



U.S. Department of
Transportation
Office of the Secretary
of Transportation

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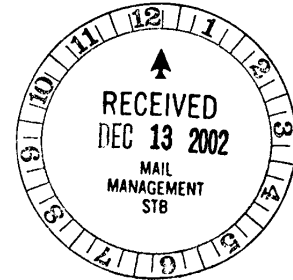
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December 13, 2002



Vernon A. Williams, Secretary
Surface Transportation Board
Suite 700
1925 K Street, N.W.
Washington, D.C. 20423-0001

Re: Finance Docket No. 34178

Dear Secretary Williams:

Enclosed herewith are the original and twenty-five copies of the Reply Comments of the United States Department of Transportation in the above-referenced proceeding. There is also a computer diskette of this document, convertible into Word Perfect. I have included as well an additional copy of the Department's comments that I request be date-stamped and returned with the messenger.

Respectfully submitted,

Paul Samuel Smith
Senior Trial Attorney

Enclosures

cc: Parties of Record

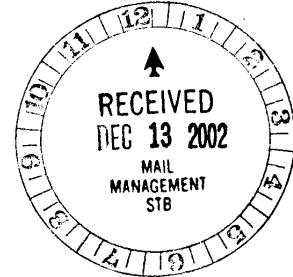
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Before the
Surface Transportation Board
Washington, D.C. 20590

DOT-3



Fin. Dkt. No. 34178

Dakota, Minnesota & Eastern Railroad Corporation and
Cedar American Holdings, Inc. -- Control -- Iowa, Chicago
& Eastern Railroad Corporation

Reply Comments of the
United States Department of Transportation

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Introduction

The Surface Transportation Board ("Board" or "STB") in this proceeding is considering whether to approve the combination of the Dakota, Minnesota & Eastern Railroad Corporation ("DME") and the Iowa, Chicago & Eastern Railroad Corporation ("ICE"), as well as a related request for trackage rights.¹

The United States Department of Transportation ("Department" or "DOT") has reviewed the record compiled to date, which includes the primary application, the application for trackage rights, and the initial comments of third parties. DOT believes that the proposed transaction meets the applicable standard for approval, but that the request for trackage rights does not. DOT does not support the conditions sought by other parties at this time. We do, however, urge the Board to consider whether it is appropriate to grant relief on the "bottleneck" issue discussed herein.

¹/ DME and ICE are referred to collectively herein as "Applicants."

The Legal Standard

The applicable legal standard requires the STB to approve this transaction unless it finds that –

- (1) as a result of the transaction, there is likely to be substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States; and
- (2) the anticompetitive effects of the transaction outweigh the public interest in meeting significant transportation needs.

49 U.S.C. § 11324(d)

The Primary Application

The primary application describes in detail the proposed combination of the DME and ICE, and their common control by a wholly-owned subsidiary of DME. The Applicants have always contended that their transaction would have no adverse competitive effects, but on the contrary would strengthen heretofore financially unstable carriers, extend single-line service to new markets, and enhance intramodal competition with larger Class I rail carriers. *E.g.*, DME-2 at 9-14, and Verified Statement of Charles E. Lamberton.

The record shows that the Applicants' rail systems would join in "end-to-end" fashion in all pertinent respects. They do not serve any shipper in common or even interchange traffic. In these circumstances it is not surprising that no party has asserted that the proposed combination fails to meet the applicable statutory standard. DOT believes that this transaction overall satisfies that standard and should be approved.

Some parties, however, have raised the prospect of more limited competitive or other harms allegedly arising out of certain aspects or implications of the transaction. We address these below.

A. The DME Powder River Basin Project

Some parties have expressed concern that the instant transaction will adversely affect the prospects for DME's construction of a new rail line into the Powder River Basin ("PRB") coal region in Wyoming. *See* Comments of Arkansas Electric Cooperative Corporation ("AECC") at 3, Verified Statement of Michael A. Nelson at 3-5 (previously projected advantages of the line are gone, and the proposed merger will add to DME's costs). *Contra*, Western Coal Traffic League ("WCTL") at 5-6, 8 (merger increases the likelihood of construction of the DME line). *See also* Comments of Soo Line Railroad Company d/b/a Canadian Pacific Railway ("CP") at (unnumbered pages) 3-4 (DME's PRB line will be less attractive if, after the merger, traffic is not interchanged with CP).

