues.

On behalf of Dow and the Council, it is an honor to be here today to address the subject of the new major rail merger rules that the Surface Transportation Board ("STB") adopted on June 11, 2001. These rules [often referred to by docket number as "Ex Parte No. 582 (Sub-No. 1)" or as STB's "Major Rail Consolidation Procedures"] will have a significant impact on the country's economy and should be carefully reviewed by Congress.

Before commenting these rules, the Council wishes to note that earlier this year, under the chairmanship of Senator Gordon Smith, this Subcommittee undertook a series of three hearings on the condition of the rail industry. Rail customers respectfully request that, after holding this special hearing on STB's new merger rules, the Subcommittee complete its original series of three hearings. Still to be examined in that series, and not on addressed today, are the on-going problems that rail customers face on a daily basis.

For several years—coinciding with the most recent wave of rail mergers—the Council and its member companies have become increasingly concerned about the lack of direct head-to-head competition between railroads. For the Council's membership as a whole, 63 percent of all rail-served chemical plants are restricted to service by a single railroad. In other words, when it comes to rail transportation, nearly two-thirds of our industry is "captive" and therefore has no opportunity to obtain competitive price quotations or service options. Member companies that have competition available at some of their facilities report that their freight rates are much higher (ranging from 15 percent to 60 percent more) where the railroad has a monopoly over the shipper's traffic. Nor is it surprising that the Council's members report that railroads are less responsive to customer service concerns at locations without rail-to-rail competition.

This lack of competition is not acceptable for the business of chemistry, which is obligated to supply customers in virtually every sector of the U.S. economy—including motor vehicles, pharmaceuticals, computers, packaging, agriculture, and water treatment. Moreover, as I have noted, the business of chemistry is the nation's largest exporting industry, with more than $80 billion in exports last year. So the business of chemistry must also rely on railroads to reach customers in Canada and Mexico and to move products efficiently to various ports.

Having underscored the importance of rail service to the business of chemistry, I will now focus on the specific topic of today's hearing—rail mergers. Throughout the recent 15-month moratorium, the Council took part in every phase of STB's rail merger policy review. Our industry took those STB proceedings very seriously. But we are extremely disappointed with the outcome. STB had the opportunity to establish clear *rules* for the next round of rail mergers. And make no mistake, now that there are only two Class I railroads in the East and two in the West, the next round of mergers will be the last round. The Council believes that within a few years there will be only two major railroads in North America. Obviously, with our members already subject to monopoly conditions at almost two-thirds of their rail-dependent facilities, we are worried that there will be even more concentration and even fewer alternatives for captive shippers.

In the rulemaking docket, the Council asked STB to make competition the centerpiece of its new merger guidelines. Unfortunately, however, *STB declined to enhance competition when railroads merge*. To be sure, STB invited—and perhaps, to some extent, may be said to have encouraged—railroads to "talk the talk" about competition and improved customer service when they file their next round of merger applications. But STB clearly did not adopt any rules that would *require* railroads to "walk the walk" by competing directly with each other at all points on their merged systems.

The American Chemistry Council commends to the Subcommittee's careful attention the following three points about the current status of Federal rail merger policy:

1. Ideally, the final round of rail mergers should not be reviewed by STB, which simply can't bring itself to address the needs of captive rail customers. We therefore urge you to adopt legislation, like S. 526 (already introduced by Senators Dorgan and Rockefeller), which would elevate the involvement of the U.S. Department of Justice in rail mergers. Given the extreme concentration already existing in the rail

industry and the market power that railroads exert over individual captive shippers, it would certainly be appropriate to give more authority to an agency with a balanced view of competition.

2. Even if Congress chooses to leave rail merger authority with STB, that authority must be explicitly clarified to require the examination of so-called "marketing alliances" and other cooperative agreements between railroads. STB has generally not interpreted its authority to include such transactions. Because railroads, like Major League Baseball teams, are not subject to normal antitrust review, there is the risk that "de facto" rail mergers could occur without any meaningful Federal scrutiny.

3. Finally, this special hearing may well be the Senate's only chance to direct STB to reconsider its new rail merger guidelines before it is too late. Instead of issuing precise rules, which all interested parties would understand in advance of a merger, STB has left everyone wondering. Captive shippers see clearly that merging railroads will not be required to enhance competition in a future consolidation under these rules. Although STB itself recognizes that rail mergers can lead to serious service problems, the new rules do not require carriers to compensate shippers, who have suffered tremendously in the wake of four of the past five mergers. For that matter, how can short lines and rail labor unions and potentially affected communities know what will happen to them? In fact, even the Class I railroads may not be sure how STB will judge the final round of mergers, until after that round has been completed.

In conclusion, the American Chemistry Council thanks the Subcommittee for the opportunity to participate in today's hearing. Because our members depend so heavily on the railroads, we urge the Senate to provide clear pro-competitive rules in place of vague merger guidelines. We also urge you to pass legislation that would promote the long-term health of the nation's railroads—as envisioned in the Staggers Rail Act of 1980—by allowing free-market forces to operate in a truly competitive manner.

Thank you.

Railroads Need to do More Than Talk, ACC Testifies

[American Chemistry Council News Release]

ARLINGTON, VA—In a special hearing held today before the U.S. Senate Surface Transportation and Merchant Marine Subcommittee, the American Chemistry Council emphasized that time may be running out to reconsider rail merger guidelines. On June 11, 2001, the Surface Transportation Board (STB) released new major rail merger rules that the business of chemistry believes missed the opportunity to make rail-to-rail competition the centerpiece of the new merger guidelines.

"The new rail merger guidelines may have encouraged the railroads to talk about competition and improved customer service when they file their next round of merger applications," testified William L. Gebo, Manager of Rail Services for The Dow Chemical Company of Midland, Michigan, "but the STB clearly did not adopt any rules that require railroads to compete directly with each other at all points on their merged systems." Gebo pointed out that captive shippers see clearly that merging railroads will not be required to enhance competition in a future consolidation under current rules. "Make no mistake, the next round of, mergers will be the last round. With almost two-thirds of our members already subject to monopoly conditions, our industry is worried that there will be even more concentration and even fewer alternatives for captive customers," he stated.

The U.S, Congress should adopt legislation that would elevate the involvement of the U.S. Department of Justice in rail mergers, Gebo urged. Currently, rail mergers are subject to review by only the Surface Transportation Board. "It certainly would be appropriate to give more authority to an agency with a balanced view of competition," he said.

Gebo also proposed that the STB's authority be explicitly clarified to require examination of "marketing alliances" and other cooperative agreements between railroads. The STB generally has not interpreted its authority to include such transactions. "There is a risk," Gebo continued, "that rail mergers could occur without any meaningful Federal scrutiny."

Safe and efficient rail service is crucial for the member companies of the American Chemistry Council. The business of chemistry is second only to the nation's electric utilities in terms of its dependence on railroads and the size of its freight bill. Chemicals and plastics annually account for 150 million tons of rail traffic, which provides our rail service providers with $5 billion in revenues.

"We urge the U.S. Senate to provide clear pro-competitive rules in place of vague merger guidelines," Gebo concluded. He noted that on June 26, Senators John D.

Rockefeller (D-WV), Bryon L. Dorgan (D-ND) and Conrad Burns (R-MT) introduced S. 1103, the "Railroad Competition Act of 2001." The U.S. Congress, he emphasized, must "pass legislation such as S. 1103 that would promote the long-term health of the nation's railroads by allowing free-market forces to operate in a truly competitive manner."

The American Chemistry Council represents the leading companies engaged in the business of chemistry. Council members apply the science of chemistry to make innovative products and services that make people's lives better, healthier and safer. The Council is committed to improved environmental, health and safety performance through Responsible Care, common sense advocacy designed to address major public policy issues, and health and environmental research and product testing. The business of chemistry is a $462 billion a year enterprise and a key element of the nation's economy. It is the nation's #1 exporting sector, accounting for 10 cents out of every dollar in U.S. exports. Chemistry companies invest more in research and development than any other industry.

Senator BREAUX. Thank you, Mr. Gebo.

Mr. Marshall, you are from Louisiana. Do you have anything to add to Mr. Gebo's testimony?

Mr. MARSHALL. I fully concur with his comments, sir.

Senator BREAUX. OK.

You had some interesting comments in your remarks regarding KCS. You may want to talk to Mike Haverty there before you all leave and work it out.

[Laughter.]

Senator BREAUX. It will save me a meeting.

[Laughter.]

Senator BREAUX. Ms. Howells, we are glad to have you here and are pleased to take your testimony.

STATEMENT OF CLAUDIA L. HOWELLS, RAIL DIVISION MANAGER, OREGON DEPARTMENT OF TRANSPORTATION

Ms. HOWELLS. Thank you, Chairman Breaux and Senator Rockefeller. I am very honored to be here today.

My name is Claudia Howells and I manage the Oregon Department of Transportation's Rail Division. And I am here to talk to you today about the consolidation rules, as well as to bring some other issues forward, if I may.

Because Oregon's economy continues to be based in great part on agricultural and timber production and because we are distant from major markets, rail transportation is essential to keeping Oregon producers competitive. We are somewhat unusual in the country in having over half of our rail miles in short line management, with 60 percent of our rail-served industries served by a short line. The Union Pacific is by far the dominant Class I carrier since the recent mergers, with Burlington Northern Santa Fe generating only a small percent of the Class I railroad revenue in the State.

I will mention that the short lines and their production of carloads equals the Port of Portland's, which is the other primary shipper in Oregon.

All of Oregon's shippers have been significantly affected by all of the recent railroad mergers, including the Eastern ones, since most of our markets are in fact in the East and the South. While most Oregon shippers consider rail service to be good today—it is always a relative term in this business—only one shipper, when we recently surveyed them, found any benefit from the mergers in terms of service or rates. The best that can be said at present is that

service and rates are comparable to what they were before the mergers.

We reviewed the merger rules and we commend the Surface Transportation Board for taking a very balanced approach to drafting those rules. The Board clearly recognizes that the rail system today is profoundly different than when the Staggers Act was put in place. But what we say is I think what others have said, and that is these rules come too late.

Had they been in place even 7 to 10 years ago, I think we would have a better and stronger rail system than we do now.

One of the problems that I have seen over the last 18 years, the last 50 years of public policy decisions on railroads come only after a catastrophic event such as a bankruptcy of a major rail system or these service disruptions that have caused so much agony to so many shippers.

What I would like to bring forward today are some issues that I see coming ahead, and I think some of them rather quickly. One of them is actually the breakup of the major carriers, not in a way that will necessarily make sense, but driven primarily by the need to spin off those parts of the new mega-railroads that are costly and that are also less lucrative. This will be as disruptive to shippers as have been the mega-mergers and I suggest will not necessarily enhance competition.

Another issue we have been very concerned about, but that tends to be treated as a minor transaction, is the ongoing consolidation of the short line holding companies. While there certainly are not competitive problems, we foresee that this will result in a wave of abandonments that are not necessarily the kinds of abandonments that we saw in the mid-1980s.

We also predict a bankruptcy of many of our independently owned short lines, primarily because they are captive and because they are unable to withstand the damage caused by the new heavier rail cars. In Oregon we see several short lines facing very serious financial difficulties even while the traffic levels are, in fact, fairly good. We would like to see the STB play a stronger role in protecting the interests of these smaller railroads and helping States and shippers deal with what I see are up and coming bankruptcies.

Finally, the issue of passenger use of freight lines. We in Oregon are very much involved in redeveloping intercity, interurban, and commuter rail, but we also recognize that the needs of the freight railroads need to be protected, and we see the STB has having a larger role in mediating the needs of moving people and moving goods.

Finally—and I have said this for a long time—we need a national rail policy. Without it, we believe that railroads will continue to engage in risky financial moves, such as mega-mergers, which we believe are primarily done to generate capital. Railroads will continue to reduce system capacity because Wall Street punishes railroads that make long-term capital investments or retain marginal operations.

Railroads will continue to hang on to their franchise, perhaps irrationally, because it is all they have left.

I have noted some things I think that can be done. Chief among them is that the three Federal agencies involved in railroads, the STB, the FRA, and the FTA, need to work together in developing a policy that will make sure that we have a rail system as we move forward into the 21st Century.

We have a tremendous asset that we need to protect and not simply treat as some other private investment.

I appreciate again the opportunity to be here. Thank you.

[The prepared statement of Ms. Howells follows:]

PREPARED STATEMENT OF CLAUDIA L. HOWELLS, RAIL DIVISION MANAGER, OREGON DEPARTMENT OF TRANSPORTATION

My name is Claudia L. Howells, and I am the Manager of the Oregon Department of Transportation (ODOT) Rail Division. Thank you for the opportunity to testify today on behalf of the State of Oregon and Oregon producers as the committee addresses new procedures on major railroad consolidations adopted by the Surface Transportation Board.

ROLE OF ODOT RAIL DIVISION

Oregon State Law vests the Department of Transportation Rail Division with the responsibility of representing the customers of railroads before the Surface Transportation Board (STB) and other Federal agencies. We also are responsible for maintaining a current State Rail Plan, which is an element of the Oregon Transportation Plan. The 2001 update of the Rail Plan, which includes both freight and passenger rail, is in the final stages of the approval process.

SIGNIFICANCE OF RAIL TRANSPORTATION TO OREGON'S ECONOMY

Because Oregon's economy continues to be based in great part on agricultural and timber production and because we are distant from major markets, rail transportation is essential to keeping Oregon producers competitive. We are somewhat unusual in having over half of our rail miles under short line management, with sixty per cent of rail-served industries served by those short lines. The Union Pacific (UP) is by far the dominant Class I carrier, with the Burlington Northern Santa Fe (BNSF) generating only a small percent of the Class I railroad revenue in the state.

Oregon shippers have been significantly affected by all of the recent railroad mergers. The 2001 Oregon Rail Plan includes a survey of Oregon shippers on rail service and their perception of the effects of the recent mergers. While most Oregon shippers consider current rail service to be reasonably good, with the short lines getting most of the credit, only one shipper surveyed has found any benefit from the mergers in terms of service or rates. The best that can be said is that at present, service and rates are comparable to what they were before the mergers.

COMMENTS ON STB MERGER RULES

We commend the Surface Transportation Board for a taking a balanced approach in drafting new procedures governing major rail consolidations. The Board clearly recognizes that the railroad system today is profoundly different than when the Staggers Act, and its regulatory predecessors, were put in place. We will say though what I am sure others will say. These are rules that come too late, and sadly, they will have little affect on the ability of the railroads to survive.

I would suggest that had these rules been in place prior to the merger of the Union Pacific and the Chicago Northwestern, there might have been a more rational, less destructive chain of mergers that began with the merger of the Union Pacific and Chicago Northwestern. Had the new merger rules been in place before the merger of the Southern Pacific and Denver & Rio Grande Western, a stronger railroad might have emerged and been capable of standing on its own. But the rules were not in place because, in my opinion, the last fifty years of public policy decisions on railroads have come only as a result of catastrophic events—like the bankruptcies of the Penn Central, the Rock Island and the Milwaukee Road, and now the service disruptions caused by poorly planned and poorly implemented railroad consolidations.

THE FUTURE OF THE RAILROAD INDUSTRY

I suggest that we must begin to anticipate the challenges facing railroads rather than waiting for the next disaster. Based on what we see in Oregon, I will make the following predictions:

1. Break Up of Major Carriers

I predict that we will see few, if any, major railroad consolidations in the coming years, once the Kansas City Southern/Canadian National merger is completed. Although it seemed for a time that we were headed for a round of transcontinental mergers, the resulting service disruptions, I suspect, have cooled the interest in the financial community for any more major railroad mergers. I think we will begin to see, soon, spin-offs from these new mega-railroads into small Class I or Class II railroads as the big railroads attempt to jettison the less lucrative, costlier parts of their systems. I also predict that these break ups will prove just as disruptive to shippers, and just as destructive to the overall national transportation system, as the mega-mergers. Without some clear direction now to the STB, the regulatory response will again come too late.

2. Short Line Consolidation

I also predict that we will see further consolidation of short line holding companies that will result in a new wave of abandonments as they, like the Class I railroads, attempt to keep stockholders and financial analysts happy by dropping less profitable lines. Under current regulatory constructs, short line consolidations are handled as minor transactions, because clearly the competitive issues do not exist, and there is little in the way of statutory direction to look much beyond those issues. The STB needs to address this issue with the same level of attention as it has the issue of Class I railroad mergers.

3. Bankrupt Short Lines

I also predict that many of the smaller independent short lines will head toward bankruptcy. Absent financial support from either the public, or the connecting Class I, these smaller lines will not be able to bear up under heavier cars. Many of these short lines, having experienced financial losses because of merger related service disruptions, may not ever recover. In Oregon, several short lines are facing serious financial difficulties, for the most part not of their making. The STB should play a greater role in protecting the interests of the smaller railroads, and Federal law needs to allow a greater level of participation by shippers and public interests in abandonment proceedings.

4. Passenger Use of Freight Lines

We will see growing pressure to use the freight rail system for passenger and commuter trains. The Oregon Department of Transportation fully supports redeveloping intercity, interurban and commuter rail, which is very much a mission of Oregon's rail program. However, we cannot afford to reduce the capacity of the freight system or in any way adversely affect the profitability of the freight railroads. I believe the STB should take the lead role in balancing the interests of current and future users, both passenger and freight so that the overall system remains solid.

NATIONAL RAIL POLICY

Most importantly we need a National Rail Policy that is integrated into the overall transportation policy, and that better balances the interests of all the commercial transportation industries. If we fail in that, then I predict, railroads will continue to engage in risky financial moves, such as mega-mergers, because that is the only way to generate capital. Railroads will continue to reduce system capacity, because Wall Street punishes railroads that make long-term capital investments or retain marginal operations. Railroads will continue to hang on to their "franchise", perhaps irrationally, because it is all they have left. Shippers will be left with an increasingly unstable railroad industry; something no one wants.

What can be done to avoid this? First, the railroads, large and small, need a financial safety net. Second, railroads need to remain under a regulatory agency that has a greater mission than simply mitigating competitive damage. The STB should be given a greater mission to protect railroads as a national resource, which may not always be consistent with the desires of either railroad management or railroad labor or even rail shippers. Third, railroad mergers, acquisitions and abandonments should continue under the jurisdiction of the STB and not be transferred to any other Federal agency. Fourth, the missions of the STB and the Federal Railroad Administration need to be complimentary, and these agencies need to work together. Fifth, the STB, the Federal Railroad Administration and the Federal Transit Ad-

ministration need to establish compatible policies when it comes to the management of the railroad system.

With a clearly stated National Rail Policy and with the STB given an expanded role, we may be able to head off the next major railroad crisis.

CONCLUSION

Recently, a member of the Oregon Transportation Commission observed something that I do not believe I have ever heard so clearly stated. She began by remarking on the initial investment by the government in building the nation's railroads. She then went on to say that government has all but abandoned the railroads and in so doing has demonstrated a lack of stewardship over a valuable public resource, and over that initial public investment.

Railroads continue to be the best example of a public-private partnership that this Nation has ever seen. It is clearly a partnership that needs to be reestablished if indeed we place any value on our nation's rail system. In truth, we as a Nation should be grateful every day that the railroads maintain their own infrastructure, run their trains every day and help keep industries all over the country in business without costing the taxpayer a dime. We must remember that rail is not an alternative mode. It is an essential part of our transportation system, and if not in private hands, would by necessity become the responsibility of the public. In short, railroads most assuredly need to act in the public interest, but in return the public interest needs to support the railroads.

While I may believe that the STB's rules came too late, I also believe that the quality of the new rules indicate an agency that understands the industry and also understands its responsibility to shippers and the public.

