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BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 32760

UNION PACIFIC CORPORATION, UNION PACIFIC RAILROAD COMPANY
AND MISSOURI PACIFIC RAILROAD COMPANY
-- CONTROL AND MERGER --
SOUTHERN PACIFIC RAIL CORPORATION, SOUTHERN PACIFIC
TRANSPORTATION COMPANY, ST. LOUIS SOUTHWESTERN RAILWAY
COMPANY, SPCSL CORP. AND THE DENVER AND
RIO GRANDE WESTERN RAILROAD COMPANY



UP'S REPLY TO BNSF'S RESPONSE TO ORDER TO SHOW CAUSE

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UP'S REPLY TO BNSF'S AND CMA'S RESPONSES TO ORDER TO SHOW CAUSE

In Decision No. 96, BNSF gained a second chance to prove that UP and BNSF had mutually agreed to remove certain costs from post-merger URCS calculations when performing the BNSF Settlement Agreement's annual trackage rights fee adjustment.¹ In its Response, BNSF abandons that claim. Adopting a new theory of the parties' intent, BNSF – joined by CMA² – now claims that UP and BNSF mutually agreed to an entirely different procedure. BNSF now claims that the true agreement was to adjust fees based only on comparisons of UP's URCS costs between post-merger years. BNSF no longer says that the disputed costs should be excluded from

¹ See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., STB Finance Docket 32760, Decision No. 96 (STB served Mar. 21, 2002), slip op. at 6 (“[W]e will allow BNSF a further opportunity to demonstrate that the disputed items should be omitted from the URCS calculations required to create the Section 12 adjustment factor.”).

² We refer to the American Chemistry Council (formerly the Chemical Manufacturers Association) by the acronym used throughout these proceedings, “CMA.”

post-merger URCS. Instead, it says that the parties intended to adjust fees using post-merger URCS that should have included the disputed costs.

In adopting this new theory, BNSF again asks the Board to disregard the BNSF Settlement Agreement's plain language, which requires comparisons using pre-merger URCS. It asks the Board to find a contrary intent that is inconsistent with the Agreement, inconsistent with the evidence in the merger proceeding, inconsistent with BNSF's and CMA's behavior, internally inconsistent, and inconsistent with preserving the competitive balance between BNSF and UP.

The parties never agreed to depart from the plain language that they carefully negotiated for the BNSF Settlement Agreement. Nor is there any competitive justification for altering the agreed-upon fee adjustment process. BNSF pays trackage rights fees (a) lower than the rates it originally negotiated, and which it swore would make it competitive, (b) lower than rates the Board would have prescribed under its *SSW Compensation* methodology, and (c) much lower than rates BNSF charges UP to remedy the anticompetitive effects of the BN/Santa Fe merger.

While paying these fees, BNSF's trackage rights traffic has grown "to the size and scale of a new Class I railroad," and BNSF has "exceeded [its] goal" for the trackage rights. BNSF-PR-20 at 4. BNSF has reported, and the Board has agreed, that the trackage rights have effectively preserved rail competition in the West. See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., STB Finance Docket 32760 (Sub-No. 21), Decision No. 21 (STB served Dec. 20, 2001).

The Board should reject BNSF's ever-changing stories regarding the parties' intent and dismiss BNSF's Petition with prejudice.

In the following sections, we briefly summarize our arguments and review the background of the BNSF Settlement Agreement and the CMA Agreement negotiations. In Part I of our Argument, we demonstrate that BNSF and CMA offer no credible evidence that the parties intended to depart from the BNSF Settlement Agreement's plain language. In Part II we show that their new theory of intent does not rationally apply to one of the two types the costs that BNSF and CMA seek to disregard in the fee adjustment. In Part III we explain why BNSF's proposed recalculation of the fee adjustment is unworkable. Finally, in Part IV we show that the trackage rights fees allow BNSF to be a vigorous competitor using its trackage rights and allow UP and BNSF to compete fairly. This Reply is supported by verified statements from John H. Rebensdorf, Keith A. Rhoades, and Richard F. Kauders, and by a joint verified statement from James V. Dolan, Paul A. Conley, Jr., and John T. Gray.

SUMMARY OF ARGUMENT

BNSF and CMA ask the Board to override the plain language of the BNSF Settlement Agreement – language that adopts a CMA proposal and that BNSF agreed upon with UP after intensive negotiations. Unable to provide the evidence that the Board invited them to produce in support of BNSF's December Petition, BNSF and CMA offer an entirely new theory never voiced in the six years since UP and SP merged. They argue for the first time that the BNSF Settlement Agreement is wrongly drafted, and that the parties had a different but unarticulated intent. They walk away from their prior theory that the parties intended to remove some of UP's costs in adjusting the fees.

The plain language of the BNSF Settlement Agreement's provision for adjusting trackage rights fees requires the parties to adjust the fees every year based on the difference in pertinent UP system-average URCS costs for the prior two years. The language is clear; the

computation is straightforward; and the Agreement contemplates no exceptions or modifications. BNSF and CMA now claim that the true intent was to use the difference between the current year (at a time when URCS costs would not yet be available) and the year before.

The BNSF Settlement Agreement's plain language carries out the specifications of a CMA expert witness, Thomas D. Crowley. CMA's witness specifically urged that the first adjustment occur in 1997, based on a comparison between UP's 1995 and 1996 system-average URCS costs (hence we will call this comparison the "CMA Method"). BNSF and UP then agreed to use the CMA Method. BNSF and UP faithfully incorporated the CMA Method into the BNSF Settlement Agreement, and UP has employed it since. Even though the trackage rights fees were one of the most contentious and closely watched issues in the UP/SP merger proceeding, no party ever suggested that BNSF and UP got the language wrong – until BNSF and CMA filed their Responses last month.

The new BNSF and CMA theory is remarkable not only because it lay unexpressed for half a decade, but also because it points in the opposite direction from the theory that BNSF advocated only five months ago. In its December Petition, BNSF repeatedly asserted that the railroads intended to modify UP's URCS every year to exclude two elements of UP's costs associated with the UP/SP merger: (1) the difference between SP's book value and the higher amount that UP paid to acquire SP (the "SP purchase cost") and (2) the costs of certain post-merger capacity improvements on the trackage rights lines that UP agreed to fund in Sections 9(c)(i) and 9(c)(iii) of the BNSF Settlement Agreement (the "merger capacity costs"). BNSF-98 at 12-16.

BNSF and CMA now ignore BNSF's previous claims of intent to exclude these costs from URCS beginning in 1997. They provide none of the evidence that the Board requested

to support these claims. In their Responses, they instead claim that the parties intended to compare only post-merger URCS costs. They now argue that the parties intended to adjust fees using post-merger URCS costs that should have included the disputed items. They claim that the BNSF Settlement Agreement should have expressed that intent. See BNSF-102 at 7-9; CMA-17 at 2.

The Board should reject this new argument for a host of reasons:

- The BNSF Settlement Agreement does not restrict fee adjustments to post-merger URCS costs, but instead requires an adjustment in 1997 based on two prior years' URCS costs.
- Not a shred of evidence shows that BNSF, CMA, and UP ever discussed, much less agreed to, the alleged intent to base fee adjustments on only post-merger URCS costs.
- The BNSF Settlement Agreement accurately adopts the CMA Method recommended by CMA witness Thomas Crowley.
- BNSF and UP jointly adopted the language that implements the CMA Method.
- BNSF and CMA have never before suggested that the BNSF Settlement Agreement misstates the parties' intent, even though BNSF and CMA were intensely interested in this issue during the merger proceedings.
- BNSF's and CMA's new allegations leave them with no theory that explains how the parties could have intended to avoid reflecting merger capacity costs in the fee adjustment. The post-merger URCS they want to use reflected those cost increases as UP incurred them.
- As a BNSF witness inadvertently demonstrates, the adjustments BNSF now wants cannot be performed. They would require illegitimate distortions of URCS costs and principles.

Finally, the evidence demonstrates that BNSF has been a formidable competitor using the trackage rights it obtained in the UP/SP merger, as the Board has repeatedly found. BNSF has repeatedly bragged of competing successfully, despite paying trackage rights fees that it now claims are too high. The CMA Method has proven highly favorable to BNSF: As we will show, BNSF's trackage rights fees are 10 percent below the fees BNSF would be paying under the

RCAF(U) adjustment to which it initially agreed, 19 percent below the fees BNSF charges for trackage rights that UP received in connection with the BN/Santa Fe merger, and 28 percent below the fees the Board would have established for similar trackage rights.³ There is no competitive justification for departing from the BNSF Settlement Agreement's plain language.

BACKGROUND

BNSF and UP established the initial trackage rights fees in the original BNSF Settlement Agreement through intense, arms-length negotiations. They agreed on rates of 3.0 mills per gross ton-mile for bulk traffic, 3.1 mills per gross ton-mile for most intermodal and carload traffic, and 3.48 mills per gross ton-mile for intermodal and carload traffic moving between Keddle and Stockton, California. They initially agreed to adjust those rates from year to year to reflect seventy percent of increases or decreases in RCAF(U). Responding to concerns from other participants in the UP/SP merger proceedings, however, UP and BNSF subsequently amended the BNSF Settlement Agreement by agreeing to adjust the trackage rights fees using system-average URCS costs instead of RCAF(U). That agreement reduced the fees.

A. The September 1995 Negotiations

In their initial settlement negotiations in September 1995, BNSF and UP bargained over the rates that they would pay each other for the rights they exchanged. Their negotiations used as benchmarks trackage rights fees in their other recent trackage rights agreements. See *Rebensdorf V.S.* at 2. The parties negotiated the levels of the trackage rights fees, but they never discussed costs or exchanged any information about costs. Id. As all of UP's negotiators testify,

³ See also Decision No. 96 at 5 n.6 ("We note that BNSF has benefited, and competition over the trackage rights lines has been enhanced, by the change from the RCAF-based fee adjustment (initially agreed to by BNSF) to the URCS-based adjustment that we imposed, at the urging of CMA and other parties, as a condition to our approval of the UP/SP merger.").

neither UP nor BNSF ever mentioned the SP purchase cost or the accounting treatment of the purchase. Id. at 2-3; Dolan/Conley/Gray V.S. at 3-4.

If BNSF made any assumptions about whether the initial rates reflected the SP purchase cost or the timing of UP's accounting for the SP purchase, it never shared them with UP. Rebensdorf V.S. at 3. UP did not even consider these issues. Id. UP simply sought to establish rates that the parties and the Board would accept and that would cover UP's operating and maintenance costs while contributing to its investment costs. Id. The parties adopted an adjustment based on 70 percent of RCAF(U) because it is commonly used in the industry. Id. at 2. Under a flat-rate agreement with an RCAF(U) adjustment, the SP purchase cost was irrelevant. Id. at 3.

UP agreed to use flat rates with an RCAF(U) adjustment to avoid the substantial clerical work and expense associated with traditional joint facility arrangements. Id. at 4. Traditional arrangements require annually allocating the actual cost of maintenance and operation between the parties on the basis of their relative usage, adding appropriate overheads, and then adding an interest rental factor to provide a return to capital invested in the trackage rights lines. Using flat rates with an indexed adjustment eliminates the need to monitor separately the maintenance expenses and capital investments associated with the lines. It also eliminates uncertainty about what the tenant will pay. Id.

In sworn testimony, BNSF represented that it could compete effectively using the original trackage rights compensation provisions. In 1995 BNSF's Executive Vice President and Chief Operations Officer, Carl Ice, testified: "With respect to the level of compensation for trackage rights under the agreement, the terms of the agreement were the subject of intense arms-length negotiation. From BN/Santa Fe's perspective, they are at a level at which we believe we

can offer competitive pricing . . . and will not place BN/Santa Fe at a disadvantage in competing with the landlord railroad UP/SP.” BN/SF-1, Ice V.S. at 12. BNSF’s latest position in this proceeding, and Mr. Ice’s new testimony, cannot be reconciled with Mr. Ice’s sworn testimony in BN/SF-1.

B. The Revised Adjustment Mechanism

BNSF’s confidence in 1995 notwithstanding, other participants in the merger proceeding raised concerns that the RCAF(U) fee adjustment mechanism might eventually place BNSF at a competitive disadvantage. CMA, among others, argued that RCAF(U) reflected changes in prices but not changes in productivity. If UP’s productivity improved, they worried, UP’s costs associated with maintaining and operating the trackage rights lines might fall even as RCAF(U) increased, leaving BNSF at a competitive disadvantage. See, e.g., CMA-7 at 14.

Although UP disagreed with those concerns, UP agreed to adopt the URCS adjustment mechanism proposed by its critics. Rebensdorf V.S. at 5-6. In fact, UP agreed to adopt the URCS adjustment mechanism exactly as proposed by Thomas D. Crowley, a witness for CMA. On behalf of CMA, Mr. Crowley argued that “the proper measure for the adjustment mechanism is cost changes,” and he supplied an exhibit showing which system-average URCS components should be included in the adjustment calculation. CMA-7, Crowley V.S. at 57 & Ex. (TDC_11). Crowley also stated that the adjustment “should reflect a 1-year lag so that the 1997 adjustment would be based on the change in costs between 1995 and 1996.” Id., Crowley V.S. at 57.

BNSF and UP adopted CMA’s formula as Mr. Crowley had proposed it. UP specifically agreed that the fee adjustment would reflect a one-year lag, so that the 1997 adjustment would be based on the difference between 1995 and 1996 URCS costs, as Mr. Crowley

had recommended. Rebensdorf V.S. at 6. The parties recognized that the Board's URCS calculations were typically not available until several months after the end of the year in question, so the annual adjustment had to include a lag period to be workable, exactly as Mr. Crowley had suggested. Id. at 6-7. This is the mechanism BNSF and CMA now attack.

In its negotiations with UP, CMA never suggested that UP's URCS costs should be modified to exclude the SP purchase cost or the merger capacity costs, or that the CMA Method required the use of only post-merger URCS costs. Id. at 7; Dolan/Conley/Gray V.S. at 3-4. BNSF, also a party to the CMA Agreement, never raised these issues with UP either. Rebensdorf V.S. at 7; Dolan/Conley/Gray V.S. at 3-4. Neither CMA nor BNSF ever told UP that they understood that the initial trackage rights rates already included the anticipated effects of the SP purchase cost. Rebensdorf V.S. at 7; Dolan/Conley/Gray V.S. at 3-4.

The URCS adjustment first appeared in section 7 of the CMA Agreement, which provided that "BN/Santa Fe's trackage rights fees shall be adjusted upward or downward each year by the difference between the year in question and the preceding year in UP/SP's system average URCS costs for the categories of maintenance and operating costs covered by the fee." UP/SP-219, CMA Agreement, § 7. Although this language is subject to multiple interpretations, UP promptly announced that it had agreed to the CMA Method as specified in Mr. Crowley's statement. Just eleven days after the CMA Agreement was signed, on April 29, 1996, UP's John Rebensdorf testified:

[W]e have decided to address the concerns leveled at the adjustment provision by amending Section 12 to provide that trackage rights fees shall be adjusted upward or downward July 1 of each year by the difference for the two preceding years in UP/SP's system average URCS costs for the categories of maintenance and operating costs (including depreciation and return on investment) covered by the trackage rights fee.