The Department believes that this is not an issue the STB needs to consider as a regulatory matter. The Board approved DME's application to construct a rail line into the PRB after an exhaustive consideration of all aspects of the proposal, including its financial viability. Finance Docket No. 33407, Decision served January 30, 2002 ("PRB Decision"). Financial viability in this context relates to the effect of the project on DME's ability to continue to meet its common carrier obligations to existing shippers, not to protect the carrier or its investors. *Id.* at 35 and note 86. Most relevant for present purposes was the Board's acknowledgement that its approval permits but does not require the project to be built: "It is, of course, the financial marketplace that will ultimately

determine whether this project is attractive enough financially to investors for [DME] to obtain the needed capital.” *Id.* at 40.

It is thus not particularly pertinent whether the proposed transaction makes construction of the PRB line more or less likely. That is a question for potential investors and financial supporters. What is important to the Board is whether the combination of DME and ICE will affect the ability of these carriers to meet their common carrier obligations and such related matters as the provision of essential services. As indicated, the Applicants have consistently asserted that their merger will produce a stronger rail system that will be better able to offer improved services to their existing shippers. No party has introduced persuasive evidence to the contrary.²

B. Access to Chicago

The means by which the combined DME/ICE would gain access to Chicago has been a concern to several parties. ICE’s predecessor, the I&M Rail Link (“I&M”), reached Chicago via trackage rights it acquired from CP on the line of a rail passenger commuter railroad, Metra, and has attempted to assign these rights to ICE. DME-2 at 7, 19. CP claims that although it permitted I&M to use rights granted to CP on the Metra line, litigation may determine whether ICE can exercise these rights without the consent of Metra, and this situation is rife with “implications” for shippers, freight railroads, and Metra. Comments of CP at (unnumbered pages) 5-6. CP does not propose a specific condition, but wants the Board to be aware of “ongoing questions.”

^{2/} The prospect of a stronger, more financially stable DME/ICE would not seem to undercut the likelihood for completion of the PRB project even if that were a significant issue in this proceeding.

During the proceeding in which ICE acquired the assets of I&M (Finance Docket No. 34177), Metra expressed concern about the impact of ICE operations on Metra's line, particularly if unit trains of coal from the PRB were taken into account. Comments of Metra (filed June 19, 2002) at 3-4. Since then Metra has informed the Board in this proceeding both that it is optimistic that negotiations will address its concerns, and that it now believes that it is in position to safeguard its interests independently of the STB in any event. Letter dated November 13, 2002. Metra accordingly does not oppose the transaction.

Any route used to transport large volumes of PRB coal may pose significant questions, including the Metra line into Chicago. It is also conceivable that Metra is indeed able to protect its own interests, regardless of such traffic, although that is not certain.³ The Department believes, however, that at this time there is no basis to attempt a definitive resolution of any potential issue on this subject.

As regards access into Chicago generally, CP offers only the vaguest of references to unspecified "implications" arising from this subject. There is thus no clear indication on the record of an issue that warrants the Board's attention. As regards coal traffic from the PRB reaching Chicago (via the Metra line or any other), the Board has already dealt with a similar situation in Finance Docket No. 34177. In the face of uncertainty about the construction of DME's line into the PRB and the routing of such

^{3/} In Finance Docket No. 33388 rail passenger commuter carriers entered into arrangements with CSX and/or Norfolk Southern Railway addressing their concerns about the impact of the division of Conrail on commuter rail operations. DOT was not wholly convinced that these agreements resolved all relevant public interest issues, however, and recommended that the STB include this subject in its oversight of that transaction. The Board agreed. F.D. No. 33388 (STB served July 23, 1998) slip op. at 96. We do not here propose any oversight condition, but only point out that there are circumstances in which settlements among parties do not automatically resolve all related public interest concerns. In this case there is simply no record to support STB action of any sort at this time.

traffic on I&M/ICE lines, the STB there decided that it would be premature to address the impact of such traffic and possible mitigation measures. F.D. No. 34177 (STB served July 22, 2002) at 15-16. The same response is appropriate here because the same uncertainties remain. The Board should defer any decision on ICE's access to Chicago and the impact of large volumes of additional traffic on the ultimate line used until such time as there is a more realistic prospect of such traffic.

