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January 11, 2001

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BY HAND

Vernon A. Williams, Secretary
Surface Transportation Board
Office of the Secretary
Case Control Unit
Attn: STB Ex Parte No. 582 (Sub-No.1)
1925 K Street, N.W.
Washington, DC 20423-0001



Re: Major Rail Consolidation Procedures (STB Ex Parte No. 582 (Sub-No. 1))

Dear Secretary Williams:

Enclosed for filing in the above-referenced matter are an original and 25 copies of the Rebuttal Comments of Canadian National Railway Company, together with a diskette in WordPerfect format. A certificate of service accompanies the document.

Kindly date-stamp the extra copy of this letter and the Rebuttal Comments, which our messenger is presenting, and return them to the messenger.

If there are any questions concerning this matter, please call the undersigned at (202) 973-7601.

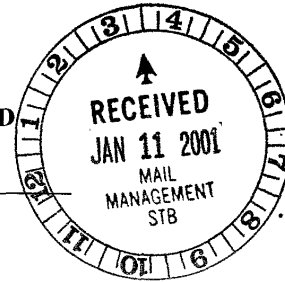
Very truly yours,

Paul A. Cunningham /H34

Paul A. Cunningham

Enclosures

BEFORE THE
SURFACE TRANSPORTATION BOARD



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EX PARTE NO. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REBUTTAL COMMENTS OF CANADIAN NATIONAL RAILWAY COMPANY

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January 11, 2001

BEFORE THE
SURFACE TRANSPORTATION BOARD

EX PARTE NO. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

EX PARTE NO. 582 (Sub-No. 1)

MAJOR RAIL CONSOLIDATION PROCEDURES

REBUTTAL COMMENTS OF CANADIAN NATIONAL RAILWAY COMPANY

Canadian National Railway Company, Grand Trunk Western Railroad Incorporated, and Illinois Central Railroad Company (collectively, "CN") hereby file rebuttal comments in response to the reply comments filed on December 18, 2000 in this proceeding.¹

SUMMARY

CN urges the Board to avoid accepting the many arguments, both explicit and implicit, that the Board should no longer allow markets to work, or should impose special burdens on applicants seeking to merge in transnational markets. It remains to be seen whether Class I railroads will propose further mergers between them to enhance efficiency and whether any such proposals would warrant approval. But the Board should welcome progress toward more efficient railroads if it is possible. Only the following conclusions as to the matters that CN has addressed will avoid diminishing that possibility:

¹CN uses the abbreviations and short-form citations listed in Appendices A and B in the NOPR. CN cites the November 17, 2000 comments as "Opening Comments" and the December 18, 2000 comments as "Reply."

First, the Board should resist the importuning of many shippers and several railroads to adopt two kinds of anti-market regulation: (1) non-market based “enhancements” to competition, which would have the perverse effect of diminishing the likelihood that railroads will propose mergers that would increase market-based competition among railroads, between railroads and other modes of competition, and between products in different locations that are transported by rail; and (2) measures designed to maintain the structural status quo that have been pressed upon the Board by railroads seeking to reduce the likelihood that they will have to face more efficient and stronger rail competition. The Board should reject barriers to increased competition from new capital investment and enhanced efficiency.

Second, there is a better way to respond to concerns about transcontinental mergers than to adopt a rule governing the consideration of downstream transactions in individual merger proceedings. The Board can repeal its present cumulative effects rule without adopting a new rule that would determine in advance the nature of its consideration of downstream transactions. The Board should leave that determination to individual proceedings, where it can have the benefit of specific requests around which it can shape appropriate orders. That is the proper course, given the continued uncertainty and controversy as to what, if anything, the Board could do with evidence of downstream transactions, and the inherent speculation and opportunity for error that would be involved in considering them. Certainly this proceeding has not generated a new intellectual base for evaluating transcontinental mergers, and the record confirms that downstream review in individual merger proceedings is not the best way to try and develop one. The Board should

conduct a workshop on transcontinental mergers, bringing together the best of current thinking in an appropriate forum. If the Board subsequently were to be presented with a transcontinental proposal, its ability to manage the proceeding to ensure a fully developed record would have been increased.

Third, the Board should not presume that transnational mergers, simply because they are transnational, are contrary to the public interest. Accordingly, the Board should not impose special requirements for applications in such mergers, requiring applicants to disprove supposed problems when there is no basis for believing that the supposed problems exist. For domestic mergers, the Board assumes that applicants will cooperate with the Federal Railroad Administration, that ownership restrictions to which they might be subject do not call into question whether their merger is consistent with the public interest, that they are properly motivated by profit-seeking and not political or other non-economic goals, and that they will continue to meet defense needs. The Board should afford the same treatment to applicants in transnational mergers, while standing ready in both domestic and transnational mergers to hear evidence that these assumptions are not correct in the particular case. The Board will have the opportunity to examine the impacts of transnational mergers in the U.S. through its proposed requirement for a “full-system plan” and related provisions, which CN supports.

Fourth, the Board should not require applicants to obtain its prior approval of voting trusts, nor should the Board attempt to apply a public interest standard to voting trusts. Application of the Board’s traditional tests for control, in a review initiated at the option of applicants, will continue to fulfill the proper function of aiding applicants seeking to avoid

unauthorized control. To apply a public interest standard would turn review of voting trusts into an inadequate merits determination, and would involve the Board in second-guessing applicants' decisions concerning the allocation of regulatory risk during the pendency of the merger proceeding

Fifth, the Board should focus its final efforts on its many positive proposals that would "raise the bar" to ensure that mergers otherwise consistent with the public interest do not diminish the public interest through harms such as service disruptions or reduced competition. Thus, CN has supported more rigorous examination by the Board of the effects of a proposed transaction on the financial ability of the merged carriers to maintain and improve service. CN has generally supported the Board's proposals relating to detailed market analyses, including route level reviews of service and more examination of geographic and product competition and of impacts on Class II and III railroads, service assurance plans, and safety integration plans. This focus on the Board's central regulatory role will ensure that, if a merger offers likely efficiency gains, shippers pursuing collateral agendas, railroads seeking protection against increased competition, and parties unwilling to accept NAFTA as the public policy of the U.S. or to face stronger competition in the most rapidly growing north-south corridors, will have no reasonable prospect of securing their goals by blocking otherwise qualified transactions.