UP/SP-231, Rebensdorf R.V.S. at 10. Mr. Rebensdorf's testimony reinforced three points that were clear from the parties' discussions and Mr. Crowley's testimony for CMA: (i) the adjustment would be made on July 1 of each year based on the difference between the two prior years' URCS costs; (ii) the adjustment would necessarily include a lag period, so the "year in question" would be the full calendar year before each year's annual adjustment; and (iii) the relevant maintenance and operating costs included depreciation and return on investment. Id.; see also Rebensdorf V.S. at 7. Neither CMA nor BNSF ever suggested (until their May 22, 2002 Responses) that Mr. Rebensdorf's testimony incorrectly reflected the parties' agreement of a few days before.

On June 27, 1996, some two months after Mr. Rebensdorf's testimony and after extensive negotiations between BNSF and UP, the two railroads filed the Second Supplemental Agreement to the original BNSF Settlement Agreement. This filing incorporated the CMA Method. Section 9 of the Second Supplemental Agreement amended the original fee adjustment provision to reflect the CMA Agreement. It provided:

All trackage rights charges under this Agreement shall be subject to adjustment upward or downward July 1 of each year by the difference in the two preceding years in UP/SP's system average URCS costs for the categories of maintenance and operating costs covered by the trackage rights fee. "URCS costs" shall mean costs developed using the Uniform Rail Costing System.

UP/SP-266, Second Supplemental Agreement, § 9. This is the language that was before the Board when it approved the UP/SP merger.⁴ It calls for adjustments based on URCS costs for two prior years.

⁴ The identical language is incorporated in Section 12 of the Restated and Amended BNSF Settlement Agreement, which was submitted to the Board on March 1, 2002. See UP/SP-393; BNSF-100, Joint Submission of Restated and Amended BNSF Settlement Agreement, § 12.

UP and BNSF exchanged multiple drafts of the Second Supplemental Agreement. In several of those drafts, they focused specifically on the fee adjustment provision. Rebensdorf V.S. at 8-9. BNSF never suggested that UP's system-average URCS costs should be modified to exclude the SP purchase cost or the merger capacity costs (BNSF's and CMA's original theory). Id. at 9; Dolan/Conley/Gray V.S. at 3-4. Nor did BNSF ever suggest that the parties would use only post-merger URCS in the fee adjustment process or that the Second Supplemental Agreement incorrectly reflected the CMA Agreement's fee adjustment process (BNSF's and CMA's new theory). Rebensdorf V.S. at 9; Dolan/Conley/Gray V.S. at 3-4. If BNSF harbored any such beliefs or intentions, it withheld them from UP.

BNSF considered the URCS adjustment provision an improvement to already acceptable trackage rights fees. BNSF's Carl Ice told the Board: "I testified in my first Verified Statement that the trackage rights compensation levels included in the Original Agreement were established at a level at which BN/Santa Fe believes it can offer competitive pricing. . . . To the extent that shippers have expressed concern about the effect of the negotiated compensation level on BN/Santa Fe's ability to compete, the CMA Agreement's favorable revision of the rate escalator clause should alleviate much of that concern." BN/SF-54, Ice V.S. at 7-8.

C. The Effect of Adopting CMA's URCS Adjustment Mechanism

BNSF implies that the trackage rights fees exceed the amount it was willing to pay if the URCS adjustment includes the SP purchase cost and the merger capacity costs. See BNSF-102 at 4; id., Ice V.S. at 10. As the Board has already recognized, however, this impression is false. The URCS adjustment using the CMA Method reduced the fees that BNSF said would let it compete. See Decision No. 96 at 5 n.6. BNSF now seeks further advantage.

In order to appreciate how much BNSF has already benefited, one need only compare the changes in trackage rights fees that would have occurred using the original RCAF(U) adjustment with the changes using the CMA Method. Chart 1 provides this comparison using the 3.1 mills per gross ton-mile fee for intermodal and carload traffic. As Chart 1 shows, the rates BNSF pays have never increased above their initial levels, and they are now below the original rates. In contrast, under the RCAF(U) adjustment, the rates would have increased above their original levels beginning with the very first adjustment, and they would have climbed even higher in recent years.⁵

The benefits BNSF has obtained from the CMA Method are also apparent from the higher fees that BNSF charges UP. Chart 2 compares the fees that BNSF pays under the CMA Method with the fees that UP pays to BNSF for rights over BNSF between Pueblo and Ft. Worth. BNSF granted SP rights between Pueblo and Ft. Worth in order to remedy competitive losses caused by the BN/Santa Fe merger. As Chart 2 shows, the rates BNSF pays UP under the BNSF Settlement Agreement are far below the rates that UP pays BNSF for its rights between Pueblo and Ft. Worth. Moreover, the rates BNSF pays under the BNSF Settlement Agreement actually decreased between 1996 and 2000, while the rates UP pays to use BNSF's lines between Pueblo and Ft. Worth increased by 3 percent between 1996 and 2000. If the UP/SP trackage rights fees compromise BNSF's ability to compete, UP is at an even greater disadvantage.

⁵ The UP data do not reflect the parties' recent agreement to calculate 1995 and 1996 URCS by creating combined UP/SP URCS rather than weighting each railroad's separate 1995 and 1996 URCS. See *Kauders V.S.* at 8. BNSF had argued that the parties should use a combined URCS, and UP agreed as part of a compromise of several other outstanding issues. Ironically, UP's preliminary calculations suggest that BNSF's proposal will actually result in higher fees in certain years. If that turns out to be the case, UP remains willing to use the weighted average URCS methodology it originally proposed.

As a final means of placing BNSF's claims in perspective, we note the Board's conclusion that under its *SSW Compensation* capitalized earnings methodology, the trackage rights fees would have been at least 3.84 mills per gross ton-mile – much higher than the rates BNSF pays. See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., 1 S.T.B. 233, 415 (1996). The Board concluded that “because the agreed levels are lower than [the Board] would set under *SSW Compensation*, they are reasonable.” Id. at 414. BNSF's rates six years later remain far below the levels that would be reasonable under the Board's *SSW Compensation* methodology. We provide this comparison in Chart 3.

ARGUMENT

I. BNSF AND CMA OFFER NO CREDIBLE EVIDENCE THAT THE PARTIES INTENDED TO DEPART FROM THE BNSF SETTLEMENT AGREEMENT'S PLAIN LANGUAGE

The BNSF Settlement Agreement's plain language requires an annual fee adjustment based on the difference in the two preceding years in UP's system-average costs developed using the Board's URCS. In this proceeding, however, BNSF has offered two different, inconsistent theories for calculating the fee adjustment using a modified URCS. BNSF initially claimed that the parties intended to calculate the fee adjustment by deducting costs from URCS. BNSF and CMA now claim that the parties intended to calculate the fee adjustment using post-merger URCS costs only and assume that all the disputed costs were included in URCS costs before 1997.

Without providing any contemporary evidence to support their new theory, BNSF and CMA try to explain how this supposed intent was defeated. BNSF and CMA argue that (i) UP misled BNSF and CMA by altering the CMA Agreement's language in the BNSF Settlement Agreement, see BNSF-102 at 9; CMA-17 at 2-3; and (ii) in “a development that was not and could

not have been anticipated," UP's recorded the SP purchase cost in 1997 rather than 1996, see BNSF-102 at 8. Both claims are demonstrably wrong.

BNSF never explains its sudden shift in its position. Neither BNSF nor CMA credibly accounts for its failure to mention its new theory for more than half a decade. Neither BNSF or CMA provides any evidence that the parties mutually intended to do anything other than adjust the trackage rights fees based on system-average URCS costs for two prior years as specified by BNSF Settlement Agreement's plain language. Neither BNSF nor CMA provides any evidence that UP's accounting for the SP purchase cost was incorrect or unexpected.

A. BNSF Altered Its Claims About the Parties' Intent

In its December Petition, BNSF claimed that UP and BNSF had agreed to deduct the SP purchase cost and merger capacity costs from URCS when calculating the BNSF Settlement Agreement's annual trackage rights fee adjustment. BNSF-98 at 16.⁶ CMA filed a statement supporting BNSF. CMA-15 at 2-3. The Board was not persuaded, but it gave BNSF and others who supported its December Petition a second chance "to demonstrate that the disputed items should be omitted from the URCS calculations." Decision No. 96 at 6.

BNSF failed to do what the Board authorized. It presented no evidence of any intent to exclude costs from URCS. Instead, its Response offers a new, inconsistent version of the parties' intent, adopted by CMA as well. Rather than argue that the parties intended to exclude the disputed items from post-merger URCS, it now argues that the parties intended to adjust the fees

⁶ In its December Petition, BNSF asked the Board to clarify that "(i) in the application of the adjustment methodology, the combined UP/SP 1997 URCS costs must exclude any amounts attributable to the purchase premium paid by UP for SP; and (ii) the separate 1996 UP and SP URCS costs as well as the combined UP/SP URCS costs for 1997, 1998, and any applicable subsequent years must exclude any merger-related capital expenditures relating to the trackage rights lines for which UP has sole responsibility under Section 9c of the BNSF Settlement Agreement." BNSF-98 at 16.

based on post-merger URCS costs only, using 1996 and 1997 URCS costs that included the disputed items.⁷ BNSF never even acknowledges this abrupt reversal in position.

B. The Parties Never Agreed to Use Only Post-Merger URCS Costs

BNSF and CMA provide absolutely no evidence that the parties to the CMA Agreement or the BNSF Settlement Agreement ever discussed using – much less agreed to use – only post-merger URCS costs to calculate trackage rights fee adjustments.

1. CMA Proposed Adjustments Based on Comparing Pre-Merger and Post-Merger URCS Costs

As we explained above, the URCS adjustment provision incorporates CMA's demand in the merger proceedings. CMA's witness, Mr. Crowley, called for an URCS adjustment provision that would include "a 1-year lag so that the 1997 adjustment would be based on the change in costs between 1995 and 1996." CMA-7, Crowley V.S. at 57. In March 1996, when CMA made its submission, it surely understood that the SP purchase cost could not be reflected in UP's pre-merger 1995 URCS. BNSF and UP then agreed on language for the BNSF Settlement Agreement that closely tracks Mr. Crowley's language. See pp. 13-14, above.

Neither CMA nor BNSF provides any evidence that, despite Mr. Crowley's recommendations and the carriers' adoption of the CMA Method, the parties to the CMA Agreement mutually agreed to adjust the trackage rights fees based only on post-merger URCS costs. CMA admits that its negotiations were "[b]ased on Mr. Crowley's recommendations." See

⁷ See BNSF-102 at 8 ("the CMA Agreement provided for an annual adjustment mechanism in which URCS costs from one post-merger year would be compared with URCS costs from another post-merger year"); id. at 9 n.6 ("it was BNSF's expectation and understanding that the language [of the Second Supplemental Agreement] would be interpreted and applied in such a manner that all comparisons of URCS costs would be between post-merger years"); id. at 9 ("Accordingly, if pre-merger years are to be used . . . appropriate adjustments must be made to the URCS costs in such years . . .").

CMA-17, Schick V.S. at 3. None of CMA's or BNSF's witnesses claims to have discussed the alleged intent with UP. UP's witnesses did not discuss the issue with CMA or BNSF. Rebensdorf V.S. at 7; Dolan/Conley/Gray V.S. at 3-4. Neither CMA nor BNSF produced a single document reflecting the parties' discussion of or supposed intention to use only post-merger URCS costs, and UP's documents lack any such evidence.

The CMA Method is consistent not only with Mr. Crowley's specific testimony, but also with the thrust of CMA's concerns. CMA was concerned that the original mechanism for adjusting the trackage rights fees would "not include the cost savings projected by UP/SP as one of the benefits of the merger." CMA-17, Schick V.S. at 3.⁸ An adjustment provision that begins by comparing pre-merger and post-merger URCS is consistent with CMA's effort to capture cost savings resulting from the merger; an adjustment that takes only post-merger years into account would violate CMA's intent by failing to reflect any initial cost savings.⁹ An adjustment provision that begins by comparing 1995 costs to 1996 costs is also consistent with the adjustment mechanism in the original BNSF Settlement Agreement, which used 1995 as the base year for the RCAF(U) adjustment.¹⁰

⁸ BNSF had the same concern. See BNSF-102, Ice V.S. at 2 ("UP/SP had projected substantial improvements in efficiency, and it was important to BNSF that reductions in the costs of the merged entity should be passed on to BNSF in the form of lower rates for trackage rights.").

⁹ UP and SP costs declined substantially from 1995 to 1996, thereby reducing the trackage rights fee under the CMA Method. If UP had based the adjustment on post-merger years only, one suspects that BNSF and CMA might be before the Board pointing to Mr. Crowley's testimony and the BNSF Settlement Agreement's plain language and arguing that UP was violating the parties' clearly expressed intent.

¹⁰ The original adjustment mechanism provided: "All trackage rights charges . . . shall be subject to adjustment annually beginning as of the effective date of this Agreement . . ." UP/SP-22 at 337, BNSF Settlement Agreement, § 12 (emphasis added). The Agreement was made "effective upon execution," in September 1995. Id. at 336, BNSF Settlement Agreement, § 11.

The CMA Agreement's fee adjustment language provides that the fees shall be adjusted upward or downward "each year by the difference between the year in question and the preceding year in UP/SP's system average URCS costs." The CMA Agreement does not state that the "year in question" and the "preceding year" are the two years preceding the yearly adjustment, but that is the only reasonable reading. Moreover, CMA's witness specifically proposed that the two preceding years be compared, and that was certainly UP's intent. See CMA-7, Crowley V.S. at 57; Rebensdorf V.S. at 6-7. UP accepted a one-year lag because it was unavoidable: Based on past practice, everyone recognized that the Board could not publish the 1997 URCS costs until 1998. If there was to be an annual adjustment during 1997, it would have to be made using a comparison of 1996 (the "year in question") and 1995 (the "preceding year"). Rebensdorf V.S. at 7.

If there were ever any doubt about the CMA Agreement's meaning, UP resolved it just eleven days after the CMA Agreement was signed. On April 29 1996, John Rebensdorf testified that "that trackage rights fees shall be adjusted upward or downward July 1 of each year by the difference for the two preceding years in UP/SP's system average URCS costs for the categories of maintenance and operating costs (including depreciation and return on investment) covered by the trackage rights fee." UP/SP-231, Rebensdorf R.V.S. at 10. Neither BNSF nor CMA suggested at that time, or at any time before their May 22, 2002 filings, that Mr. Rebensdorf's statements misrepresented the intent of the parties to the CMA Agreement.¹¹

¹¹ CMA misleadingly suggests that it did not have time to catch to the alleged misstatement of the CMA Agreement in the BNSF Settlement Agreement, because the Second Supplemental Agreement was filed on the last business day before oral argument in the UP/SP merger proceeding. CMA-17 at 2. Mr. Rebensdorf's testimony, which tracks the language of the fee adjustment provision contained in the Second Supplement Agreement, was served on CMA more than one month before CMA filed its Brief in the UP/SP merger proceedings on June 3, 1996, see (continued...)

2. BNSF Agreed to Adjustments Comparing Pre-Merger and Post-Merger URCS Costs

Less than two months after Mr. Rebensdorf's testimony, and after meticulous negotiations, BNSF and UP adopted the CMA Method in the Second Supplemental Agreement to the original BNSF Settlement Agreement. Section 9 of the Second Supplemental Agreement provided for an adjustment upward or downward "each year by the difference in the two preceding years in UP/SP's system average URCS costs for the categories of maintenance and operating costs covered by the trackage rights fee." UP/SP-266, Second Supplemental Agreement, § 9. That language, still in effect, reflects both Mr. Crowley's method and Mr. Rebensdorf's endorsement of that method of adjusting fees. BNSF never even hinted at a concern that the Second Supplemental Agreement had altered the CMA Agreement's terms, as BNSF and CMA now claim. Rebensdorf V.S. at 9; Dolan/Conley/Gray V.S. at 3-4.¹²

3. BNSF's and CMA's Past Actions and Inaction Belie Their Current Claims

Both BNSF and CMA now claim that they believed in 1996 that the language of the BNSF Settlement Agreement – which BNSF jointly proposed with UP – departed from the intent of the CMA Agreement. These assertions are inconceivable and should not be credited.