Thank you again for the opportunity to testify before the subcommittee today.

Senator BREAUX. Thank you, Ms. Howells, and thank you for coming from Oregon, and all of our guests from distances that they have traveled to be with us. Thank you for being here.

Let me start.

John Snow and Monsieur Tellier, you both indicated that there are no new merger plans out there. You want to concentrate on what we have got and make it work. If that is the state of the industry, no new mergers, would it not have been just as good just to leave the moratorium on for no new mergers?

Mr. SNOW. I think this is a better approach, Mr. Chairman, because it lays out sensible rules of the road for railroads to follow. There may come a time—I do not know when it would be, I certainly do not foresee it—when the benefits of alliances will have been exhausted, when the shipping public will say we desire more single line services, when the investing public says mergers make sense—none of that is true today—and where mergers would once again be viewed as an appropriate way to advance the well-being of shippers, investors, and railroads. So, this Ex Parte 582 rulemaking sets broad guidelines, sensible guidelines for dealing with that possibility. I see it as a remote one for many years frankly.

Senator BREAUX. Thank you.

Mr. Tellier, the same question. It just seems to me that if there are no mergers that are going to be occurring in the foreseeable future, according to your and Mr. Snow's feelings on this issue, why do we not just leave the moratorium in place, and if that time ever gets here, then we can see at that time what the appropriate rules are at that time rather than try to set the rules today for something that may happen sometime in the foreseeable future, we know not when?

Mr. TELLIER. Well, Mr. Chairman, I think it is important to keep an open mind about these possible mergers. I will give you a very concrete example that you will be able to relate to.

I have here on my left a representative of Dow Chemical. Dow Chemical is one of the biggest customers of Canadian National. We serve them in two places. We serve them out of Edmonton in northern Alberta, where they have access to good feedstock, and we provide them a single line service, for instance, to your State where there is also a very large concentration of chemical production, Geismar. Why have we been able to improve the quality of service to customers like Dow Chemical? Because today Canadian National and Illinois Central are the same company—common ownership, common leadership, a single operating plan, and so on. So, therefore, although at this point in time we are not planning a big mega-merger, like John, I would say let us make sure that the rules are there and we keep an open mind.

The analogy that I like to use—and Senator Rockefeller was using this analogy a few minutes ago questioning another witness—if you decide to fly anywhere in this country today, you will do your best to get a direct flight without a connection. And what mergers have achieved is that we can provide a customer like Dow Chemical a single bill of lading, a single invoice, a single tracking system——

Senator BREAUX. Mr. Tellier, I do not want to interrupt you, but I am going to do it anyway. I appreciate what you are saying, but you are talking about past mergers. The point I am making to you and Mr. Snow is you are saying there are not going to be any more new mergers. So, my question really to you is if there are not going to be any new mergers, why do we have to change the moratorium on no mergers?

Mr. TELLIER. Well, Mr. Chairman, if I may, respectfully.

What I am saying is we do not see any one planned at this point in time, but it is very difficult to forecast the future.

Senator BREAUX. But you may have one in mind.

Mr. TELLIER. No, we do not. But I do not see why our industry should be treated differently from the other industries in the North American economy. So, the rules are there. What we say is that under the leadership of Ms. Morgan, we have a set of rules that make sense, and if at one point in time economic conditions, to better serve the shippers, make sense to have a merger, the rules would be out there. But I do not foresee the use of these in the foreseeable future.

Mr. SNOW. Mr. Chairman, if I could just comment. Based on the current environment, I think we have a de facto moratorium. I think to enact a moratorium or leave the moratorium in place at the agency would probably have exceeded the agency's regulatory authorities. So, I think there was a very good reason to put good rules in place because if you do not have good rules in place, you have the old rules. The new rules are better than the old rules. My understanding of the Act is that to leave the moratorium in place would have exceeded the regulatory authority of the agency.

Senator BREAUX. Thank you.

Let me ask the railroads to comment on this. What in the new rules regarding mergers, from your perspective, is a greater burden or a greater standard that you have to meet in terms of accomplish a merger than existed in the old rules?

Mr. TELLIER. Well, in many different ways this is the case. For instance, the benefits. In some of the past mergers, you know, as well as I do, that the benefits of these mergers were overstated. Now the Board is telling us they are going to adopt a "show us" attitude. That is one example.

Competition. The Board will not only be satisfied in the future that there is no reduction in competition, but they want to make sure that, to the extent it is desirable, competition is enhanced.

So, I think the bar is being raised, and this is the right way to go about it. As a matter of fact, if I may say so, Mr. Chairman, when our aborted merger last year with BNSF took place, we were ourselves proposing to the regulator, to the STB, to raise the bar to make sure that the disastrous results of some of the past mergers would not repeat themselves.

Senator BREAUX. What in the new rules guarantee that we are going to have the same result in a future merger, though?

That is what I am asking.

Mr. TELLIER. Well, the service assurance plan that Ms. Morgan has described is surely one. Any applicant would have to reassure the Board that there will not be the kind of disruption that has taken place in the last 5 years in the case of some mergers.

Senator BREAUX. Mr. Snow, do you agree with that?

Mr. SNOW. Yes, very much so, Mr. Chairman. As a former practicing lawyer, who practiced before the old Interstate Commerce Commission and was involved in merger proceedings, I think any lawyer who did not counsel his client that mergers are much more difficult would be failing to fulfill his duties to his client. It is the clear intent of the agency, as you read those rules, clear state of mind of the agency that anybody who comes before us with a merger proposal has got to jump through some more hoops, has got to show the public interest in more and compelling ways.

So, if I were a practicing lawyer and two railroads came to me and said, I would like you to represent me, I would be very careful in making sure, before we filed it—in fact, my first advice to them would be right now, do not file any mergers. The agency has spoken pretty clearly. They are very inhospitable to mergers. That is the only way to read those rules, is that the agency is inhospitable to mergers, and you have to make a compelling case.

So, I think the attitude expressed by the agency in the rules is *in terrorem*. It brings terror to any proposed application. And I think the bar will bring that to the attention of would-be railroad applicants.

Senator BREAUX. Mr. Haverty, I have to phrase the question to you differently because you are not part of the new rules.

[Laughter.]

Senator BREAUX. So, what in the new rules was so onerous that led KCS to say, we cannot be part of them and want an exemption?

Mr. HAVERTY. Well, I do not think that they were that onerous. All we were asking for was the right to be treated as the other Class I's had been treated under the previous rules—because Kansas City Southern has never been involved in a major transaction ever in its history. The four big railroads in the United States, Union Pacific, Burlington Northern Santa Fe, CSX, and Norfolk Southern, have been in multiple mergers. All we were saying is be-

cause we were so much smaller, let us be judged under the same rules where they put their 30,000 mile systems together. That is what we were asking for.

It was not that they were all this onerous. I agree that some of the hurdles are clearly higher, and I agree that they are mostly intended for transcontinental type mergers.

But again, I fail to see, at some point in time, if we do something, that a 3,150-mile railroad in the United States is going to trigger transcontinental mergers. I just do not see that.

Senator BREAUX. But you are the smallest of the Class I railroads under the old rules and you never requested an exemption from them based on your smaller size. Why not then?

Why now?

Mr. HAVERTY. Well, because we were not involved in any kind of merger proceedings. We have, as I think everybody knows, pursued a course of independence. It is no secret. As I think I mentioned in my testimony, we are building a new corporate headquarters. A couple of weeks ago, I was out trying to sell equity in the company. I think if we thought that somebody was going to gobble us up next week, we would not have been doing that.

But we have to be realistic about this, Senator. If it comes a point in time where our company cannot survive and for me to stand there and wave the flag of independence while the company goes under and the customers suffer and the employees suffer and the shareholders suffer, that is not in anybody's best interest.

Senator BREAUX. I do not understand why a Class I railroad, as you are, although the smallest of the Class I's, if you have a suitor out there that is looking for an acquisition, just hypothetically, you would feel, if that was to occur, you would not be able to meet the new standards under the new rules? The only thing that I see which is new is a plan that has to be agreed to between the two merging railroads that say they are going to somehow enhance service. What is wrong with meeting a standard that says we are going to have enhanced service if we have a merger?

Mr. HAVERTY. Well, first of all, we did not——

Senator BREAUX. Regardless of the size.

Mr. HAVERTY. We did not write the rules here.

Again, I will say what I said earlier. There is a rebuttable presumption here. So, if someone thinks that Kansas City Southern is going to trigger the next round of mergers or what we are doing is going to stymie competition, clearly they have the right, I think as Vice Chairman Clyburn said, to come to the Board and say we think that this should be done under the new rules.

Senator BREAUX. Yes, but the point is apparently, I take it, that KCS did not want to be part of the new rules. Is that not true?

Mr. HAVERTY. Well, that is no secret. As I said, you can go back 15 months and we said that. And we said, as you very correctly said earlier, if it was a friendly transaction, that we felt it should be a significant transaction, which basically would be completed in 12 months. If it was a hostile transaction, we said basically that it should be considered as a major. That was our position. That is not what was chosen, but that is what our position was. But clearly, we have made no secret for 15 months.

And also, Senator, we supported Wisconsin Central back in November when they said that they wanted hearings held to talk about changing the classifications for Class I's. They wanted to raise the bar to $500 million. We said that we would like to be part of those hearings. We did not say that the number ought to be $500 million. I think we have been pretty clear that we have said that we think any railroad with less than $1 billion in revenue should be treated differently.

Senator BREAUX. That is a whole other question I want to ask.

My final point. You got your exemption. Suppose with your exemption you are the subject of a hostile takeover. Are you going to come back before the Board and argue against your own exemption?

Mr. HAVERTY. I do not think there is much chance of doing that.

Senator BREAUX. I said hypothetically.

Mr. HAVERTY. It is hard for me to answer, Senator.

Senator BREAUX. Do you see the predicament you are in? You are arguing that if it is a hostile takeover, you ought to be treated as a major merger, but if it was a friendly takeover, you should be treated as a significant merger. And what you end up with is a complete carve-out of the new rules. If they put you under the old rules, whether it is a hostile or a friendly takeover, you are subject to the same rules. Is that correct?

Mr. HAVERTY. First of all, what we proposed, the hostile versus friendly, was not accepted. That was number one.

Senator BREAUX. I understand that.

Mr. HAVERTY. Again, I respectfully disagree that it is a carve-out because that would indicate that we are not subject to any rules. Again, any party, whether it be a shipper or whether it be a railroad or whoever, who wants to come back in and say that Kansas City Southern merging with somebody else should be considered under these rules.

Senator BREAUX. That certainly changes the burden of proof, though, does it not?

Mr. HAVERTY. Well, it does. But it certainly does not keep that from happening. And the Board has every right to decide that they want to do that.

So, that is why I think that this thing is—quite frankly, Senator, not that big of a deal. Also, I have not heard a lot of outcry from shippers or shipper organizations saying that they think this is outrageous that we were grandfathered under the old rules. In fact, many of them say that we understand because you are so much smaller and much closer to the Wisconsin Central that is being purchased, that we can understand that. So, I have not seen an outcry from shippers over this.

Senator BREAUX. Senator Rockefeller.

Senator ROCKEFELLER. Thank you, Mr. Chairman.

I am one of those who tends to think that mergers kind of keep taking place until they cannot anymore. So, I make the presumption that there will be a merger. I cannot afford not to make that presumption. Therefore, I also cannot take the chance not to explore the whole concept of enhanced competition and what Chairman Morgan and I were sparring on in terms of language.

Mr. Tellier, in Canada when you have service problems, your customers have what form of redress?

Mr. TELLIER. There are several types of redress that they have. The simplest one is final offer arbitration, which is binding arbitration. Another one is interswitching arrangements where, within a radius of 18 miles, if a customer is off an interchange point, if the customer is not satisfied with the railroad that serves his or her plant, he can ask the other railroad to come and provide him with the service. And that interswitching arrangement is provided with the regulated rate.

The so-called bottleneck situation that exists in this country——

Senator ROCKEFELLER. You say with a related? You mean a spoken rate?

Mr. TELLIER. With a regulated rate. So, it is a fixed rate. So, basically the rate is fixed by the regulator and it varies, I think, from $160 to a couple of hundred dollars per car depending on the distance.

Another remedy or shipper's protection that exists is what is called competitive line rates, which is to address situations that you describe on this side of the border—the bottleneck situation.

So, these are the key provisions that do exist.

Senator ROCKEFELLER. So, in effect, it is a fairly streamlined and fairly varied approach that people have to try and find the service which is a part of enhanced competition, if they seek redress.

Mr. TELLIER. This is correct.

Senator ROCKEFELLER. There is a variety of ways to do it. In Canada, railroads do not have an exemption from review by your Ministry of Justice, do they?

Mr. TELLIER. No, they do not.

Senator ROCKEFELLER. I think it was you—or somebody—said "I do not see why any industry should be treated differently."

Mr. TELLIER. I said that.

Senator ROCKEFELLER. Would a shipper suffering from a bottleneck situation in Canada, in the sense of enhanced competition, ever just have to sort of have a "take it or leave it" rate put upon them because the government deferred to the wishes of the railroad?

Mr. TELLIER. Well, let us go back to one of the provisions, which is the final offer arbitration. Let us suppose, to use my example, our friends here from Dow Chemical are not satisfied with the rate proposal that we put on the table. What could happen is that if there is a breakdown in negotiations, the customer would put forward a package saying this is our final offer. This is what we are ready to pay Canadian National to move that traffic. And Canadian National would put its best offer on the table, saying this is the best rate that we can provide Dow Chemical for moving their shipment. And a third party basically decides in favor of package A or package B. Does this happen often? No. But when we sit down and negotiate with Dow Chemical, we know that this exists.

Senator ROCKEFELLER. It is because you have behind that the threat of the choice.

Mr. TELLIER. Yes. Senator, I know where you are leading, and let me just make that comment. The regulatory regime north of the border is quite different, and I would suggest that one has to be

very cautious before we import south of the border that regulatory regime. If you are asking me why, I would say a somewhat different history, different economics, different situations. There are only two railroads and not seven as south of the border.

Senator ROCKEFELLER. And I understand what you are saying, but I also heard you, as you affirmed, say that no industry should be treated differently than another. We have one industry which has exemption under antitrust. You do not. Industries are treated here differently from another. Whether there are two in Canada and seven in North America is less important to me than the fact that there is a principle involved here of fair and equal treatment which I think is transnational or ought to be.

Mr. TELLIER. But the broad point I was making, Senator, is that I have shareholders. We have succeeded in convincing some people, some of the best money managers in this country, to buy shares of my company. Therefore, I have to be able to tell these money managers this is the regulatory regime within which we operate. Therefore, it makes sense to do an alliance or to do a merger. Yes, the regulatory regime will provide me the opportunity to do this. Otherwise, it would be a form of penalty toward our shareholders who have invested——

Senator ROCKEFELLER. And I understand that. In spite of, let us say, being nervous about where I am going——

Mr. TELLIER. I just said I think you have to be cautious.

Senator ROCKEFELLER. I know. But you affirm that you have this system in place, regardless of whether there are going to be mergers or not. It is here now. It not a question of new rules/old rules. It is your situation right now.

I think that becomes very important because enhanced competition is not only a function of price, but it is a function of service. And that is exactly the point that you have made.

Mr. Snow, first of all, I need to say I have another life actually in which I work on aviation, and one of the very best pieces of news in that life is that you are heading up a group of five very brave souls who are taking on how do we do aviation in the United States of America better, which is rationalizing the whole system and all the rest of it. It is going to be a difficult job, and we will work together on that.

But having said that—and I can hear your answer, but I want to ask the question anyway. Why should shippers in the United States in a sense be at a disadvantage to shippers in Canada with regard to bottleneck prices, number one? Why is that in your interest or potential interest or disinterest?

And second, what justification can CSX or other railroads in the U.S. give for a pricing system that would be illegal in any other industry in this country and, as it so happens, in Canada?

Mr. SNOW. Senator, I am not an authority on the——

Senator ROCKEFELLER. Yes, you are, Mr. Snow.

Mr. SNOW. No, not on the Canadian system. You and Chairman Morgan lose me when you get into the intricacies of that bottleneck debate. So, you are talking to a relative layman here.

Senator ROCKEFELLER. Mr. Snow, let the record show——

[Laughter.]

Mr. SNOW. But I will do my best.

Senator ROCKEFELLER. All right.

Mr. SNOW. As I understand the Canadian system, it has this provision for access under the conditions that were described by Mr. Tellier for the binding arbitration. We have a different system. I am not sure it does not give shippers just as good and perhaps better alternatives.

Under our system, shippers are able to go to a regulatory agency, if they think they are being mistreated with respect to rates, and complain and say, our rates are too high. And they have done that with relative rarity I think because——

Senator ROCKEFELLER. Of high prices, cost.

Mr. SNOW [continuing]. Because they recognize that, by and large, the rates that railroads charge are not above some reasonable maximum level. The best evidence of that is simply the earning power of railroads.

I know there is concern about monopoly power, but people who claim we have monopoly power often overlook, I must say, that the alternative forms of competition we face from different modes and from geographic competition and product competition and so on. Those are all arguments you and the Chairman have had.

The shippers in the United States, Mr. Gebo suggested, should also have access to the antitrust laws. I think that is part of your question to Mr. Tellier about why should shippers be treated differently in one industry than in another. That may be a good argument. That is an open debate. Maybe shippers would feel they would do better under the antitrust laws than they do under the STB. That is an open debate. I do not know what the answer is.

But I do not think we should be subject to two regulatory regimes, to two masters. One master is enough.

I really do not know whether shippers would do better—maybe you have a response to that—under the antitrust laws than they do under the STB. It seems to me it may be a good subject for the Subcommittee to debate.

Senator ROCKEFELLER. Well, I am going to call on Mr. Gebo, with the indulgence of the Chairman, because he and I both meant to be elsewhere.

Let me just simplify it to North America. Why is it that you should be able to operate under exemptions and an antitrust situation would be illegal in any other industry?

How does one describe that in 2001?

Mr. SNOW. Oh, I think you describe it, Senator, because the alternative was putting us under the antitrust laws and having the antitrust regime prevail. I think it was recognized that you do not want two regulatory regimes, and when the Staggers Act was passed back in 1980, it was determined that a regulatory regime that provided for maximum rates under an expert agency would protect and balance the interests of both shippers and railroads most effectively.

Senator ROCKEFELLER. Well, let me just say two things.

One is that when you indicate that the redress for service under enhanced competition in a merger situation is simply a matter of going to the STB, the answer to that is you and I perfectly well know, if you want to take extreme examples, the McCarthy decision, but it is the cost of doing it. People know they cannot afford

to. They know that you cannot afford to, that you will out-weigh them. That is not a criticism.

This is the way of the world. But that is the answer to that.

As we have joked here before, I have in my lineage those who did well under monopolies, and in fact, one of the reasons that I think about that, it did not stop until the monopoly was 99 percent, which is what makes me think that a further merger is still possible. And that was declared illegal by the United States Supreme Court. That was declared illegal.

You can operate under rules that would be illegal for any other industry in this country to do. And I do not understand how you are comfortable with that. No, I understand how you are comfortable with that, but I do not understand how you justify that.

Mr. SNOW. Senator, I really do not know, as much as I respect you, whether that statement is accurate. I think under the antitrust laws, our maximum rates, challenged under an antitrust action under the Clayton Act or Section 1 of the Sherman Act or under Section 2 or under the Federal Trade Commission Act, would probably fare at least as well as they fare under the STB. I really question the basic proposition that railroad rates or conduct in any way, including mergers, would be found invalid under the antitrust laws.

Senator ROCKEFELLER. Mr. Gebo, your thoughts, sir.