I. COMPETITION

A. Access And Merger Policy

The Board's proposal for competition-enhancing conditions is being criticized from many quarters. Railroads argue that the Board lacks authority to require conditions unrelated to identified specific merger harms; that the proposal rests on assumptions about future mergers that are not justified and that do not provide a logical or proportional basis for the proposal; that the proposal would constitute a per se rule, foreclosing inquiry and moving the Board in the opposite direction from the constructive evolution of antitrust enforcement; that the uncertainty and apparent steep regulatory price entailed by the proposal would deter beneficial mergers; that the Board could not apply the proposal in principled fashion; and that the proposal would encourage opportunism by shippers or other parties that would reduce the likelihood of settlements.

Shippers argue along two different lines, which in the end are not consistent. The first line is that the Board should improve the proposal; the second is that the proposal is inherently inadequate because it would apply only to mergers. Along the first line, shippers argue that the proposal is too vague, that it must be supplemented by a specific list of conditions in order to have "teeth," and that the Board should not give credit for enhanced intermodal competition. Along the second line, shippers argue that the Board must provide rail options at least for all "captive" shippers; that past mergers have caused an industry-wide decline in intramodal competition, which the Board should seek to offset; and that the proposal, because it is limited to merger conditions, will create new competitive problems in

the form of imbalances between merging and non-merging railroads and between shippers that are and those that are not served by merging railroads.

Thus, for example, NITL argues that “by focusing purely on merger policy to accomplish its objective of ‘enhanced competition,’ the agency was creating an ‘uneven playing field’ between merging and non-merging carriers, to the detriment of the merging carriers and the shippers of the non-merging carriers.” NITL Reply 12; *see also id.* at 12-13 (summarizing “[n]umerous other commenters” that “noted the need for the Board to act more broadly than it has proposed, to provide for enhanced competition not just for merging carriers, but for non-merging carriers as well”; *see also* Certain Coal Shippers Reply 6 (Board must not only revise merger rules but also its regulations “pertaining to rail service and competition outside of the merger context”) (“CCS”); CURE Reply 3 (expansion of this proceeding “beyond the merger context”); Dow Reply 3, 6-7 (“uneven playing fields both among carriers and among shippers” could discourage mergers “that would yield substantial net public benefits”); DuPont Reply 3 (avoid an “unbalanced” policy that would expose only the merging carriers to enhanced competition).

The Board should not forge ahead with its proposal despite the diverse objections in the record, the near-certain dysfunctional consequences, and the clear indications that adoption of the proposal would not lay to rest shipper concerns about access. The Board should recognize that, whatever the proper response to those concerns, the Board’s merger rules cannot resolve them. The debate about access is a renewal of the debate about the fundamental goals of the Staggers Act: to allow railroads the opportunity to become profitable, innovating, investing enterprises and at the same time protect shippers from

abuses of market power. The Board's proposal for competition-enhancing conditions would be a futile attempt to address these issues through a merger policy that, in the end, would satisfy no one and would discourage efficiency-enhancing mergers.

What is most remarkable about the "enhanced competition" debate in this proceeding is the lack of any real defense of the proposition that merger conditions should be imposed when they are not a direct and proportional remedy for identified merger-related harms. This is, in effect, a debate about access, but that debate has completely lacked substance in this proceeding. The overarching question of how regulation can best allow the functioning of markets and reasonably emulate competitive market results when markets fail bears constant, serious inquiry. CN welcomes this inquiry. But there has been little or no contribution to that inquiry by the advocates of "enhanced competition" here.

Few, if any, commenters answer the most basic of questions. What exactly do they mean by competition; when does competitive rivalry lead to efficient outcomes and when does it not? What regulation of rates and service would be required to make this competition sufficiently efficient to meet their goals? How would this regulation square with the need to assure carriers the opportunity to earn enough to replace and expand their capacity for service?

There is no systematic response from the commenters who oppose future rail mergers, or support them only with onerous conditions. None has addressed the fundamental tension between conditions of the type they propose and reinvestment. This is not an industry making supra-normal profits. It is an industry making subnormal profits, and still seeking the efficiency and revenues that will generate the reinvestment needed to sustain and upgrade the

rail network. Efficiency-enhancing mergers can increase railroad profits and resulting reinvestment. Mergers burdened by supposed competition-enhancing conditions, if such mergers are proposed at all, will be less profitable, which will lead to less reinvestment and weaker long-run intramodal and intermodal competition.

Parties have simply failed to produce a record sufficient to support the conditions proposed by the Board. CN would not object if the new merger rules were to provide that competition-enhancing conditions will be examined on a case-by-case basis if and when merger applicants present them. If, however, there is to be a substantive debate over the difficult tradeoffs between maintaining competition among two or more rail lines and ensuring that railroads earn profits sufficient to justify reinvestment, that debate will require another forum. It has not been conducted here.

In the remainder of this section, CN briefly rebuts certain specific replies relating to the Board's statutory authority to adopt the proposal for competition-enhancing conditions, the impossibility of principled application of the proposal, the antitrust laws as a source of policy guidance on the competition element of the overall public interest standard, and the maintenance of major gateways.²

²On this and other subjects at issue, as in our reply comments, CN's silence does not mean that it agrees with comments of other parties. CN's judgment as to such matters is that the record will be sufficient without additional CN comment in rebuttal. Thus, PPL (Reply 9) states that CN (and BNSF) "completely ignore" paper barriers. CN's shortline and regional connections are an integral and valued component of CN service, and CN believes that mergers should not have the effect of extending paper barriers. With respect to proposals to eliminate paper barriers as a general merger condition, CN has seen no reason to distinguish such proposals from the general question of access, which CN has of course addressed throughout this proceeding. As CN stated at the outset, access proposals relating to "paper" and "steel" barriers "are not properly a part of merger policy." CN ANPR Opening Comments 35.

