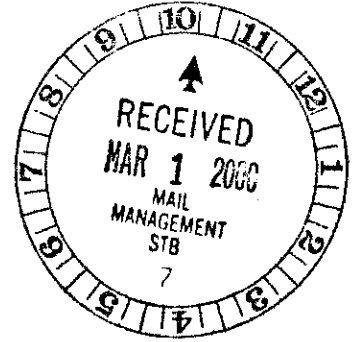


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BEFORE THE
SURFACE TRANSPORTATION BOARD



STB EX PARTE NO. 582
PUBLIC VIEWS ON MAJOR RAIL CONSOLIDATIONS

COMMENTS OF THE
U.S. DEPARTMENT OF AGRICULTURE

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Public Record

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Washington, D.C. 20250

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AUTHORITY AND INTEREST

The Secretary of Agriculture is charged with the responsibility under the Agricultural Adjustment Act of 1938 and the Agricultural Marketing Act of 1946 to represent the interests of agricultural producers and shippers in improving transportation services and facilities by, among other things, initiating and participating in Board proceedings involving rates, charges, tariffs, practices, and services.

Shortly after notification by Burlington Northern Santa Fe Corporation (BNSF) and Canadian National Railway Company (CN) of their intention to combine their systems, the Board instituted this hearing to provide interested persons an opportunity to express their views on the subject of major railroad consolidations as well as the present and future structure of the North American railroad industry.

USDA's general concern with railroad mergers in recent years has been based on the decline in the number of Class I railroads from 33 competing carriers in the early 1980's to only seven today. This has resulted in increased overall levels of concentration and reduced competition in the railroad industry which has affected U.S. agriculture more than any other industrial sector of the country. While the top five railroads originated 57 percent of all rail grain traffic in 1982, by 1995 this figure had climbed to 90 percent. By 1999, the top five railroads originated 96 percent of the 1.3 million carloads of grain hauled by rail. The result for U.S. agriculture of this rail consolidation has been rate increases, car shortages and other merger-related logistical problems.

RAIL TRANSPORTATION AND AGRICULTURE

The continued success of U.S. agriculture depends on maintaining an effective and efficient railroad industry. This is particularly true in large areas of the Midwest, where inland waterways are not nearby and distances to market are great. While American grain farmers bear the ultimate burden of inadequate and ineffective rail service, there are more than ten thousand local country grain elevators and more than 500 short line and regional railroads whose profitability is also fundamentally linked to access to a competitive U.S. railroad industry.

In 1999, American farmers produced more than 16 billion bushels of grain and oilseeds. Agricultural shippers pay more than \$3.5 billion annually in freight costs to U.S. railroads to transport agricultural products. These figures demonstrate that an adequate and efficient rail infrastructure is essential for the marketing of U.S. agricultural products.

Nearly half of all grain produced in the U.S. moves to market by rail. Nearly 80 percent of all interstate wheat shipments from Plains States are by rail, and rail accounts for 90 percent of all export traffic from the region. Rail is also the dominant mode of transportation for interstate shipment of wheat – accounting for approximately 80 percent of such shipments in the Upper Great Plains States and more than 60 percent of the intrastate shipments in the Lower Plains States.

Nine of the ten top wheat-producing states are more than 150 miles from barge transportation on the Mississippi River which typically provides the strongest intermodal competition to railroads on the long distance movement of grain for export. Among agricultural shippers in the United States, wheat shippers in the Upper and Lower Great Plains have no cost-effective transportation alternatives to railroads. The wheat produced in these areas moves long

distances to domestic markets for processing and consumption or to coastal ports for export. Shippers in these regions have little direct access to inland waterway transportation and the distances involved make truck transportation uneconomical.

Grain farmers are dispersed over the entire country. Unlike many other industries, grain producers are unable to move their operations to other locations – indeed, their operations are tied to the land and often to a particular climate. Rail and barge are the only two cost-efficient transportation modes for hauling bulk commodities long distances. To compete effectively in increasingly competitive world markets, U.S. farmers must have access to efficient, reliable and cost-competitive transportation. The rates agricultural shippers pay for rail transportation must be at a level which promote, not penalize, American competitiveness in world agricultural markets.

Because of the importance of rail transportation to agricultural producers, shippers and rural communities, USDA has actively participated and commented in a number of past rail merger and rail service proceedings before the Board on behalf of our constituents. The Union Pacific and Chicago Northwestern in 1994, Burlington Northern and Atchison, Topeka & Santa Fe in 1995, and the Union Pacific and Southern Pacific in 1996 were some of the more recent rail merger proceedings in which USDA participated. We submitted comments and recommendations to assure that the rail shipping needs of the agricultural community received fair and equitable consideration as consolidation decisions were made and conditions imposed during the merger review process. At the request of Secretary Glickman, Under Secretary Michael V. Dunn appeared before the Board and presented testimony during two open hearings held in 1997 that examined rail service in the Western United States. Several USDA

recommendations designed to address the Western rail service crisis were offered, some of which were adopted and instituted by the Board.