Mr. GEBO. Yes, thank you. Our thought on the question of DOJ involvement was more with having a chance for DOJ to review the mergers, which they do not under the current system with any kind of power. So, it did not have to do necessarily with other aspects of antitrust per se.

When you talk about the issues in Canada versus the U.S., though, I think you will see some very significant differences in terms of operating in both countries, which Dow does. We get involved commercially doing that.

In actual fact, interswitching is fundamentally terminal access, as it is described under your bill. It is a tool that really does give, in almost all situations, shippers in Canada access to a second railroad. It has been in place, from my understanding, since 1908 because they have only had two railroads for almost all of their history. It may be a picture of what the U.S. will look like 10, 20, 30 years from now. But it is a very effective access tool in the sense that we do get a choice. It is not a choice that is available to shippers, for the most part, in the U.S., at least in the chemical industry.

Senator ROCKEFELLER. Getting the choice is important to chemical companies, steel companies, coal companies, granaries, et cetera.

Mr. GEBO. You seldom have to even invoke that, although it is very simple to do. We do several hundred carloads a year out Fort Saskatchewan through that interswitching rule.

But for the most part, our relationship with CN is very good.

It is probably the best of all the railroads that we deal with. Certainly part of that has to do with the management of the CN, but I also feel very strongly part of it has to do with the regulatory regime that is in place.

Senator ROCKEFELLER. I understand. I thank you, Mr. Chairman. I thank Mr. Snow, all of you, very much.

Senator BREAUX. Thank you, Senator Rockefeller, for your good questioning on this.

I think that there is not a board or an antitrust office that is going to do more in providing good service to consumers than competition will. If you do not have competition, you have to have regulation, which is my main point. I do not want to have the government boards and bureaucrats in Washington determining that people get good service. I would rather the free market do that. I would rather competition do that. But if you do not have competition, you are going to have regulation, which I think is probably the worst way of guaranteeing good service.

Mr. Marshall, you have some plants that are served by only one railroad in Louisiana, and you have other locations where you have more than one railroad. What is the difference in the type of service you get?

Mr. MARSHALL. Considerable difference, sir.

Senator BREAUX. In what way?

Mr. MARSHALL. The facilities that we have in the United States with one railroad, it is basically a "take it or leave it" freight rate that is presented to you. There is no true spirit of cooperation in negotiating a rate. It is apparent at the two locations where we do have choices, there is an opportunity to sit down to discuss what we have, the reason we are trying to move various tonnages to various locations, and there is a chance to negotiate a rate that is acceptable to both the railroad and to Albemarle.

Senator BREAUX. So, in the case where you have one service and you do not feel like you are getting good treatment, in comparison to what you get in markets where you have competition, what is your relief?

Mr. MARSHALL. It has been pretty much we roll over and take it. We have made attempts, where we can, to move tonnage to barge facilities. We have also made attempts to move tonnage to truck carriers. Part of the problem we are having there, as well, are ongoing regulations, municipal, State, and Federal regulations, that are limiting the amount of hazardous material going down various lanes.

So, our options are few. The most damning option would be, as we experienced with previous mergers, sending people home and shutting down the plant.

Senator BREAUX. If you find yourself in that situation where you do not have a choice and you are getting what you consider to be bad service, why do you not just go to the Surface Transportation Board and tell them about it?

Mr. MARSHALL. That is a fair question. Talking to various colleagues in the industry who have made those attempts, they were most often failed attempts. And I opted not to go that route.

Senator BREAUX. Well, I want to thank all of you. We have got three good railroad people. You are probably the best, Mr. Haverty, Mr. Tellier, and John Snow. You all are outstanding railroad men. I mean that very sincerely. You do a terrific job running your companies in difficult circumstances.

The purpose of this hearing is to express my concern and I think the Senator from West Virginia's concern. I am more and more concerned that more and more we have less and less: fewer airlines, fewer telephone companies, fewer oil companies, fewer railroads, fewer of everything. If that continues, we are going to have more regulation. When you have fewer competitors, you cannot have competition, and if you do not have competition, you have regulation. And I do not what the Government of the United States and the Congress setting the rates and the rules for everything. We have to have a competitive society.

This Subcommittee is going to be aggressive in making sure that we try and create circumstances that lead to more competition, not less, because none of you want to be the only railroad alive and have Congress regulate everything you do.

That would be much worse. That would be an impossible situation for you to have to deal with, and we want to make sure that does not happen.

I think your testimony has been extremely helpful in shedding some light on where we are and where we are headed, and we thank you for being with us.

That will conclude the hearing.

[Whereupon, at 4:41 p.m., the hearing was adjourned.]

APPENDIX

PREPARED STATEMENT OF HON. TRENT LOTT,
U.S. SENATOR FROM MISSISSIPPI

I want to commend my good friend John Breaux for holding this hearing today in his new capacity as Chairman of this Subcommittee.

Railroads are vitally important to both of our neighboring States. Mississippi is served by five class railroads and several short lines. With Mississippi's focus on increasing its manufacturing presence and serving as a gateway for Latin American trade, I am keenly interested in ensuring adequate railroad capacity and service. Generally, the railroads that serve Mississippi have been good partners in meeting the needs of my home State's manufacturers and ports. The State is working with Canadian National and CSX to provide service to the new Nissan manufacturing plant in Madison County, and with KCS to upgrade the track connecting the Port of Gulfport to Hattiesburg.

The previous two hearings held this year on railroad issues made it clear that most railroads are having a hard time meeting their capital requirements to maintain their infrastructure and expand their capacity. As international trade flows increase across the United States, the railroad infrastructure will be under greater strain than ever. As we consider the Surface Transportation Board's recently adopted new merger rules, I urge this Committee to use caution before considering calls by some to legislate additional requirements that will make it even more difficult to maintain and expand the industry's infrastructure.

Aging railroad infrastructure is a problem for other besides the class I railroads. The regional and short line railroads, which feed and connect the class I railroads, are having an even harder time obtaining capital to maintain and upgrade their systems. Historic main line routes through the centers of cities and towns are increasingly encountering conflicts with local motor vehicle traffic and economic development needs. The development of high-speed passenger rail service to relieve increasing highway and airline congestion will require major investments in railroad infrastructure.

The Columbus and Greenville Railroad in Mississippi is a good example of a short line that is struggling to obtain private capital to upgrade a portion of its network, but still has severe problems maintaining other parts of its system. Similar situations exist in almost every State. The House of Representatives may soon consider H.R. 1020, which would help fund the regional railroad and short line infrastructure problem. It is my hope that the Commerce Committee will take up this bill shortly after it comes over from the House.

Senator Kerry and I introduced S. 948, the Community Rail Line Relocation Assistance Act of 2001, to address municipal concerns with existing downtown railroad lines. Relocating those rail lines, including the use of tunnels or bridges, would improve safety, ease traffic congestion, and facilitate economic development. While the bill was referred to the Environment and Public Works Committee, this Committee may have a role in addressing that concern.

Several Senators, including me, cosponsored S. 250, the High-Speed Rail Investment Act of 2001, which was referred to the Finance Committee. While Amtrak's management is struggling with meeting the requirements of the 1997 Amtrak reform legislation, the Nation needs to make a decision to either invest in the future of passenger rail to see if a nationwide system will work or get out of the business and let the States organize and finance their own systems.

Addressing infrastructure requirements is complex and requires making difficult tradeoffs. All too often, it is easier to respond to the symptoms of inadequate infrastructure by imposing additional performance requirements rather than solving the underlying problem. Although energy, aviation, and railroad transportation are different industries with different regulatory issues and capital funding mechanisms, we are seeing similar effects of inadequate infrastructure and similar calls to treat the symptoms, not the causes, for all three.

I urge my colleagues on this Committee to work together to facilitate the upgrading of our nation's system of private railroad infrastructure to handle the transportation needs of the 21st century. Let us make rational decisions regarding the regulation of the railroad industry. I look forward to listening to and working with today's witnesses, those from our previous hearings, and my colleagues on this Committee and in the Senate to address this nation's railroad needs.

PREPARED STATEMENT OF EDWARD R. HAMBERGER, PRESIDENT & CHIEF EXECUTIVE OFFICER, ASSOCIATION OF AMERICAN RAILROADS

My name is Edward R. Hamberger and I am President and Chief Executive Officer of the Association of American Railroads (AAR). The AAR is the primary trade association representing the interests of major North American railroads. Our members account for the vast majority of rail mileage, rail employees and rail revenue in Canada, Mexico and the United States. The AAR includes among its members all of the Class I railroads.

The AAR is pleased to have this opportunity to express its views, in addition to those of its individual members, on the new rail merger rules issued by the Surface Transportation Board on June 11, 2001.[1] Our overall assessment is that the Board accomplished what it said it was going to do in its October 2000 Notice of Proposed Rulemaking, which is to "raise the bar" for approval of proposed rail mergers. The bar appears to have been raised in at least two ways. First, the Board has imposed stricter standards on merger applicants in terms of the details and planning that must be included in future merger applications. The newly required Service Assurance Plans are a primary example of this. Second, and more significant, the Board has placed on the applicants "a heavier burden to show that a major rail combination is consistent with the public interest." (Final Rules Decision at 9) The applicants' burden will be to show that the public benefits flowing from a major rail combination clearly outweigh any potential harms and do so by a substantial margin.

It is apparent that avoidance of future merger-related service disruptions was a primary goal underlying the new rules. No one wants such disruptions to occur in connection with any future rail merger, and if the application process can be changed so that the likelihood of such disruptions are minimized, it should be.

It is also apparent that the Board feels that any future rail merger proceeding between Class I carriers will be viewed as a high stakes proceeding.

While we understand the impetus for the new rules, AAR does not agree with all the substantive changes adopted by the Board. We do agree generally with the increased emphasis on service planning and with the requirement that rail merger applicants submit detailed Service Assurance Plans. More troubling to AAR are certain aspects of the Board's treatment of competition issues in rail merger proceedings. Specifically, we are troubled by the idea that the Board will expect rail carriers to propose non-remedial enhancements to competition that are not an outgrowth of market forces as part of their merger applications. This concept is expressed in various places throughout the new merger rules, for example in new section 1180(c) ("Public interest considerations": "[T]o assure a balance in favor of the public interest, merger applications should include provisions for enhanced competition, and, where both carriers are financially sound, the Board is prepared to use its conditioning authority as necessary . . . to preserve and/or enhance competition."

Non-remedial restructuring of rail markets is not consistent with the public interest. The practice of the Federal agencies entrusted with carrying out competition policy underscores the point that non-remedial enhancements of competition through government mandate is not consistent with the public interest. The Antitrust Division of the Department of Justice and the Federal Trade Commission are in the business of protecting competition and not of manufacturing it.

While we are opposed to involuntary, non-remedial restructuring of rail markets, I want to make it very clear that AAR believes that the Board should recognize the *voluntary, pro-competitive initiatives* of merger applicants as public benefits.

The Board has recognized in many contexts that voluntary, private sector initiatives prompted by market forces should be encouraged. Private agreements between merging carriers and other interested parties have been an important source of procompetitive benefits in past rail merger proceedings. Apart from such negotiated

---

[1] STB Ex Parte No. 582 (Sub-No. 1), *Major Rail Consolidation Procedures.* Each of the AAR's Class I railroad members participated separately as a party in the proceeding before the STB and expressed its respective position on various aspects of the new merger rules. The AAR is addressing in this statement those issues of common concern to its members.

agreements, there are powerful pro-competitive incentives that lead rail carriers to propose mergers in the first instance. In fact the predominant impulse driving rail mergers of the recent past has been the need that the merging carriers have perceived to compete more effectively in surface transportation markets.

Railroading is a network industry. Railroads make themselves more effective competitors through mergers by strengthening their networks and expanding the reach of those networks. Expanded networks make railroads more effective competitors because they can provide their customers a greater range of service opportunities. Expanded networks and, in particular, extended single-line service enables railroads to compete more effectively with trucks. If merging carriers can show the Board that a proposed transaction will result in increased intermodal competition, the prospect of such increased intermodal competition should be recognized as a public benefit flowing from the merger. I believe the new merger rules as written would permit the Board to recognize increased competitiveness of merged railroads vis-a-vis trucks as a competitive enhancement, and I would hope the Board would interpret the new rules in this manner.

With regard to remedying competitive harms, the new rules indicate that the Board will continue to be vigilant in remedying potential reductions in competition.[2] This is clearly appropriate. The governing statute specifically instructs the Board to consider "whether the proposed transaction would have an adverse effect on competition among rail carriers in the affected region or in the national rail system." The Board's practice of identifying adverse effects on competition and remedying them through conditions that are narrowly tailored to remedy the identified harm is sound and consistent with the statute. The Board's standards for remedying competitive harm are so well known and understood that merger applicants generally try even before filing an application to identify areas where competitive problems are likely to arise and to propose solutions to those problems, typically through negotiated agreements with other interested parties. These negotiations often lead to voluntary structural changes beyond those needed to remedy specific harms.

It is appropriate that the Board decided to retain this remedial focus, and it is also appropriate that the Board rejected proposals of some parties that the new merger rules become the vehicle for widespread restructuring of rail markets that extended beyond the scope of rail mergers. AAR was very concerned that some of the parties participating in the merger rulemaking proceeding were promoting an agenda that went well beyond merger proceedings. These parties seized upon the Board's suggestion in its October 2000 Notice of Proposed Rulemaking that it might require non-remedial market restructuring as the point of departure for an array of proposals seeking imposition of broad pro forma conditions on rail merger applicants and even on non-merging carriers. Those proposals were unrelated to the effects of particular mergers and lacked any foundation in the statutory public interest standard. We are gratified that the Board rejected the argument that the Board should use its conditioning power to force successful merger applicants to grant broad competitive concessions and to require such concessions of non-merging carriers.[3] The Board was correct in concluding that its focus should be "on ensuring that any mergers that are approved are in the public interest, not on imposing a new scheme of regulation upon the railroad industry through the back door of merger approval.[4]

No one would expect that the Board's revised merger rules would be entirely satisfactory to any particular party. I have already suggested that we believe the emphasis on non-remedial enhancements of competition is misplaced. We are also pleased however that the rules retained a focus on markets within the scope of a rail merger transaction rather than looking to a restructuring of the industry.

Prepared Statement of George Marshall, Director of Supply Cycle, Albemarle Corporation

Thank you, Mr. Chairman, for allowing me the opportunity to submit this statement for the record as the Subcommittee examines the issue of rail mergers and the STB ruling.

I am George Marshall, Director of Supply Cycle for Albemarle Corporation. Albemarle is a global supplier of specialty and fine chemicals that enhance consumer

---

[2] "Our primary focus in imposing conditions—including competitive conditions—should and will continue to be remedial." Final Rules Decision at 31.

[3] The Board explained that "[c]ontrary to the arguments raised by numerous shippers and shipper groups, conditions should not be sought to fix competitive and other longstanding problems that have no nexus to the merger at hand." Final Rules Decision at 31.

[4] Final Rules Decision at 32.

products. We serve markets for polymers, surfactants and biocides, pharmaceuticals, agricultural chemicals, photographic chemicals, water treatment and petroleum products. Thanks to the work of 3,000 employees worldwide, Albemarle is a leading worldwide supplier of chemical flame retardants for computers, TVs and other household products as well as manufacturers of bulk ibuprofen used as an analgesic. Our corporate operations group is in Baton Rouge, Louisiana and we spend over $6 million a year on rail freight.

My comments about our relationship with the U.S. rail industry are many and varied. Today, your Committee is addressing one of the largest issues of concern to all who ship product by rail—rail mergers.

In the past 20 years or so, we have seen the number of independent railroads shrink from around 30 to a total of four Class One railroads today. We can expect to have only two railroads in the near future as further consolidations are anticipated. While Bill has addressed the immediate issue of the STB merger rules just issued, I would like to take a minute to talk about the impact such mergers have had on Albemarle's business. I believe that the impact is similar to other chemical companies in Louisiana and elsewhere. Our fear is that the problems we have encountered with the mergers of the past will repeat themselves if something isn't done about future mergers.

Albemarle has several facilities in the U.S. that are dependent on raw materials coming into the plant and immediately being turned around into product and shipped out to our customers around the country. We often do not have facilities for storage nor are we in some cases able to store product. This means rail cars are constantly coming in and going out. When the cars don't come in, we can't manufacture product. If we can't produce product, we have nothing for our employees to do so we find ourselves shutting the plant down until we can get raw supplies in to the facility. Needless to say, this is a costly venture.

Immediately following the UP merger with the SP, we found ourselves week after week shutting our facility down in Magnolia, Arkansas, to cite one situation. Because we had no product to ship, nor any cars to ship in, we had late deliveries to customers and even lost business to competitors. Ironically, our employees in Magnolia could watch car after car go right by the plant without stopping heading for places unknown to us. When we were able to ship, rail cars full of our products were lost for weeks at a time.

Even today, long after the merger, we are still confronted with problems with the UP ranging from their failure to deliver cars to the right place to incorrectly charging us demurrage when they place cars on Albemarle leased track. More frighteningly, again in our Magnolia facility, the county raised concerns about all of the derailments and the condition of the track. We inquired of the UP who responded that there have been no derailments since 1998 even though we have letters from the UP to the contrary. We continue to struggle with trying to get cars through Shreveport and Monroe, Louisiana.

We met with the UP on the track condition at our plant in Magnolia and we found them to be confrontational and defensive. The UP representative was belligerent and had no interest in hearing our concerns and certainly felt no need to relate to us as customers. UP inspectors had found several rail ties to replace, but during this meeting, the UP representative said his inspector had "gotten carried away with the paint can" and he didn't think any ties needed to be replaced. We do not feel that given the hazardous nature and volume of rail traffic which Albemarle has to pass through that yard that any standard of track condition which could lead to derailments is not acceptable even though it is to the UP.

I bring these issues to your attention because these are problems we have had to deal with ever since the UP merged with the SP. It continues to be such a horrific situation, that the thought of any more mergers is enough to give us real heartburn.

I'm particularly glad to see the representative from the KCS here today because we continue to have a difficult time in Baton Rouge with KCS service. Suffice it to say, we have had numerous problems with the KCS in Baton Rouge. It takes over 30 minutes to get someone on the phone in dispatch and often takes up to three requests to get a car moved. Frequently, nobody shows up to move the car and we loss an entire day in transit time. KCS in Baton Rouge is unaware of what KCS is doing in Shreveport and we end up doing their work for them. While this is not the topic of today's hearing, we look forward to future opportunities to discuss the service issues.

We are not opposed to railroads merging with each other. But unless certain conditions are met, such mergers (as the UP-SP proved) should not be allowed. The only way we feel we will have quality service is if the railroads compete with each other for our business. Today the carriers give you freight rates and you take it or leave it, no longer is there the spirit of cooperation. Our freight rates have increased

7-46 percent over the past 2 years, and we are being informed by the railroads to expect additional increases while at the same time their customer service is deteriorating and services being offered are being reduced or simply eliminated. The shippers have to spend much more time shipping the same material today than we did 2 years ago due to deteriorating service conditions—adding to our overall costs. Very recently I was in a discussion with UP regarding freights rates, and how the increases are making it very difficult to remain competitive. The UP representative shared this point with me, he stated, "UP recently had an opportunity to bid on moving a commodity for another chemical shipper, and UP elected to withdraw from the bid process because it was no longer profitable to UP". This gentleman then pointed out the following, "this example points out something we should consider as well, if the margins are this close Albemarle should consider not making the commodity anymore". I then stated to this gentleman, "This is exactly why I support measures underway today to stop any further rail mergers. Clearly, Union Pacific elected not to bid this because you had an option and the other chemical company thankfully in this case also had an option. But those shippers who are captive to one carrier must now also be forced to accept whatever ridiculous increases the railroad shoves to them, or we must stop producing the commodity. This is a real example that clearly points out that competition is the only thing that will improve service and thus the financial condition of the entire rail industry. Competition means our ability to have a railroad provide a shipper with a rate quote for any two points on their system. Competition means allowing shippers to seek competition at terminal facilities where railroads routinely interchange cars. That would have been very useful to Albemarle when the UP was not delivering cars into our Magnolia facility because they were so confused after their merger with the SP. We would have been able to have another carrier without the problems UP faced come in and deliver our raw materials.