B. The Lack Of Statutory Authority.

Those who support the Board's authority to require competition-enhancing conditions invoke the statutory policy "to allow, to the maximum extent possible, competition and the demand for services to establish reasonable rates for transportation by rail." 49 U.S.C. § 10101(1). *See, e.g.*, EEI Reply 11-12; NITL Reply 20; Dow Reply 12. These parties appear to regard this policy as authorizing any requirement that increases competition (except, presumably, where the substantive provision under which the Board is acting simply does not allow such a requirement).

That is a misreading of the policy, which was enacted as part of the Staggers Act,³ and reaffirmed in the ICCTA, that competition should substitute for regulation wherever possible, that is, wherever competition occurs through the operation of markets, not regulation.⁴ A requirement for competition-enhancing conditions would be the opposite; it would expand the regulation of mergers by conditioning approval on entry even where none is required to preserve competition. It is no response to assert that such entry once accomplished would increase competition; the entry condition is itself intrusive and far-reaching merger

³Pub. L. No. 96-448, Title I, § 101(a), 94 Stat. 1897 (1980).

⁴The overall Congressional policy did not cause the substantive provisions of the Staggers Act to be interpreted in this expansive fashion. For example, the court in *Midtec Paper Corp. v. U.S.*, 857 F.2d 1487, 1507 (D.C. Cir. 1988), held that, if the Board could order access "whenever such an order could enhance competition between rail carriers, it could radically restructure the railroad industry. We have not found even the slightest indication that Congress intended the Commission in this way to conform the industry more closely to a model of perfect competition." There is nothing to support a different reading of this policy in the context of the ICCTA. Other procompetitive provisions in the Rail Transportation Policy cited by Dow (Reply 13) also were enacted as part of the Staggers Act.

regulation. In addition to the other infirmities of the enhanced-competition proposal, reliance on this policy as a source of authority is misplaced.⁵

C. The Impossibility Of Principled Application

CN pointed out that, under the Board's proposal for enhanced competition, the required conditions "would no longer be logically bounded by the nature and extent of the competitive harm the merger would cause. Because enhancements would be neither direct nor proportional, there would be no gauge for determining how much enhancement would be enough." CN Opening Comments 11.

IMPACT attempts to reply to these comments by offering "principles" for the Board to apply: in "rail dependent markets" the Board should increase the number of serving rail carriers "from one to two or from two to three, to the extent possible." IMPACT Reply 33. This is no response to criticisms of a proposal that would establish *merger* conditions. IMPACT is simply proposing a program of general access that happens to be triggered whenever there is a merger, without relation to any circumstance specific to the merger. IMPACT's supposed "principles" are not principles for defining conditions in mergers; instead, they confirm that there would be no merger-related gauge for determining how much

⁵CCS (Reply 9 n.10) and IMPACT (Reply 31) state that a requirement for competition-enhancing conditions would somehow be deregulatory rather than regulatory because asserted regional rail duopolies, captive shippers, and paper barriers mean that the structure of the market is insufficiently competitive. That, however, is the position rejected by the *Midtec* court. Moreover, the structure of the market is the outcome of innumerable private economic decisions, including the decisions of shippers to establish facilities at locations where they are served by one railroad, or of shortlines to agree to paper barriers. A legal requirement designed to change that structure is regulation, not deregulation. Proper merger review examines the incremental effects of a merger on the existing market structure. To convert merger review into general reform of existing market structure would be the most intrusive type of regulation.

enhancement would be enough. That is not a correct approach to merger conditions, because, among other reasons, the Board has defined its task as *balancing* merger benefits and harms.⁶

Because the Board rested its proposal in part on the risk of service disruptions, CN also asked in earlier comments what would be the “common yardstick that enables an apples-and-oranges comparison of service risk with competition enhancement?” CN Opening Comments 11-12. No party answers this question. NITL, acknowledging that the Board applies a balancing test, simply asserts that there is nothing in that test that prohibits balancing a risk of service failure against the benefit of increased competition. NITL Reply 25. That begs the question. The record is silent on how the Board could quantify even a range of estimates of the risk of service disruption. If the Board cannot estimate the size of the risk, it cannot know how much increased competition it may reasonably require under the balancing test to offset the risk.⁷ The appropriate way for the Board to address the risk of

⁶PPL states that CN witness Bernard Black argues for “relaxed STB merger standards” because “the major railroads’ market capitalization puts them in the middle of the Fortune 500.” PPL Reply 6 n.2. Professor Black did not argue for “relaxed” standards but against the ultra-enhanced review that the Board proposed. Recognizing the railroads’ particular “status as part of the transportation infrastructure” (CN Opening Comments 50 (Black V.S. at 9), Professor Black noted that, from “a policy perspective, the most important regulatory role is ensuring that a merger does not have anticompetitive effects.” *Id.* at 49 (Black V.S. at 8). Professor Black considered the “[a]dditional regulatory scrutiny” proposed by the Board to be unwarranted in light of the relative market capitalization of the six largest railroads, the largest of which (UP) ranks 191st among U.S. firms and the smallest of which (CSX) ranks 306th. *Id.* (Emphasis added). “Any possible rail merger is dwarfed in size by many other mergers that occasion far less regulatory oversight.” *Id.*

⁷Thus, the extent of required enhanced competition would not vary to reflect differences between merger applicants that could bear on the degree of risk. Some applicants may have had successful track records in implementing prior mergers while other applicants may have had repeated service problems. The financial terms of some transactions could mean that the applicants might unduly risk service problems through accelerated implementation, or be capital-constrained in their responses to service problems, while the

service disruptions is directly, through service plan review, including any service guarantees negotiated by the applicants with shippers.

NITL attempts to link service disruptions with competition-enhancing conditions by stating that it “strongly believes” that increased competition from conditions will reduce the risk of service disruptions. NITL Reply 26. But saying this does not make it so. NITL assumes that merging carriers somehow lack sufficient incentives to avoid service disruptions, but that is not the case. As recent experience confirms, railroads will suffer competitive traffic and revenue losses to trucks and other railroads, as well as depressed stock prices, from post-merger service disruptions.⁸ And proponents of competition-enhancing conditions simply assume that their proposals would themselves carry no risk of service disruptions. That is an unsupported and implausible assumption, with which DOT disagrees. *See* DOT Opening Comments 5.⁹

financial terms of other transactions would not leave the applicants in that situation.