(footnote cont'd)

CMA-12, and almost two months before the Second Supplemental Agreement was filed with the Board on June 28, 1996.

¹² Moreover, while UP and BNSF were negotiating the Second Supplemental Agreement, they were also negotiating individual implementing agreements for each segment of trackage rights granted under the BNSF Settlement Agreement. Each of the implementing agreements contained the fee adjustment provision. The implementing agreements provide that the first fee adjustment would take place in July 1997, based on "the difference in the two (2) preceding years in UP/SP's system average URCS costs," thus confirming that a comparison between pre-merger and post-merger URCS would be required. *See, e.g.*, UP/SP-266, Denver, CO to Stockton and San Jose, CA Trackage Rights Agreement, § 3(c); *id.*, Houston, TX to Valley Junction, IL Trackage Rights Agreement, § 3(c). Again, no one suggested that this language was incorrect. Rebensdorf V.S. at 9 n.3.

CMA admits that it never mentioned the alleged misinterpretation to UP or the Board. CMA says that it understood the perceived difference between the CMA Agreement and the BNSF Settlement Agreement to be a "technical amendment" that would have no practical effect. CMA-17, Schick V.S. at 6.¹³ Yet CMA protected its interests in the UP/SP merger proceeding with fervent intensity, raising serious questions about whether it would have accepted any "technical amendment." In any event, CMA provides no proof whatsoever of any agreement with UP to depart from the BNSF Settlement Agreement's plain language, which tracks the testimony of CMA's own witness.

BNSF itself negotiated and adopted the revised language of the BNSF Settlement Agreement. BNSF considered the initial fee and the fee adjustment provisions to be among the most important aspects of the September 1995 negotiations. See BNSF-102, Ice V.S. at 2. The new fee adjustment provision was one of the most significant changes in the Second Supplemental Agreement. The language BNSF and UP negotiated faithfully implemented the recommendation of CMA's expert. The Board can only conclude that the Second Supplemental Agreement and implementing agreements accurately reflected the intent of the parties to the CMA Agreement.

Until its Response, BNSF never raised the claim that the BNSF Settlement Agreement failed to carry out the CMA Agreement. BNSF did not raise this claim in its final progress report to the Board. See BNSF-PR-20. BNSF did not raise this claim in the recently concluded proceeding to develop a final version of the BNSF Settlement Agreement, which BNSF and UP worked on for months. See UP/SP-393; BNSF-100. BNSF did not raise any claims at all

¹³ Mr. Schick correctly describes the reasons for the one-year lag, but incorrectly suggests that UP and not CMA's own witness was the source of the one-year lag in the fee adjustment provision. See id.

about the fee adjustment provision until 2000. When it then brought its claims to the Board, it made a different argument. See BNSF-98 at 16. BNSF's newest argument about the parties' intent in 1996 is imaginative, but it is not credible.

C. The Purchase Accounting Was Properly Reported in 1997 and Its Timing Was No Secret

Even if the BNSF Settlement Agreement's fee adjustment provision had departed from the CMA Agreement's language, BNSF and CMA could not prevail. BNSF and CMA argue that they expected to compare 1996 URCS costs with 1997 URCS costs. Even under that theory, though, the first annual fee adjustment would still have involved a comparison between pre-merger (1996) and post-merger (1997) URCS costs.

BNSF dances around this problem by asserting that UP caught BNSF off guard. BNSF mistakenly asserts that UP's purchase accounting in 1997 "could not have been anticipated," and that the parties understood that 1996 and 1997 would both be post-merger years. BNSF-102 at 8. The second page of the UP/SP Merger Application proves that BNSF is mistaken.

UP had explained on the second page of the Merger Application that its "present intent [was] to merge SPT, SSW, SPCSL and DRGW into UPRR, although these subsidiaries of SPR may retain their separate corporate existence for a period of time." UP/SP-22 at 2 (emphasis added). Due to the uncertainties regarding the IRS rulings and SSW shareholder issues, UP did not know when the legal mergers at the railroad level would occur. Rhoades V.S. at 3-4.¹⁴ UP

¹⁴ Union Pacific Corporation ("UPC") acquired Southern Pacific Rail Corporation ("SPR") on September 12, 1996, following STB approval of the UP/SP merger. The railroads themselves remained separate direct and indirect subsidiaries of UPC. The railroad-level mergers did not begin until 1997. Before the railroad-level mergers could occur, UP needed to obtain certain tax rulings from the IRS, and it needed to deal with minority shareholders of SSW. Id. at 3-4. The (continued...)

never told BNSF or CMA that the railroad mergers and the consequent purchase accounting would occur in 1996 as opposed to 1997. *Rebensdorf V.S.* at 7, 9. Neither BNSF nor CMA ever asked when the mergers would occur. *Id.* at 7, 9. BNSF and CMA cannot claim to have been misled, as the Application put them on notice that the railroad-level mergers might not occur until some time after the UP/SP merger was approved.

UP's accounting for the SP merger was dictated by tax and shareholder considerations and by STB accounting rules, not ulterior motives. *Rhoades V.S.* at 2-3. UP did not "elect" to make the purchase cost adjustment in 1997 rather than 1996, as BNSF claims. *See* BNSF-102 at 3. It followed well-established accounting rules. Its accounting was reviewed and approved by the STB staff. UP's accounting was proper and public. *Rhoades V.S.* at 4-5.

Moreover, BNSF recognized in subsequent years that the purchase accounting for the UP/SP merger had occurred in 1997 yet said nothing. UP's accounting for the SP merger in its 1997 R-1 was the subject of a hard-fought Board proceeding brought by Western Coal Traffic League. This challenge was common knowledge. AAR participated as an amicus, and BNSF's witness Weicher appeared on the pleadings in support of UP's purchase accounting. If BNSF or CMA had been surprised that the purchase accounting occurred in 1997 rather than 1996 – and if the timing mattered to them – one would have expected them to object years ago.

* * *

BNSF and CMA provide no evidence to support their claims that the BNSF Settlement Agreement's plain language fails to reflect the parties' intent when they agreed upon

(footnote cont'd)
timing of UP's purchase accounting followed from the timing of the railroad-level mergers. *Id.* at 3. Until the railroad subsidiaries themselves could be merged or consolidated, UPC could not allocate the SPR purchase accounting to UP's property accounts. *Id.*

the URCS adjustment provision. Nor do they provide any support for their complicated explanation of how UP defeated the parties' supposed intent by altering the CMA Agreement's language and engaging in undisclosed accounting tricks.

II. BNSF'S AND CMA'S NEW VERSION OF THE PARTIES' INTENT CONTRADICTS THEIR POSITION ON MERGER CAPACITY COSTS

BNSF's and CMA's new claim that the parties intended to compare only post-merger URCS costs creates a logical inconsistency in their position. UP's post-merger URCS cost reflected UP's increasing merger capacity costs as UP incurred them. If trackage rights fees are to be adjusted based on changes in post-merger URCS costs, as BNSF and CMA now claim, the adjusted fees would increase to reflect the merger capacity costs, as UP invested the money in 1996, 1997, into 1998, and beyond. BNSF and CMA cannot have it both ways: they cannot claim an intent to use post-merger URCS costs but deny that UP's post-merger URCS costs increased over time as UP incurred merger capacity costs.

BNSF and CMA have no theory whatsoever to explain how the parties intended to use post-merger URCS costs but disregard the merger capacity costs in performing the fee adjustment. BNSF and CMA offer no explanation of how the BNSF Settlement Agreement language can be reconciled with any intent to modify UP's post-merger URCS costs. They know well that the parties never agreed to disregard the merger capacity costs in the annual fee adjustment.

In the BNSF Settlement Agreement, the parties agreed that BNSF would not have to pay its own funds for capacity improvements on the trackage rights lines that were necessary to achieve the benefits of the merger. BNSF Settlement Agreement, § 9(c)(i). In order to minimize disputes about which capacity improvements were necessary to achieve the merger's benefits, UP agreed that it would fund any capacity improvements on the trackage rights lines for 18 months

following the merger. Id., § 9(c)(iii). After the 18-month period, the parties would determine on a case-by-case basis whether a particular capacity improvement on a trackage rights line was necessary to achieve the merger's benefits or whether BNSF would fund the improvements in accordance with its relative usage. Id., § 9(c)(ii). UP and BNSF agreed that BNSF would not be required to pay the initial merger capacity costs, but they never agreed to try to modify the impact of those costs on the fee adjustment when they adopted the CMA Method. Rebensdorf V.S. at 5.

BNSF and CMA are unable to supply either a theory or a shred of evidence for the assertion that the parties mutually agreed to disregard these merger capacity costs in the annual fee adjustment. Under BNSF's and CMA's own theory that the fee adjustment should be based on post-merger URCS costs, merger capacity costs would be reflected in the fee adjustment. BNSF's argument reveals an explicit but erroneous assumption. BNSF assumes that every UP URCS beginning in 1996 would have included the merger capacity costs. BNSF-102 at 9.¹⁵ This assumption is demonstrably wrong. By definition, the merger capacity costs could only be incurred over time after the merger.¹⁶ As UP incurred merger capacity costs in post-merger years, UP's URCS costs for those years would increase to reflect the new investment, and the trackage rights fee would rise.

UP could not have included all the merger capacity costs in its early post-merger URCS even if it had wanted to. UP had made few of the investments by 1997 when the first fee

¹⁵ BNSF incorrectly assumed that both the SP purchase cost and the merger capacity costs "would be included in all post-merger years." Id.

¹⁶ BNSF and CMA were on notice that merger capacity costs would be incurred over a four-year period. UP said so in the Application, where it anticipated that merger investments would occur over four years. See UP/SP-24 at 114.

adjustment occurred. The amount and timing of the future investments was then unknowable.

The Board cannot conclude that the parties agreed to perform an impossible adjustment.

This glaring defect alone destroys the new BNSF and CMA argument, because it demonstrates that BNSF and CMA cannot offer a consistent theory to support the result they seek.

III. BNSF'S PROPOSED METHOD OF PERFORMING THE FEE ADJUSTMENT VIOLATES URCS PRINCIPLES AND IS UNWORKABLE

BNSF presents Christopher D. Kent's testimony to quantify the difference between the CMA Method and BNSF's approach to the fee adjustment and to suggest how the fees could be recalculated in accordance with BNSF's theory of the parties' intent. He does so using a method that departs from the newly alleged intent of the parties to use post-merger URCS.¹⁷ A review of Mr. Kent's calculations demonstrates that there is no practicable way to recalculate the fees. Mr. Kent's efforts suffer from three major conceptual flaws. They also exaggerate the amount in dispute.

First, Mr. Kent's URCS costs bear no relationship to the actual costs UP and SP would have incurred in 1995 and 1996 had the railroads been merged. In order to calculate fee adjustments under BNSF's theory, Mr. Kent purports to "correct" for the fact UP's purchase accounting occurred in 1997 by shifting UP's 1997 investment and depreciation data into UP's and SP's actual 1995 and 1996 data, and then calculating hypothetical, combined UP/SP 1995 and 1996 URCS costs. BNSF claims that the results show what UP's 1995 and 1996 URCS costs

¹⁷ BNSF argues that the first annual fee adjustment was supposed to be based on a comparison of 1996 and 1997 URCS costs. See BNSF-102 at 8. Mr. Kent compared 1995 and 1996 URCS costs. See id., Kent V.S. at 4. Mr. Kent apparently generated a modified 1995 URCS because UP's costs decreased sharply between 1995 and 1996. He therefore departed from BNSF's theory and based the first annual fee adjustment on a comparison of 1995 and 1996 URCS costs. Kauders V.S. at 7 n.2.

would have been if the UP and SP systems had combined and the results reflected in a combined UP/SP URCS. BNSF-102, Kent V.S. at 2-3. BNSF is mistaken.

While Mr. Kent substitutes UP 1997 investment and depreciation data for 1995 and 1996 data, he still uses actual UP and SP 1995 and 1996 gross ton-miles and maintenance-of-way costs to calculate URCS costs. He thus creates several apples-and-oranges comparisons that undermine any effort to provide a meaningful restatement of 1995 and 1996 URCS costs.

For example, when Mr. Kent calculates URCS costs for return-on-investment using 1997 beginning-of-year investment levels and 1995 and 1995 gross ton-miles, he disconnects the physical network from the ton-miles it produced. UP's and SP's gross ton-miles in 1995 and 1996 reflect the railroads' physical structure, actual operations, and competitive relationships in those years. We cannot know how many gross ton-miles UP would have moved in 1995 and 1996 if the UP and SP systems had been configured as they were at the beginning of 1997 and the railroads had been merged. We do not know whether mileage savings from reroutes made possible by the merger (for example, UP rerouted SP's Central Corridor traffic to UP's Wyoming mainline after the merger) and traffic losses to BNSF from its use of its trackage rights would have offset increases in traffic resulting from new business opportunities. We do know, however, that Mr. Kent's computations have no connection to reality, because they are based on investment in a post-merger network and gross ton-miles produced by two different, pre-merger networks. Kauders V.S. at 3-4.

Mr. Kent creates a similar inconsistency by combining UP's 1997 investment and depreciation costs with SP's and UP's maintenance-of-way costs for 1995 and 1996.¹⁸ Once

¹⁸ This procedure directly contradicts BNSF's theory that the parties agreed to use only post-merger URCS costs.

again, no one can guess what UP's maintenance-of way costs would have been in 1995 and 1996 had the UP and SP systems been configured as they were at the beginning of 1997 and had the railroads been merged. We know, however, that Mr. Kent's computations are based on investment and depreciation costs for one network in one year and maintenance-of-way costs for two different, pre-merger networks in different years. Id. at 4.

Mr. Kent creates yet another inconsistency by combining 1997 depreciation data with actual 1995 and 1996 gross ton-miles to calculate the URCS unit costs for return on investment and depreciation. UP's 1997 depreciation expense is a function of UP's gross ton-miles in 1997, which are used to measure use of the track assets in question. When Mr. Kent calculates URCS depreciation costs for 1995 and 1996, however, he uses UP's 1997 depreciation expense and divides it by UP's and SP's gross ton miles in 1995 and 1996. This produces a disconnect between depreciation costs and the assets used. Id.

Mr. Kent's computations violate the principle of "causality" that underpins URCS theory. The causality principle means that operating and maintenance expenses, return on investment, and depreciation costs must all derive from the same physical plant in the same reporting period. See Railroad Accounting Principles Board, Final Report, Vol. 1 at 29. Mr. Kent's modifications to URCS ignore this principle. His railroad and its costs are developed using data from various different periods. Kauders V.S. at 3-4. Mr. Kent's calculations cannot be used to provide a meaningful comparison of costs.

Second, Mr. Kent's calculations artificially mask changes in UP's costs. The provision for adjusting the trackage rights fees is designed to adjust the fees based on changes in UP's URCS costs. Mr. Kent's calculations are flawed because they ignore changes in UP's

investment and depreciation costs resulting from increased UP and SP investment unrelated to the disputed SP purchase cost and merger capacity costs.