To conclude Albemarle has become a captive shipper for the most part that relies on a single rail carrier satisfying our transportation needs, and I truly fail to recognize whom other than the railroad benefits from this.

One comment frequently made by many of us in the chemical industry is we would never be able to merge with each other the way the railroads have been doing and that is mainly due to the fact that we are subject to FTC review and anti-trust laws. It still amazes us that in the beginning of the new millennium, railroads are the only industry not subject to antitrust laws, so now it may be time to consider this, and then develop a "Shipper's Bill of Rights", when dealing with the railroads going forward.

Each and everyone one of us who relies on the railroad to handle their transportation needs could suffer, and this will eventually reach each and every one of us as a consumer, resulting in higher costs of goods and services. We know better than anyone that if the railroads are not economically viable, we will not be economically viable. If they fail, we fail. Albemarle's motto is "Don't worry about what's good for the company—worry about what's good for the customer". We would like that to be the motto for the rail industry as well.

Prepared Statement of The American Forest Resource Council

The American Forest Resource Council (AFRC) respectfully submits testimony to the committee on the important issue of railroad mergers and consolidations. AFRC is a forest products trade organization representing nearly ninety forest product manufacturers and landowners in 12 states west of the Great Lakes. Our membership represents a cross section of the industry from large multi-national corporations to small family owned operations. AFRC and its two predecessor organizations, the Independent Forest Products Association and the Northwest Forestry Association were parties of record in the Surface Transportation Board's (STB) recent rulemaking effort on this important matter (STB Ex Parte No. 582 (Sub-No. 1)).

Most of our members rely on railroads to transport a portion of their finished products to market. Some are located where they rely solely on Class 1 railroads for their shipping needs. Others utilize shortlines to connect with Class 1 railroads, while some truck their products to a reload usually located on a Class 1 railroad. On average, transportation costs are between 10 and 25 percent of sales value and are the third highest cost of production. Like coal and grain, the total tonnage of forest products relying on rail is large, however, our industry has many more producers and even more customers receiving the freight. This fact makes our situation somewhat unique and more vulnerable to changes in the railroad structure.

Consequently, any changes in the existing railroad system would have a direct impact on our members businesses and for that reason AFRC has been actively en-

gaged in making certain that our member's concerns regarding the subject of major railroad consolidations and the present and future structure of the North American railroad industry are addressed.

AFRC is generally pleased with the STB's recent issuance of a new merger and consolidations rule since it appears to reflect a major shift from pro-merger regulations to pro-service and competition regulations. We will continue to remain concerned though until the new rule is put to the test in evaluating the next proposed Class 1 railroad merger.

From the beginning of the STB's rulemaking process we have had three major areas of concern, which are: (1) The forest products industry cannot afford any more service disruptions or difficulties like those experienced in the last round of major railroad mergers; (2) Any future changes in the North American railroad structure should result in an increased level of competition among the railroads and not further oligopolistic situations that could negatively affect service levels and rates paid by shippers and; (3) Any changes in the North American railroad structure should be both market and trade neutral.

SERVICE

Historically, our organization and its predecessors have focused its efforts on forest policy and regulatory issues at the Federal level, but in 1997 we became involved with railroad transportation issues due to our member's difficulties resulting from the Union Pacific/Southern Pacific merger. Forest product manufacturers from across the west came to us with horror stories of Union Pacific's failure to provide a reliable means of transporting their products to the marketplace. In response, we worked with our Congressional Delegation and Union Pacific to find a workable solution to this crisis situation. As part of this effort, we responded to the STB's January 13, 1998, Service Order No. 1518, by conducting a survey of forest products manufacturers in Oregon and Washington and reported our findings to the STB.

Even though, the Burlington Northern/Santa Fe's service history is somewhat better than Union Pacific's, our members continue to have problems with consistent and timely door-to-door service. Terminal to terminal transit times have been good and relatively reliable, but getting shipments to and from the terminals continues to be a problem.

These types of service difficulties and disruptions have a direct effect on our members' bottom line. An inability to have a reliable means to transport their goods to the customer means higher costs and/or lost opportunities. Unfortunately, some forest products companies are still recovering from the impact of the last round of railroad mergers. While market share that was lost may return, the financial losses suffered can never be recovered.

Our ability to compete in the forest products marketplace should not be held hostage by incompatible computer systems or labor union conflicts resulting from mergers. Simply put, the forest products industry cannot afford anymore railroad mergers until shippers are receiving an acceptable level of service and are provided a guarantee that includes a form of measurement and remedy to the shippers.

The STB's new rules require railroads that are proposing to merge to address service concerns. The new policy of the STB emphasizes service. Railroads are required to submit a Service Assurance Plan. We applaud this step, but are concerned that when the STB reviews a merger and then conducts oversight, that these plans be binding on the railroads, not something discarded because of changed economics or some oversight on the railroads' part in creating the Plan. We want to avoid service problems resulting from mergers.

Critical elements of the Service Assurance Plan are the problem resolution teams, loss and damage claims handling process, service failure claims process, and alternative rail service options the STB is requiring the railroads to address. The STB should give these items at least as much weight as competitive concerns. Rail mergers should benefit the railroads' customers in addition to their investors. As has been said, poor service hurts present and future business, employees and the investors in the railroads' customers. The STB is seeking to avoid the poor planning and worse execution of the last several rail mergers with these new rules, but it must be vigilant when implementing the rules.

COMPETITION

Since the first crossties and rails were laid on North American soil, people have voiced concerns regarding railroad monopolies and competition. While mergers and consolidations in the business world promote corporate efficiencies, railroads have large fixed capital assets that prevent free market principles from operating ideally. This is one of the main reasons why the Federal Government regulates railroads

and why there is a STB, but more important is that Congress and this subcommittee retain oversight of this critical form of commerce and transportation.

Simply put, AFRC's members are concerned that any additional mergers would lead to less competition among the railroads and result in increased shipping rates. Without competition, the benefits of mergers, such as increased efficiencies, will not occur and in its place will be stagnation, complacency and disrepair. There needs to be a "critical mass" of service providers or there may be a need for some kind of intervention that promotes competition.

We expressed concern during the rulemaking process that the approval of another major Class 1 railroad merger would result in the other major railroads attempting to forge their own deals and win STB approval. This process would ultimately lead to a North American railroad structure with only a couple of transcontinental lines. Shippers would be at the mercy of these oligopolies and ultimately sections of the nation's railroad system could collapse due to competition from transportation alternatives such as trucks, barges and container ships.

The evaluation of proposed mergers must be based on whether they are in the public's interest and not whether they are in the interests of the railroads and their investors. A case in point is the Union Pacific/Southern Pacific merger approved by the STB in 1996. The Southern Pacific was in financial trouble and disrepair. The merger with Union Pacific and the influx of new capital saved the railroad. Therefore this merger benefited the public's interest.

We feel that the STB's new rulemakes a strong effort to this end by requiring the proponents to prove that the merger will result in a financially sound railroad and that competition will not be sacrificed.

A much more detailed and critical look at the resulting financial fitness of a merged railroad appears to be one goal of the STB's new rules. But, the STB and its predecessor required substantial financial information from the applicants under the old rules. However, over the years, the Interstate Commerce Commission and STB got away from making detailed financial analyses and started accepting the railroads' proposals, unless challenged by a party, without a searching and independent analysis. AFRC believes that the STB has an obligation to the American people to conduct an independent analysis of the proposed financial health of every railroad resulting from a merger, regardless of what the hired banking houses from Wall Street have said.

TRADE & MARKET NEUTRALITY

The wood and paper products industry is a highly competitive sector of our nation's economy. Nation-wide there are several thousand producers, with annual sales totaling approximately $200 billion. Products are shipped around the continent and the world, competing with products produced in the consumer's own local area. Therefore, since the forest products industry is so competitive, we cannot afford market externalities such as a railroad merger to affect individual producer's access to markets.

As discussed above, a two transcontinental railroad system could limit which markets producers could sell to. For example: West Coast Company X has been a major supplier to East Coast Retailer A. Retailer A's distribution center is located on Railroad 1, while Company X's manufacturing site is located on Railroad 5. Today, rail shipments are transferred at a point along the Mississippi River. Unfortunately, due to several mergers, Railroads 1 and 5 are now parts of competing trans-continental railroads and Company X looses its cost effective access to Retailer A. Such a scenario would be totally unacceptable to AFRC's members.

Like domestic markets, international trade is another area where railroad mergers could have a significant effect on individual companies' businesses. International trade is an important aspect of our nation's economy. Unfortunately, trade relationships and agreements are usually more political than based in economics and such is the case with forest products. For this reason, the STB should be weary of any decisions that may have international trade implications and that could have negative consequences on domestic producers.

AFRC members feel that any proposed change in the North American railroad structure should be market and trade neutral—that is not benefiting one set of producers over another.

The STB's rules also give it the ability to take a much closer look at the competitive impacts of a railroad merger. In addition to the traditional issues of competing parallel lines and 2-1 shippers, the rules give the STB the leeway to review geographic competition, bottleneck issues, and to enhance competition. AFRC does not read the rules to limit enhanced competition to proposals made by the merging rail-

roads. AFRC believes that the STB does, and must, have the power to enhance competition where justified and necessary.

We applaud the new feature of the STB's rules that require information about restrictions and preferences under foreign law. It goes without saying that there have always been disputes between the timber industries of the United States and Canada. AFRC believes that by requiring and considering this new information the STB will be able to prevent the acquisition of a US railroad to the detriment of its US customers while benefiting their competitors in another country. The STB must be vigilant in this area.

SUMMARY

In conclusion, given the concerns stated above, we believe that the STB's new merger and consolidation rule goes a long way in making the process for evaluating and approving shipper friendly, and thus in the public's interest. While we perceive that the new rule addresses our important concerns regarding service, competition and, market and trade neutrality, we will not know for certain until they are put to a test by the next merger proposal.

Thank you for this opportunity to submit written testimony. AFRC would be glad to assist the Subcommittee in its oversight of this important issue.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR DORGAN TO LINDA MORGAN

Question 1. You indicated in your testimony that the rules for small rail rate cases may still be too complex despite the Board's adoption of simplified rules in 1996, and that you would be willing to work with Congress to address these concerns. Particularly, you have suggested that a single benchmark test or some other simplified procedure for small rate cases might be the way to address those concerns.

Please prepare a list of all of the options you believe Congress could consider that might address these concerns, including specific details regarding how you believe those options could be applied. For example, what kind of test might work; who should qualify; how would a shipper make use of that test; what kind of information would be required; how long would it likely take to process such a case and what kind of expenses might be associated with bringing that case. Also, please give us your thoughts on the use of various forms of arbitration as a means of resolving these concerns.

Answer. As I have testified before, I believe that the Board's small rate case rules are as simple as they can be, given the mandates of the statute. To further simplify our processes, we have excluded product and geographic competition as considerations in market dominance determinations. Yet, I know that certain shipper representatives have said that shippers do not use the rules because of the complexity and cost that they believe might be associated with making a small rate case and defending or challenging the agency's decision in court in such a case. Because I believe that smaller businesses should be assured meaningful access to the regulatory process, I have indicated that I would work with Congress in this regard.

The following are some possible options for handling what some have called "small rate cases" that Congress could consider if it were inclined:

(1) A preset revenue/variable-cost (R/VC) percentage selected by Congress,[1] above which a small shipper rate would be deemed to be unreasonable. This approach would involve system average costs developed through computer programs. A concern about this approach is finding a percentage level that would be satisfactory to shippers without undercutting carrier revenues to a point that would be contrary to the public interest.

(2) A rate cap based on an R/VC percentage applied to similar movements. This approach is intended to deal with disparities in the treatment of different shippers having similar movements. It would require substantial regulatory involvement to resolve issues of comparability.

(3) A rate cap based on some sort of a formula that would attempt to measure a shipper's pro-rata share of the cost to operate a particular railroad and replace that carrier's rail assets. This approach would attempt to ensure that the shipper

---

[1] A bill introduced by Congressman Oberstar (H.R. 141, 107th Cong., 1st Sess. § 103 (2001)), as well as bills introduced last term by Senator Rockefeller (S. 621, 106th Cong., 1st Sess. § 6 (1999)) and Congressman Quinn (H.R. 2784, 106th Cong., 1st Sess. § 6 (1999)), would have effectively capped at 180 percent of variable cost the rates charged to grain shippers that originate or receive no more than 4,000 carloads of grain annually.

is not making too high a contribution to the carrier's revenue needs, but it could run counter to the concept of differential pricing. It could be difficult to find an inexpensive way of developing data under this approach.

(4) A provision permitting small agricultural shippers to "match" contract terms obtained by other (possibly comparable) shippers. Such an approach would apply rates that carriers have themselves set, at least for certain shippers, rather than using a rate cap. But it also could discourage carriers from offering favorable terms to some shippers out of concern that those terms would have to be applied to all.

(5) "Final offer" (baseball-style) or other forms of binding arbitration. The Board can encourage arbitration, but arbitration cannot be mandatory without legislation. With respect to arbitration in general, issues regarding the authority of the arbitrator, the standards to be applied to an arbitration, and the applicability of an arbitral award would need to be resolved.

All of these proposals would need to be more fully explored either by the Board in a rulemaking proceeding, or by Congress through the legislative process, before a full understanding of the pros and cons could be had. And there may be other options that we have not thought of. More details would need to be fleshed out before a firm conclusion could be reached and a comparison made as to the expense and processing time for each option. For any legislative small-rate case relief that the Congress may choose, it would need to carefully identify those small shippers or those types of cases that should qualify for special rate relief. If a carload-per-year standard were chosen, for example, Congress would need to select a reasonable dividing line. Congress would need to examine supporting traffic data at various levels, the amount and type of traffic that would be embraced by the various cutoff figures that could be selected, and the degree of revenue contribution (above variable costs) that this group of traffic now makes.

Question 2. You testified that you believe what shippers want is open access, which you said assumes all shippers would have access to at least two rail carriers which would be permitted to operate on each other's tracks. You also have indicated in the past that the Board's decision in the bottleneck case was driven by the fact that the law does not allow for open access. However, the debate over the bottleneck decision focuses only on whether a shipper should be allowed to get a rate quoted for that portion of track—it does not provide for one railroad operating over another railroad's tracks.

(1) Can you please explain why you believe that allowing rail customers to get a rate quoted to them over a bottleneck portion of a route is open access?

Answer. Open access, as the term is commonly used, can refer to any regulatory regime whereby a railroad is required to share with its competitors traffic that it can handle directly to ensure that a customer has access to at least two carriers. Under existing law, as confirmed by the courts, a railroad that can provide direct service from an origin to a destination generally has the right to its long haul. Requiring a railroad to quote separately chargeable rates for all segments of its lines at which other carriers can interchange with it would be a form of open access because it would also force the carrier to turn over single-line traffic to its competitor at any given junction point.

(2) Please explain why you believe the ICC's Midtec decision—which requires shippers to prove anti-competitive abuse before they can access the pro-competitive terminal area switching provisions allowed for in the law—is still appropriate in today's environment.

Answer. As the courts have held in affirming the MidTec decision and the Interstate Commerce Commission's competitive access rules, the Staggers Rail Act of 1980 was not an open access law. I have testified on many occasions that, if Congress wants to change the law, it of course may do so. At the same time, I believe that the goals of the Staggers Act—eliminating unnecessary regulation and permitting railroads to take efficiency-enhancing actions that permit them to fund needed capital improvements without subjecting captive shippers to unreasonable rates—clearly remain relevant today. And I have expressed concerns about whether it would be a good idea to legislate a system whereby all shippers would be guaranteed that at least two railroads would be able to compete for their business. Although such a system might result in rate reductions for some shippers for the short term, railroads would still need to earn enough to cover all of their costs and to provide both monies and incentive for further investment, and so that approach could end up simply replacing rate regulation with regulation of carrier access fees and other terms (which, in turn, would affect the rates that carriers would need to charge shippers). Moreover, the Board has raised concerns in the past that small shippers particularly in rural areas would not necessarily benefit, in the long run, from such an access-on-demand system, because with less revenues coming into the

system from lower rates the result could well be a smaller, more streamlined rail system serving only larger shippers in heavier traffic lanes.

Question 3. Please describe what rationale the Board used in prescribing trackage rights over approximately 4,000 miles of track in the UP/SP merger, and how the UP and the BN are faring under this system. What were your expectations and is this approach working?

Answer. The Board prescribed trackage rights, into which the Union Pacific (UP) and Burlington Northern Santa Fe (BNSF) railroad systems voluntarily entered, to mitigate the competitive harm that could have resulted from the departure of the Southern Pacific (SP) rail system as an active, independent competitor. The idea was that replacing a weak (indeed, a nearly failing) competitor (SP) with a strong competitor (BNSF) would protect shippers from any potential loss of competition. The trackage rights have been successful, and indeed, in some areas, BNSF has been competing with UP far more vigorously than SP ever could have done.

Question 4. The proposed merger regulations would require applicants to list points where the number of serving railroads would drop from two to one and from three to two, respectively, as a result of the proposed transaction.

(1) Does this mean that the Board will not place an enhanced emphasis on the preservation of three independent rail options for shippers who enjoy three options pre-merger?

Answer. In the decision adopting final rules, the Board addressed the so-called "3-to-2" issue—which has to do with preserving, rather than enhancing, competition—that the agency had discussed in several prior merger proceedings. The Board indicated that it would continue its practice of always preserving 2-railroad competition where feasible, and that it would also continue to review 3-to-2 issues in on a case-by-case basis, but that it would not adopt the suggestion of the Kansas City Southern Railway Company that it should never permit any reduction in the number of railroads serving a particular shipper, regardless of the circumstances.

The proposed merger rules State that future merger applications will have to demonstrate enhancement to competition in order to be found consistent with the public interest.

(2) Given the fact that many markets, large and small are served by only two major independent railroads, does this mean that the Board is concerned that two railroads might not be enough to adequately serve the public?

Answer. No. The Board has found that, where two railroads compete (for example, in handling coal out of the Powder River Basin), competition has been sufficient to spur railroads to continue to seek productivity gains and to pass along the majority of those gains to their customers.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR MCCAIN TO LINDA MORGAN

I commend the Board for initiating its rulemaking proceeding and recognizing the need to reassess its merger guidelines given the restructuring to date by the industry and the expectation that the next merger proposal will likely result in a transcontinental railroad.

Question 1. According to your statement, the Board intends to now "take a more skeptical view of claims of merger benefits". I had been under the impression the Board had always worked to carefully weigh merger benefits as it considered its public interest standards.

(a) Does the Board feel that based on the actual implementation problems associated with recent mergers that it may have been somewhat remiss in its handling of prior merger decisions?

(b) Does the Board feel that carriers have made promises that couldn't be kept just to receive the Board's approval?