⁸The railroads involved in the recent service disruptions “suffered huge losses in revenue, profit, and goodwill. The risk of service disruptions is now widely understood. It will be embedded in firms’ judgments about the efficiencies of a proposed merger and how to carry out integration. Merger participants have huge incentives to avoid service disruptions.” CN Opening Comments 50 (Black V.S. 9).

⁹Various proposals could, for example, re-Balkanize the industry, vastly increase coordination requirements, and, in the long run, limit the railroads’ ability to invest in their systems, making service disruptions more likely and causing a long-term decline in “normal” service.

D. The Antitrust Laws

CN noted in its opening comments that, although the public interest includes elements other than competition, and the Board's authority therefore is broader than that of an antitrust court, the Board has looked to the antitrust laws for guidance on the competition element of the public interest.¹⁰ CN pointed out that the Board's enhanced competition proposal would depart from the constructive evolution of antitrust law over the past two decades away from per se rules to rule-of-reason analysis. CN Opening Comments 14-15. The Board's proposal would amount to a "per se rule that future Class I mergers are inconsistent with the public interest in the absence of conditions to enhance competition." *Id.* at 14.

NITL quotes the Board's statement in *UP/SP* that its mandate "sharply contrasts" with the approach of the DOJ and FTC (NITL Reply 22), but neglects to describe the distinction that the Board drew there, which was that the antitrust laws at that time did not take into account merger efficiencies, whereas the Staggers Act required the Board "to balance efficiency gains against competitive harm." *UP/SP*, Decision No. 44, slip op. at 101. The Board noted in *UP/SP* that the antitrust enforcement agencies were considering revisions to the Merger Guidelines "that would make their antitrust enforcement more consistent with our

¹⁰According to IMPACT, CN "concedes" that the Board's authority is broader than that of an antitrust court. IMPACT Reply 32 n.27. The public interest standard is of course multi-factored, and the Board takes into account elements other than competition that an antitrust court would not consider. The relevant point is that, with respect to the competition element of the public interest, the Board, and before it the ICC, has looked to the antitrust laws for guidance.

approach to judging rail mergers.” *Id.* at 101 n. 93. In fact, those agencies subsequently amended the Merger Guidelines to take efficiencies into account.¹¹

CN’s point is not that the Board necessarily must adopt all substantive and remedial features of antitrust law.¹² It is, rather, that, in adopting a per se rule, the Board would be foreclosing inquiry itself, and the lesson of the antitrust laws is that such foreclosure is not wise, unless there is *no* plausible efficiency-based justification for the corporate conduct in question -- which is hardly the case for rail mergers. No party has demonstrated why the Board should depart from the overall approach of the antitrust laws in so fundamental a way.

NITL’s further assertion that the antitrust agencies “deal with mergers in numerous industries, most if not all of which are not nearly as concentrated as the current rail industry” (NITL Reply 22), is a non sequitur. NITL assumes that a small number of railroads means that all relevant markets are also concentrated, but that is demonstrably not the case for numerous properly defined local, regional and national transportation markets. Moreover, under the Merger Guidelines, concentration data are only the “starting point” for analysis. Merger Guidelines § 2.0.¹³

¹¹See U.S. Department of Justice and Federal Trade Commission Horizontal Merger Guidelines, § 4 (as amended 1997), *reprinted in* 4 Trade Reg. Rep. (CCH) ¶ 13,104.

¹²For example, a general policy of divestiture, as IMPACT seems to advocate (Reply 32), would, particularly in end-to-end mergers, obviously re-Balkanize rail transportation, multiplying the very problems with interline service that shippers have long complained about on other occasions. *See generally* UP/SP, Decision No. 44, slip op. at 157-58. And the Board’s balancing test may take efficiencies into account in a way that is not identical to the way antitrust enforcement agencies take them into account.

¹³KCS would have the Board deem any reduction in the number of serving carriers, for example, from five to four, to be a reduction in competition. KCS Reply 8-9. KCS provides no support for this proposal, which would substitute a head count for proper

Some parties deny that the Board is adopting any presumptions,¹⁴ but that is wrong. The Board very clearly based the proposed requirement for competition-enhancing conditions on irrebuttable presumptions about unidentifiable or irremediable losses of competition and the risk of service disruptions. *See* NOPR 13; *see also* proposed § 1180.1(c).

E. Preserving Major Gateways

CN has supported a rule that would preserve the “contract exception” for separate bottleneck rates for shippers that might otherwise lose the exception through the creation of new single line routes as a result of merger. *See* CN ANPR Opening Comments 31. UP has proposed a rule that would impose a condition entitling shippers to separate bottleneck rates without having first secured a contract, and even where the contract exception was in fact unavailable pre-merger because the merging bottleneck railroad participated in joint or proportional rates. *See* UP Reply 13; UP Opening Comments 33 (Appendix A at 12).

If the Board were to adopt this proposal, shippers on existing systems such as UP’s would remain limited to the contract exception, while all exclusively served rail-dependent shippers on systems that merge in the future would have a right to bottleneck rates. UP’s proposal would impose a heavy cost on future mergers. Such a cost would be unreasonably discriminatory unless applied to all railroads, either through a rule of industry-wide applicability or through reopening mergers since the Staggers Act, including UP’s five mergers, and imposing the condition on those systems as well. UP’s proposal would be best

competition analysis.

¹⁴NITL Reply 21-22; DuPont Reply 4. USDA suggests a “rebuttable presumption – that there are competitive problems.” USDA Reply 8. The requirement for competition-enhancing conditions would, however, rest on irrebuttable presumptions.

evaluated as part of a broader industry-wide access proceeding. If the Board were to adopt UP's proposal as part of the merger rules, the Board would have increased regulatory costs for future mergers while protecting existing systems, without any justification for this imbalance.