THE TIMING OF A NEW ROUND OF RAIL CONSOLIDATIONS

On December 20, 1999, the BNSF and CN railroads announced plans to combine their rail systems, creating the largest railroad in North America. A combination of these two large rail systems would result in a 50,000 mile railroad system stretching from Los Angeles to Halifax, Nova Scotia, and from the Gulf of Mexico to Vancouver, British Columbia.

The BNSF-CN announcement is certain to spark a new surge in rail merger activity among the few remaining Class I rail carriers. It is conceivable that one or more of the remaining five Class I railroads after a BNSF-CN combination would seek a merger partner for defensive reasons as a result of the proposed BNSF-CN merger. USDA is encouraged by the Board's intention to broaden the issues relevant to the review process for the BNSF-CN proposed merger in order to consider the transaction's potential ramifications on the composition of the United States rail industry should other mergers occur.

USDA notes that the Chairman has expressed surprise at the timing of the BNSF-CN proposal. USDA was also surprised at the timing. In fact, USDA believes that the timing of this proposed combination could not have been worse. There is a lot of concern among agricultural producers and shippers in rural farming regions of the country over the poor and inadequate rail service they have encountered and are still experiencing as a result of past rail mergers. These rail users feel that the direction we are going with rail mergers and rail service in this country is wrong. Our agricultural shippers simply cannot imagine why the BNSF and CN railroads would

want to combine their systems so soon after the disastrous merger problems of the past few years and ongoing service problems in the East as a result of the 1999 takeover of Conrail by Norfolk Southern (NS) and CSX Transportation (CSXT).

Since last Fall, USDA has been in contact with several agricultural producer and shipper organizations and individual shippers served by NS and CSXT to ascertain the quality of their rail service in light of Conrail integration problems. While certainly not back to normal levels, the USDA transportation staff has been told by agricultural shippers that rail service in the East is starting to get better. But our constituents also say that the rail industry, as a whole, needs to provide better service before more rail mergers should be allowed.

In 1997 and 1998 USDA held a series of ten listening sessions in grain producing States. The purpose was to gather input from local rail users about their experiences with rail service since the last wave of railroad mergers. Under Secretary Dunn personally sat in on a number of the listening sessions and was concerned by much of the testimony. Agricultural producers, shippers and local and State officials who participated in the sessions generally focused on the following problems: lack of competition among railroads, unavailability of general tariff freight cars, unreasonable delays by railroads in moving loaded cars from shippers' facilities, railroads' failure to timely notify shippers of car placement, and inappropriate and ineffective railcar ordering systems that do not meet the needs of smaller grain shippers.

For these reasons, the USDA opposes any further rail consolidation in the near future because we believe railroads need to improve the service they are currently providing to agricultural and other shippers throughout the entire U.S. rail network before attempting any additional consolidation. Railroads need to get better before they get bigger. We think that

railroads need to deliver on the promised benefits of past mergers before they are allowed to continue merging. We would also like to see railroads passing some of those so-called “merger-related efficiencies” back to shippers in the form of lower rates. Many times, 40 percent of the price of grain delivered to a market or to a port is made up in rail freight cost. Consequently, any decrease in the price of rail freight from rail efficiencies being passed back puts more money in the pocket of farmers.

CONSEQUENCES OF ANOTHER ROUND OF RAIL CONSOLIDATION

An important policy objective of the Board is increased railroad efficiency, which is defined by economists as the cost-minimizing organization of economic activity. The fact that many recent railroad mergers have resulted in the payment of substantial premiums over the market value of the acquired firms, indicates that the railroads expect to derive considerable gains – due either to increased efficiencies or to increased market power.

Efficiency benefits, in contrast to benefits which shippers derive from effective competition, are speculative. Based upon the results of recent mergers, even stockholders may never realize the promised efficiency benefits of a merger. Also, market power possessed by railroads may prevent efficiency benefits from being passed through to shippers in the form of lower prices. The degree to which railroads pass along cost savings through lower rates is dependent upon the competitive environment in which they price. If consolidation reduces effective railroad competition and effective intermodal competition is not present, cost savings derived from a merger will not be passed along to shippers. Conversely, should the merger result in a loss of efficiency, captive shippers will bear the increased costs.

The railroad mergers and consolidations of the past decade have had serious effects upon the availability of rail transportation for the agricultural industry. Increased market power derived from those railroad consolidations have allowed Class I railroads to dictate changes in prices and service terms which are detrimental to shippers, agricultural producers and rural communities.