Answer. (a) The more skeptical view that the Board will be taking of claimed merger benefits is not based on a conclusion that the Board was remiss in its handling of prior merger decisions. Prior mergers were approved because the agency found that the proposals were in the public interest, and the benefits that were projected—many of which are in fact now being achieved, although in certain cases not as quickly as anticipated—related largely to eliminating excess capacity. The Board's current, more skeptical view of projected benefits reflects our conclusion that much of the excess capacity has already been wrung out of the rail system, and thus we will be requiring other types of benefits such as competitive enhancements. The service problems associated with recent mergers were largely the result of operational integration problems that we hope can be avoided in the future through the submission of service assurance plans and more contingency planning as required

under our new rules, as well as through our oversight process, which has evolved during this last round of rail mergers and has been formalized under our new rules.

(b) Although I cannot speak to the motivation of any particular party, it is possible that expected benefits were oversold for a variety of reasons, some of which could have been related to regulatory approval. Our new rules reflect the need for parties to be more careful in predicting benefits and in making sure that they take the necessary steps and precautions to ensure that the expected benefits materialize.

Question 2. Please describe how the Board intends to interpret its new merger guidelines—how will carriers be held more accountable to their claims of merger benefits, as mentioned in your written testimony?

Answer. The Board will require the carriers to submit service assurance plans that address the service levels to be provided by the merged entity and potential service integration problems, and the agency has in place procedures to provide temporary access to other carriers in cases of severe service problems. Furthermore, because the risks of failure in an "endgame" situation would be high, the Board will require merger applicants to identify specific measures that can be taken in the event that anticipated public benefits should fail to materialize in a timely manner. The Board stated in its decision that if things do not work out (from either a service or a competitive standpoint), carriers should "be prepared to try different approaches," and the Board "would look with more favor on applications that provide back-up or contingency plans when we weigh projected benefits against harms." The new rules are designed to discipline the applicants to project benefits honestly and realistically.

Question 3. There has been much attention to the issue of "enhanced competition." Do the new rules clearly require a merger application to expand competition or can the Board envision that based on particular circumstances that a merger could be approved without increasing competition?

Answer. It is possible that the benefits of a particular merger proposal could be so overwhelming—and the risks to competition and rail service so minimal—that a showing of enhanced rail-to-rail competition would not be required. But at this time, no such proposal comes to mind, and so the practical effect of the new rules is that applicants are fairly warned that they had better show enhanced rail-to-rail competition if they want to have their applications approved, or the Board will use its conditioning power to ensure such enhanced competition.

Question 4. To what extent was the Board unable to address proposals submitted throughout the rulemaking process? Are there particular areas in which the Board did not have statutory authority to include otherwise reasonable proposals?

Answer. The Board addressed all of the concerns raised in one way or another, and it adopted appropriate proposals. It did not adopt all of the proposals submitted—for example, it did not revisit the recent "bottleneck" decisions, and it did not provide for access to additional railroads on demand—given existing law. Whether those proposals that could not be adopted under current law are reasonable depends on what Congress believes the appropriate rail transportation policy to be.

Question 5. By law, merger decisions involving two or more Class I railroads must be determined within 16 months from the date the application is filed. Given the Board believes it has issued much more difficult guidelines, do you foresee any necessity to lengthen the time period under which the Board reviews mergers?

Answer. At this time, I do not foresee any necessity to lengthen the time period under which the Board reviews mergers.

Question 6. Do you envision any future mergers occurring?

Answer. I cannot say. It depends on a variety of factors, such as the economy, and on how carriers, customers, and the financial community view the industry's structure and our new rules.

Question 7. Would any of the mergers approved by the Board in the last 5 years have been precluded if these new rules had been applicable at the time those mergers were submitted?

Answer. I cannot answer that question, as each case is decided on the record made at the agency. The merger proposals that were before the Board in the past 5 years were developed and evaluated on the basis of the rules then in effect. If different rules had been in effect, different presentations would have been made.

Question 8. How do you believe the new mergers rules will affect rail shippers?

Answer. For considering new merger proposals, the new rules focus on enhancing competition, protecting service, and providing accountability for projected benefits. Additionally, I hope that the new rules remind railroads that mergers do not have to be the first choice or the only choice when they are considering ways to strength-

en and improve their networks, and that their main focus should be on effectively and creatively running, day-to-day, the businesses that they now have.

Question 9. When were the rail merger rules last revised? How many consolidations were approved by the Board, and previously, the ICC, under the former rules?

Answer. The last major revisions to the merger rules and policies were issued in 1980 and 1982. The Board and its predecessor, the ICC, approved, with conditions, nine major consolidations under those rules. Those consolidations were: Norfolk & Western/Southern; Union Pacific (UP)/Missouri Pacific/Western Pacific; UP/Missouri-Kansas-Texas; Rio Grande/Southern Pacific (SP); UP/Chicago North Western; Burlington Northern/Santa Fe (BN/SF); UP/SP; CSX/Norfolk Southern/Conrail; and Canadian National/Illinois Central. A tenth, the Soo/Milwaukee, was assessed by the ICC under those rules in an advisory capacity in connection with a bankruptcy court proceeding. And another application involving two large railroads, the SF/SP proposal, was denied.

Question 10. The Board's final rules provide a waiver for the Kansas City Southern Railway Company (KCS) from the application of the new major merger rules. I understand this waiver was not a unanimous decision by the Board—you dissented.

(a) Please offer your perspective on this waiver. I am interested in hearing both perspectives.

(b) I recognize the KCS is a smaller Class I carrier compared to others, but it is nonetheless a Class I carrier. If the specific size of the company is the issue, perhaps a more appropriate route would be for the Board to initiate a proceeding to revisit its classification guidelines. Has the Board considered taking such action and if not, why not?

Answer. (a) I believe that it would have been more appropriate to permit a carrier to seek a waiver from the rules on a case-by-case basis, rather than to assume that one large railroad would not be covered in the first instance. In my view, KCS is strategically situated, and a merger involving KCS could well set off the final round. Therefore, the KCS waiver is, as I see it, inconsistent with the entire thrust of the new rules, which were formulated to address the final round.

(b) In late 2000, the Board initiated a rulemaking proceeding (which has not yet been concluded) to consider requiring consolidated financial reporting by related railroad systems. If such a proposal were adopted, it would potentially give Class I status to more railroads, rather than fewer. I see no reason why the agency would want to make KCS a Class II carrier, and in my view the carrier has presented no such reason other than its desire to be exempted from the merger rules that would apply to mergers that would trigger the final round.

Question 11. Did DOJ or DOT comment on your rulemaking proposal and if so, to what extent do the Board's new merger rules reflect the views of those Departments?

Answer. The Department of Justice did not comment on the proposal. The Department of Transportation filed written comments, but at the oral argument its representative indicated that the agency wished to assume an essentially neutral position at that time principally because there had been a change in Administration.

Question 12. I understand that this week, Senators Rockefeller, Dorgan, and Burns introduced a bill, S. 1103, intended to enhance rail competition. I haven't had the opportunity to study their proposal, and believe it will likely be discussed more at a future hearing. But, I would like to ask you to offer your views on the proposal for the Record.

Answer. Among other things, S. 1103 would overrule the Board's bottleneck decisions to allow rate regulation by segment, and would provide a system in which access through terminal trackage rights and switching is the norm. The bill would eliminate or dramatically reduce the opportunity for carriers to engage in differential pricing, and could have substantial impacts on the extent of rail service and the size of the rail system. In a letter to Senator Specter last year (copy attached), I expressed my concern about the possible effects from changes to the regulatory system such as those intended by S. 1103.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR SPECTER TO LINDA MORGAN

As you requested, I have reviewed the transcript of the hearing held before the Senate Appropriations Committee on September 12, 2000. At the hearing, you asked me whether I support provisions of the bill introduced by Senator Rockefeller. I answered that I could not say, categorically and without reservation, that I support that bill, which calls into question the fundamental tenets of the Staggers Rail Act

of 1980 (Staggers Act). You then asked me to review the hearing transcript, which I received last week, and further explain "the pros and cons, policywise," of requiring rail carriers to open up their lines to their competitors. This letter will amplify the response that I gave in my oral testimony.

The Board's Hearings

In 1998, at the request of Chairman McCain and Subcommittee Chairman Hutchison of the Senate Committee on Commerce, Science, and Transportation, the Surface Transportation Board (Board) held extensive informational hearings on access and competition in the railroad industry. Several parties testified about access, bottleneck relief, and other issues related to competition in the railroad industry. After reviewing the record on the issue, the Board concluded that changing current law and the policy behind the law to ensure that at least two railroads would be available to serve every shipper might, at least for the short term, reduce the rates paid by some shippers; at the same time, it could reduce carrier revenues and cause the carriers to abandon their less profitable traffic over time, which could degrade or cutoff service to smaller shippers and shippers in rural areas. If that occurred, then although cumulative railroad revenues would decline, the rates paid by those shippers that would continue to receive service could actually increase, because the overall traffic base from which costs would be recovered would be reduced. Ultimately, the Board found that "it is quite possible that open access would produce a smaller rail system . . . that would serve fewer and a different mix of customers than are served today . . . ."

Because the Board concluded that only Congress was in a position to determine whether it wanted that type of system—a smaller, more streamlined system that limited output and served a smaller customer base composed mostly of larger shippers in heavier traffic lanes—we did not make a specific recommendation on the open access issue at that time. I followed up with a letter in December 1998 to Chairman McCain and Subcommittee Chairman Hutchison explaining the Board's concerns and position, a copy of which is appended to the written testimony that I submitted for the September 12, 2000 hearing.

My Testimony

At the hearing on September 12, you directed me to answer, yes or no, whether I personally supported opening up access (in particular, by reversing the Board's judicially approved "bottleneck" decisions and by eliminating the current judicially approved requirement that a party seeking competitive access must first show that the existing carrier engaged in some sort of anticompetitive behavior). My response—that I could not answer "yes"—is consistent with past testimony before the Senate Commerce Committee and should be viewed in the context of the Board's decision in the Access and Competition proceeding and the available research on the issue. I am aware that a study commissioned by one of the shipper lobbying groups has concluded that forcing more competition in the railroad industry would actually increase carrier profits and produce across-the-board benefits, but the conclusions of that study are inconsistent with other recent studies of the industry.

Meanwhile, the railroad industry has testified to the adverse consequences to the industry, its customers, and its employees associated with the significant revenue loss that would result from an open access scheme. Additionally, a recent study ("Efficient Access Pricing For Rail Bottlenecks," June 1, 2000) commissioned by the Federal Railroad Administration (FRA) has expressed concerns about the longer-term consequences of some of the proposals to change the approach to rail regulation, and has concluded that forcing down bottleneck rates by, for example, overturning the Board's bottleneck decisions, "may not be taken as an unambiguous good. . . . Lower costs would be effected by reducing quantity or quality of service, or both." And many of those shippers that continued to receive service, the FRA study concluded, would face "upward pressure on the price of rail service." In short, as of this time, a persuasive case has not been made that Senator Rockefeller's bill would produce uniformly positive results.

The General Accounting Office found in a 1999 report that rail rates have declined substantially since passage of the Staggers Act. Nevertheless, certain shippers, at least looking to the short term, have apparently concluded that their rates would drop even further and that service would improve if every shipper were guaranteed service by more than one railroad. I could understand why they might not want to worry about the longer term, and would instead be willing to cross that bridge when they get to it. Notwithstanding any short-term effects, however, I am concerned that over the long-term, adding rail competitors throughout the system could have negative implications on railroads, rail customers, and rail employees

that must at least be fully understood and fully embraced before such changes are made.

Basis For My Position

Of course I understand the benefits of competition as a general matter, and indeed, the Board in revising its merger rules and policies is looking at enhancing competition in the context of new merger applications. And of course I recognize that a lack of competition can bring higher prices to certain consumers, and throughout my tenure at the Board, I have tried hard to assure fair treatment for all segments of the rail transportation community, particularly those with less leverage. But the Staggers Act concluded that, in order for the railroad industry to maintain its infrastructure and remain viable in the private sector, it must be able to recover its high fixed costs by setting rates sufficiently above the incremental or marginal costs associated with providing a particular service. Thus, under the regulatory regime that Congress set up in 1980, some shippers with fewer competitive alternatives must necessarily pay higher prices than other shippers with a greater range of options. More recently, the FRA study concluded that, if that approach to pricing (termed "differential pricing") were altered in order to simulate a competitive market so that railroads could price and produce "at the socially optimal level," the "first-best" solution would be "a subsidy from government," to cover the costs of maintaining the infrastructure, which presumably would then allow railroads to charge rates at or near marginal cost and would thus produce some rates that are lower than what we have today.

Therefore, unless Congress is willing to subsidize the railroad industry in the future to cover a capital shortfall or to ensure the retention of the type of system we have today, or until someone figures out some other way to protect the shippers that could be abandoned under an open access system, I am not prepared to say that I support some of the major regulatory changes that are being discussed, in particular those provisions in Senator Rockefeller's bill that you discussed in the hearing. Of course, if Congress were to conclude that it wanted major changes, the Board would carry out the law as Congress passed it.

I hope that this clarifies my position in accordance with your request.

WRITTEN RESPONSE TO QUESTION SUBMITTED BY SENATOR SMITH TO LINDA MORGAN

Question. Some Oregon rail users, the railroads' customers, today have the option of using more than one railroad to pick up a shipment and deliver it to one of two railroads in the east. If there are two mergers, leaving just two transcontinental railroads, what will happen to the options available to Oregon rail users? What incentive would one merged transcontinental railroad have to keep the gateways open with the other transcontinental railroad? How would the Oregon rail user go about getting a price to transport goods across the country? Would there truly be price competition, or would the railroad that can provide single-line service always quote the lower rate? How do the new merger rules help an Oregon shipper in this situation?

Answer. The new rules require merger applicants to include measures not only to preserve existing competitive options, but also, as part of their showing of merger benefits, to demonstrate ways in which new proposals will indeed enhance existing competitive options. Carriers could meet this burden by, for example, maintaining existing gateways, preserving opportunities to challenge "segment" rates in "bottleneck" situations, and by providing trackage rights or other access to other rail carriers, or eliminating "paper barriers" to interchange by shortline carriers. In the absence of a specific application, it is impossible to know how a particular proposal would affect particular shippers. Because a new merger proposal would not likely be approved without competitive enhancements, however, any new proposals that are submitted should provide substantial competitive benefits for shippers overall.

The addition of new competitive options should translate into lower rates, even if a shipper does not have direct access to two transcontinental railroads. I could not know the specific rates that particular carriers or combinations of carriers would quote. But in general terms, single-line service from origin to destination should be more efficient, and the savings should be passed on to the shipper because the shipper can threaten to use, and can indeed use, the new competitive options to which the merged carrier would agree in order to secure merger approval.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR ROCKEFELLER TO LINDA MORGAN

Question 1. As a very general matter, can you: (A) Explain to the Subcommittee what you see as STB's primary role in terms of its oversight of the freight railroad industry; and (B) Explain the statutory authority for the Board's position?

Answer. In general terms, the Board's role in overseeing the freight railroad industry is to balance the variety of policy objectives identified in the Rail Transportation Policy of 49 U.S.C. 10101. Those policies, which the courts have described as sometimes competing and conflicting, require the agency, among other things, to look at competitive issues, service, rate levels, the health of the industry, and employee issues, and to do that in a way that minimizes regulation and Federal involvement in the operations of the private sector.

Question 2. During your tenure as Chairman: (A) How do you believe the Board has carried out this primary role; and (B) What decision or decisions best demonstrate the Board's understanding of its oversight responsibilities?

Answer. As reflected in its impressive record in court, the Board has carried out this role in an appropriately balanced and effective way. We have balanced the interests of all of the stakeholders in a way that has given effect to each of the RTP objectives and that has advanced the public interest by providing for a rail system able to meet the needs of not just a particular group of shippers, but of the shipping public overall. In the "bottleneck" cases, for example, the two reviewing courts found that we had construed the statute properly when we provided new opportunities for shippers to challenge bottleneck rates while maintaining the ability of originating rail carriers to set rates and routes in the first instance. In various rate cases, we have protected captive shippers from paying unreasonable high rates, and we have changed the "market dominance" rules so as to enhance access to the regulatory system. In our merger decisions, we have allowed market efficiencies but have ensured that no shipper that had two rail service options before a merger has been left with just one option as a result of the merger. And our new major rail merger rules reflect changed circumstances in accordance with our statute.

The rail industry did, of course, experience severe service problems in recent years as a result of merger operational integration difficulties. But these problems were not products of the way in which the Board carried out its statutory mission, and indeed, the Board's responses to the service problems reflect the agency's understanding of its oversight responsibilities. In addressing the service crisis in the West, for example, the Board, recognizing the interdependence of the rail network, knew that a regulatory edict from the Federal Government would not make the trains run more smoothly or more quickly but rather could have the opposite effect by interfering with the marketplace in such a way as to cause further harm to shippers. During the crisis, the Board acted to ensure that all shippers were treated fairly and that one shipper group could not exploit the situation to the detriment of others. And while the Board did not use a suggested "open access" solution that the agency believed might aggravate rather than fix the problem, it did provide for cooperation among the involved carriers and other affected parties, altered the service through the Houston area on a temporary basis, directed on a permanent basis a clear route through the Houston area, ordered the filing of a plan for improving the infrastructure in Houston, and gave effect to the "joint dispatching" that helped relieve congestion in the Houston area and has since been used successfully to address operational issues elsewhere in the rail system.

Question 3. Recently, the STB issued a decision that suggested the Board should streamline its own procedures, including filing requirements, for stand-alone cost cases. Apparently, the Board believes staffing constraints are making it difficult for the Board to meet the demands of its current caseload. However, the President's budget request for the Board is $18.457 million (essentially the same as fiscal year 2001, adjusted for inflation and pay raises). How would you comment on how the Board plans to carry out its responsibilities under these tight budgetary constraints, including how the Board will carry out any proposed regulatory changes that might result from the current merger procedures rulemaking?

Answer. In various Congressional hearings over the past several years, I have been asked whether the Board needs more resources, and how I would use them if we had them. My answers have been consistent: the workload is heavy, and if Congress were inclined to give the agency more resources, I would have no trouble deploying them. In the meantime, we will continue to work efficiently and productively with the resources we have. Because we are always looking for ways to be more efficient and productive, when we noticed a sharp increase in rate filings over the past several months—a workload that is a challenge regardless of agency staffing levels—we issued the recent order modifying, in a focused way, some of the pro-

cedures in stand-alone cost cases. We will continue to review our caseload and our processes and make any adjustments that we believe will improve the decisional process. At this time, I do not believe that the new merger rules present any new or unique resource challenges that the Board has not already faced in implementing its responsibilities.

Question 4. How might the Subcommittee expect STB procedures to change if staffing levels were improved to more reasonably reflect the Board's caseload?

Answer. As we are always looking to streamline and improve our processes and to expedite our decisional response time, I do not believe that increased staffing levels would produce a major change in how we approach the handling of our work.

Question 5. Regarding the merger rulemaking, and the moratorium on rail mergers that preceded it, I believe it gave all those of us concerned with the current State of the freight rail industry a welcome pause to consider what should be done to create a system that better addresses the legitimate goals of financially viable railroads and a truly competitive rail environment. In light of the Board's hesitance to act in the past without explicit authorization of Congress, how would the Board explain to the Subcommittee the authority by which it acted on the moratorium?

Answer. The Board imposed the merger moratorium because it concluded that the old merger rules were not appropriate for reviewing the final round of mergers, and that a moratorium was necessary to prevent the final round from beginning before the new rules were in place. The Board believed that its moratorium had a good chance of surviving judicial review because it did not contravene any substantive statutory provision or any recent court decision. As the reviewing court found in denying the petitions for review of the Board's action, in light of its express authority to review rail mergers, the agency has implied authority to put a temporary hold on further mergers when warranted to realize the broader goals of the statute.

Question 6. Assuming for the sake of this inquiry that the STB's authority to call the moratorium was properly exercised, do you believe the Board is empowered also to review, and possibly reverse, its earlier decisions?