By projecting the same 1997 beginning-of year investment level back into 1995 and 1996, Mr. Kent's calculation implicitly assumes that UP's and SP's level of investment did not increase between 1995 and 1996. Mr. Kent's calculations thus ignore changes in UP's URCS costs resulting from all of UP's and SP's capital investments in 1996, not just the disputed merger capacity costs. Id. at 5.¹⁹ In 1996, UP invested hundreds of millions of dollars in capital projects, such as the triple mainline between Gibbon and North Platte, Nebraska. As a result of capital investments in 1996, UP's and SP's 1996 expenses for return on investment were higher than their 1995 expenses for return on investment. Under Mr. Kent's calculations, however, the combined UP/SP expense for return on investment in both 1995 and 1996 was based on 1997 investment data, thus eliminating the increase between 1995 and 1996. This in turn has the effect of artificially reducing the trackage rights fees. Id. at 5-6.

Similarly, by using the same depreciation charge in 1995, 1996, and 1997, Mr. Kent implicitly assumes that UP's depreciation expense did not change between 1995 and 1996, or between 1996 and 1997. This is a false assumption, because depreciation is a function of a railroad's investment and gross ton-miles, and both of those factors were different for UP and SP in 1995 and 1996 than they were for UP in 1997. In particular, UP's and SP's investments in 1996 increased their 1996 depreciation expenses above their 1995 levels, and UP's investments in 1997 increased its 1997 depreciation expenses above its 1996 levels. By projecting 1997 depreciation

¹⁹ BNSF claims that capital expenditures for capacity improvements on trackage rights lines necessary to achieve the merger's benefits should be excluded from URCS cost calculations, but it accepts that UP's other capital expenditures should be included in URCS costs.

charges back into 1995 and 1996, Mr. Kent wipes out all increased depreciation resulting from all of UP's and SP's investments, including investments that BNSF agrees should be included in the fee adjustment. This in turn has the effect of artificially reducing the trackage rights fees. Id. at 6.

Third, Mr. Kent did not even try to address merger capacity costs. As Mr. Kent recognizes, BNSF theory that the parties intended to use post-merger URCS costs does not address the merger capacity costs issue, because those costs occurred in post-merger years.²⁰ Mr. Kent claims that his calculations provide a way to address BNSF's claims with respect to merger capacity costs incurred in 1997. BNSF-102, Kent V.S. at 4 n.4. As even Mr. Kent appears to acknowledge, however, shifting 1997 beginning-of-year investment back into 1995 and 1996 addresses only those modest merger capacity costs that were incurred in the last four months of 1996. It fails to address merger capacity costs incurred in 1997 and later years. Moreover, it also wipes out any impact of all of UP's additional investments in 1996, even though BNSF has accepted that such investments should be considered in performing the fee adjustment. Kauders V.S. at 6-7.

Finally, Mr. Kent's calculations exaggerate and distort the amount in dispute by using an unrelated dispute between the parties to accentuate the apparent magnitude of the issues before the Board. BNSF and UP disagree about whether one calculates the fee adjustment by calculating the difference or computing a percentage change between two years of URCS costs. The financial impact is significant. UP and BNSF agreed to arbitrate their disagreement between

²⁰ As Mr. Kent recognizes, trying to untangle the accounting for each of the merger capacity projects in order to exclude those costs from URCS calculations, which was BNSF's original theory, would be exceedingly difficult. BNSF-102, Kent V.S. at 4. BNSF requested and received discovery from UP on this issue, and it sought and received thirty additional thirty days from the Board to analyze the material UP provided, but it apparently concluded that it could not make significant inroads on this problem. See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., STB Finance Docket 32760, Decision No. 97 (STB served Apr. 16, 2002).

the “difference” and “percentage change” approaches. BNSF specifically disclaimed any intent to submit this issue to the Board. See BNSF-98 at 2 n.3.

Mr. Kent compares (i) the fees under UP’s adjustments each year based on the difference in the two preceding years’ URCS costs with (ii) the fees under BNSF’s proposed approach of adjusting the fees each year based on the percentage change between the two preceding years’ URCS costs. However one views the merits of the parties’ dispute between the “difference” and “percentage change” approaches, Mr. Kent’s use of two different computational methods is misleading.²¹ If Mr. Kent’s calculations are corrected to use a consistent method, the apparent difference between the parties’ position on URCS costs is cut in half, to 0.1 mills per gross ton-mile. See Kauders V.S. at 7-9.²²

IV. THE ADJUSTED FEES HAVE FOSTERED VIGOROUS COMPETITION

BNSF devotes a substantial portion of its Response to arguing that the CMA Method places BNSF at a competitive disadvantage. The short answer to BNSF’s complaints is the one the Board already identified: BNSF pays lower fees under the URCS adjustment than it would have paid under the RCAF(U) adjustment, which it initially told the Board would allow it to compete successfully. See Decision No. 96 at 5 n.6. BNSF also pays lower fees under the BNSF Settlement Agreement than UP pays for trackage rights between Pueblo and Ft. Worth, even though both sets of rights were designed to preserve pre-merger competition. See p. 15, above.

²¹ This issue is not before the Board for resolution because it is being arbitrated. UP expects to introduce extensive evidence on this issue, and we expect BNSF to do the same.

²² UP calculates the adjusted fees to one decimal place. The fees were presented in the BNSF Settlement Agreement using one decimal place, and UP has billed BNSF using fees calculated to one decimal place, except for the fee for the Keddie-Stockton trackage rights, which was initially presented using two decimal places. Id. at 9 n.5.

BNSF tries to show that a 0.2-mill difference in its fee provides UP with a \$25-to-\$50-per-car advantage, and that this advantage could meaningfully effect competition. See BNSF-102, Smith V.S. at 4. Even ignoring the many flaws in Mr. Kent's calculations, the actual difference is only 0.1 mill. More importantly, BNSF's arguments are based on several false claims regarding BNSF's ability to compete with UP.

A. UP Has No Cost Advantage over BNSF

UP has no cost advantage over BNSF, because it pays all of the disputed costs. UP's costs encompass the same operating and maintenance costs that BNSF pays through the trackage rights fee. UP thus pays the SP purchase cost and the merger capacity costs. BNSF pays a fixed fee while UP's actual costs vary based on the specific lines involved, but neither railroad is systematically advantaged or disadvantaged.

BNSF and CMA claim that the CMA Method tilts the competitive playing field in UP's favor. They claim that the CMA Method creates a double count and thus deprives BNSF of a level playing field on which to compete. BNSF's and CMA's new approach, however, is the one that would tilt the playing field, but in BNSF's favor. The CMA Method does not create a double count, and unless the fee adjustment mechanism reflects UP's increased costs as a result of the SP purchase cost and the merger capacity costs, BNSF will gain an unfair competitive advantage over UP.

BNSF and CMA incorrectly claim that including SP purchase costs in the fee adjustment produces a double count. BNSF-102 at 3; CMA-17 at 3. There is no double count because the initial trackage rights fee could not have included the purchase costs. Evidence presented during the merger proceeding demonstrates that the initial rates did not reflect purchase costs, and the Board agreed. During the merger proceeding, the Board found that including the purchase costs would have increased the initial trackage rights compensation to at least 3.84 mills

per gross-ton mile. See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., 1 S.T.B. at 415. The initial trackage rights rates of 3.0, 3.1, and 3.48 mills per gross-ton mile were thus 28 percent, 24 percent, and 10 percent, respectively, lower than they would have been had the fees been derived based on UP's full costs, including the cost of acquiring SP. The rates remain far below the 3.84 rate today.²³

Because the initial trackage rights fees did not reflect the SP purchase cost, the annual fee adjustment must be calculated using pre-merger and post-merger URCS in order to preserve a level playing field between UP and BNSF. BNSF repeatedly asserts that comparing pre-merger and post-merger URCS is inconsistent with the parties' statement in Section 12 of the BNSF Settlement Agreement that "[i]t is the intention of the parties that the rates and charges for trackage rights and services under this Agreement reflect the same basic relationship to operating costs as upon execution of this Agreement." See, e.g., BNSF-102 at 6-7, id., Ice V.S. at 5; id., Weicher V.S. at 3, 8 & 10. BNSF's approach, however, is the one that would distort the parties' intentions, because it would disregard real changes in UP's URCS costs after the September 1995 execution of the BNSF Settlement Agreement that resulted from the SP purchase cost. The BNSF

²³ BNSF and CMA argue that the SP purchase cost was included in the original fee because UP described the trackage rights fee as "comprehensive." See BNSF-102 at 5; id., Ice V.S. at 4; CMA-17, Schick V.S. at 6 n.3. As Mr. Rebensdorf explained at the time, the rates were "comprehensive" in the sense that BNSF would not have to pay additional fees to conduct routine trackage rights operations – there were no separate fees for maintenance and operations, overheads, or return to capital. See UP/SP-22, Rebensdorf V.S. at 308; see also Rebensdorf V.S. at 4. An annual adjustment calculated using UP's actual system average costs is not an additional type of fee. Rebensdorf V.S. at 4.

BNSF also argues that an adjustment based on RCAF(U) would not have included the SP purchase cost, so the URCS adjustment should not include the purchase price adjustment either. See BNSF-102, Weicher V.S. at 9. This argument is a red herring. The two adjustment provisions rely on entirely different approaches to approximating changes in UP's costs, and thus they rely on different underlying data. If BNSF would prefer to return to the RCAF(U) adjustment and pay UP millions of dollars in higher fees to avoid the supposed double count introduced by the URCS adjustment, UP will agree.

Settlement Agreement as written therefore preserves the basic relationship of the fees to UP's operating costs, as the Agreement specifies. BNSF suggests that the SP purchase cost does not represent actual costs, see BNSF-102, Weicher V.S. at 6, but the Board has already rejected that argument: "URCS costs, when calculated in the required manner, reflect actual costs; that, in fact, is what URCS is all about." Decision No. 96 at 5.

B. BNSF Does Not Have to Match UP's Costs to Provide Meaningful Competition

Even if UP had a slight cost advantage, it would be irrelevant. BNSF does not have to match UP's costs to provide the competition the Board expected it to provide. The Board did not expect BNSF to replicate UP's costs. The Board expected BNSF to step into SP's shoes and thus to match or better SP's costs. See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., 1 S.T.B. at 423. BNSF once recognized this. It understood that the BNSF Settlement Agreement was designed to allow it to replace the competition SP provided, not to match UP's costs. In its December Petition, BNSF noted that "the purpose of the trackage rights conditions was, in effect to put BNSF in the 'shoes of SP' as a competitor so that BNSF could replace the competitive service that would otherwise have been lost when SP was absorbed into UP." BNSF-98 at 6-7.

BNSF does not have to match UP's costs to step into SP's shoes. As BNSF has told the Board, comparisons between BNSF and UP costs "are misguided, because they focus on UP – rather than SP, the less efficient carrier." BN/SF-54 at 7. BNSF's experts, including Mr. Kent, testified during the merger proceeding that the relevant issue was whether BNSF's costs would be lower than SP's costs, not whether they would be lower than UP's costs. See BN/SF-55,

Klick & Kent V.S. at 43-44.²⁴ In fact, Messrs. Klick and Kent presented data showing that BNSF expected its variable costs for traffic moving over the trackage rights lines to be far more than \$25 to \$50 above UP's costs. See id. at 50 (Table 6).²⁵ Yet BNSF argued that it would be highly competitive using the trackage rights, and the Board agreed. See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., 1 S.T.B. at 417.

C. BNSF Has Proven It Can Compete Vigorously

The evidence shows that the Board and BNSF were correct in their belief that BNSF would be a vigorous competitor. BNSF is highly competitive using the trackage rights lines. The trackage rights fees have allowed BNSF to compete vigorously for the traffic opened up to it by the merger, as the Board has found in five consecutive oversight decisions.²⁶ In its final annual oversight decision, the Board concluded that "BNSF has competed vigorously for the traffic opened up to it by the BNSF Agreement and has become an effective competitive replacement for the competition that would otherwise have been lost or reduced when UP and SP

²⁴ See also BN/SF-55, Kalt V.S. at 42 ("A proper analytic framework asks whether BN/Santa Fe can come to the post-merger marketplace with at least as much competitive vigor as SP would possess in the non-merger environment.").

²⁵ For example, BNSF's witness Smith claims that the 0.2-mill rate puts BNSF at a \$46.26 disadvantage for traffic moving between Denver and Stockton. See BNSF-102, Smith V.S. at 4. Messrs. Klick and Kent showed that BNSF expected its variable costs between Denver and Sacramento, which is near Stockton, to be \$135 higher than UP's variable costs. See BN/SF-55, Klick & Kent V.S. at 50 (Table 6). A few other examples further illustrate the basic point: between Houston and Chicago, BNSF expected its variable costs to be \$92 higher than UP's; between Chicago and Salt Lake City, the difference was \$137; between Chicago and Oakland, the difference was \$225. See id. BNSF thus appears to be much better off than it expected.

²⁶ See Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., STB Finance Docket 32760 (Sub-No. 21), Decision No. 16 (STB served Dec. 15, 2000); Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., STB Finance Docket 32760 (Sub-No. 21), Decision No. 15 (STB served Nov. 30, 1999); Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., 3 S.T.B. 987 (1998); Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., 2 S.T.B. 703 (1997).

merged.” Union Pacific Corp. – Control & Merger – Southern Pacific Rail Corp., STB Finance Docket 32760 (Sub-No. 21), Decision No. 21 (STB served Dec. 20, 2001), slip op. at 4.

The Board’s conclusion endorsed BNSF’s own pride in its competitive success. In its final oversight report, BNSF told the Board that it “has been and continues to be an aggressive and effective competitor utilizing the rights it obtained pursuant to the BNSF Settlement Agreement and the conditions imposed by the Board.” See, e.g., BNSF-PR-20 at 2. Before the merger, BNSF told the Board “that it would grow the traffic associated with its rights . . . to the size and scale of a new Class I railroad.” Id. at 4. Five years later, BNSF reported that it had met that commitment and, in fact, “has exceeded that goal.” Id. Even though it had already exceeded its goal, BNSF said that it “anticipates the continued customer growth and commercial success of its UP/SP franchise.” Id. at 7.

Nonetheless, BNSF warns that it may not be competitive in the future. Its concerns are not credible. BNSF claims that UP will take away all of BNSF’s traffic because UP will always be able to underbid BNSF by \$25.00 to \$50.00 per car. BNSF-102, Smith V.S. at 3. If BNSF’s theory were accurate, UP would already handle all of the competitive business over the trackage rights lines, because UP has had this cost advantage for years. Yet BNSF has captured substantial amounts of competitive business using its trackage rights. See UP/SP-384, Confidential App. B. BNSF has “exceeded” its own ambitious goals. BNSF-PR-20 at 4.

BNSF must disavow five years of its own oversight reports in order to argue that the fees are too high to permit it to compete or that BNSF will be unable to compete in the future. The Board would have to ignore five years of oversight decisions in order to agree. The fees BNSF has paid in the past have not hindered its ability to compete, and there is no prospect that

BNSF's position will worsen in the future. Public policy concerns do not justify Government assistance to promote BNSF's interests.

CONCLUSION

BNSF has had two opportunities to show that UP and BNSF mutually agreed in some way to depart from the BNSF Settlement Agreement's plain language. BNSF has failed both times. The Board should dismiss BNSF's petition with prejudice.