II. DOWNSTREAM TRANSACTIONS

It continues to be the case, as CN described in its reply comments, that “[m]any parties appear to share a premise – that the next major transaction is likely to lead to others – but none has demonstrated how that premise could justify the Board’s [downstream] proposal or any variant of it.” CN Reply 6. The record still does not show, for example, what the Board would do with evidence relating to downstream mergers. No party even attempted to reply to Professor Black’s demonstration that if “the STB could conduct downstream review perfectly – with accurate prediction of the future efficiency gains from downstream mergers – it would be virtually certain that the STB’s decision on the merger before it would be the same, with or without downstream review.” CN Opening Comments 51 (Black V.S. at 10). Still less did anyone explain how, if perfect downstream review would produce no change in the Board’s decisions, actual, inevitably imperfect, review could avoid degrading the quality of Board decisions.

Attempting to respond to numerous and detailed concerns about the speculation that review of downstream transactions would require, some parties argue that the rule would not require speculation because of the small number of remaining combinations or because the remaining possible combinations will become evident once the next merger is proposed. *See, e.g.,* IMPACT Reply 35. That would not be true, however, except if the next proposed

merger is between a U.S. eastern and a U.S. western railroad, as EEI seems to recognize (EEI Reply 16-17). There are many other possible Class I mergers.

Moreover, naming likely parties to a possible responsive transaction would only begin the speculation, which would then require hypothesizing when, whether, and if those parties would in fact propose such a merger, how the parties might structure the transaction, what traffic they would expect to divert, their intentions with respect to use of gateways and other routing issues, what their operating plan would be, what investments they would make, and so forth. *See* CN Reply 9-12 (discussing other comments); *see also* CN Opening Comments 18-20. These matters are unknowable until parties in an actual transaction present their lengthy and detailed studies and proposals.

Further, multiple speculations would be involved because the Board's goal is to examine the "eventual structure of the industry" (proposed § 1180.1(i)), which would require looking not only at possible direct responses to the pending transaction but at possible responses to the possible responses. And after all of that speculation, the Board would then either, and most probably, as Professor Black's analysis shows, reach the *same* decision that it would have reached without downstream review, *or* "impose its own industrial policy, by accepting or rejecting the projected industry structure, thereby displacing the market and picking winners and losers in the abstract." CN Opening Comments 18.¹⁵

¹⁵IMPACT argues that the Board should address downstream transactions because "approval of one merger may make the next merger the lesser of two evils – as happened when the UP-SP merger was proposed right after the BN-SF merger was approved – and thereby limit the Board's options." IMPACT Reply 36. There is nothing in the *UP/SP* decision to suggest that the Board considered that merger the lesser of two evils rather than a beneficial transaction in its own right. Moreover, IMPACT's argument confirms CN's point: the Board would be adopting an industrial policy, with winners gaining new opportunities for

Some parties would justify the Board's proposal on the ground that the Board must be able to impose "contingent" conditions (DuPont Reply 6), or to give "fair warning" as to what "adjustments" to conditions might be made if some future transaction were to be proposed and approved (CSX Reply 79). Fashioning such conditions, however, would entail all of the speculation that parties have discussed. No party has shown how such conditions could possibly turn out to be realistic except by chance. And whether characterized as "contingent" or as "adjustments," these would amount to springing conditions that would unreasonably bias the process against earlier transactions, and could deter beneficial transactions.¹⁶

The Board's proposal with respect to downstream transactions responded to the state of the debate over the future shape of the industry at the conclusion of the ANPR. This rulemaking has now made it evident that downstream review is speculative and impractical, and cannot effectively respond to shippers's real concerns. There are other and better ways to address the issue. EEI points out that "the shippers' concern is not, in many respects, with which railroads merge, as that there will be a two-railroad industry in North America." EEI

enhanced rail services and access to markets, and losers losing them, including not only winning and losing railroads but winning and losing shippers, regions, and ports. Under the "lesser evils" approach, the Board would become a master planner, deciding for all time which railroads could merge with which other railroads, a role well beyond the Board's statutory mandate and fraught with opportunity for unfortunate outcomes.

¹⁶KCS urges the Board to condition its approval of future mergers on enhancements of the competitive effect of conditions imposed in prior mergers. KCS Reply 13. Like its proposal that the Board require such enhancement in its oversight of mergers approved prior to adoption of the rules (KCS Opening Comments 20), KCS's proposal that the Board second-guess itself would increase uncertainty and entail impermissible retroactivity. *See* UP Reply 4-7.

Reply 16-17. Although stated less explicitly by others, it is evident from their comments that EEI is correct; the real concern is with the prospect of two transcontinental railroads.

EEI believes that the Board should adopt the downstream rule as proposed in response to those concerns. But that is not a useful response, as the numerous and fundamental criticisms of the proposal have shown. Nor is it the only response. CN has pointed out that the Board could repeal the present no-downstream rule without adopting any rule that would determine in advance the extent to which the Board would consider downstream transactions. CN Reply 15-17. Moreover, the Board, building on the record in this proceeding, could initiate a workshop to consider issues specific to transcontinental mergers and a two-railroad structure. *See Id.* at 14-15. Such a proceeding would provide the opportunity “for those who believe there are matters relating only and generically to transcontinental mergers to identify what those matters are.” *Id.* at 14.¹⁷

DOT appears to have reached a similar conclusion. In response to UP’s proposal that the Board require merger applicants to address whether a two-railroad transcontinental structure would be in the public interest, DOT states that “the time to consider the question of a rail duopoly is not when the transaction that would create it is presented, but in advance.” DOT Reply 11. Thus, “the Board could open a proceeding now on issues that might be

¹⁷CN has previously suggested some of the subjects that the Board might notice for such a workshop: “the kinds of efficiencies that a transcontinental railroad could bring, the existing or potential demand for transcontinental rail services, the bearing of globalization and international trade, ways of identifying relevant markets for competition analysis, the significance of the vigorous competition in two-railroad markets that exists today, the framework for analyzing possible effects on incentives or ability to exercise market power, labor issues, issues of managerial control and customer responsiveness, the significance of new information technologies, and the likelihood and consequences of failure of one of two systems.” CN Reply 14-15.

involved in transcontinental mergers or those resulting in a rail duopoly, to surface and address the issues that drive concerns about such mergers.” *Id.*¹⁸