C. "Bottleneck" Issues

Muscatine Power and Water Company ("Muscatine") is an electric utility in Iowa that obtains coal from the PRB at mines served by the Union Pacific ("UP") and the Burlington Northern & Santa Fe ("BN") railroads. Three of Muscatine's four generating plants are solely served at one location by ICE. This shipper believes that the proposed merger, in combination with construction of the DME line into the PRB, will harm its competitive posture in two ways. First, ICE will be eliminated as a "neutral" bottleneck carrier because the combined DME/ICE will favor its single-line routing over competing options from UP and BN. Second, Muscatine claims that it will be disadvantaged in attempting to obtain and challenge a rate on the bottleneck portion of movements from the PRB under the "contract exception" to the Board's bottleneck decisions. Comments of Muscatine at 4-5. Muscatine seeks conditions that would preserve the *status quo*.

It seems clear that this transaction, coupled with the construction of DME's PRB project, does not change Muscatine's situation in an economic sense. That is, then as now, the shipper will receive rail service from a single ("bottleneck") carrier that is in a position to extract the maximum profit (the "one lump") from the transportation services it provides. What changes is the regulatory regime Muscatine would face.

Now, as the Board made clear in its "bottleneck decisions," Muscatine could obtain a contract from UP or BN to deliver coal to an interchange point with ICE and the shipper could secure a (challengeable) rate from the ICE for the bottleneck segment.⁴ After the merger and PRB project, the combined DME/ICE would serve both origin and destination points, and in that circumstance the Board indicated that the Applicants would not have to provide a rate over the bottleneck segment of an alternative interline route. "Instead, the shipper must first proceed under our competitive access regulations ... [in which proceeding] a contract obtained for service over a non-bottleneck segment ... may prove useful in making a successful access case." Bottleneck II at 6. This would appear to place an additional hurdle for Muscatine to overcome to obtain access to a second carrier (UP or BN) that it does not now have to face. Simply entering into a contract with a competing interline railroad would no longer be sufficient, and it is unclear exactly how the terms of such a contract would be used.⁵

Although the shipper may be disadvantaged procedurally in these circumstances, the Department cannot quantify the extent of this difference and whether it merits a remedy. Moreover, of course, this situation may never come to pass because it is dependent upon both the completion of DME's PRB line and on Muscatine's execution of a contract with UP or BN. In these circumstances DOT cannot recommend whether and to what extent relief would be appropriate. We urge the Board to give careful

⁴/ Central Power & Light Co. v. Southern Pacific Transp. Co., Nos. 41242 et al. (STB served December 31, 1996)("Bottleneck I") *clarified* (STB served April 30, 1997)("Bottleneck II").

⁵/ The STB indicated that the terms of a non-bottleneck segment contract might "provide benefits, advantages, and projected efficiencies" that would make the service proposed by the shipper superior to that offered by the bottleneck carrier and possibly warrant relief. Bottleneck I, at 9.

consideration to all these factors and decide whether and how best to address the issue in the midst of these uncertainties.

D. Trackage Rights

The Applicants' systems meet in Owatonna, Minnesota, but the carriers cannot interchange traffic or otherwise connect at that point because of restrictions on DME's use of track owned by the UP. These restraints date from the DME's creation, when UP's predecessor parted only with overhead rights at this point in order to retain feed traffic. Application for Terminal Trackage Rights ("Terminal Application") at 3-4; UP-4 at 8-9. The result was, and is, a 2.4 mile "island" of track owned by UP but unconnected to the rest of the UP system. DME has requested trackage rights on this island to enable it to connect and interchange traffic with ICE at Owatonna.

DME asserts that the stretch of line at issue is a "terminal facility" that the STB should authorize it to use because such use meets the applicable legal standard: it would be "practicable," in the public interest, and it would not impair UP's use of the facility. 49 U.S.C. § 11102(a). DME also contends that grant of its request would make possible the full measure of new competitive routings and other public interest benefits from the proposed merger. Terminal Application at 4-7. Finally, DME acknowledges that the Board approved construction of a connection between itself and ICE east of Owatonna as part of the PRB Decision, but emphasizes that this connection is environmentally inferior to the trackage rights sought, and would be "completely unnecessary and wasteful." Id. at 6.