Respectfully submitted,

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June 19, 2002

CERTIFICATE OF SERVICE

I hereby certify that on this 19th day of June, 2002, I caused a copy of the foregoing "UP's Reply to BNSF's and CMA's Responses to Order to Show Cause" to be served by first-class mail, postage prepaid, or by a more expeditious manner of delivery on all parties of record in Finance Docket No. 32760 (Sub-No. 21).

A handwritten signature in black ink, appearing to read "Michael L. Rosenthal", is written over a horizontal line.

Michael L. Rosenthal

Charts

Chart 1
Adjustments in 3.1 Mill Rate Using CMA Method
Compared with Adjustments in 3.1 Mill Rate Using 70 Percent of RCAF(U)

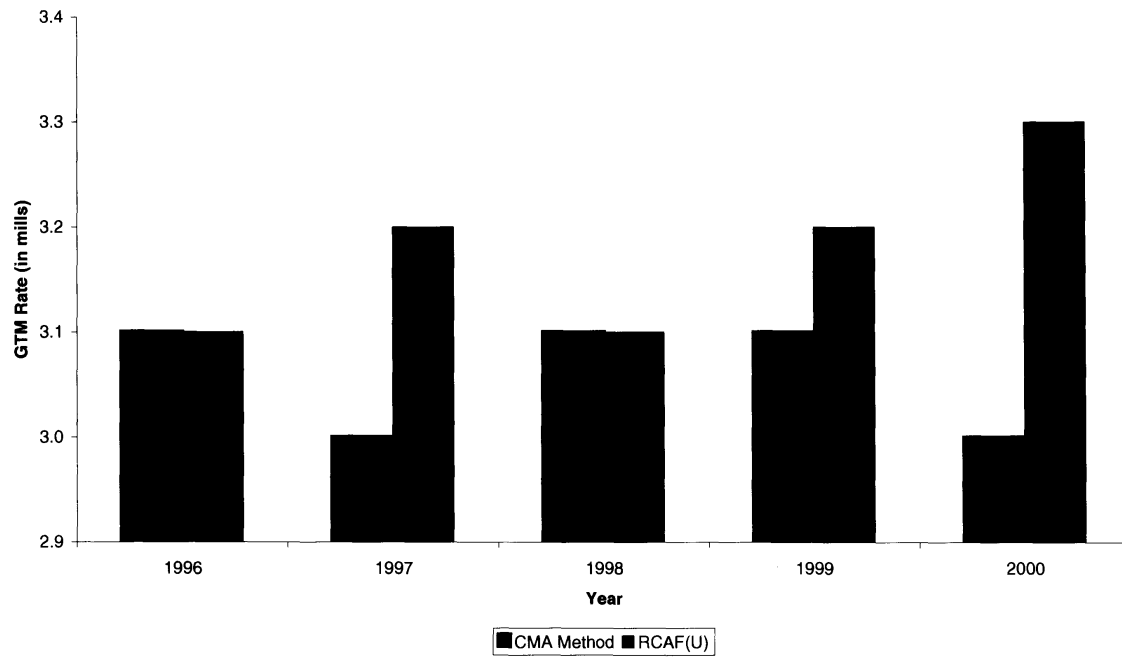


Chart 2
Adjustments in 3.1 Mill Rate Using CMA Method
Compared With Adjustments in Pueblo-Ft. Worth Rate Using 75 Percent of RCAF(U)

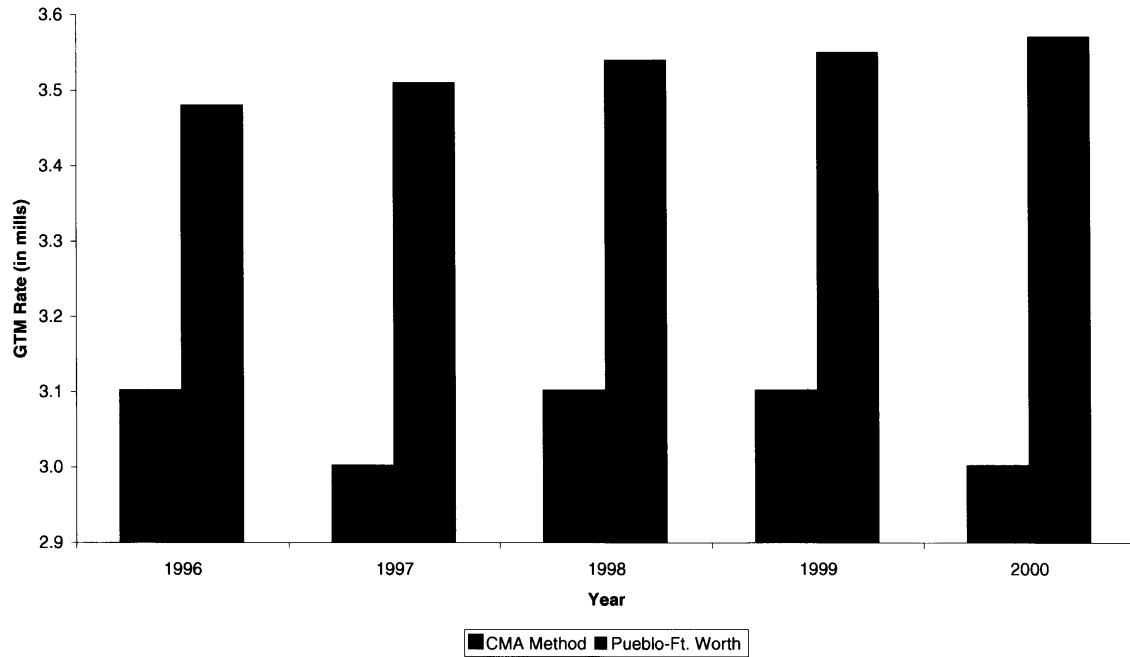
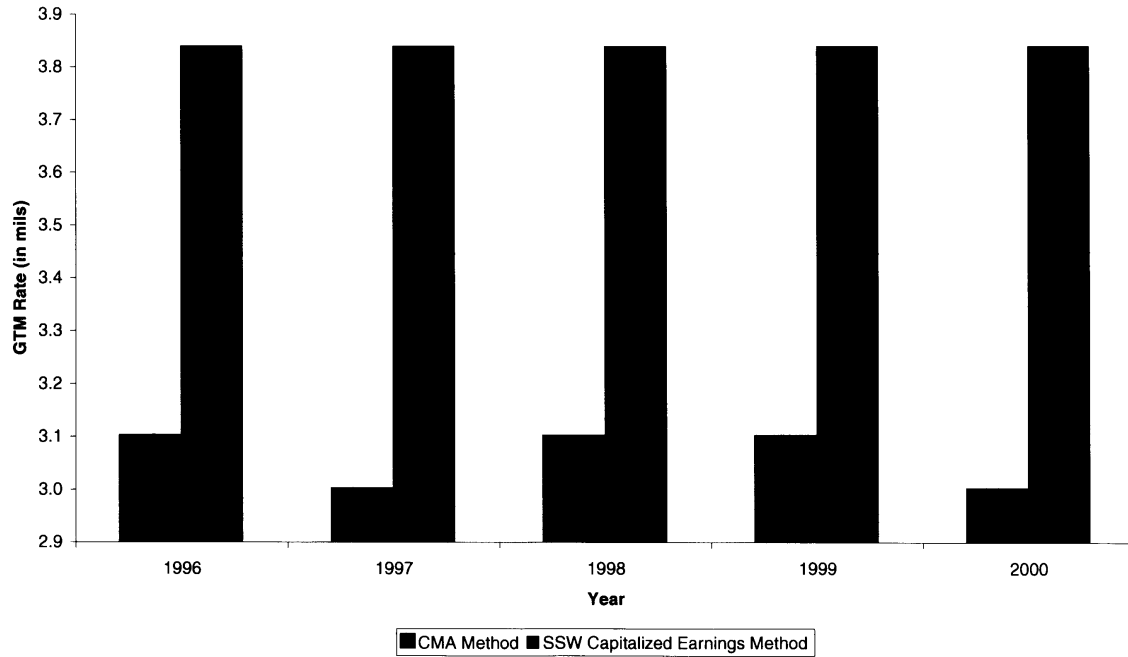


Chart 3
Adjustments in 3.1 Mill Rate Using CMA Method
Compared With Trackage Rights Rate Calculated Using SSW Capitalized Earnings Method



Rebendorf

VERIFIED STATEMENT

OF

JOHN H. REBENS DORF

My name is John H. Rebensdorf. I am Vice President-Network and Service Planning for Union Pacific Railroad Company. I hold a Bachelor's Degree in Civil Engineering from the University of Nebraska and a Master's Degree in Business Administration from Harvard University. Before coming to UP, I was employed as a management consultant by Temple, Barker and Sloane. I have worked in the Mechanical Department of the Chicago, Burlington & Quincy Railroad and in the Operating and Engineering Departments of the Chicago, Rock Island and Pacific Railroad. I joined UP in 1971 as Manager of Budget Research. I became Assistant Controller in 1976, Assistant Vice President-Planning and Analysis in 1980, Assistant Vice President-Finance in 1984, and Vice President-Strategic Planning in 1987, and I was appointed to my present position in 1998.

I. THE ORIGINAL BNSF SETTLEMENT AGREEMENT

When UP and SP decided to merge, UP charged me with responsibility for negotiating an agreement that would preserve rail competition for all of our customers who had been served by UP and SP and no other railroad ("2-to-1" customers). I described this assignment and the resulting agreement with BNSF in the UP/SP Merger Application. See UP/SP-22, Rebensdorf V.S. at 292-316. I was involved in every meeting in which the original BNSF Settlement Agreement was negotiated and drafted. I presented the BNSF Settlement Agreement as an attachment to my verified statement in UP/SP-22.

In order to preserve competition for "2-to-1" customers, UP negotiated trackage rights and line sales with BNSF that would provide service to most of those customers. We also negotiated the fees that BNSF would pay for its trackage rights.

The fee negotiations between UP and BNSF focused on other recent trackage rights agreements between the parties. In particular, we considered BNSF's agreement with SP that addressed competitive concerns arising from the BN/Santa Fe merger, which the Interstate Commerce Commission had approved just three months earlier. The rates under that agreement were initially 3.0 mills per gross ton-mile for bulk traffic and 3.48 mills per gross ton-mile for all other traffic. These rates were subject to an annual adjustment mechanism based on 75 percent of the RCAF(U).

After extensive, arms-length negotiations, we agreed on rates of 3.0 mills per gross ton-mile for bulk traffic and 3.1 mills per gross ton-mile for most carload and intermodal traffic. We also agreed to adjust the rates annually by applying 70 percent of the RCAF(U) to the rates. We agreed to use an RCAF(U) adjustment because it was used in the BN/Santa Fe merger, it is commonly used in the industry, and it provides a simple, straightforward method for adjusting the rates.

The parties negotiated the rate levels for the trackage rights. We never discussed assumptions about the parties' costs, and we never exchanged information about costs.¹ We never discussed purchase accounting or whether the rates reflected the SP purchase price. We never discussed the timing of UP's accounting for the UP/SP merger. Almost all of BNSF's

¹ Our only discussions about costs involved (i) our agreement that the trackage rights fee included capitalized track maintenance costs (costs for replacing rails, ties, and other track material), so UP would not charge BNSF separately for program track maintenance on the trackage rights lines, and (ii) our agreement to use a mechanism in addition to the RCAF(U) adjustment designed to ensure that costs do not get out of line with the trackage rights charges.

arguments – all of its claims about double counts and manipulations – assume that the initial fees reflected purchase accounting costs, but the parties did not negotiate or agree about costs or cost-based fees: our goal was to agree upon trackage rights fees that we and the Board could accept.

I have reviewed Carl Ice's and Richard Weicher's verified statements describing the September 1995 negotiations. Messrs. Ice and Weicher discuss their views and assumptions about how the initial fees related to BNSF's costs and whether the rates covered UP's costs. As Mr. Ice admits, however, the parties never exchanged any cost data. See BNSF-102, Ice V.S. at 6. During the negotiations, BNSF never shared any views or assumptions about costs. If they had, we could have corrected any misimpressions and resolved any differences.

Messrs. Ice and Weicher also make assertions about their own intent and their assumptions regarding UP's intent with respect to purchase accounting for the UP/SP merger. During the negotiations, however, they never described their intent or asked about UP's intent. They never mentioned purchase accounting, "merger premiums," or anything of that nature in connection with the trackage rights fees. If BNSF made any assumptions about whether the initial rate reflected purchase accounting or the timing of UP's accounting for the UP/SP merger, they never shared them with UP. UP did not consider these issues, and I would be surprised if BNSF actually considered them, since under a flat-rate agreement with an RCAF(U) adjustment, purchase accounting was irrelevant.

UP had no secret intent. UP sought simply to establish rates that the parties and the Board would accept and that would cover operating and maintenance costs while contributing to investment and other fixed costs. UP intended to agree to the initial rates and the adjustment mechanism as set forth in the BNSF Settlement Agreement's plain language.

Messrs. Ice and Weicher misleadingly argue that the BNSF Settlement Agreement reflects the parties' mutual intent to include purchase accounting in the initial rates. They point to the provision allowing the parties to revisit the adjustment mechanism every five years to insure that the rates and costs retain the "same basic relationship as upon execution of the Agreement." This "truing" provision reflects the parties' understanding that the RCAF(U) adjustment might not accurately track changes in operating costs. It does not say that the initial rate included or excluded purchase accounting.

Messrs. Ice and Weicher also make misleading references to my earlier statements that the trackage rights fees are "comprehensive." I described the flat rates as comprehensive because they combine into one fee the several elements included in traditional joint facility arrangements. Unlike traditional joint facility arrangements, the parties are not required to calculate and pay separate charges for operations, maintenance, and rent. We agreed with BNSF to use flat rates to eliminate the substantial clerical work and expense associated with traditional joint facility arrangements. Including in the rates the effects of an annual fee adjustment, whether based on RCAF(U) or based on URCS, does not make the fee any less comprehensive: BNSF still only pays one fee to engage in routine trackage rights operations.² Since the parties never discussed purchase accounting, I did not intend to include it within the term "comprehensive."

Messrs. Ice and Weicher also discuss UP's agreement to pay for capacity improvements on trackage rights that were necessary to achieve the benefits of the UP/SP

² I refer to "routine" trackage rights operations because the BNSF Settlement Agreement contains separate provisions regarding funding for capital improvements other than track programs, employee protection benefits, and liability for loss and damage – elements that are not included in the flat fee. See BNSF Settlement Agreement § 9(c), (e) & (f).

merger. UP and BNSF agreed in the September 1995 negotiations that BNSF would not have to pay for such improvements. BNSF was required, however, to pay its share of capital expenditures on trackage rights lines other than those related to capacity improvements necessary to achieve the merger's benefits. The costs of these capital expenditures were not included in the trackage rights fee. In order to minimize disputes about which capital expenditures were capacity improvements necessary to achieve the merger's benefits, we agreed to a simple procedure under which UP would pay for any capacity improvements on trackage rights lines for 18 months following the merger. We had no reason in September 1995 to engage in detailed discussions about whether these costs would affect the fee adjustment, because they would have no impact under the RCAF(U) adjustment provision. The parties' intent was to determine how to handle expenditures required for the capacity improvements; we did not intend to address future affects on UP's system-average costs associated with the improvements. In the Merger Application, I described these provisions as providing "relief from capital expenditures at the inception of trackage rights operations." See UP/SP-22, Rebensdorf V.S. at 309. We never discussed the effects on URCS, because the BNSF Settlement Agreement did not include an URCS adjustment provision at the time.