While CN does not believe that such a proceeding could yield firm answers, it would bring together the best of current thinking in an appropriate forum. The railroads’ economic evaluations of possible transcontinental mergers would not likely be fundamentally affected by what is learned in such a proceeding, but their assessments of regulatory risk and opportunity could be. And if the Board subsequently were to be presented with a transcontinental proposal, its ability to manage the proceeding and ensure a fully developed record would have been increased. The Board would be better informed at the outset of any such merger proceeding as to the considerations, if any, that are specific to such transactions, the issues likely to emerge during such a proceeding, and any need to specify additional information requirements for the application. Evidence in the proceeding would be more refined, because parties would have had the benefit of the materials submitted in the workshop; in effect, the evidence in the proceeding would be a second round. New policy-oriented research might be stimulated either prior to or after such a workshop.¹⁹

¹⁸DOT anticipates that the filings in such a proceeding, although “largely theoretical,” could allow the Board to provide “advance guidance” on what would be required of transcontinental merger applicants, or might convince the Board to ask Congress for authority to “reject out-of-hand any ‘duopoly’ merger.” *Id.* CN does not expect that a “largely theoretical” proceeding would provide firm conclusions, but CN believes that a workshop could be useful nonetheless.

¹⁹For example, DOT points out that “several large regions of the country already have duopoly rail service” and a new proceeding could examine performance in those areas with respect to “willingness to innovate, service, safety and rates.” DOT Reply 11. IMPACT asserts that a transcontinental merger could bring few efficiencies because only a small fraction of traffic moves transcontinentally. IMPACT Reply 30. This kind of assertion could prompt inquiry into whether, if the statement is correct, it would follow that railroads’

The bottom line is that this proceeding has not generated a new intellectual base for evaluating transcontinental mergers, and downstream review, especially in a merger proceeding not involving a transcontinental merger, is not the occasion to try and develop one. In these circumstances, a workshop would be a sensible next step.

III. VOTING TRUSTS

CN disagrees with the Board's proposals to require approval of voting trusts and to apply a public interest standard in doing so. CN described in earlier comments how applying a public interest test at the outset of a merger proceeding would be inconsistent with the statute, and would be an ill-advised attempt at a merits determination prior to receiving evidence. Further, the Board would be "second-guessing the applicants' allocation between them of regulatory risk during the pendency of the merger proceeding." CN Opening Comments 21. And to convert the present option for informal staff review of a proposed voting trust agreement into a requirement of prior Board approval, even under a control test, would substitute regulation for the applicants' decision to assume the regulatory risk of unauthorized control during the pendency of the merger proceeding. *Id.* at 22.

No party replied to these objections. The Port Authority of New York and New Jersey ("PANYNJ"), while opposing a public interest test for voting trusts, argues for a financial test under which applicants would be required to establish that "the financial aspects of the proposed transaction will not leave the surviving carrier(s) in a situation where it or

incentives to propose transcontinental mergers would be low as well, and that, if a transcontinental merger were completed, any reductions in competition would be correspondingly small, as well as into whether the railroads would have the ability through lower rates and new and improved services to increase transcontinental traffic.

they will not be able . . . to meet the investment needs of the carrier(s).” PANYNJ Reply 4. According to PANYNJ, the Conrail transaction “had essentially become a *fait accompli* before any financial information was submitted to the Board,” but left NS and CSX unable to invest adequately in their systems. *Id.* at 3. EEI supports the Board’s voting trust proposal on the ground that approval of a voting trust is the “‘point of no return’ after which, as a practical matter, it is almost impossible” for the Board to deny an application. EEI Reply 4.

From the outset of this proceeding, CN has supported 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.²⁰ The examination of financial terms, however, like the examination of any other element of the public interest, should occur during and not prior to the merger proceeding. This timing is required by the statute and supported by sound policy, as CN has earlier described. CN Reply 19-20; CN Opening Comments 21-22. It is illusory to think that the Board could apply a financial test in isolation, when there might not even be a definitive merger agreement,²¹ the marketplace has not yet responded to the proposal through the tendering or voting of shares, and the Board lacks evidence on all

²⁰See Ex Parte No. 582, Written Statement of Paul M. Tellier at 24 (Feb. 29, 2000) (“Future applicants should . . . be prepared to demonstrate that their cash flows and debt levels will permit them to respond with alacrity to any service problems that require additional financial resources.”); see also CN ANPR Opening Comments 15 (May 16, 2000) (Board’s financial inquiry “should include the amount of debt involved in the transaction, and its effects on the merged railroad’s cost of capital and on the speed with which the merged railroad might be impelled to attempt complete implementation of its transaction.”).

²¹For example, in seeking control of Conrail, NS began a two-stage tender offer. NS sought voting trust approval prior to the initial tender offer, when a definitive merger agreement had yet to be negotiated.

relevant aspects of the proposed transaction, including, for example, the predicted traffic diversions and efficiencies that will drive revenues and earnings expectations.²²

The assertion that the use of a voting trust somehow puts the Board in a straight-jacket is unsupported. The ICC denied an application involving a voting trust in *SF/SP*. And there is no suggestion in the Board's opinion in the *Conrail* proceeding (or any other proceeding of which CN is aware) that the Board would have preferred to disapprove the transaction, or to impose more extensive conditions, but was deterred by the stock acquisitions and voting trusts.

Any disapproval after a merger proceeding is costly, whether or not a voting trust is involved, but the Board is not for that reason constrained from disapproving a transaction. If an applicant in a disapproved transaction were to suffer a loss in connection with the divestiture of railroad stock held in the voting trust, the loss would be a function of the marketplace at that time. This a risk that merger applicants must face if they use a voting trust, but it is not one that the Board should address. The voting trust assures the independence of the subject railroad as required by the Board's existing regulations. The market values of the stock and the underlying rail assets will vary over the period of the voting trust just as they would if there were no voting trust. Applicants and the capital

²²Either a public interest test or a financial test for the use of a proposed voting trust could involve the Board in handicapping one or the other bidder in a takeover contest, where the bidders use a voting trust to effect the acquisition of a partial stock interest in the railroad target. The Board would be handicapping on the basis of highly incomplete information, particularly because the voting trust may well precede the setting of the final financial terms for the proposed control transaction. Even apart from a bidding contest, a public interest test in combination with a requirement for prior approval could advantage non-railroad acquirers not subject to the Board's control jurisdiction.

markets, which learn from experience, are aware of this risk and have every reason to temper their use of voting trusts in light of this risk. The Board should not second-guess these financial judgments by turning approval of a voting trust proposal into any kind of a merits determination.