Answer. As the reviewing court found, the Board did indeed act properly in imposing the moratorium under the particular circumstances prevailing at the time. The finding that an agency has implied authority to take actions necessary to effectuate its express authority, however, does not mean that there are no limits on how an agency interprets its governing statute. An agency can, of course, change its view, particularly on questions of policy. But where a particular statute has been expressly construed in court in affirming a prior agency decision—for example, where the D.C. Circuit specifically found that the Interstate Commerce Act is not an "open access" statute—the agency would have a hard time supporting in court a decision reversing that particular prior precedent. Or, where an agency's very recent decisions interpreting a particular statute have been found on judicial review to reflect the proper balancing of the various competing statutory policy objectives (as in the case of the bottleneck decisions), it would be difficult for the agency to sustain a new decision finding that the statute should be interpreted differently.

Question 7. If so, what if any decisions would the current Board revisit, and on what grounds?

Answer. As the various examples I have cited indicate, the Board revisits prior actions when it believes it is appropriate to do so. The new merger rules are a recent example of a situation in which the agency revisited prior precedent and made major changes in how the statute is administered in a way that will likely be defensible in court. The Board will continue to revisit prior actions where appropriate.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR MCCAIN TO WILLIAM CLYBURN, JR.

Question 1. Please describe how the Board intends to interpret its new merger guidelines. How will carriers be held more accountable to their claims of merger benefits?

Answer. The new rules were intended to be interpreted to provide all transportation stakeholders, including rail carriers, rail customers, consumers, and public entities with a more comprehensive application process to help ensure that the benefits projected in a future merger application are reconciled with the benefits actually realized shortly after that merger is consummated.

The Board has consistently stated that these rules represent a significant change in direction from our previous rules. When the Staggers Rail Act of 1980 was passed, the railroads were experiencing excess capacity and the merger rules helped promote rationalization. Today, excess capacity is not the major issue—lack of competition and transitional service problems resulting from prior mergers are the fore-

most concerns facing transportation stakeholders. Accordingly, the Board intends to view any future mergers with those issues in mind and hold applicants to a heightened scrutiny in proving that an application is beneficial to competition and that any potential service problems are properly addressed.

Applicants will have additional issues to address and higher expectations to meet. For example, the applicants should include provisions for enhanced competition to help ensure protection of the public interest. Applicants are required to make a good-faith effort to accurately calculate the net public benefits of their proposed merger, so the Board expects the application to include additional recommendations if the projected net public benefits fail to materialize in a timely fashion. The Board also will hold applicants accountable if they fail to act reasonably to achieve promised benefits when actual circumstances are different than those projected. 49 CFR § 180.1(c)(1). Applicants must propose remedies to mitigate and offset competitive harms, including measures to preserve existing gateways, build-outs and build-ins, and shippers' opportunity to challenge bottleneck rates. 49 CFR § 1180.1(c)(2)(i). The Board will require applicants to provide a detailed service assurance plan (see 49 CFR § 1180.1 (c)(2)(iii)) and are expected to explain how their transaction and conditions they propose would enhance competition (49 CFR § 1180.1(c)(2)(iv)). Applicants will be required to work with the Federal Railroad Administration to formulate and then submit a Safety Integration Plan to ensure that safe operations are maintained. 49 CFR § 1180.1(f)(3). Applicants also must provide evidence to the Board, for at least the first 5 years (on no less than an annual basis) following approval, to show that the merger conditions imposed by the Board are working as intended, that applicants are adhering to representations made, that no unforeseen harms have arisen necessitating the alteration or imposition of new conditions, and that the merger benefits projections are being realized in a timely fashion. 49 CFR § 1180.1(g). In addition, the rules encourage applicants and rail labor to enter into early negotiated implementing agreements and discourages management requests to override collective bargaining agreements 49 CFR § 1180.1(e).

Question 2. There has been much attention to the issue of "enhanced competition." Do the new rules clearly require a merger application to expand competition or can the Board envision that based on particular circumstances that a merger could be approved without increasing competition?

Answer. Without prejudging the facts and circumstances of a specific merger proposal, theoretically a major merger proposal could involve a fact pattern where the competitive harm is so minimal as to not necessitate enhanced competitive access to ameliorate or offset those harms. The rules were promulgated for the express purpose of helping to ensure that if there is another major merger, the applicants provide the Board with the requisite information to address the increased concerns that transportation stakeholders have with additional mergers in an already highly consolidated industry.

The Board, after obtaining testimony in hearings and oral arguments and in several rounds of written filings, has determined that while mergers can be beneficial, there may be competitive harms that result that cannot be mitigated by conditions. In such circumstances, the new rules require applicants to provide a plan for enhancing competition. It is clear that a filing absent such a plan would be less likely to be approved by the Board.

Question 3. To what extent was the Board unable to address proposals submitted throughout the rulemaking process? Are there particular areas in which the Board did not have statutory authority to include otherwise reasonable proposals?

Answer. There were some proposals submitted that arguably exceeded the parameters of our merger review. For example, there were recommendations for forms of competitive access and open access; imposition of conditions on non-applicants; removal of contractual agreements; changes to the Board's procedures regarding resolution of rate disputes which probably exceed the Board's statutory authority. While many debate how far the Board can go in terms of rail-to-rail competition or how feasible certain Board actions would be, the Board attempted to balance the need for rail customers to have reliable service at reasonable rates, and fair treatment of labor, with the need for rail carriers to be financially viable.

Question 4. By law, merger decisions involving two or more Class I railroads must be determined within 16 months from the date the application is filed. Given the Board believes it has issued much more difficult guidelines, do you foresee any necessity to lengthen the time period under which the Board reviews mergers?

Answer. As long as the Board has the necessary resources in terms of budget and skilled personnel, the Board should be able to maintain its record with respect to consistently issuing decisions in a timely manner.

Question 5. Do you envision any future mergers occurring?

Answer. I don't know whether additional major mergers will take place in the near future. The import of these new merger rules is to address the concern of the impact on our national transportation network of an additional major merger in an industry that has gone from 30 independent Class I railroads in 1976 to arguably 7 independent Class I railroads today.

Question 6. How do you believe the new merger rules will affect rail shippers?

Answer. I believe the new merger rules will give shippers more information during the application process with which to respond regarding the benefits of a major merger proposal. The rules also provide for additional safeguards such as enhanced competition proposals, a service assurance plan, and higher accountability requirements to address harms and contingency measures. With the higher thresholds applicants must cross, railroads must think long and hard whether there are possibilities short of a merger which can accomplish their goals, and before an application is approved the heightened concerns of today's transportation stakeholders must be addressed.

Question 7. When were the rail merger rules last revised? How many consolidations were approved by the Board, and previously, the ICC, under the former rules? What are the benefits of the new merger rules?

Answer. The merger rules were revised in Ex Parte No. 282 (Sub-No. 3), *Railroad Consolidation Procedures*, 363 I.C.C. 200 (1980) (decided August 8, 1980 and published on September 23, 1980, at 45 *FR* 62991). In addition, they were revised again to address the Board's exemption procedures in a decision printed at 366 I.C.C. 75 (1982) (decided February 19, 1982, and published on March 8, 1982 at 47 *FR* 9844. Nine major consolidations were approved under the former rules: Norfolk & Western/Southern; Union Pacific/Missouri Pacific/Western Pacific; Union Pacific/Missouri-Kansas-Texas Railroad Company; Denver and Rio Grande/Southern Pacific; Union Pacific/Chicago and Northwestern; Burlington Northern/Santa Fe; Union Pacific/Southern Pacific; CSX/Norfolk Southern/Conrail; and Canadian National/Illinois Central. Also, the ICC assessed the Soo Line/Milwaukee Road in an advisory capacity in connection with a bankruptcy proceeding and denied the Santa Fe/Southern Pacific proposal. The benefits of the new rules are that they address the needs of the public as they exist today, not 20 years ago. Accordingly, increased competition and accountability are stressed.

Question 8. The Board's final rules provide a waiver for the Kansas City Southern Railway Company (KCS) from the application of the new major rail merger rules. I understand this waiver was not a unanimous decision by the Board—Chairman Morgan dissented. (a) Would you please offer your perspective on this waiver; (b) I recognize the KCS is a smaller Class I carrier compared to others, but it is nonetheless a Class I carrier. If the specific size of the company is the issue, perhaps a more appropriate route would be for the Board to initiate a proceeding to revisit its classification guidelines. Has the Board considered taking such action and if not, why not?

Answer. The idea of treating KCS in a manner different from the other Class I railroads was initially sought by KCS itself. KCS has argued that any merger between itself and another Class I would not affect the national transportation system in the same manner as would a merger between two of the large Class I railroads. In considering this request, the Board considered the original purpose of our review of the old merger rules and recognized the unique status of KCS in the realm of Class I carriers.

Following the December 20, 1999 notice of intent to file the proposed merger between the Burlington Northern Santa Fe and the Canadian National, the Board, in a decision served January 24, 2000, instituted a proceeding in STB Ex Parte No. 582, *Public Views on Major Rail Consolidations*, to conduct public hearings on the possible repercussions of such a merger which many believed would lead to a final round of mergers eventually leaving only two transcontinental railroads. After those hearings, by decision in Ex Parte No. 582, served March 17, 2000 (the decision whereby the Board initiated its 15-month moratorium on major mergers), the Board recognized that only 6 large railroads remain in the United States and Canada—Burlington Northern Santa Fe (BNSF), Union Pacific (UP), CSX Transportation, Inc., Norfolk Southern Railway Company, Canadian National Railway Company (CN), and Canadian Pacific Railway Company (CP). KCS was not included.

It was recognized that two smaller Class I railroads, Grand Trunk Western Railroad Incorporated and Illinois Central Railroad Company, are affiliated with CN and that a third smaller Class I, Soo Line Railroad Company, is affiliated with CP. Finally, the Board stated that KCS was also a smaller Class I but was an independent entity. While technically meeting the revenue requirements to be classified as a Class I (annual operating revenues of over $250 million), KCS is much smaller than the other large railroads in revenue and miles of road operated. KCS had oper-

ating revenues of approximately $522 million in 2000 and operated over 2,756 miles of road. By comparison, in the same year BNSF had operating revenues of approximately $9.2 billion and operated over 33,262 miles of road and UP had operating revenues of approximately $10.5 billion and operated over 33,341 miles of road. In fact, KCS is closer to the size of Wisconsin Central Limited (WC) (operating revenues of about $281 million in 1999) than the large railroads. Additionally, WC's proposed merger with Canadian National was deemed by the Board not to be a major transaction or a significant transaction, but a minor transaction—the least rigorous category. Accordingly, a majority of the Board was persuaded that KCS should be treated in a manner similar to WC.

However, I was not fully persuaded by the KCS arguments. KCS sought a revision of the proposed rules to have the Board consider a merger involving a carrier with revenues of less than $1 billion to be considered as a significant transaction (involving lesser evidentiary requirements) rather than as a major transaction as mergers involving Class I railroads usually are handled. I did not see the basis for the presumably arbitrary $1 billion threshold. Also, by including such a high threshold and considering that KCS' proposal was framed in terms of Class I railroads, the Board would have to treat any major merger involving CN or CP as only a significant transaction, since they are Canadian carriers and technically not Class I railroads. (Our jurisdiction over a merger proceeding involving those carriers is dependent on our jurisdiction over their U.S. affiliates which are now Class I railroads but would also fall below that threshold under KCS' recommendation). In addition, the statute in 49 U.S.C. 11324(b) requires the Board to consider certain factors when reviewing a merger involving two Class I railroads. If such a transaction were considered a significant transaction rather than a major transaction some of these factors may not be considered, and therefore arguably run contrary to the statute. For these reasons, the Board did not incorporate a proceeding changing the classification threshold.

KCS is a Class I carrier but as stated in 49 CFR 1201 (the Board's regulations defining the classes of carriers) those classifications are made for purposes of accounting and reporting. Class I railroads are required to file annual and quarterly financial report—s as well as other operational reports to the Board. The idea of classifications is to reduce the burden on smaller carriers. As a result of the Staggers Rail Act of 1980, the Interstate Commerce Commission (ICC) eliminated the reporting requirements for Class II and Class III carriers. Thus, although KCS is classified as a Class I carrier for accounting and reporting purposes, it is reasonable to consider the limited impact of KCS on the national transportation network as compared to the large railroads.

The procedure the Board has authorized is actually more stringent than that proposed by KCS (to be deemed a *significant* transaction) because any merger involving KCS and another Class I railroad will be considered a *major* transaction under the old rules and the factors listed in section 11324(b) will be considered. Finally, it must be pointed out that this waiver is not an outright exemption but a rebuttable presumption. If interested parties have concerns about a merger application involving KCS and another Class I, they will have an opportunity to file those concerns. If the Board determines that the rebuttable presumption is met, it would evaluate the proposal under the new rules, just like a merger with a large railroad. The Board will be involved at every stage to help protect the public interest.

Question 9. Did DOT or DOJ comment on the STB's rulemaking proposal and if so, to what extent do the Board's new merger rules reflect the views of those Departments?

Answer. DOJ did not file any comments in this proceeding. While DOT did participate in all phases of the proceeding, DOT's representative, at the oral argument in this proceeding held on April 5, 2001, testified that because of leadership changes, DOT, except for a few specific issues, could neither support nor oppose the positions it had taken in its previously filed written comments. DOT stated it agrees with the Board's imposition of the 15-month moratorium. DOT also supports the Board's development of new standards to evaluate Class I mergers which take into consideration the impact of those standards on all interested parties in the transportation community.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR MCCAIN TO WAYNE O. BURKES

Question 1. Please describe how the Board intends to interpret its new merger guidelines. How will carriers be held more accountable to their claims of merger benefits?

Answer. The new merger rules impose many specific requirements on future merger applicants, which should not be subject to much interpretation by the Board. For example, the new rules establish detailed procedures that must be followed and list specific information requirements that must be submitted by future applicants.

The major area in the new rules that could be subject to Board interpretation is in the area of preserving and enhancing competition. The new rules do not specifically require the applicants to preserve the existing level of rail to rail competition nor do they define what the Board will consider when determining whether a particular transaction enhances competition. There are many ways to enhance competition and our new rules leave it to the applicants to propose such enhancements. The decision (but not the new rules) states that enhanced competition "*could be*" the enhancement of "intramodal" or rail-to-rail competition, such as the establishment of shared access areas, the granting of trackage rights, the removal of so-called "paper barriers" and other approaches. However, enhanced competition also "could be" the enhancement of "intermodal" competition (e.g. rail-truck or rail-barge competition) or some other type of competition that may not even be related to transportation.

The decision leaves it to the Board's discretion as to what constitutes enhanced competition. It is my hope that future railroad merger applicants will not only preserve the existing level of rail-to-rail competition, but also focus on enhancing rail-to-rail competition.

In terms of holding the railroads more accountable to their claims of merger benefits, the new rules require the applicants to identify additional measures or contingency plans that would be used in the event anticipated public benefits should fail to materialize in a timely manner. These additional measures were designed as a regulatory mechanism that should encourage applicants to carefully consider and to limit the exaggeration of potential benefits and, at the same time, provide a possible solution to problems if and when they might arise.

Question 2. There has been much attention to the issue of "enhanced competition." Do the new rules clearly require a merger application to expand competition or can the Board envision that based on particular circumstances that a merger could be approved without increasing competition?

The changes to the Board's major railroad consolidation rules and procedures set forth in our decision correctly shift the focus away from a policy that encouraged mergers to one that raises the threshold for approving a new merger, including considerations of enhanced.competition. However, Class I railroads will not be specifically "required" to include provisions to enhance competition. Enhanced competition is an encouraged goal rather than a mandated standard.

I am not in favor of a mandated enhanced competition standard, absent a definition of that term in the rules. As previously stated, the new rules do not define enhanced competition. If we are to impose an enhanced competition standard, future merger applicants should know what steps they need to take to meet that standard and shippers should know what to expect.

Nonetheless, I do not believe that a future merger will be approved unless it contains elements that increase competition. It is my hope that the Board will closely scrutinize future applications and use its conditioning power, if necessary, to preserve and enhance competition in a way that promotes a competitive and healthy railroad system.

Question 3. To what extent was the Board unable to address proposals submitted throughout the rulemaking process? Are there particular areas in which the Board did not have statutory authority to include otherwise reasonable proposals?

I believe that the Board carefully evaluated and addressed all proposals submitted during the rulemaking process. A few parties commented that the Board should condition every future major railroad transaction in a way that would allow any shipper to request its serving carrier, whether or not that particular carrier was involved in the transaction, to allow a second carrier to use the incumbent carrier's facilities in order to provide competitive rail service. I do not think the Board would have statutory authority to enforce such an open access proposal.

Question 4. By law, merger decisions involving two or more Class I railroads must be determined within 16 months from the date the application was filed. Given the Board believes it has issued much more difficult guidelines, do you foresee any necessity to lengthen the time period under which the Board reviews mergers?

Answer. I do not foresee any necessity to lengthen the time period under which the Board reviews mergers.I should note the new rules require a substantial amount of planning by future merger applicants, e.g., the service assurance plan, which will require a substantial amount of work by the future applicants prior to the submission of the application and, therefore, should not adversely affect our timetable.

Question 5. Do you envision any future mergers occurring?

Answer. There are currently seven (7) Class I railroads. Therefore, there remain twenty-one (21) possible merger combinations, some of which are more likely than others. For example, it is very unlikely that the two eastern (i.e., CSX and NS) or the two western carriers (i.e., UP and BNSF) would attempt mergers. I do not envision any more mergers in the near future, but would expect another merger in the next two to 5 years.

Question 6. How do you believe the new merger rules will affect rail shippers?

Answer. Shippers, of course, will not be directly affected by the new merger rules until a merger is proposed and the rules are implemented. However, I believe that rail shippers did benefit from the Board's moratorium and rulemaking, which helped stabilize the railroad industry.

The primary benefit, in my opinion, is that new rules encourage the enhancement of competition, whereas the former old rules actually encouraged railroad mergers. For example, the former rules encouraged private transactions that lead to "rationalization of the nation's rail facilities and reduction of its excess capacity." Conversely, the Board's new rules encourage the enhancement of competition. The new rules substantially increase the burden on applicants to demonstrate that a proposed transaction would be in the public interest, by requiring them, among other things, to demonstrate that the transaction would enhance competition where necessary to offset negative effects of the merger, such as competitive harm or service disruptions.

I should note that rail shippers could benefit from future railroad mergers, under the new or former rules. Single-line, transcontinental rail service could substantially reduce transit and cycle times for certain shippers, which would reduce equipment and inventory costs. For example, I understand that it currently takes approximately 30 hours to move railroad traffic through the congested Chicago area. Mergers could substantially reduce this time and congestion, which would benefit shippers.

However, the benefits from future mergers may be very limited and competitive harms may be difficult to remedy. Consequently, mergers could also harm some shippers. There is a substantial amount of overlap between the remaining large Class I carriers. As a result, rail shippers could lose the benefits of direct competition and indirect competition. Hopefully, the Board, as it has in past mergers, will continue to strive to remedy direct competitive harm and other competitive harms would be offset by competitive enhancements.

Question 7. When were the rail merger rules last revised? How many consolidations were approved by the Board, and previously, the ICC, under the former rules? What are the benefits of the new merger rules?

Answer. The railroad merger rules were last revised by the Interstate Commerce Commission (ICC) in 1980 and 1982 in Ex Parte No. 282 (Sub-No. 3), *Railroad Consolidation Procedures*. Major revisions to the merger rules were issued in a decision in this proceeding decided August 8, 1980, printed at 363 I.C.C. 200 (1980) and published on September 23, 1980, at 45 FR 62991. Major revisions addressing the exemption procedures were issued in a subsequent decision decided February 19, 1982, printed at 366 I.C.C. 75 (1982) and published on March 8, 1982 at 47 FR 9844.