II. THE CMA AGREEMENT

In response to several concerns about the BNSF Settlement Agreement, UP further expanded the rights granted to BNSF. Many of these enhancements were embodied in an agreement with the Chemical Manufacturers Association ("CMA"). BNSF was also a party to this agreement. I was part of the team that developed UP's position in the negotiations with CMA, and I described the changes and clarifications to the BNSF Settlement Agreement and other matters that we agreed on with CMA and BNSF in my rebuttal verified statement in the merger proceedings. See UP/SP-231, Rebensdorf R.V.S. at 5-11. Although most of the face-to-

face negotiations between UP and CMA were handled by the late Arvid E. Roach II, UP's outside counsel, Mr. Roach was in constant communication with the rest of the UP team and apprised us of all developments.

One concern the CMA Agreement addressed involved the method for adjusting the trackage rights fees. CMA and others argued that the RCAF(U) method would, over time, result in BNSF's paying fees that were greater than UP's actual costs of maintaining and operating the trackage rights lines. I did not agree, because the "truing" provision described above was designed to ensure that costs do not get out of line with the trackage rights fees, and because BNSF had already concluded that it could compete under the BNSF Settlement Agreement's terms. Also, UP must pay BNSF a higher fee that is also escalated at a higher percentage of the RCAF(U) for the trackage rights granted to SP to solve the competitive problems of the BN/Santa Fe merger. Nonetheless, in order to eliminate the issue, UP agreed to adopt the fee adjustment provision proposed by CMA.

The URCS adjustment mechanism was CMA's idea. CMA's expert witness in the merger proceedings, Thomas D. Crowley, argued for an adjustment mechanism based on changes in UP's URCS costs. He described which URCS cost categories should be included. He also explained how the procedure would work, using a one-year lag "so that the 1997 adjustment would be based on the change in costs between 1995 and 1996." CMA-7, Crowley V.S. at 57 & Ex. (TDC-11).

UP agreed to adopt Mr. Crowley's proposal and his procedure. We agreed to use the URCS components that Mr. Crowley had identified. We also agreed that the adjustment should reflect a one-year lag so that the 1997 adjustment would be based on the difference in UP's 1995 and 1996 system average URCS costs. We recognized that the one-year lag made

sense, because the Board's URCS calculations were typically not available until several months after the end of the year in question. By using a one-year lag, we could adjust the rate and apply it immediately. This provided certainty to the tenant and avoided the extra work that retroactive adjustments would have required. It was also important to us that, like the RCAF(U) adjustment, the URCS adjustment would be a straightforward process that relied on a neutral source of data and that avoided complex computations and adjustments.

To the best of my knowledge, in the negotiations regarding the CMA Agreement, neither CMA nor BNSF ever suggested that UP's URCS should be modified to exclude the effects of purchase accounting or the costs of capacity improvements UP had agreed to pay. Neither CMA nor BNSF ever suggested that the adjustment should be based only on post-merger URCS. Neither CMA nor BNSF ever told UP that they understood the initial trackage rights fees already included the anticipated effects of purchase accounting. Neither CMA nor BNSF ever mentioned purchase accounting, "merger premiums," or anything of that nature in connection with the provision for adjusting trackage rights fees. If CMA or BNSF had raised any of these issues, I am certain that Mr. Roach would have informed me and the rest of the UP team.

I described UP's understanding of the fee adjustment provision in my rebuttal testimony in the merger proceeding on April 29, 1996, less than two weeks after the parties had signed the CMA Agreement. My testimony reinforced three points that were clear from the parties' discussions and Mr. Crowley's testimony: (i) the adjustment would be made on July 1 of each year; (ii) the adjustment would include a lag period, so the comparison each year would involve the two preceding years; and (iii) the URCS costs used to calculate the adjustment would include depreciation and return on investment.

I believe I accurately reflected the parties' intent in the CMA Agreement. Once again, UP had no secret intent. We intended to replace the original RCAF(U) adjustment with a new but equally simple means of calculating an annual adjustment to the already agreed-upon rates. We intended to do this by adopting CMA's proposal as reflected in Mr. Crowley's statement. Until BNSF began this latest proceeding, no one ever suggested to me that my statement of the parties' agreement was inaccurate in any respect. I am certain that BNSF and CMA would have objected in 1996 had I erred in any way.

III. THE SECOND SUPPLEMENTAL AGREEMENT TO THE BNSF SETTLEMENT AGREEMENT

UP and BNSF signed the Second Supplemental Agreement to the BNSF Settlement Agreement on June 27, 1996. The Second Supplemental Agreement was designed to place into one document the additions and revisions to the original BNSF Settlement Agreement necessary to implement the CMA Agreement, as well as additional changes unilaterally offered by UP to address concerns of shippers and clarifications negotiated between UP and BNSF to address issues that had arisen in developing detailed implementing agreements for the trackage rights.

The negotiations regarding the Second Supplemental Agreement occurred largely through the exchange of drafts and telephone calls between Paul A. Conley, Jr., UP's Assistant Vice President-Law, and Richard E. Weicher, one of BNSF's in-house lawyers. Throughout the negotiating process, Mr. Conley was in contact with me and the rest of the UP team, and he apprised us of all developments. I reviewed every draft UP provided to BNSF or vice versa, and Mr. Conley relayed any comments from his BNSF counterpart to me and the rest of the UP team. The parties' negotiations were detail-oriented and intense, and Mr. Conley called on the people

who had been involved in the September 1995 negotiations and the CMA Agreement negotiations to ensure that the Second Supplemental Agreement correctly reflected our intent.

In several of the drafts, UP and BNSF focused specifically on the CMA Agreement's provision for adjusting the trackage rights fees. We agreed to use the CMA mechanism as Mr. Crowley had described it. To the best of my knowledge, BNSF never suggested that UP's URCS should be modified to exclude the effects of purchase accounting or the costs of capacity improvements UP had agreed to pay. BNSF never suggested that the adjustment should be based only on post-merger URCS costs. BNSF never told UP that they understood the initial trackage rights fees to include the anticipated effects of purchase accounting. BNSF never mentioned purchase accounting, "merger premiums," or anything of that nature in connection with the provision for adjusting trackage rights fees. BNSF never suggested that the final form of the fee adjustment provision differed from the CMA Agreement's fee adjustment process, as BNSF now claims. If BNSF had raised any of these issues, I am certain that Mr. Conley would have informed me and the others on the UP team.³

I believe that the plain language of the Second Supplemental Agreement's provision for adjusting trackage rights fees, which was the language before the Board when it approved the UP/SP merger and which is the same language in the Restated and Amended BNSF Settlement Agreement that UP and BNSF filed in March 2002, accurately records CMA's, UP's

³ At the same time UP and BNSF were negotiating the Second Supplemental Agreement, the parties were also negotiating the implementing agreements for each segment of the trackage rights granted under the BNSF Settlement Agreement. The implementing agreements all contained the fee adjustment provision. In the negotiations regarding the implementing agreements, as in the negotiations regarding the Second Supplemental Agreement, BNSF never raised any of the claims it is now making. As the negotiations regarding the implementing agreements were coordinated with the negotiations over the Second Supplemental Agreement, I am confident that I would have been informed had such claims been raised.

and BNSF's intent as reflected in the CMA Agreement. I believe that it also accurately records UP's and BNSF's intent in their negotiations regarding the Second Supplemental Agreement. If BNSF had any beliefs or intentions inconsistent with the plain language, no one ever shared those beliefs or intentions with UP. I am confident that BNSF would not have agreed had it believed the language was inaccurate.

IV. BNSF'S COMPETITION CLAIMS

I will not spend much time addressing BNSF's claims that the fee adjustment places BNSF at a competitive disadvantage. BNSF's statements to the Board throughout five years of oversight and the Board's conclusions in its five years of oversight proceedings refute BNSF's claims better than I ever could.

I do want to address, briefly, BNSF's misleading argument that it cannot compete effectively if UP has a \$25 to \$50 per car advantage in the costs measured by the trackage rights fees. BNSF's argument is completely inaccurate for several reasons, many of which the Board identified when it rejected similar arguments by parties opposed to the UP/SP merger.

First, BNSF has no basis for claiming that it cannot compete under the BNSF Settlement Agreement, because it requires UP to pay much higher rates for trackage rights designed to remedy the anticompetitive effects of the BN/Santa Fe merger. Under BN/Santa Fe's settlement agreement with SP in 1995, the initial rates were established as 3.0 mills for bulk traffic and 3.48 mills for all other traffic, and the parties agreed to an annual adjustment based on 75 percent of the RCAF(U). As of January 2000, those rates were 3.08 mills for bulk traffic and 3.57 mills for all other traffic. By comparison, the rates as of January 2000 under the BNSF Settlement Agreement were 2.9 mills for bulk traffic and 3.0 mills for all other traffic, and those rates are adjusted based on changes in UP's URCS costs.

Second, BNSF has no basis for claiming that UP has an advantage when BNSF uses the BNSF Settlement Agreement trackage rights. UP pays all of the same costs to operate its own trains over the trackage rights that BNSF pays through the trackage rights fee. BNSF complains that the trackage rights fees have increased faster than UP's costs because the fees reflect costs associated with the SP acquisition, but UP pays those acquisition costs as well. The same is true of the initial capacity costs.

Third, BNSF has no basis for claiming that UP has an advantage because the trackage rights fee represents only a portion of BNSF's total costs for any move. In many cases, BNSF utilizes a portion of its own existing routes in conjunction with the trackage rights line, and the trackage rights fee represents a fraction of BNSF's fully allocated costs. BNSF is a very efficient carrier, so its remaining costs of operating over the trackage rights segments are likely to be low in all cases, and lower than UP's costs in many cases, thus offsetting any alleged advantage UP may have based on the trackage rights fee.

Finally, BNSF has no basis for claiming that UP has an advantage because, even if BNSF's costs were higher than UP's costs for some shippers or routes, UP could never be certain of its advantage. UP knows BNSF's trackage rights fees, but it does not know whether BNSF's total costs of moving traffic on any particular route are higher or lower than UP's costs. UP thus cannot negotiate with shippers as if it can always undercut BNSF. Moreover, even if UP knew it had a slight advantage, it would be foolish to try to win away all of BNSF's business by pricing down to the level of incremental costs, because UP may then be unable to generate a satisfactory return on its investment.

The Board need only look to the past five years to see who is correct. BNSF promised during the merger proceedings that it would be an effective competitor using the

trackage rights lines. BNSF has competed. It has won business. In its final oversight report, BNSF told the Board that it had exceeded its goals. See BNSF-PR-20 at 4. When it was not trying to convince the Board that it needed lower trackage rights to compete, it told the Board that it “anticipates the continued customer growth and commercial success of its UP/SP franchise.” Id. at 7. BNSF’s doomsday claims are refuted by its own success and own predictions of future success.

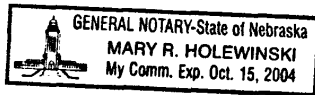
VERIFICATION

STATE OF NEBRASKA)
)
COUNTY OF DOUGLAS) ss:

I, JOHN H. REBENDS DORF, Vice President - Network & Service Planning, for Union Pacific Railroad Company, being duly sworn, depose and state that I have read the foregoing Verified Statement, that I know its contents, and that those contents are true as stated to the best of my knowledge, information and belief.


JOHN H. REBENDS DORF

SUBSCRIBED AND SWORN TO before me this 14th day of June, 2002.




Notary Public

My commission expires: October 15, 2004

VERIFIED STATEMENT

OF

JAMES V. DOLAN

PAUL A. CONLEY, JR.

AND

JOHN T. GRAY

Our names are James V. Dolan, Paul A. Conley, Jr., and John T. Gray. We were all deeply involved in the negotiations of the original BNSF Settlement Agreement, the CMA Agreement, and the Second Supplemental Agreement to the BNSF Settlement Agreement. This statement addresses claims by BNSF and CMA that the parties to the BNSF Settlement Agreement and the CMA Agreement mutually agreed to adjust the BNSF Settlement Agreement's trackage rights fees in order to exclude the impact of (1) purchase accounting for the UP/SP merger and (2) costs of merger-related capacity improvements that UP agreed to fund under Section 9(c)(i) and (iii) of the BNSF Settlement Agreement.

QUALIFICATIONS

Dolan: I was UP's Vice President-Law when the original BNSF Settlement Agreement, the CMA Agreement, and the Second Supplemental Agreement were negotiated and drafted. I remain in that position today. I was involved in the negotiating sessions during the three days in September 1995, when UP and BNSF drafted the original BNSF Settlement Agreement. I also attended several preliminary meetings between UP and BNSF that occurred in late August and September 1995. During the negotiation of the CMA Agreement, I was in constant communication with UP's outside counsel, the late Arvid E. Roach II, who was primarily responsible for communicating with CMA's representatives. I participated in all of

UP's internal decisions regarding the content of the CMA Agreement. I reviewed the various drafts of the CMA Agreement, and I approved the final CMA Agreement. As Vice President-Law, I also participated in UP's internal discussions regarding the Second Supplemental Agreement, I reviewed the various drafts in order to insure that they reflected the agreements between and among UP, BNSF, and CMA, and I approved the final form of the Second Supplemental Agreement.

Conley: I was UP's Assistant Vice President-Law when the original BNSF Settlement Agreement, the CMA Agreement, and the Second Supplemental Agreement were negotiated and drafted. I am now retired from UP. I attended all of the negotiating sessions during the three days in September 1995, when UP and BNSF drafted the original BNSF Settlement Agreement. I personally drafted much of the BNSF Settlement Agreement's language. During the negotiation of the CMA Agreement, I was in constant contact with UP's outside counsel, the late Arvid E. Roach II, who was primarily responsible for communicating with CMA's representatives, and I participated fully in all of UP's internal decisions regarding the content of the CMA Agreement. I was also involved in drafting the language in the CMA Agreement, including the URCS adjustment provision. Finally, I was responsible on behalf of UP/SP for negotiating and drafting the Second Supplemental Agreement, and I exchanged many drafts and phone conversations with BNSF's Richard E. Weicher during the negotiating and drafting process.

Gray: I was SP's Vice President-Network and Corporate Development when original the BNSF Settlement Agreement, the CMA Agreement, and the Second Supplemental Agreement were being negotiated. Today I am UP's Executive Director-Interline. I attended all of the September 1995 meetings during which the BNSF Settlement Agreement was drafted. I

was also involved in several preliminary meetings in late August and September 1995. I signed the BNSF Settlement Agreement on behalf of SP. During the negotiation of the CMA Agreement, I regularly communicated with UP's outside counsel and the other members of the UP/SP team. I reviewed the drafts and the final CMA Agreement, and I approved the agreement on behalf of SP. I also participated in internal UP/SP discussions regarding the Second Supplemental Agreement and reviewed all of the drafts in order to insure that they reflected the agreements between and among UP, BNSF, and CMA. I signed the Second Supplemental Agreement on behalf of SP.

STATEMENT

The plain language of the fee adjustment provision in Section 12 of the BNSF Settlement Agreement, as amended by the Second Supplemental Agreement, reflects our intention of how the provision for adjusting trackage rights fees would apply. (The identical language is incorporated in Section 12 of the Restated and Amended BNSF Settlement Agreement, which was submitted to the Board on March 1, 2002.) The fee adjustment provision was intended to implement a procedure proposed by CMA using terms proposed by a CMA expert. It reflects our understanding of UP's, BNSF's, and CMA's agreement in the CMA Agreement. It reflects our understanding of UP's and BNSF's agreement in the Second Supplemental Agreement.