The risk that the Board *can* manage is the risk of regulatory miscalculation by applicants leading to disapproval or to the imposition of conditions that make the transaction uneconomic for the applicants. The way to minimize that risk is to avoid the regulatory uncertainties inherent in the Board's proposals with respect to conditions to enhance competition, downstream review, and transnational transactions, and to expedite the merger review process as much as possible. CN Opening Comments 6-10.

IV. TRANSNATIONAL TRANSACTIONS

CN has shown that the Board's proposed additional special requirements for applications in transnational mergers (proposed §§ 1180.1(k), 1180.11) "would presume that Congress's general expectations in approving NAFTA" are incorrect with respect to the enumerated subjects (such as ownership restrictions) in the transnational provisions, "notwithstanding the absence of evidence supporting that conclusion and the experience that supports Congress's view." CN Opening Comments 24. Even apart from NAFTA, such proposals would "unreasonably discriminate." *Id.* CP also found the Board's proposals to be in "conflict with the trade policies embodied in NAFTA" and otherwise unsupportable. CP Reply 13-20. Both CN and CP pointed out that the Board can and should resolve any issues credibly raised in the course of a merger proceeding, but should not impose special burdens

on transnational applicants. CN and CP support the Board's proposal for a "full system" plan.²³

Instead of identifying a specific concern that would justify the discrimination against foreign applicants in proposed § 1180.11, DOT argues that the Board simply knows more or can more easily find out about "facts, law and policy" relating to domestic mergers in comparison with transnational mergers, and that this relative absence of knowledge justifies the discrimination. DOT Reply 9. DOT's view is that a proposal for a transnational merger creates an uncertainty that places the Board "in jeopardy" of not adequately protecting the public interest. *Id.* This is nothing more than an argument that the Board should impose special requirements on foreign applicants simply because they are foreign.²⁴ NAFTA, however, was designed for the very purpose of ending bias based solely on nationality. DOT's comment precisely demonstrates why the proposed rules do not square with NAFTA and are otherwise arbitrary.²⁵

²³CN stated in its opening comments: "While any regulatory requirement creates the possibility of unreasonable application, CN does not in principle oppose these requirements, which, consistently with NAFTA, turn on the nature of the impacts, and not the foreignness of the applicants." CN Opening Comments 23.

²⁴Indeed, DOT itself recognizes elsewhere that the various other proposals directed by other parties at transnational mergers are unjustified for virtually the same reason that it advances in support of the discriminatory proposal of the Board: that there "is no information as yet on the factual specifics of any of these issues." DOT Reply 9.

²⁵DOT also requests that the Board "pay special heed to DOD's views." DOT Reply 9. DOT does not address any of those views specifically. As CN's reply comments demonstrated, the concerns DOD has expressed with respect to transnational mergers are contrary to more than a century of experience, can in any event be addressed in merger proceedings without a discriminatory application requirement, and, as to some, are not specific to mergers.

PANYNJ attempts to justify one element of the Board's proposal (national or provincial goals) by referring to a 1992 provincial report that recommended a change in law to permit below-cost rail rates for the purpose of promoting container traffic moving through the Port of Halifax. PANYNJ Reply 5. PANYNJ states that the Board's proposal will provide parties to a merger proceeding "with an opportunity to address those possible discriminations." *Id.*

But the Board need not adopt its proposal in order to provide parties with such an opportunity. All parties would be free in a transnational merger proceeding to introduce the study into evidence for what it is worth.²⁶ Moreover, parties would have such an opportunity with respect to any program that, unlike the recommendations cited by the PANYNJ, has actually been adopted. Neither PANYNJ nor any other party suggests that a national or provincial program detrimental to the U.S. public interest could be sustained on a covert basis.

Taking a different tack, UP denies that the proposed rules would discriminate. According to UP, the proposed rules would do no more than allow the Board to "hold foreign applicants to the same standards as domestic applicants" by eliciting information on impacts on "the U.S. rail network and public interests." UP Reply 25. Of course the Board will decide both transnational and domestic mergers under the same ultimate public interest standard, which requires evaluating impacts on the U.S. rail network. The special requirements in proposed § 1180.11 for applications in transnational mergers would,

²⁶The proposals in the study were never adopted. PANYNJ was a party in the *CN/IC* proceeding but did not introduce this or any other evidence.

however, change the rules under which that determination is made, by reversing the Board's assumptions about merger applicants. For applicants in domestic mergers, the Board simply assumes adequate cooperation with FRA, the absence of harm to the public interest from any ownership restrictions to which the applicants may be subject, and the primacy of the profit-seeking motive. The Board's proposals would reverse those assumptions with respect to applicants in a transnational merger, and impose additional requirements for the application accordingly.²⁷ The Board would impose these additional requirements despite the satisfactory experience with foreign ownership of U.S. railroads for over a century, the absence of any specific basis for reversing the assumptions, and Congress's overall determination that NAFTA's application to rail transportation would enhance the economic welfare of the U.S. *See* CN Opening Comments 23-38. The Board can stand ready to entertain credible evidence from any party that questions any of these assumptions, but it should not impose on foreign applicants the burden of coming forward in the first instance when there is no apparent issue to be resolved. *See id.* at 23-25. The Board should not impose on CN or another foreign carrier the burden of disproving the supposed harms suggested by proposed § 1180.11, in the absence of any evidence that the supposed harms exist.

²⁷Although the Board proposes to require domestic applicants to discuss defense ramifications in the application (proposed § 1180.1(*l*)), it proposes a separate and presumably additional requirement on applicants in transnational mergers (proposed § 1180.11(*c*)). CN has no objection to otherwise reasonable application requirements relating to defense that apply uniformly in domestic and transnational mergers, but it opposes special requirements for applications in transnational mergers. *See* CN Reply 23-27; CN Opening Comments 37-38.