Railroads point constantly to rate reductions that have occurred since passage of the Staggers Act as evidence of better, lower cost rail service. But a major reason rates have fallen is that all shippers, and grain shippers in particular, are shouldering greater responsibility for car supply and other functions railroads formerly provided. Grain shippers now pay additional to obtain guaranteed car service – but these additional payments are not considered when comparing current rail rates to those of the past. Demurrage penalties have been increased and loading windows shortened – even though railroads usually do not give grain elevators adequate notice of railcar delivery, thus preventing them from having the opportunity to schedule their staff efficiently. Also, due to railroad emphasis upon unit-trains, shippers have had to make significant capital investments in sidings, inventory, storage capacity and loading facilities to obtain cost-effective rail service. In addition, many railroads have greatly increased the lease fees shippers are charged for the use of railroad-owned rights-of-way, forcing some grain elevators out of business. USDA believes this is a manifestation of the lack of competitive alternatives for most grain shippers and the resulting market power of railroads. These offsetting costs should not be ignored by the Board when considering the public benefits resulting from future mergers.

The decreased price of rail transportation for farm products does not accurately indicate

the total changes in producer and shipper transportation costs. The increased costs of additional truck transportation, caused by the loss of rail service to many grain elevators, often more than offsets the lower rail transportation costs. The loss of rail service has usually been a result of branch line and secondary route abandonment brought about by rail consolidation. However, it also has also been due to the failure of Class I railroads to provide adequate service to smaller shippers. This additional truck transportation has damaged rural roads and highways and has greatly affected the tax burdens of those living in rural communities.

Success in business requires both efficiency and effectiveness – where efficiency is defined as “doing the job well” as contrasted with effectiveness being “doing the right job.” Railroads have made substantial gains in efficiency since 1980. However, as the Class I railroads have become increasingly large, they seem to have lost effectiveness -- expecting customers to adjust to their policies, rather than responding themselves to the service needs of their customers.

U.S. agriculture is currently experiencing major transitions in the way agricultural products are produced and marketed. Newly developed bio-engineered crop varieties are requiring segregated handling to preserve the specific traits for which each variety will be grown. Moreover, agricultural processors are also beginning to demand varieties of grains which have specific processing traits. Both of these trends imply the need among agricultural shippers for smaller-size shipments in which the identity of the shipment is preserved and a reduced need among agricultural shippers for large unit-train size shipments. However, even with these changes in agricultural shipping needs, Class I railroad companies are still promoting the use of unit-trains and shuttle trains since it is in their benefit.

Due to the lack of adequate intramodal railroad competition, the quality of service provided by Class I railroads has not been adequate for agricultural shippers. Captive shippers, even though paying the highest rail rates, also receive the worst rail service because Class I railroads choose to serve first those shippers having competitive options. This has resulted in captive shippers losing equal access to markets – particularly during those critical periods when the prices for grain are rising. Smaller grain shippers are regularly denied adequate rail service while unit-train shippers receive regular service.

Future Class I railroad mergers will most likely be end-to-end mergers, particularly since the Board has been much more vigilant on parallel mergers which have substantial anti-competitive effects. Even though considered by many to be relatively free of anti-competitive impacts, end-to-end mergers still allow the vertical foreclosure of markets through the denial of competitive access, denial of trackage rights and discriminatory pricing against railroads operating competing segments of rail line.

Another problem is that Class I railroads regularly deny co-loading privileges to short line railroads. Future mergers of Class I railroads will increase the size of the rail network controlled by each Class I railroad and increase their ability to deny co-loading privileges, forcing smaller volume grain shippers to pay higher tariffs. The cost of transporting a unit-train received from a short line railroad is the same as if it were received from an elevator on the Class I railroad's own line – especially since many short line railroads are willing to absorb the additional switching costs. Since several elevators can usually co-load a unit-train more quickly than just one elevator, demurrage charges and equipment utilization would be no different than it would be at a unit-train-loading facility. Thus, the denial of co-loading privileges to short line railroads

appears to be based upon the desire to force traffic to those grain elevators located on lines operated by the Class I railroad.

Agriculture relies on the preservation of many of the low-density feeder lines served by short line and regional railroads to provide a gathering network. This is particularly true in the Upper and Lower Great Plains regions. Current Class I railroad policies regarding co-loading and the shift to larger railcars presents a significant threat to these lines which are vital to agriculture.

Class I railroads have also worked to reduce competition by making it overly difficult for short line railroad operators to purchase certain abandoned rail lines which agricultural producers in the affected regions consider essential. The Towner, Kansas to NA Junction, Colorado line, the Kansas City, Missouri to St. Louis, Missouri line, and the central corridor in Kansas are recent examples of lines which Class I railroads made difficult to purchase.