The Iowa Department of Transportation ("IDOT") and the town of Owatonna support DME. They both point out the anticompetitive nature of the "paper barrier" that

prevents the Applicants from making use of the existing track. Comments of IDOT at (unnumbered page) 2; Owatonna at 10. Owatonna also emphasizes the inefficiency of constructing a separate connection to the east and stresses that use of this connection would mean that traffic interchanged between DME and ICE would go through town twice, and therefore double its impact on the community. Comments of Owatonna at 11-17.

UP opposes the grant of these trackage rights. It contends that the track in question is not a terminal facility and that the much more difficult "competitive access" standard applies. UP-4 at 14-19, 23-26. UP also argues that grant of this request would not be in the public interest because paper barriers are not inherently anticompetitive and because DME chose not to purchase the track "island" that it now seeks to use. UP concludes that without STB interference both parties have "strong incentives" to negotiate an agreement. *Id.* at 11-13.

The Department is sympathetic to the concerns raised by Owatonna and the Iowa DOT. DOT accepts the clear superiority (from almost any perspective) of using existing track over construction of a new connection. We also acknowledge the negative impact on competition that commonly flows from "paper barriers."⁶ Under the circumstances of this case, however, we cannot support the trackage rights request; regardless of whether the track in question is a terminal facility, the request fails to satisfy applicable Board precedent.

^{6/} It is virtually always the case, for example, when small carriers are spun off from larger ones that paper barriers limit competition and preserve traffic "feed" for the large railroad. Subsequent assertions that such barriers could have been avoided for a higher price are similarly commonplace.

In rail merger cases the STB and the Interstate Commerce Commission before it have routinely imposed trackage rights conditions on merging carriers in order to allow other railroads to redress demonstrable competitive losses occasioned by the merger. The Board has also visited such conditions on non-merging third party carriers, but “only in limited circumstances where the rights were designed to bridge a gap within broader trackage rights imposed on [the merger] applicants and deemed necessary to remedy or mitigate anticompetitive effects in the transaction.” Finance Docket No. 33556, (STB served May 25, 1999) Decision No. 37, slip op. at 51-52 (citation omitted). Without a sufficient nexus to the harms of a merger, the much more demanding requirements of the “competitive access” standard apply. *Id.* at 53.

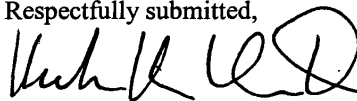
The proposed merger presents no threat of competitive harm. In this situation the competitive access standard would apply, which requires evidence of competitive abuses by UP. But the Applicants have not introduced such evidence. Moreover, the Board has already approved a different (admittedly inferior) means by which the Applicants may connect. Finally, it does seem likely that UP and the Applicants have sufficient incentive to negotiate an agreement avoiding increased community impacts on Owatonna. In these circumstances, DOT does not support the requested terminal trackage rights.

Conclusion

The proposed transaction poses no demonstrable competitive threat and may increase the Applicants’ financial stability, to the benefit of the shippers they serve. The combination accordingly meets applicable legal standards and warrants approval. The related trackage rights request, by contrast, does not satisfy the pertinent standard and

should not be granted. There is at the same time a reasonable basis to hope that negotiations will produce a superior means to connect the DME and ICE. With one exception, the other concerns expressed and conditions sought are either premature or otherwise ill-founded and merit no relief at this time. We are uncertain whether a condition is appropriate at this time to address the bottleneck issue raised by Muscatine.

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kirk K. Van Tine", with a stylized, looped ending.

KIRK K. VAN TINE
General Counsel

December 13, 2002

CERTIFICATE OF SERVICE

I hereby certify that on this date I caused a copy of the Reply Comments of the United States Department of Transportation in STB Finance Docket No. 34178 to be served by first class mail, postage prepaid, upon all Parties of Record in this proceeding.

A handwritten signature in cursive script, reading "Paul Samuel Smith".

Paul Samuel Smith

December 13, 2002