UP also urges the Board to require foreign applicants to maintain all major gateways that are wholly within another country. UP argues that applicants should not be allowed “to determine unilaterally whether their foreign activities will have impacts on U.S. interests.” UP Reply 25. In fact, however, the full-system plan will include applicants’ use of major gateways within a foreign country, so that the Board will be able to decide whether it must condition approval of the transaction on keeping those gateways open in order to avoid adverse impacts in the U.S. Applicants therefore will not be allowed to decide unilaterally whether their activities will have impacts on U.S. interests. The Board cannot, however, reasonably do what UP is urging, which is to determine in advance in its rules that in any future transnational merger all major gateways located in foreign countries must be kept open in order to avoid adverse impacts on the U.S. There is not and could not be any support for such a blanket finding.

Without giving any reason, RLD supports the view that “foreign applicants should be required to provide assurances of continued FRA supervision” of operations that applicants propose to move to foreign locations. RLD Reply 14. The Board’s proposal, however, is broader. It would require professions of good faith whether or not applicants are proposing to move any operations to a foreign location. RLD provides no response to CN’s objection that Congress, when it found “NAFTA to be in the public interest, did not expect NAFTA to undercut the efficacy of U.S. regulation, including safety regulation.” CN Opening Comments 27 (footnote omitted). The Board, however, “is proposing on an across the board basis to presume otherwise with respect to cooperation with FRA, without adequate basis.”

Id.

Moreover, the rule would be arbitrary even where applicants intend to move some operations to a foreign location. In such a case, applicants would identify those moves in the normal course as part of the operating plan, the safety integration plan, and the employee impact exhibit.²⁸ Parties would then have the opportunity to offer evidence purporting to demonstrate that the move would impair FRA enforcement, and applicants could respond accordingly. The fact of a move is no reason to presume lack of cooperation with FRA.²⁹ The proposed transnational rule relating to cooperation with FRA is not necessary to protect the public interest in safety.

V. MERGER HARMS

UP proposes an open-ended expansion of cognizable “potential ‘costs’” of a merger. UP Reply 21-22. These would include “atrophy” of existing alliances, or a shift by the merging carriers away from “multi-carrier cooperative opportunities”; for example, “if two railroads that connect in Chicago merge, they are likely to invest their time and money in improving their route through Chicago rather than in solving the industry’s mutual problems in that crowded terminal.” *Id.* at 22.

This is a proposal to preserve the status quo. Any significant economic change causes myriad economic costs and benefits, which ripple outward and over time, extending to

²⁸The employee impact exhibit (proposed § 1180.6(b)(9)) would require applicants to identify and quantify positive and negative impacts on employees in the foreign country. The Board has explained that the “‘Jobs Transferred To’ column will capture, among other things, anticipated cross-border transfers.” NOPR 31.

²⁹The rule would therefore not be reasonable even if amended, as RLD suggests (Reply 15), to require assurances of cooperation with FRA from domestic carriers in domestic merger if they intend to transfer to another country operations that would impact safety in the U.S.

second and third order effects and beyond. No process can fully identify them. UP would have the Board expand the list of costs but not the list of benefits.³⁰ And any list of either would be arbitrary. To elaborate the obvious, rail mergers can help some shippers and communities and not others. Those not helped may face the costs of a decline in their competitive position, including the loss of some volume-related efficiencies. Some of those who in the future would make plant location or other decisions to gain the benefits of a merger may not even know who they are at the time the merger is before the Board. Neither parties to a merger proceeding nor the Board could possibly identify and value the expanded universe urged by UP, nor could the Board rationally limit it. And not all costs should be cognizable. Increasing efficiency is an endless process of substitution of better ways of doing things. The inevitable “costs” of that substitution are not reasons to stop the substitution.³¹

UP’s approach would easily become the protection of competitors rather than competition. For example, the ICCTA protects other railroads from greater competition only insofar as they provide “essential services.” There is no reason why an alliance should receive greater protection, particularly because, in choosing to propose a merger, one or both of the merging parties must have decided that the merger would bring greater economic benefits. UP’s proposal would convert alliances from efficiency and service opportunities to

³⁰To take UP’s example, efforts by merging carriers that meet in Chicago to improve their routing through or around Chicago can reduce congestion in that terminal, thereby benefitting all carriers.

³¹The Board could not adopt UP’s proposal in conformity with the notice provisions of the Administrative Procedure Act, 5 U.S.C. § 553.

potential regulatory constraints on greater economic opportunities, which could only deter the formation of alliances in the first place.

VI. CLASSIFICATION OF CARRIERS

UP proposes that the financial classification of merger applicants for purposes of applying the new merger rules be determined by combining affiliated carriers that are contiguous. UP Reply 36. UP argues that a merger of a Class I carrier and a “large” regional railroad “may involve significant competitive and service issues.” *Id.*

The Board would, however, consider significant competition issues in a merger not involving two Class I railroads; the statute directs the Board to consider competitive issues in such mergers. 49 U.S.C. § 11324(d). There is no reason to believe that such mergers would pose risks of severe service disruptions that warrant the extensive examination contemplated by the new rules. The Board saw no basis for amending its existing rules when it provided notice of its proposals at the outset of this proceeding. UP has provided no reason to believe that the Board’s existing rules have somehow become insufficient to protect the public interest in mergers not involving two Class I railroads.

CONCLUSION

CN has welcomed the opportunity to contribute to this proceeding, both as a highly efficient Class I railroad and as a Canadian railroad with a long history of successful participation in transnational and U.S. transportation markets. CN believes that the Board should adopt the rules that will support rigorous examination of merger effects on competition, service, and safety, while avoiding protectionism and unnecessary regulation of

all kinds. Both through what it does and does not contain, the record provides sound guidance on those critical distinctions.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Paul A. Cunningham" with a stylized flourish at the end.

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January 11, 2001

CERTIFICATE OF SERVICE

I certify that I have this 11th day of January, 2001, served copies of the foregoing Rebuttal Comments of Canadian National Railway Company upon all known parties of record in this proceeding by first-class mail or a more expeditious method of delivery.


Cynthia A. Colaiaacovo