We do not recall any occasion on which BNSF or CMA ever mentioned purchase accounting, "merger premiums," or anything of that nature in connection with the fee adjustment provision. We do not recall any occasion on which BNSF or CMA ever suggested that SP's purchase costs should be excluded from the trackage rights fee adjustment. We do not recall any occasion on which BNSF or CMA ever suggested that the fee adjustment should be based only

on post-merger URCS costs. We do not recall any occasion on which BNSF or CMA ever suggested that the cost of certain merger capacity costs should be excluded from the trackage rights fee adjustment. We do not recall ever being informed by anyone that BNSF or CMA had ever raised any of these issues during the negotiations of the original BNSF Settlement Agreement, the CMA Agreement, or the Second Supplemental Agreement. And we do not recall any occasion on which BNSF or CMA ever suggested that the plain language of the BNSF Settlement Agreement did not reflect their intent.

If BNSF or CMA made any assumptions about modifying UP's URCS costs or excluding SP's purchase cost or certain merger capacity costs from the trackage rights fee adjustment provision, neither BNSF nor CMA disclosed those assumptions to UP during the negotiations or drafting of the original BNSF Settlement Agreement, the CMA Agreement, or the Second Supplemental Agreement. UP's understanding and intention was that the plain language of the BNSF Settlement Agreement, as amended by the Second Supplemental Agreement, provided the procedures for adjusting the trackage rights fees.

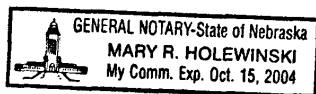
VERIFICATION

STATE OF NEBRASKA)
)
COUNTY OF DOUGLAS) ss:

I, JAMES V. DOLAN, Vice President-Law for Union Pacific Railroad Company,
being duly sworn, depose and state that I have read the foregoing Verified Statement,
that I know its contents, and that those contents are true as stated to the best of my
knowledge, information and belief.

James V. Dolan
JAMES V. DOLAN

SUBSCRIBED AND SWORN TO before me this 14th day of June, 2002.



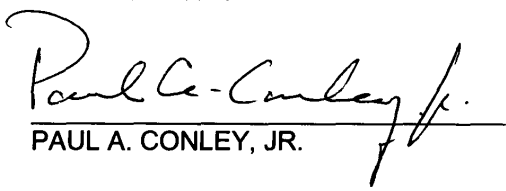
Mary R. Holewinski
Notary Public

My commission expires: October 15, 2004

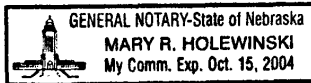
VERIFICATION

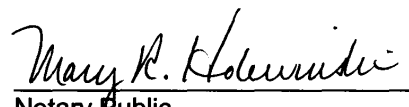
STATE OF NEBRASKA)
)
COUNTY OF DOUGLAS) ss:

I, PAUL A. CONLEY, JR., being duly sworn, depose and state that I have read the foregoing Verified Statement, that I know its contents, and that those contents are true as stated to the best of my knowledge, information and belief.


PAUL A. CONLEY, JR.

SUBSCRIBED AND SWORN TO before me this 14th day of June, 2002.




Notary Public

My commission expires: October 15, 2004

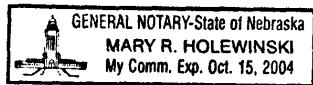
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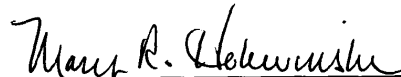
STATE OF NEBRASKA)
)
COUNTY OF DOUGLAS) ss:

I, JOHN T. GRAY, Executive Director - Interline, for Union Pacific Railroad Company, being duly sworn, depose and state that I have read the foregoing Verified Statement, that I know its contents, and that those contents are true as stated to the best of my knowledge, information and belief.


JOHN T. GRAY

SUBSCRIBED AND SWORN TO before me this 12th day of June, 2002.




Notary Public

My commission expires: October 15, 2004

Rhodes

VERIFIED STATEMENT

OF

KEITH A. RHOADES

My name is Keith A. Rhoades. I am Director-General Ledgers/Financial Research for Union Pacific Railroad Company ("UP"). I graduated from Brigham Young University in 1972 with a B.S. in Accounting. I have worked in UP's Finance Department for 29 years in a variety of positions of increasing responsibility, including Internal Auditor, Internal Auditor-Supervisor, Manager-Division Accounting Development, Manager-Ledgers and Financial Reporting, Assistant Director-Ledgers and Financial Reporting, and Manager-Financial Research. I was promoted to my present position in 1988.

As Director-General Ledgers/Financial Research, I am responsible for research and analysis concerning accounting issues, policies, principles, and procedures. I am also responsible for ensuring UP's accounting and reporting integrity. I have been personally involved in the accounting for UP's acquisitions of Missouri-Kansas-Texas Railroad Company, Chicago & North Western Transportation Company, and Southern Pacific Rail Corporation.

I previously have submitted testimony to the Surface Transportation Board in the FMC,¹ WCTL,² and WPL³ cases with regard to UP's accounting treatment of its acquisitions. In each case, I explained UP's accounting treatment and how that treatment was required by

¹ FMC Wyoming Corp. v. Union Pacific R.R., STB Docket No. 42022 (STB served May 12, 2000).

² Western Coal Traffic League v. Union Pacific R.R., STB Finance Docket No. 33726 (STB served May 12, 2000).

³ Wisconsin Power & Light Co. v. Union Pacific R.R., STB Docket No. 42051 (STB served Sept. 13, 2001).

generally accepted accounting principles ("GAAP") and the Board's own railroad accounting rules, the Uniform System of Accounts ("USOA").

In this statement, I address BNSF's allegations that UP's accounting and reporting of the UP/SP merger was improper and unexpected. In particular, I address BNSF's claims regarding the purchase accounting adjustments necessary to reflect the fair value of the assets that UP acquired from SP. I show that UP properly accounted for the UP/SP merger in its Annual Report Form R-1 for 1997 and that its plans and proposed timing for its merger accounting should have been expected.

After the FMC, WCTL, and WPL cases, I am surprised that anyone would question UP's purchase accounting in connection with the UP/SP merger. In each case, the Board agreed that UP's accounting treatment of purchase accounting adjustments conformed to GAAP and the USOA. In each case, the Board agreed that UP's 1997 Annual Report R-1 properly reflected the purchase accounting entries in UP's books for the acquisition of SP. The results in those cases were not surprising, because UP had discussed its plans with the Board's accounting staff and had received the staff's approval for its reporting of the UP/SP merger.

BNSF is mistaken when it suggests that UP should have recorded the effects of purchase accounting in its 1996 R-1 report rather than in its 1997 R-1 report. GAAP did not dictate that purchase accounting should be reflected in the railroads' 1996 financial statements. UP followed GAAP and the USOA in determining the manner and timing for recording the purchase accounting adjustments associated with the UP/SP merger.

The UP/SP merger was consummated in September 1996 when Union Pacific Corporation ("UPC") acquired Southern Pacific Rail Corporation ("SPR"). As a result of the acquisition, UPC owned six different railroads, all of which were distinct corporate entities with

separate books and records – Union Pacific Railroad Company (“UP”), Missouri Pacific Railroad Company (“MP”), Southern Pacific Transportation Company (“SPT”), St. Louis Southwestern Railway Company (“SSW”), SPCSL Corp. (“SPCSL”), and The Denver & Rio Grande Western Railroad Company (“DRGW”).

UPC accounted for the transaction as a purchase at the parent-company level in 1996, and its books and SEC reports reflected the effects of purchase accounting in 1996. The railroads themselves remained separate, direct or indirect subsidiaries of UPC. Until SPR’s railroad subsidiaries were merged or consolidated with UP, the effects of purchase accounting should not have been included in UP’s R-1.

There were two important reasons why the mergers of the various railroad subsidiaries could not occur in 1996. First, UP was awaiting a ruling from the IRS to ensure that the SPR railroad subsidiary mergers would not jeopardize the tax-free status of UPC’s initial purchase of SPR. A favorable ruling was not received until 1997.⁴ Second, UP needed to deal with minority shareholders before the SSW merger could be completed. Once these issues were resolved UP merged the SPR railroad subsidiaries into UP. As a result, UPC should not have included the purchase accounting in UP’s R-1 until 1997.⁵

⁴ Had the IRS ruling been unfavorable, UP would have considered different means of consolidating the SPR railroad subsidiaries into one merged system. See UP/SP-22 at 2 (describing the possibility that “in lieu of such mergers some or all of [the SPR subsidiaries] will be merged into, or their assets leased to, MPRR or other means used to accomplish their consolidation into the merged system”).

⁵ The final merger of subsidiaries, in which UP merged into SPT and SPT changed its name to Union Pacific Railroad Company, took place in February 1998, but its effects were appropriately recorded in UP’s 1997 financial statements, because UPC had both the intent and ability to consummate the merger before issuing UP/SPT financial statements. See AICPA AU Section 560, Subsequent Events. UPC did not have the intent and ability with respect to SPT or the other SPR railroad subsidiaries in 1996 because of the tax and shareholder issues described above.

It was no secret that the railroad-level mergers might not occur until sometime after the Board approved the Merger Application. UP explained on the second page of the Application that its "present intent is to merge SPT, SSW, SPCSL and DRGW into UPRR, although these subsidiaries of SPR may retain their separate corporate existence for a period of time." UP/SP-22 at 2. Moreover, the accounting rules governing this type of transaction are well established; any knowledgeable person reviewing the Application should have recognized the distinct possibility that purchase accounting might not be reflected in UP's books until sometime after the application was approved and the transaction was consummated.

UP never tried to disguise its accounting methodology. UP affirmatively asked the Board's staff to approve its proposal for reflecting the UP/SP merger and the associated purchase accounting adjustments in its 1996 and 1997 R-1 reports. See Letter from UP's Robert W. Schmidt, Jr., to STB's Ward L. Guinn, Jr., dated Sept. 26, 1996 (attached as Exhibit A). The Board's staff confirmed that UP and SPT should file separate R-1 reports for 1996 reflecting each railroad's historical costs and a combined R-1 report for 1997 reflecting the revaluation of the SPR rail subsidiaries' assets as a result of purchase accounting. See Letter from STB's Ward L. Guinn, Jr., to UP's Robert W. Schmidt, Jr., dated Oct. 2, 1996 (attached hereto as Exhibit B).

I am surprised to see this issue raised at such a late date. If anyone truly thought that the effects of purchase accounting would be reflected in UP's 1996 R-1 report and relied on that accounting occurring in 1996, that report's publication should have put any such misimpressions to rest. UP's 1996 R-1 report revealed that purchase accounting had not occurred at the railroad level in 1996. The explanatory notes regarding the UP/SP merger state:

The business combination with Southern Pacific has been accounted for as a purchase, but SP's results are not currently included in UP's results.

An even more obvious indication that UP's and SPT's accounts had not been combined in 1996 was the fact that SPT filed a separate 1996 R-1 report. Finally, if anyone was still under the misimpression that the 1996 R-1 report reflected UP's purchase accounting for the UP/SP merger, they could not possibly still misunderstand the situation after publication of UP's 1997 R-1. UP's 1997 R-1 report contained an extensive discussion of purchase accounting and should have made clear to anyone precisely how and when UP's books reflected the purchase accounting adjustment associated with the UP/SP merger.

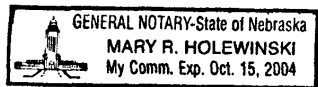
VERIFICATION

STATE OF NEBRASKA)
)
COUNTY OF DOUGLAS) ss:

I, KEITH RHOADES, Director - General Ledgers - Financial Research, for Union Pacific Railroad Company, being duly sworn, depose and state that I have read the foregoing Verified Statement, that I know its contents, and that those contents are true as stated to the best of my knowledge, information and belief.

Keith Rhoades
KEITH RHOADES

SUBSCRIBED AND SWORN TO before me this 17th day of June, 2002.



Mary R. Holewinski
Notary Public

My commission expires: October 15, 2004

UNION PACIFIC RAILROAD COMPANY

FINANCE DEPARTMENT

1416 DOOGIE STREET
OMAHA, NEBRASKA 68179

September 26, 1996

Mr. Ward L. Ginn
Chief, Section of Costing and Financial Information
Surface Transportation Board
Office of Economics and Environmental Analysis
Room 3219
Washington, D.C. 20423

RECEIVED
OFFICE OF ECONOMICS
DIRECTOR'S OFFICE
OCT 2 10 50 AM '96
NATIONAL
SURFACE TRANSPORTATION
BOARD

Dear Mr. Ginn:

In reference to my conversation with Paul Aguiar and Jeff Warren, of your staff, regarding reporting requirements of Southern Pacific Transportation Company and Union Pacific Railroad for third and fourth quarter 1996 and for 1997 — below is our understanding of the STB requirements.

We will continue to report as separate railroads in 1996, and file consolidated reports for 1997 operations. Thus, for 1996, separate Revenue Expense and Income (RE&I), Condensed Balance Sheet (CBS), Wage Statistics (Forms A and B) and Quarterly Commodity Statistics (QCS) will be filed for each road. A separate 1996 Annual QCS, Forms A&B and Form R-1 will also be filed for each railroad on the same cost basis as has historically been submitted.

Beginning in 1997 we will file combined UP/SP reports for quarterly RE&I and CBS, quarterly and annual QCS and Forms A and B, and annual R-1. We will include the revaluation of SP assets and liabilities and all appropriate eliminations.

Please review this request and provide us confirmation of the reporting requirements for the acquisition of SP. If you have any questions, please call me at (402)271-4269

Very truly yours,

Robert W. Schmidt Jr.
Manager, Reporting & Analysis

cc: Mr. James R. Young, Union Pacific Railroad, Omaha, NE
Mr. Fred van Naerssen, Union Pacific Corporation, Bethlehem, PA
Mr. Brian Kane, Southern Pacific Railroad, San Francisco, CA



Surface Transportation Board
Washington, D.C. 20423-0001

October 2, 1996

Mr. Robert W. Schmidt, Jr.
Manager, Reporting & Analysis
Finance Department
Union Pacific Railroad Company
1416 Dodge Street
Omaha, NE 68179

Dear Mr. Schmidt:

Thank you for your letter of September 26, 1996, regarding the post-merger reporting requirements of Southern Pacific Transportation Company and Union Pacific Railroad.

Your proposal to file separate reports for 1996 and combined reports for 1997 is approved. Also, use of the same historical cost basis for the separately filed 1996 annual QCS, Forms A&B, and Form R-1 is likewise approved.

With respect to the revaluation of SP assets and liabilities reflected in all reports filed for 1997, we would appreciate that you disclose by separate letter the accounting to be performed to reflect the necessary revaluation. It is also important that UP/SP's Schedule 250 for the year 1997 be footnoted to disclose any significant adjustments pertaining to the merger.

Your assistance in this matter is greatly appreciated. Please call me at (202) 927-6204 if you have any questions.

Sincerely,

A handwritten signature in dark ink, appearing to read "Ward L. Ginn, Jr.", is written over a horizontal line.