By removing shipping alternatives, these tactics also deny agricultural and rural shippers access to markets. USDA wants to be certain that an adequate level of competition is maintained in those markets and on those routes where competition will likely suffer as a result of a rail merger.

The preservation of effective competition has many concrete benefits. It promotes reasonable rates, minimizes the need for regulatory control, and encourages honest and efficient management of railroads. Competition is also important since it is the force which drives process and product innovation. To USDA, effective competition to meet the needs of the public must include effective rail competition – the kind of competition that minimizes the number of captive shippers and the need for regulatory control over rates and service. Since intermodal competition

does not provide effective competition for all agricultural regions of the United States, the presence of effective rail competition is required. Unfortunately for agricultural shippers, effective intramodal rail competition has been allowed to disappear in some of the very regions in which intermodal competition is not effective.

FINANCIAL EFFECTS OF ADDITIONAL CONSOLIDATION

The huge premium paid for the other firm, as well as the potential for subsequent operating losses, affects both the revenue-to-variable cost ratios and the revenue adequacy of the combined railroad. This greatly reduces the ability of captive shippers to win rate appeals and increases the probability that the cost of the merger will be borne by captive shippers in the form of higher tariffs. Rail rates paid by shippers may also have to increase in order to pay for operational problems caused by rail mergers. Assuming the involved railroads had been pricing efficiently prior to the rail consolidations, the tariff rates could only be increased due to a decrease in competition.

The consolidation of the railroad industry has also resulted in the subsequent abandonment of rail lines. This, combined with the increase in rail traffic, has resulted in the rail industry operating at or near capacity on many of the main lines. Since many secondary routes have been abandoned, railroads have a significantly reduced ability to adjust to periodic operational difficulties and spikes in demand. Thus, the rail system is very fragile and disruptions in operations quickly spread beyond the area causing the problem. In addition, many of the current rail yards are operating at or beyond capacity and are badly in need of modernization. Thus, newly merged railroads have had to make significant investments to

increase capacity in key corridors and rail yards.

CONCLUSIONS

For these reasons, USDA believes that any future consolidation involving the seven remaining Class I railroads in the United States should be curtailed. Should the Board decide to grant future Class I railroad mergers, those transactions should be scrutinized much more closely for anti-competitive effects upon shippers, agricultural producers, rural communities, and short line railroads.

USDA believes that now is an extremely poor time to approve any further Class I railroad mergers. Shippers are still reeling from the effects of past mergers, including the Conrail split, that has resulted in continuing service difficulties in the Eastern United States. The BNSF/CN proposed merger will also likely stimulate further rail consolidations among railroads still struggling with the service and financial effects of prior mergers. Hence, USDA believes that now is the time to halt the rail merger trend and insist that railroads get better before they get bigger.

USDA also believes that in approving additional mega-mergers, the Board must be extraordinarily sensitive to the possibility of competitive harm to shippers of all types, and to agricultural and bulk shippers in particular. The Board should use its broad conditioning power to advance the public's interest in competition.

USDA and most shippers do not believe intermodal competition is always effective enough to constrain market power without the presence of intramodal railroad competition. Curtailment of Class I railroad mergers will give the Board and other interests a chance to study

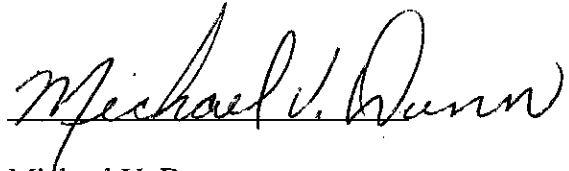
the impacts of past mergers more completely. The cost of undoing the possible unforeseen competitive harms due to future Class I railroad mergers, which the Board may approve, will probably be much greater than the loss of efficiency due to denying those mergers.

The Board, and the Interstate Commerce Commission before it, has traditionally placed a greater focus on those rail transportation policies relating to the financial health of the railroad industry than the other policies which are enumerated in both the Staggers Act and ICCTA. Since the policy goals of railroad industry profitability and shipper protection through effective competition conflict with each other, the Board's choice to emphasize industry profitability was a reasonable choice given the financial condition of the railroad industry during the 1970s and 1980s.

However, the railroad mergers and consolidations occurring since 1994 have resulted in increased market concentration and greatly decreased intramodal competition – events not foreseen at the time the Staggers Act was passed. These factors, combined with renewed profitability in the railroad industry, indicate that now is the time for the Board to place more emphasis upon those goals relating to preservation of intramodal competition and shipper protections.

Consequently, the USDA strongly opposes additional railroad consolidation and recommends that the Board promote policies which result in better railroad service and not bigger railroad companies at this time.

Respectfully submitted,

A handwritten signature in black ink, reading "Michael V. Dunn". The signature is written in a cursive style with a horizontal line underneath the name.

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