A review by Board staff indicates that there were nine (9) Class I railroad consolidations approved, with conditions, by the ICC/STB under the former rules. There was only one (1) Class I railroad merger that was denied by the ICC/STB during this period. It should be noted that ICC assessed another Class I merger in an advisory capacity connected with a bankruptcy proceeding.

It should also be noted that there were many other railroad consolidations and transactions approved by the ICC/STB during this period, however, these did not involve two (2) Class I railroads and, therefore, were not classified as "major" transactions. These consolidations or transactions were classified as either significant, minor or exempt transactions. The rules regarding these transactions were not specifically addressed or significantly changed by the Board's most recent rulemaking, which focused on major transactions.

In terms of the benefits of the new rules, see my response to Question No. 6.

Question 8. The Board's final rules provide a waiver for Kansas City Southern Railway Company (KCS) from the application of the new major rail merger rules. I understand this waiver was not a unanimous decision by the Board—Chairman Morgan dissented. (a) Would you please offer your perspective on this waiver? (b) I recognize the KCS is a smaller Class I carrier compared to the others, but it is nonetheless a Class I carrier. If the specific size of the company is the issue, perhaps a more appropriate route would be for the Board to initiate a proceeding to revisit its classification guidelines. Has the Board considered taking such action and if not, why not?

Answer (a). Our rules establish four criteria for reviewing railroad mergers: major, significant, minor, and exempt. The size of the carrier and the type of transaction determines which category the merger fits into and what burdens such railroad applicants must meet for their merger to be approved. The standards for a "significant" transaction are less rigorous than the rules for a "major" transaction and the time period to review such "significant" transactions is almost half of that for "major" transactions. The new rules focused on "major" transactions and changed what would be required of merger applicants in such "major" transactions.

During the entirety of this proceeding, KCS requested that the definition of "major" merger transaction be limited to include only Class I railroads that had annual operating revenues in excess of $1 billion per year and that any merger involving a Class I railroad under that threshold be treated as a "significant" transaction rather than a "major" transaction. In addition, KCS asked that if it was involved in a hostile transaction it would like to be treated under the "major" rules. KCS asked for this differential treatment throughout the entire 15-month process and other parties provided comments both in support and opposition of the proposed rule.

In merger proceedings, the ICC and the STB have a long history of treating railroads differently based upon their size. In reviewing the record in this proceeding, I determined to continue that tradition and suggested we adopt the rule requested by KCS. The final rule adopted by the majority of the Board, however, decided to treat a merger with KCS as a "major" transaction, but applied the old rules for such "major" transactions involving KCS rather than the new rules. It should be noted that, in adopting this rule, the Board actually imposed a higher burden on KCS than that requested by KCS, although not as high a burden as imposed on the other Class I carriers, which are substantially larger than KCS. Future transactions involving other Class I carriers must comply with the new rules for "major" transactions.

Answer (b). The current rules regarding the classification of railroads are set forth in 49 § 1201, General Instructions 1-1. These rules were last revised by the ICC in 1992 in Ex Parte No. 492, *Montana Rail Link, Inc. and Wisconsin Central Ltd., Joint Petition For Rulemaking with Respect to 49 C.F.R. Part 1201*, served June 17, 1992. In that rulemaking, the ICC raised the revenue threshold for Class I carriers status from $50 million (1978 dollars) to $250 million (1991 dollars). Under the current standards and indexed to a current level, carriers having annual operating revenue of $261.9 million or more are considered Class I carriers. Class II carriers are those with revenues from $31.4 million to $261.9 million in revenue. Class III carriers have revenues less than $31.4 million.

It may be time to revisit the classification standards. On November 14, 2000, Wisconsin Central (WC) petitioned the STB to open a proceeding to consider amending the rail carrier classification regulations. WC suggested that the threshold for Class I carriers should be adjusted upward to $500 million dollars. KCS filed in support of the WC's request to open a proceeding and urged the Board to reevaluate the threshold classifications between carriers. To date, the Board has not acted on WC's request.

Question 9. Did DOT or DOJ comment on the STB's rulemaking proposal and, if so, to what extent do the Board's new merger rules reflect the views of those Departments?

Answer. The Department of Transportation (DOT) submitted comments in our rulemaking, but the Department of Justice (DOJ) did not submit comments. In addition to DOT, the Department of Agriculture (DOA) and the Department of Defense (DOD) submitted comments.

In remarks at the oral argument held in the rulemaking proceeding on April 5, 2001, DOT indicated that, because its leadership had "changed significantly" after the filing of DOT's written comments, DOT could neither support or oppose positions it had taken in written comments.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR JOHN MCCAIN TO JOHN W. SNOW

Question 1. If the STB had not initiated a moratorium on mergers and rewritten the rules on major rail mergers, do you believe the Board would already be facing the final round of mergers?

Answer. Yes. The proposed merger that precipitated Ex Parte 582 would have significantly altered the competitive environment. Had the STB not initiated the moratorium, the remaining major roads likely would have put forward their own respon-

sive merger proposals, leading to the premature and final restructuring of the nation's rail network.

Question 2. Do you believe the new merger rules will lead to any merger approvals in the next 5 years? When do you think we can expect to see movement by any carriers in an attempt to consolidate?

Answer. I do not anticipate any major merger proposal being submitted to the Surface Transportation Board (STB) in the next 5 years. I believe future merger proposals will emerge only when rail customers support and have faith that the new carrier's expanded single line system service will achieve the benefits anticipated from the merger in an efficient, timely manner.

Question 3. Based on your experience, do you think it will be possible to complete a major rail merger under the new rules?

Answer. The Board has appropriately raised the bar on future mergers. While overall I believe the requirements under the new rules are achievable and do not represent an insurmountable barrier to future consolidations, there are more risks. For example, future Boards might seek to impose conditions that appear pro-competitive but actually limit the merged carrier's ability to foster single system service enhancements that produce the economic efficiencies which are shared with the shipper community. In addition, the new rules impose on railroads seeking mergers additional costs, including more analysis and planning on top of an already strenuous process.

RESPONSE TO WRITTEN QUESTION SUBMITTED BY SENATOR GORDON SMITH TO JOHN W. SNOW

Question 1. Some Oregon rail users, the railroads' customers, today have the option of using more than one railroad to pick up a shipment and deliver it to one of two railroads in the east. If there are two mergers, leaving just two transcontinental railroads, what will happen to the options available to Oregon rail users? What incentive would one merged transcontinental railroad have to keep the gateways open with the other transcontinental railroad? How would the Oregon rail user go about getting a price to transport its goods across the country? Would there truly be price competition, or would the railroad that can provide single-line service always quote the lower rate? How do the new merger rules help an Oregon shipper in this situation?

Answer. It is customary in the rail system for competing carriers to maintain longstanding joint line routes. The STB in its new rules requires merging carriers to explain how they will ensure that customers will continue to have available for some time existing routings through major gateways.

Some customers prefer to separately negotiate with each carrier that may be involved in a joint line movement; other shippers prefer to negotiate a through (or single) rate with their originating or terminating carrier. I anticipate that those options will still be available.

By and large, rail prices today are set by the marketplace with truck competition a key factor in the development of rate and service packages. In the past, expanded single system service has permitted merging carriers to operate more efficiently and economically, to reduce rates and to compete more effectively with the much larger trucking industry.

The new merger rules require development of extensive service plans designed to ensure that disruption experienced during implementation of recent consolidations does not occur in future transactions. The rules also impose a higher standard of proof of anticipated benefits. By meeting these thresholds, shippers in Oregon and elsewhere will be able to receive the benefits of single line service and pricing without facing major disruptions in operations.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR MCCAIN TO PAUL M. TELLIER

Question 1. In your testimony, you point out that you are pleased that the final rules provide equal treatment for both domestic and internationally headquartered railroads and that you believe that, if properly implemented, the rail industry can operate effectively. However, you also stated that, "we may not agree with all aspects of the new merger rules."

Question (a). Can you inform the Committee about the areas you still have concern with and why?

Answer. Throughout the course of the deliberations of the Surface Transportation Board (STB) on its new merger rules, our concerns focused on four major issues

First, we were very concerned about the Board's proposed requirements related to transnational mergers, which would have required foreign applicants to meet a greater evidentiary burden than domestic carriers as part of the initial merger application. In the final rules, however, the Board states that it will apply higher public interest standards for mergers equally to all applicants—both domestic U.S. companies and foreign-headquartered corporations.

Second, CN has urged that efforts to enhance competition as part of a rail merger not be used as a means to artificially introduce competition where no competitive problems exist. In our view, conditions related to competition should focus on remedying competitive harms that may arise from a merger so that a transaction will be consistent with the public interest. The Board's final rules have allayed some of our concerns by clarifying that applicants would be required to demonstrate that a proposed transaction would enhance competition where necessary to offset merger-related harms that cannot be directly or effectively mitigated. As the Board noted in its decision, its focus in requiring competition-related concerns "is on ensuring that any mergers that are approved are in the public interest, not on imposing a new scheme of regulation upon the railroad industry through the back door of merger approval." Third, we have been concerned about the Board's proposed analysis required with respect to the "downstream" effects of a proposed transaction. As initially proposed, this analysis would have been highly speculative and impractical and would not have served to respond effectively to shippers' concerns about the prospect of two transcontinental railroads. In the final rules, the Board declined to require merger applicants to present alternative merger benefit calculations based on specific alternative possible responses of other carriers. Instead, the Board will require applicants to generally discuss the likely impact of future Class I mergers on the anticipated public benefits of their own merger proposal. So long as these rules are not used as a means to extend merger inquiries unreasonably or to over-manage the market for railroad control in a search for the hypothetically "perfect" set of railroad combinations, they should not diminish the Board's capacity to efficiently review merger proposals.

Last, we have been concerned about the Board's new requirements regarding voting trusts. Under the previous merger rules, the decision as to whether to assume the regulatory risk of unauthorized control during the pendency of a merger proceeding was left to the applicants, who had the option of obtaining informal staff review of a proposed voting trust agreement. The new rules, however, require applicants to obtain formal Board approval of voting trusts at the outset, with the Board applying a public interest standard in addition to the no-control test. Depending on how the rule is applied, it could require the Board to make a decision on elements of a merger's merits prior to receiving evidence on all relevant aspects of the proposed transaction, rather than at the conclusion of a merger proceeding.

Question (b). How would you change the new rules to alleviate these concerns?

Answer. On three of our four major concerns—treatment of transnational mergers, enhancement of competition, and analysis of downstream effects—implementation by the Board of the requirements in the final rules will be key to determining whether the provisions are having their desired effect. It is essential to the future of the railroad industry that the merger rules serve as a mechanism to promote efficiency and service, not a way to induce artificial, economically unsustainable competition or to protect some carriers from competition with others.

With respect to voting trusts, we would prefer that the Board revert to its prior practice. In the alternative, the Board should limit its inquiry into whether the proposed trust, rather than the transaction itself, is consistent with the public interest. The notion that the use of a voting trust somehow limits the Board's authority ultimately to protect the public interest is unsupported.[1] Application of the Board's traditional tests for control in a review of trust proposals initiated at the option of applicants would continue to fulfill the proper function of aiding applicants seeking to avoid unauthorized control. Even under the new rules, we would hope that the Board would not seek to limit the workings of the capital markets with respect to the absorption of risk by an acquiring carrier or to handicap the market for control by giving the Board the right to pre-judge the merits of a merger. Instead, the Board's focus should be on whether a voting trust itself is likely to have any serious impact on the public interest. CN supports a more rigorous examination by the Board of a transaction's financial impacts on the ability of the merging carriers to maintain and improve service. The examination of financial terms, however, like the

[1] As an example, the Interstate Commerce Commission denied an application involving a voting trust in the proposed Santa Fe/Southern Pacific merger.

examination of any other element of the public interest, should occur during and not prior to the merger proceeding.

Question 2. Do you believe the BNSF/CN transaction that you intended to submit to the Board for review last year would have been approved under the new rules?

Answer. Our proposed combination with Burlington Northern Santa Fe (BNSF) was a pro-competitive, largely end-to-end transaction. I am convinced that the CN/BNSF combination would have been good for shippers and the rail industry.

Our commitment to service was consistent with the goals of the Board's new merger rules. As part of this transaction, CN and BNSF had made a commitment to shippers to provide service to our customers at least as good as, or better than, the service they were receiving prior to the combination. Importantly, CN and BNSF also pledged to keep gateways open for customers following the combination. Not only do the Board's new rules strongly emphasize the importance of providing good service to customers, but they also incorporate this concept of open gateways.

While it is impossible to State with certainty what the fate of this proposed transaction at the Board would have been under any circumstances, the basic spirit of this proposed combination, the overall rationale for the transaction, and our commitment to customer service were consistent with the Board's goals and objectives stated in the new merger rules. I am confident that we would have been able to successfully address the Board's concerns related to continued financial viability, competition, and fulfilling our customer commitments, and believe the transaction would have merited the Board's approval.

Question 3. You briefly discuss in your testimony the impact the economy at large has had on shaping the railroad industry in the past and assert that this will continue to be the case and as such, there is no "certainty" to the future make-up of the rail industry. This would seem to disagree with the STB's assertion that one more Class I to Class I rail merger will likely kick-off the final round of mergers.

Question (a). With ever-increasing traffic volumes moving in and out of North American ports and more traffic moving north and south, what do you believe we should expect to see with regard to Class I mergers in the next several years? What about smaller mergers?

Answer. It is clear that the rail industry has an important role to play in the North American transportation system given high traffic volumes moving throughout the continent, particularly north-south trade. There is no clear answer, however, as to how individual carriers will choose to meet this challenge.

As I noted in my testimony, CN believes that no particular industry structure is inevitable. What is important is that the rail industry must emphasize responsible growth and responsive customer service. We need to help our customers increasingly find rail to be the best transportation choice. The rail industry overall has found it difficult to divert freight from other transportation modes; in fact, the railroad industry's share of the freight transportation market has declined relative to the trucking industry in every year since 1980. Railroads must increase our market share if we are to remain a viable sector over the long run.

In CN's case, we undertook our 1999 merger with Illinois Central precisely for the purpose of capitalizing on the expanding market for north-south trade that has arisen as a result of the North American Free Trade Agreement. More recently, we announced earlier this year our proposed merger with Wisconsin Central, which is currently under review by the Surface Transportation Board. By acquiring WC, we seek to secure and to increase to the maximum extent possible the efficiency of our important NAFTA route connecting western Canada and the central U.S. Outside of these merger activities, we also are continuing to seek new ways to improve our performance and enhance our customer service.

It remains to be seen whether Class I railroads will propose further mergers between them to enhance efficiency and whether such proposals would warrant approval. The Board should welcome progress toward more efficient railroads if it is possible.

Question b. How has your view on what might happen with regard to mergers changed as a result of the STB's new rules?

Answer. The Board's new rules appropriately raise the bar for future rail mergers by emphasizing the importance of customer service. The Board also will be examining more rigorously the effects of a proposed transaction on the financial ability of the merged carriers to maintain and improve service. Any carrier wishing to pursue a merger will have to be prepared not only to demonstrate the expected benefits associated with the proposed transaction, but also to identify how these benefits in fact will be realized and what actions will be taken should the expected benefits not materialize.

An important change from past precedent is the Board's more skeptical attitude toward claims of merger benefits as opposed to the previous presumption that a

merger is in the public interest. The Board is placing greater emphasis on enhancing competition as well as on obtaining information on "downstream" impacts of a transaction.

Mergers may still have an important role to play in helping the industry reduce costs and improve service, thereby enhancing competition. If the Board's new rules are properly applied, applicants with a solid business case for their transaction, consistent with the public interest, should be able to successfully pursue a merger at the Board.

With respect to smaller mergers, these may well prove to be more appealing to carriers, particularly in the short-run. Smaller mergers are less likely to raise significant "downstream" concerns, and there are likely to be fewer competitive implications surrounding such transactions. However, each rail carrier will have to examine its own strategic goals, market position, and other factors before determining whether any merger—large or small—should be pursued.

Question 4. In your written testimony you commented that your annual operating revenues in the U.S. are approximately $3.5 billion. What are CN's "total" revenues and track mileage, including your Canadian side of the operation?

Answer. The figures cited in my written testimony applied to CN's operations in both the United States and Canada. CN's total operating revenues for the year 2000 were C$5.428 billion, which equates to approximately US$3.5 billion. Approximately US$1 billion of these revenues are attributable to our operations in the United States. With respect to track mileage, CN operates over a total of approximately 15,500 route miles, roughly 3,000 of which are in the United States.

Question 5. You indicated CN and other carriers are undertaking initiatives to expand service, such as through alliances and marketing agreements with other carriers. What can't be accomplished by these approaches that only can be produced as the result of a merger?

Answer. CN has had excellent experiences with alliances with a number of different rail carriers. Major examples include the following:

(a) Our most extensive alliance to date is our 15-year Strategic Marketing Alliance with Kansas City Southern, which we announced in April 1998. Through this alliance, we are able to offer shippers extended reach through a coordinated network linking points in Canada, the Midwest and southern U.S. markets. Through KCS affiliates, the Marketing Alliance provides customers access to Mexico's largest rail system, effectively linking all three NAFTA nations.

(b) We have in place three co-production agreements with Canadian Pacific Railroad (CP): (i) directional running of CN and CP trains over a 155-mile stretch of track through the Fraser Canyon in western Canada; (ii) an agreement under which CN has access to CP's Northeastern U.S. network; and (iii) an agreement providing CP access to CN's Toronto—Chicago main line.

(c) Most recently, we announced in May 2001 a new range of services with CSX Intermodal connecting major Canadian and U.S. markets. These services should be attractive to shippers of high-value consumer goods in Canada and the U.S., as well as international shippers.

Alliances can be an important part of a carrier's effort to enhance its service offering and to meet customers' needs. However, the full congruence of interests that common control provides is not possible in an alliance. While it is fully expected that each carrier will seek to maximize its own performance, this behavior tends to prevent an alliance from achieving the higher level of performance that is possible with common control. An alliance member may find it necessary to deploy resources in such a way that maximizes its own profits or level of service, without regard to the combined profits or service levels of other alliance members.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR SMITH TO PAUL M. TELLIER

Question 1. Some Oregon rail users, the railroads' customers, today have the option of using more than one railroad to pick-up a shipment and deliver it to one of two railroads in the east. If there are two mergers, leaving just two transcontinental railroads, what will happen to the options available to Oregon rail users? What incentive would one merged transcontinental railroad have to keep the gateways open with the other transcontinental railroad? How would the Oregon rail user go about getting a price to transport its goods across the country? Would there truly be price competition, or would the railroad that can provide single-line service always quote the lower rate? How do the new merger rules help an Oregon shipper in this situation?

Answer. At the present time, the U.S. rail industry is characterized by two Class I carriers in each of the Western and Eastern regions—Union Pacific (UP) and Burlington Northern Santa Fe (BNSF) in the West and CSX and Norfolk Southern (NS) in the East, with CN, Canadian Pacific (CP), and the Kansas City Southern (KCS) operating in portions of these regions. The options available to Oregon rail users if two transcontinental railroads emerge from any next round of rail mergers—should that occur—would depend largely on the conditions that the Surface Transportation Board (STB) would impose on future mergers, as well as the extent to which competition exists from other modes and, with respect to some traffic, short-line rail carriers. The Board has stated clearly in the new rules that it views not only the preservation of competition, but also the enhancement of competition, as essential in future mergers. Future merger applicants will be required to demonstrate not only that the proposed transaction will improve economic efficiency and lead to improved service, but also that competition will be enhanced as a result.