Ward L. Ginn, Jr.
Chief, Section of Costing & Financial Information

Kauders

VERIFIED STATEMENT

OF

RICHARD F. KAUDERS

My name is Richard F. Kauders. When I retired in September 2001, I was Manager-Economic Research for Union Pacific Railroad Company ("UP"). I was employed by UP more than 29 years. My responsibilities included the development of cost and related testimony for use before the Surface Transportation Board ("Board") and its predecessor, the Interstate Commerce Commission ("Commission"). I hold a B.S. Degree from Cornell University and the M.B.A. degree from Northwestern University. My experience with UP consisted principally of work in the regulatory costing area, including mergers, trackage rights, rate complaints and investigations, and branch line abandonments.

I participated in cost studies and the calculation of benefits in a number of merger proceedings before the Commission and the Board, including Finance Docket 30000, Union Pacific – Control – Missouri Pacific & Western Pacific; Finance Docket 30800, Union Pacific – Control – Missouri-Kansas-Texas; Finance Docket 32133, Union Pacific – Common Control – Chicago North Western; and Finance Docket 32760, Union Pacific – Control & Merger – Southern Pacific.

One of my responsibilities as UP's Manager-Economic Research was to calculate the annual adjustment to the trackage rights fees under the BNSF Settlement Agreement. In this statement, I address the fee adjustment calculations Mr. Christopher D. Kent presents on behalf of The Burlington Northern and Santa Fe Railway Company ("BNSF"). I show that significant flaws invalidate the BNSF modifications to URCS costs for 1995 and 1996 and entirely undermine BNSF's effort to estimate the difference between UP's and BNSF's calculations.

BNSF's theory is that fee adjustments were to be based on comparisons of only post-merger URCS costs, beginning with a comparison between UP's 1996 and 1997 URCS costs. See BNSF-102 at 8. BNSF purports to "correct" for the fact that the purchase accounting for the UP/SP merger was first reflected in UP's 1997 R-1. Mr. Kent makes this "correction" not by carrying out the comparison between 1996 and 1997, but by constructing hypothetical URCS costs for 1995 and 1996.¹

He substitutes the investment and depreciation data from UP's 1997 R-1 for the actual investment and depreciation data used to calculate UP's and SP's 1995 and 1996 URCS costs. Specifically, he substitutes (i) UP's 1997 beginning-of-year investment data for the actual year-end investment data used in calculating 1995 and 1996 URCS costs; (ii) UP's 1997 beginning-of-year accumulated depreciation for the actual year-end accumulated depreciation data used in calculating 1995 and 1996 URCS costs; and (iii) UP's 1997 full-year depreciation charges for depreciation charges used in calculating 1995 and 1996 URCS costs. BNSF-102, Kent V.S. at 3. His workpapers reveal that he retains UP's and SP's actual 1995 and 1996 maintenance-of-way operating expenses and gross ton-miles.

Mr. Kent then calculates hypothetical, combined UP/SP 1995 and 1996 URCS costs. BNSF claims that the results show what UP's 1995 and 1996 URCS costs would have been if the UP and SP systems had been merged and the results reflected in combined UP/SP URCS. Id. at 2. BNSF is mistaken.

¹ Apparently to be consistent with BNSF's notion that the parties intended to compare post-merger URCS, Mr. Kent moves the purchase accounting back to 1995, a year before it could have happened. He presumably does this to give BNSF the benefit of substantial cost reductions on SP and UP between 1995 and 1996 for the first rate adjustment.

A. BNSF's Hypothetical URCS Costs Bear No Relationship to the Costs UP Would Have Incurred in 1995 and 1996

Mr. Kent substitutes UP 1997 investment and depreciation data for 1995 and 1996 data, but he uses actual SP and UP 1995 and 1996 gross ton-miles and maintenance-of-way costs to calculate URCS costs. This creates numerous apples-and-oranges comparisons that undermine any effort to provide a meaningful restatement of 1995 and 1996 URCS costs.

Mr. Kent's computations violate the principle of "causality" that underpins URCS theory. The causality principle means that operating and maintenance expenses, return on investment, and depreciation costs must all derive from the same physical plant in the same reporting period and should be allocated to relevant service units (such as gross ton-miles) reported for the same period. See Railroad Accounting Principles Board, Final Report, Vol. 1 at 29. Mr. Kent's modifications to URCS ignores this principle. His calculations do not reflect the costs of any railroad that did exist or could have existed.

A few examples help illustrate this basic flaw in Mr. Kent's methodology:

First, Mr. Kent introduces a fundamental inconsistency when he calculates URCS costs for return on investment using 1997 beginning-of-year investment levels and 1995 and 1996 gross ton-miles. This results in a calculation with no connection to the real world. UP's and SP's gross ton-miles in 1995 and 1996 reflect the railroads' physical structure, actual operations, and competitive relationships in those years. We cannot know how many gross ton-miles UP would have moved in 1995 and 1996 if the UP and SP systems had been configured as they were at the beginning of 1997 and the railroads had been merged. We do not know whether mileage savings from reroutes made possible by the merger (for example, UP rerouted SP's Central Corridor traffic to UP's Wyoming mainline after the merger) and traffic losses to BNSF from use of its trackage rights would have offset increases in traffic resulting from new business

opportunities. We do know, however, that Mr. Kent's computations have no connection to reality, because they are based on investments in a post-merger network, on the one hand, and gross ton-miles produced by two different pre-merger networks, on the other hand.

Second, Mr. Kent introduces another inconsistency into his 1995 and 1996 URCS calculations by combining 1997 depreciation data with actual 1995 and 1996 gross ton-miles to calculate the URCS unit costs for depreciation. This destroys the link between the use of an asset and its depreciation expense. UP's 1997 depreciation charges are a function of UP's use of its depreciable assets in 1997. For the track accounts at issue in this proceeding, use is measured by gross ton-miles. When Mr. Kent calculates URCS depreciation costs for 1995 and 1996, however, he uses UP's 1997 depreciation expense, which was based on UP's gross ton-miles in 1997, and he divides it by UP's gross ton-miles in 1995 and 1996. This produces a disconnect between depreciation costs and the actual usage. Mr. Kent's URCS cost calculations for depreciation in 1995 and 1996 thus have no connection to the real world.

Third, Mr. Kent further compounds his errors by mixing UP's 1997 investment and depreciation costs with SP's and UP's 1995 and 1996 maintenance-of-way expense. This procedure directly contradicts BNSF's theory that the parties agreed to use only post-merger URCS costs. Moreover, it repeats the mistake of improperly combining results based on two very different sets of circumstances. No one can guess what UP's maintenance-of-way costs would have been in 1995 or 1996 if the UP and SP systems were configured as they were at the beginning of 1997 and the railroads were in fact merged. We know, however, that Mr. Kent's computations, which are based on investment and depreciation costs for one network in one year and maintenance-of-way costs for two different, pre-merger networks in earlier years, do not reflect the costs of any railroad that did exist or could have existed.

B. BNSF's URCS Costs Artificially Mask Changes in UP's Costs

The provision for adjusting trackage rights fees is designed to adjust the fees based on changes in UP's URCS costs. Mr. Kent's calculations are flawed, because they ignore changes in UP's investment and depreciation costs resulting from increased UP and SP investment unrelated to the disputed SP purchase cost and merger capacity costs. Mr. Kent's calculations ignore two significant sources of cost changes by projecting 1997 investment and depreciation costs back into 1995 and 1996.

First, by projecting the same 1997 beginning-of-year investment level back into 1995 and 1996, Mr. Kent's calculation implicitly assumes that UP's and SP's level of investment did not increase between 1995 and 1996. Mr. Kent's calculations thus ignore changes in UP's URCS costs resulting from all of UP's and SP's capital investments in 1996, not just the disputed merger capacity costs. BNSF accepts that the undisputed investment costs should be included in UP's URCS costs, and those are the vast majority of the investments.

In 1996, UP/SP invested approximately \$850 million in capitalized maintenance on its lines, none of which involved merger-related expenditures for capacity improvements on trackage rights lines. In addition, in 1996 UP invested some \$110 million as part of its multi-year project to expand capacity on its coal corridor in Wyoming, Nebraska, Kansas, and Iowa. By projecting UP's 1997 beginning-of-year investment back into 1995 and 1996, however, Mr. Kent ignores any change in URCS costs resulting from any capital investments, including those that BNSF accepts should be counted in computing cost changes.

As a result of capital investments in 1996, UP's and SP's 1996 expenses for return on investment were higher than their 1995 expenses for return on investment. Under Mr. Kent's calculations, however, the combined UP/SP expense for return on investment in both

1995 and 1996 was based on 1997 investment data, thus ignoring the increase between 1995 and 1996. This in turn would have the effect of artificially reducing the trackage rights fees.

Second, by using the same depreciation charge in 1995, 1996, and 1997, Mr. Kent implicitly assumes that UP's depreciation expenses did not change between 1995 and 1996, or between 1996 and 1997. This is an entirely unrealistic assumption, because depreciation is a function of a railroad's investment and gross ton-miles, and both of those factors were different for UP and SP in 1995 and 1996 than they were for the merged UP in 1997. In particular, UP's and SP's investments in 1996 increased their 1996 depreciation expenses above their 1995 levels, and UP's investments in 1997 increased its 1997 depreciation expense above its 1996 level. By projecting 1997 depreciation charges back into 1995 and 1996, Mr. Kent does not simply cancel out increased depreciation resulting from the disputed items, he wipes out all increased depreciation expense resulting from all of UP's and SP's investments, including investments that BNSF agrees should be included in the fee adjustment. This in turn would have the effect of artificially reducing the trackage rights fees.

C. BNSF's Calculations Do Not Address Merger Capacity Costs

Mr. Kent never explains how the parties intended to remove the effects of disputed merger capacity costs from URCS cost calculations. As Mr. Kent recognizes, using only post-merger URCS costs does not address the disputed merger capacity costs, because those costs occurred in post-merger years. See BNSF-102, Kent V.S. at 4.

Relying on Section 9(c) of the BNSF Settlement Agreement, BNSF objects to the inclusion of merger capacity costs in the adjustment calculation. Mr. Kent claims that his adjustment provides a way to address BNSF's objection with respect to merger capacity costs incurred in 1997. As even Mr. Kent appears to acknowledge, however, shifting investment as of January 1, 1997 backwards into 1995 and 1996 addresses only those modest merger capacity

costs incurred in the last three months of 1996. It fails to address the effect in future years of merger capacity costs incurred in 1997 and later years, which are the majority of the disputed capacity costs. Moreover, as I have already explained, Mr. Kent's method of addressing BNSF's objection affects much more than the disputed costs – it also wipes any impact of all of UP's additional investment during 1996.

D. BNSF's Calculations Exaggerate the Size of the Dispute

Even setting aside the conceptual problems with his efforts to develop combined UP/SP 1995 and 1996 URCS and his inability to address the affect of the disputed merger capacity costs, Mr. Kent exaggerates the parties' dispute. He exaggerates the parties' dispute by using yet another apples-and-oranges comparison. He compares (i) the fees under UP's adjustments of the trackage rights fees each year based on the difference in the two preceding years' URCS costs, with (ii) the fees under BNSF's proposed approach of adjusting the fees based on the percentage change between the two preceding years' URCS costs.² I understand that UP and BNSF have agreed to arbitrate their dispute over these two approaches; that dispute should not have been used to exaggerate the disputed issues before the Board. In the chart below, I restate the comparison of the BNSF and UP approaches based on a consistent computational method.³

² If Mr. Kent's calculations were consistent with BNSF's theory, they should have ignored 1995 URCS costs and based the first years' adjustment on the difference between 1996 and 1997 URCS costs. Apparently Mr. Kent wanted to take advantage of the cost decrease between 1995 and 1996, which is larger than any other cost decrease, in BNSF's calculation of the first rate adjustment.

³ I have also provided for UP's brief a calculation of what the fees would have been had the RCAF(U) adjustment provision remained in place.

**Comparison of BNSF and UP Approaches to
Adjustment of GTM Mill Rates**

Year	BNSF Approach			UP Approach			Difference Between Parties
	GTM Unit Costs	Adjustment	Fee	GTM Unit Costs	Adjustment	Fee	
1995	\$0.00178841			\$0.00166805			
1996	\$0.00169823		3.1	\$0.00161108		3.1	n/a
1997	\$0.00164835	-0.00009018	3.0	\$0.00164835	-0.00005697	3.0	0.0
1998	\$0.00164752	-0.00004988	3.0	\$0.00164752	0.00003727	3.1	0.1
1999	\$0.00157770	-0.00000083	3.0	\$0.00157770	-0.00000083	3.1	0.1
2000		-0.00006982	2.9		-0.00006982	3.0	0.1

For purposes of obtaining a consistent comparison, I incorporated BNSF's approach to calculating 1995 and 1996 URCS costs as set forth in the table in Mr. Kent's statement. See BNSF-102, Kent V.S. at 4. I did not incorporate UP's approach as set forth in Mr. Kent's table, because his computations were based on inaccurate data. Mr. Kent's table does not correspond to the basis upon which UP actually billed BNSF; instead, it appears to be derived from a letter UP sent to BNSF as part of the parties' efforts to compromise their dispute. That letter contained a typographical error, and possibly other errors.⁴

The upshot of my comparison between BNSF's position in this proceeding and UP's past approach to billing BNSF is that, even accepting Mr. Kent's flawed calculation of

⁴ In its letter, UP attempted to demonstrate what the fee adjustment would be if the parties adopted BNSF's proposal to create a combined UP/SP URCS for 1995 and 1996 rather than a weighted average of UP's and SP's 1995 and 1996 URCS costs, but not including BNSF's proposal for excluding the effects of purchase accounting. UP's calculations were only estimates. Implementing BNSF's proposal to create a combined URCS requires access to the Phase II URCS model. UP did not have access to the model, so it estimated the impact of adopting BNSF's approach. Further research suggests that the trackage rights fees would actually be higher if BNSF's approach were adopted.

1995 and 1996 URCS, the difference in trackage rights fees between the parties would be only 0.1 mills, not the 0.2 mills that Mr. Kent claims.⁵

It is important to stress that even the 0.1-mill difference still overstates the difference between the parties' positions. Mr. Kent's (a) inappropriate substitution of 1997 data for actual 1995 and 1996 data, (b) mixing and matching of 1995, 1996, and 1997 data, and (c) effort to ignore the effect of changes in investment and depreciation costs in 1996 and 1997, all combine to overstate UP's costs in 1995 as compared to 1996, and overstate UP's costs in 1996 as compared to 1997.

Because Mr. Kent's method is invalid, I cannot correct it. The Board can safely assume, however, that the true difference between the parties' positions would be even less than my table indicates.

⁵ I calculate the adjusted fees to one decimal place because that is how the fees were presented in the BNSF Settlement Agreement and that is how UP has billed BNSF, except for the fee for the Keddie-Stockton trackage rights.

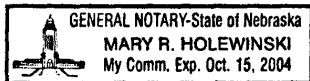
VERIFICATION

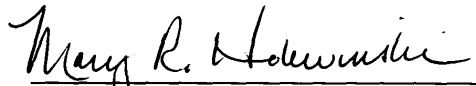
STATE OF NEBRASKA)
)
COUNTY OF DOUGLAS) ss:

I, RICHARD F. KAUDERS, being duly sworn, depose and state that I have read the foregoing Verified Statement, that I know its contents, and that those contents are true as stated to the best of my knowledge, information and belief.


RICHARD F. KAUDERS

SUBSCRIBED AND SWORN TO before me this 14th day of June, 2002.




Notary Public

My commission expires: October 15, 2004