With respect to gateways, the Board's rules require merger applicants to present an effective plan to keep open major existing gateways. The Board has stated that it will impose conditions on any approved mergers to ensure that the gateways indeed remain open. The Board's decision also notes that parties may identify gateways that require specific protection other than those initially identified by the merger applicants and the Board will determine whether conditions are necessary to protect any such gateway from closure.

As to the processes available to a shipper to determine the price of rail services, there should be no change from current practices. Shippers can go to rail carriers, either to sales representatives or to a variety of on-line options, to obtain price and service information. Unless Congress chooses to make a substantive change to the Interstate Commerce Act, the common carrier obligation still would remain in force, requiring a rail carrier to quote a rate for its services. In addition, as at present, shippers would have the option of seeking to enter into contractual relationships with carriers to meet their rail service needs.

With respect to price competition, merger rules that preclude any reduction of competition and require its enhancement should, at a minimum, assure no diminution of price competition between rail carriers and between modes.

Last, as to the impact of the new merger rules on Oregon shippers with respect to pricing, in addition to the pricing constraints imposed by the marketplace, I believe the major impact is that the Board's new rules emphasize the importance of customer service resulting from rail mergers. The Board has made it clear that it will hold carriers to the promises they make in their merger application and throughout the review process; if these promises are not fulfilled, the Board will take appropriate action. In addition, the traditional rate complaint procedures will continue to be available to shippers at the STB.

Question 2. One of the problems we have in Oregon is congestion on I-5. One way to reduce that congestion would be to divert some truck traffic to the railroads. The last two mergers in the west have created single-line routes along the entire I-5 corridor, but there has not been a substantial diversion of truck traffic to the railroads. Part of this must be based on the service problems that everybody involved with the rail industry has suffered through. As I understand, it takes a tremendous commitment from management and a huge effort to divert any truck traffic to the railroads. Doesn't it make sense to concentrate on the traffic that is available to the railroads, such as the I-5 corridor in the west, and, I understand, the I-81 corridor in the east, and get that right before diverting the attention and limited resources of railroad and management to putting together another merger and resolving the problems and addressing the opportunities of that merger? Shouldn't the problems of past mergers have been solved and the promises of past mergers kept before the railroad industry embarks on another, and apparently final round of mergers? How will we know when that time has come?

Answer. A key goal of railroads is to enhance the industry's competitiveness vis-a-vis other transportation modes. While important opportunities for generating rail traffic clearly exist in areas such as the I-5 and I-81 corridors, railroads throughout the country seek opportunities to make rail their customers' first choice as a transportation service provider. Despite service and productivity improvements over the years, however, the industry has found it difficult to divert freight from other transportation modes. For our part, CN is aggressive in seeking new service opportunities and finding ways to enhance our service offerings to customers.

With respect to past mergers, it is clearly important that problems from past mergers be solved and promises kept. However, it is not necessary—nor is it fair—to preclude rail carriers that have not suffered merger-related difficulties from pursuing future merger opportunities, should there be a strong business case and good public interest rationale for so doing.

As an example, in 1999, the STB approved the CN/IC merger. We have been successful in integrating our two railroads in an essentially flawless fashion, with no disruptions to our customers. If the Board approves our proposed merger with Wisconsin Central, which currently is under regulatory review at the agency, we have every expectation of implementing that transaction in a similarly successful fashion. Let me hasten to add that CN has no plans at this time to merge with another rail carrier beyond our ongoing transaction with WC. If an appropriate opportunity should present itself, however, we should be free to pursue it, subject to the rules established by the Board.

As to when we will know when the time has come for more mergers, I do not believe it is a certainty that any particular industry structure—such as two major North American railroads—is inevitable. Nor is it likely that there will be one defining moment when it will be clear that future mergers are inevitable. As in the past, each rail carrier will need to assess opportunities that may present themselves in the context of the carrier's current financial and operational condition and competitive status, along with the public interest and general competitive implications of a potential transaction, before deciding whether to pursue a merger.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR MCCAIN TO CLAUDIA L. HOWELLS

1a. National Rail Policy should first establish a framework for public actions related to or affecting the railroad industry. Others may have their own thoughts about what should be included, but I offer the following as a starting point.

1. Railroads are an essential part of the National Transportation System and should be considered a valued national resource.

2. It is in the public interest to retain private ownership of railroads and rail property, because it reduces the burden on the public sector. Public policy should encourage private ownership.

3. Effort should be made to reduce competitive disadvantages created by direct or indirect subsidizes to other private, competing commercial modes of transportation.

U.S. DOT's National Freight Policy should be viewed as a document that addresses all modes and not just those that use the highway system. Much of what is in that policy statement can be mirrored in a statement governing rail policy, with the understanding that railroads can and should move people.

Currently the Federal Government collects 4.3 cents diesel tax. I am well aware of that the Class I railroads want the tax eliminated, but it is reasonable to use that revenue to protect the overall integrity of the rail system. I can understand the railroads being uneasy about the precedent of creating a Railroad Trust Fund, but it is entirely *unreasonable* to suggest that Highway Trust Funds or general revenues should be used to create a Railroad Fund.

There are some small changes that can be made that would help create a "safety net." As an example, FEMA funds cannot be used on privately owned railroads (though they can on publicly owned railroads) for disaster relief. Particularly for short lines, a flood can destroy a line and isolate businesses and communities. Making railroads eligible for FEMA grants would be a small step toward creating a safety net.

Highway funds should contribute to the maintenance of crossing signals and surfaces. Again, a small contribution that would relieve the railroads of a financial burden created by highway users.

1b. First, we need to acknowledge that railroads continue to be regulated more than any other transportation industry for both service and safety. This is not necessarily bad. I would not suggest that we return to the pre-Staggers days of regulation, but because the railroads are so profoundly essential to the nation's economy they deserve protection from others, and sometimes protection from each other and themselves. A good regulator, and I believe that can exist, should function as referee. Government doesn't need to be coach or player but things can get very chaotic without a mediating or even adjudicating body. A specific role I see the STB playing is to arbitrate disputes between freight railroads and the growing commuter rail interests. In my opinion, that is no different than arbitrating disputes between the railroads, which is one reason the ICC was created in the first place. I also believe that both railroads and shippers continue to need a referee on rail line abandonments, mergers and general service issues, to protect both the interests of the customers and the public.

In my testimony, I don't believe I suggested additional regulation as much as I did the need for the STB and the FRA to better anticipate problems rather than react to a crisis, often after the damage has been done. As Commissioner Morgan

has pointed out, the statutes that govern the STB were developed for a very different railroad industry than the one we have today. It is a good time to think about a future of the rail industry and how best to structure regulations to encourage redevelopment railroads.

1c. On the issue of multiple agencies involved in railroad business, there needs to be a study of how best to define how each agency works with the railroads and how the agencies work together.

The various Federal statutes need to be evaluated to determine where statutory conflicts exist. Presumably, all should have the same "prime directive," something that does not exist now. Suggesting the restructuring agencies always sends people into panic mode, so I am reluctant to jump to that as a solution. What I can say is that after many years working with all three agencies, I am convinced that the cultures and direction of each agency are profoundly different. STB needs to be independent and separate, and the FRA and Department of Justice, both need to participate in STB proceedings. That kind of public debate is important and constructive.

The FRA needs a clarity of mission, particularly in the policy area. Where I think we need to take a hard look is which agency, the FRA or FTA, is more appropriate to oversee and fund commuter rail (not to be confused with Light Rail.) There is little difference now between commuter rail and regional intercity passenger rail, yet funding is with FTA for commuter rail, FRA for "high speed rail," and Amtrak for everything else. FRA is the safety enforcement agency for all railroad operations, including freight, passenger and commuter, but excluding Light Rail systems, which further muddles jurisdictions and missions.

There are other agencies involved as well. As an example, FHWA funds highway-railroad grade crossing improvement projects. As the FRA increasingly becomes involved in grade crossing regulations, there is a disconnect between the only funding source, FHWA, and FRA's regulatory initiatives. FRA's quiet zone initiative is one example.

All of these agencies are within U.S. DOT, and I hope that the Secretary will provide encouragement for all of the agencies to work together and to forge a common understand of how government relates to the railroad industry.

2a. I agree that the predictions I made are contrary to what the STB said *prior* to issuing the moratorium. The moratorium allowed cooler heads to prevail. I have no doubt that without the moratorium the mergers would have continued. I think many railroads believe that the moratorium was illegal, but were relieved when the STB called halt. The moratorium had exactly the affect intended, and the process in developing the rules was healthy for the industry and the public.

As to how I arrived at my conclusions, I can only say that I pay close attention to the railroad industry and to rail shippers. Every indication I have is that proposals for any more major mergers would create a firestorm within the shipping community. With perhaps one exception, the railroads seem to realize that additional mergers will not make the industry financially better off, and if anything, will distract from the business of railroading.

2b. The issues I listed as being the next wave facing the railroad industry included spin-offs of the weaker parts of the mega-Class I's, consolidation of short line companies and the abandonment of short line segments.

1. Creating economically weak Class I's could be as catastrophic as creating huge semi-monopolistic Class I railroads. The STB needs to hold such transactions to not only a competitive test, but also a test to insure the financial viability of both systems. I am not saying that these split-ups will occur, but the financial pressures on the industry will make it tempting to concentrate resources on the strongest parts of the system.

2. Consolidation of short line railroads has very little impact on competition, but these transactions have the potential for being financially risky and also could put at risk service to our most economically challenged parts of the state. Like the big railroads, publicly traded short line holding companies may need to jettison less productive properties to keep Wall Street happy.

3. Many of the short lines desperately need money for capital investment. Despite having respectable traffic levels, the heavier cars are escalating damage to the infrastructure. The first line of defense is to provide financial assistance to these lines. The STB also needs the authority to place a higher public interest standard on these abandonments. Typically, these are handled as Exempt proceedings making it almost impossible for shippers, communities or states to effectively protest. Put another way, the current process clearly favors line abandonments, notwithstanding the public interest.

4. A long time transportation manager once told me that you don't tell railroads how to run their business, just tell them what you want. I don't think it's my business or the STB's to tell the railroads *how* to deliver service. I do think that we

(government) can, as representatives of shippers and the public, tell the railroads what we expect in terms of safety and service. As I mentioned earlier, the most important role the STB can serve is as referee. The STB also needs to insure a financially stable industry. If we assume that railroads are a vital national resource then we need to protect that resource.

Furthermore, service problems are almost always an indicator of safety problems, and vice versa. Unsafe railroads can have a tremendous impact on communities, as the recent tunnel fire in Baltimore demonstrates.

The STB has been very clear in saying that it does not want to run the railroad industry. In fact, if the railroads were providing good quality service the STB would have very little to do, because the STB and the ICC before it, have been remarkably restrained in directing the industry.

5. Policy makers, at all levels of government, seem to have no problem at all partnering with the airline industry, the trucking industry and the maritime industries, all of which benefit from publicly funded infrastructure. On the other hand, investment in the rail industry, even in Amtrak, seems to send shudders through public policymakers.

If we can all agree that the railroads are still an essential part of the transportation system, rather than a "transportation has-been", we can begin to reestablish the public/private partnership that built the railroads a century ago. As the railroads like to say, they need to level the playing field. We need to look at how we tax railroads, how we contribute to them, and how we create competitive disadvantages relative to other commercial modes. We need to recognize that moving freight by rail is as important as moving people. As an example, the contribution of public funds for commuter rail is enormous compared to public funds for moving freight by rail. Why?

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR MCCAIN TO WILLIAM GEBO

Question 1. What factors do you and other members of the American Chemistry Council consider when choosing to locate new facilities? To what extent does location to a rail line play in such a decision? Does the proximity to two railroads weigh heavily in such decisions?

Answer. Chemical facilities are located on a number of factors. These include availability of labor, energy, raw materials, access to customers, and transportation. Many chemical plants were located in areas with more than one railroad, but mergers over the past 20 years have limited the current rail-to-rail competition. The Houston, Texas area is a good example of this situation.

When looking to build or expand a chemical facility in North America today rail-to-rail competition is certainly a factor that is considered.

Question 2. Can you tell us if any of your members have seen competition cease as a result of a merger—has any facility experienced a loss of a carrier option where prior to a merger, two carriers provided service but after a merger, only one carrier provided service? Have any of your members decided to relocate due to a loss in service?

Answer. Rail mergers definitely diminish competition between railroads. That problem is masked by the Surface Transportation Board's overly narrow focus on "two-to-one" points. A two-to-one point is a particular location that is served only two railroads, which happen to be the two carriers seeking merger approval.

To focus on two-to-one situations, is to overlook many types of other merger-related reductions in competition that shippers have experienced. Merged railroads close "gateways" to prevent shippers from choosing alternative routings that may offer favorable rate-and-service packages. Relatively short "bottlenecks"—where one of the merging railroads controlled the traffic between a captive shipper facility and the nearest interchange with a different railroad—become longer bottlenecks, leaving shippers with fewer competitive options. Mergers eliminate independent railroads, which provide shippers with such benefits as "geographic competition," which in some instances may mitigate the market power of other railroads. Because STB generally does not address three-to-two situations, over time many customers lost competitive carrier options. Post-merger service problems are exacerbated if only one railroad controls the infrastructure in a region, because there is no longer head-to-head competition to serve new industrial facilities.

As stated in my written testimony: "For several years—coinciding with the most recent wave of rail mergers—the Council and its member companies have become increasingly concerned about the lack of direct head-to-head competition between railroads. For the Council's membership as a whole, 63 percent of all rail-served

chemical plants are restricted to service by a single railroad. In other words, when it comes to rail transportation, nearly two-thirds of our industry is "captive" and therefore has no opportunity to obtain competitive price quotations or service options. Member companies that have competition available at some of their facilities report that their freight rates are much higher (ranging from 15 percent to 60 percent more) where the railroad has a monopoly over the shipper's traffic. Nor is it surprising that the Council's members report that railroads are less responsive to customer service concerns at locations without rail-to-rail competition."

Question 3. What is your view on the new rules? Do you believe the Board has gone far enough in its merger rule revisions?

Answer. The Council's views on the new rail rules are stated in my written testimony. We "asked STB to make competition the centerpiece of its new merger guidelines. Unfortunately, however, STB declined to enhance competition when railroads merge. To be sure, STB invited—and perhaps, to some extent, may be said to have encouraged—railroads to 'talk the talk' about competition and improved customer service when they file their next round of merger applications. But STB clearly did not adopt any rules that would require railroads to 'walk the walk' by competing directly with each other at all points on their merged systems."

Question 4. What is your view regarding the Board's blanket exemption for the KCS?

Answer. The Council has no view on STB's decision in Ex Parte No. 582 (Sub No. 1) regarding the Kansas City Southern Railway Company.

RESPONSES TO WRITTEN QUESTIONS SUBMITTED BY SENATOR MCCAIN TO MICHAEL HAVERTY

Question 1. Why should KCS receive preferential treatment under the STB's rules? Would you support an exemption of the new rules for any other Class I carrier?

Answer. Different treatment of rail carriers based upon the size of the company has been a main stay under the STB's, and the former ICC's, rules and regulations for over fifty years. Grandfathering KCS under the "major" transaction review of the old rules, as was done by the Board, is simply a continuation of that policy and recognizes that a merger with KCS does not involve the same geographic scope and market power as mergers involving the other Class I carriers.

KCS is the smallest of the Class I railroads with approximately $564 million dollars of operating revenue in 1999. In comparison to KCS, the next largest Class I carrier, Canadian Pacific Railway ("CP") (including its U.S. subsidiary, Soo Line Railroad), had annual operating revenues of approximately $2.4 billion dollars. The largest Class I carrier, the Union Pacific Railroad ("UP"), had operating revenues of $10 billion dollars in 1999. As a result, the other Class I carriers are between nearly 18 times and 4 times the size of the KCS. Indeed, KCS more closely resembles the Wisconsin Central System ("WC"), which had combined operating revenues around $400 million dollars in 2000. Earlier this year, the STB agreed to treat a transaction involving the WC as a "minor" transaction, a level of review far below that of a "major" transaction review that KCS would have to meet if it were merging with another Class I under the proposed rule. Given KCS's closeness in size to the WC, as compared to the other much larger Class I railroads, it is hard for us to see why we would be treated so differently than the WC.

KCS's north-south market reach makes it impossible for any merger of KCS and another Class I carrier to result in an east-west transcontinental merger that is the type of merger that the STB was addressing in the new merger rules. Nor, I believe, would a merger with KCS and another Class I carrier trigger the final round of consolidations that could result in only two large carriers serving the entire United States. Grandfathering KCS under the previous rules, given the huge size disparity between KCS and the other Class Is, and given its lack of market power as compared to the much larger Class I railroads, is entirely consistent with Board precedent.

Throughout the STB's rulemaking, KCS asked that the definition of a "major" merger transaction under the new rules be changed so as not to include carriers with operating revenues under $1 billion dollars. KCS drafted its proposed rule in such a manner to include other Class I carriers that were significantly smaller than the big Class I carriers. For example, WC would have become a Class I carrier on January 1, 2002 if the recently announced acquisition by the Canadian National Railway had not occurred. KCS's proposal would have included WC in this proposed treatment. KCS would support different treatment in mergers for any Class I carrier similar in size to KCS or WC.

Question 2. Am I correct that you wish to retain the waiver exemption granted to KCS by the Board so that any merger that your company is involved in would be easier to receive Board approval?

Answer. KCS does agree that it should be grandfathered under the previous merger rules as imposed in the STB's recent new merger rules. As stated in response to question one, the differential treatment of rail mergers based upon the size of the rail carrier is an established precedent of the STB and the former ICC. KCS does not view the treatment it has received as necessarily making any KCS merger easier to receive Board approval.

Under the grandfathering provision, a merger involving KCS will be thoroughly reviewed and commented on by any interested party under the same timeframes and standards that were applied to all mergers involving Class I carriers since 1980, including the most recent mergers of Burlington Northern/Santa Fe, Union Pacific/Southern Pacific, Canadian National/Illinois Central and the CSX/Norfolk Southern/Conrail transaction. In fact, because the Board's rule requires a KCS merger to be treated as a "major" merger, the Board has actually imposed a higher burden on KCS than what KCS asked for in the rulemaking. KCS requested consideration as a "significant" transaction rather than a "major" transaction. Besides, the rule as written, is a rebuttable presumption and gives other parties the right to challenge it if KCS were to become involved in a merger with another Class I carrier.

Question 3. What do you believe is the appropriate revenue threshold for classification as a Class I? Does the KCS want to be classified as a Class II and if so, why, and if not, why not?

Answer. On November 14, 2000, WC petitioned the STB to open a proceeding to consider amending the rail carrier classification regulations. WC suggested that the threshold for Class I carriers should be adjusted upward to $500 million dollars. KCS filed in support of the WC's request to open a proceeding and urged the Board to reevaluate the threshold classifications between carriers. At that time, KCS did not comment on the appropriateness of the threshold suggested by WC. KCS believes that the appropriateness of the threshold can and should be determined in the context of a proceeding to examine all of the issues. KCS has suggested a $1 billion revenue threshold for "major" transactions in its comments on the proposed new rules. That may also prove to be an appropriate threshold for classification as a Class I.

Most important in this process is that KCS is committed to protecting the interests of its employees, shareholders, and the service it provides to its shipper. Nevertheless, it is undeniable that the mega-Class I railroads play a far different role in the national rail transportation scene than do regional railroads such as KCS, WC, Montana Rail Link ("MRL"), and Florida East Coast Railway Company ("FEC"), who all serve a vital but more limited role as regional carriers.

○