



KEVIN V. SCHIEFFER
President & CEO

April 3, 2003

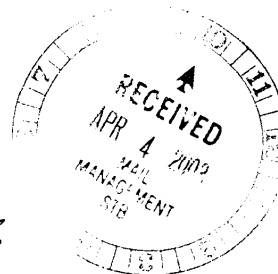
VIA FEDERAL EXPRESS

Mr. Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, N.W., Room 700
Washington, DC 20006

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Re: **Finance Docket No. 34178 - 207526**
Dakota, Minnesota & Eastern Railroad Corporation
and Cedar American Rail Holdings, Inc. -- Control --
Iowa, Chicago & Eastern Railroad Corporation

Finance Docket No. 34178 (Sub-No. 1) - 207527
Dakota, Minnesota & Eastern Railroad Corporation --
Terminal Trackage Rights -- Union Pacific Railroad Company

Dear Secretary Williams:

Enclosed for filing in the above-captioned proceedings are an original and twenty-five copies of the **Report of Dakota, Minnesota & Eastern Railroad Corporation relating to the Status of Negotiations with the Union Pacific Railroad Company** (DME-18), dated April 3, 2003. A 3.5-inch computer diskette containing the text of DME-18 in Word 2000 format is attached.

If you have any questions regarding this filing, please feel free to contact me. Thank you for your assistance on this matter.

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Respectfully submitted,

Kevin V. Schieffer
President & Chief Executive Officer

KVS:nb
Enclosures

cc: Robert T. Opal, Esq. (via Federal Express)
David L. Meyer, Esq. (via Federal Express)
Parties of record
William C. Sippel, Esq.



KEVIN V. SCHIEFFER
President & CEO

April 3, 2003

DME-18

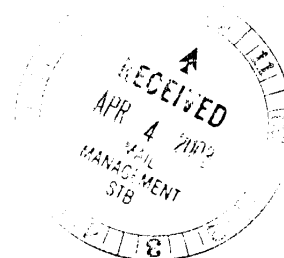
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**Finance Docket No. 34178
Dakota, Minnesota & Eastern Railroad Corporation
and Cedar American Rail Holdings, Inc. -- Control --
Iowa, Chicago & Eastern Railroad Corporation**

Re: **Dakota, Minnesota & Eastern Railroad Corporation
Report to the Board Concerning Status of DM&E/UP Negotiations**

Dear Secretary Williams:

In response to the direction of the Board in Decision No. 7 served February 3, 2003 in this proceeding, Applicants herein respectfully submit this Report to the Board on the status of their negotiations with the Union Pacific Railroad ("UP") regarding use of the existing track connection at Owatonna, Minnesota.

Background. In its decision, the Board correctly observed that "[t]he combined DM&E/IC&E system will face intense competition from the large Class I railroads that surround it."¹ The Board also found that this "transaction will benefit shippers by enabling both railroads to compete more effectively against their Class I competitors. . . . Common control also will give shippers on both the DM&E and IC&E new routing and service options and more efficient and competitive single-system access to significant new markets and gateways."²

In denying our application for terminal trackage rights submitted as part of the common control case, the Board recognized the need for a competitive connection at Owatonna but said "[w]e disagree that terminal trackage rights are necessary or appropriate to provide the full

¹ DM&E -- Control -- IC&E, STB Finance Docket No. 34178, at p. 13. (Served February 3, 2003).
Indeed, both UP and CP have, in fact, already taken substantial traffic off the IC&E system.

² *Id.*, at 14.

benefits of common control.”³ This was based on an apparent belief that “[t]he parties here have incentives to negotiate an agreement” for that purpose.⁴ The Board felt that UP’s incentive was that DM&E recently obtained “the leverage now provided by its authority to construct the new connection” at Owatonna which could bypass UP’s two-mile island at Owatonna.⁵ In support of that theory, the Board quoted a DM&E submission in an unrelated billion dollar-plus construction case in which DM&E stated that having authority to build a separate connection at Owatonna logically would lead to a negotiated settlement of this issue.

The Board’s reasoning is logical in the context of a fully funded PRB Project under development today, but not as applied to the practical and limited financial realities of a Class II railroad today. Authority that provides substantial leverage to a multi-billion consortium several after a billion dollar-plus project is funded and meets all the regulatory conditions precedent to construction provides little or nothing in the way of leverage for DM&E in the context of an immediate discussion relative to current Owatonna traffic. UP recognizes full well that DM&E is not in a position to begin construction on an Owatonna connection today – for a host of regulatory, financial and business reasons. This is not to say that it might not be done (if, indeed, the Board believes that we have satisfied the conditions precedent that are attached to its regulatory approval), but at the very least it would result in tremendous delays before any benefits of common control could be realized by the shipping public. Further, the economics of building such a connection are drastically different in the context of the PRB Construction case compared to the traffic base available today. In short, UP is not the least threatened *today* by the prospects of DM&E operating over a new Owatonna connection anytime in the foreseeable future. There is leverage only when UP recognizes it is real and imminent. And for all the common sense reasons referred to in our PRB Construction filing, there is no reason for UP to get excited until and unless construction gets underway, because there is time to work out a deal later if we actually can clear the remaining regulatory conditions precedent to construction and the financing/economic business hurdles. In short, the Owatonna connection construction authority provides leverage in the context of the PRB Project. It provides none in the context of the reasonably foreseeable future.

Negotiation Status. The above background is important to understanding the failure of the negotiations to date. As to the negotiations themselves, there is not much left to say that has not already been said in the very recent filings related to UP “emergency” petition. UP submitted a large amount of correspondence in its filing related to the negotiations. My Verified Statements in opposition to that petition added several more letters to the stack. All of those filings are included as part of this report by reference. While those filings do not include all negotiation correspondence, I expect they provide more than enough to give the Board an understanding of the distance between the parties. Rather than add more letters to this filing, this is intended to provide my sense of why we do not have an agreement.

³ *Id.*, at 18.

⁴ *Id.*

⁵ *Id.*

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The Owatonna and related agreements have a long history of being a source of problems in an otherwise fundamentally positive relationship. They have long been a source of significant disagreements with UP, and with C&NW before them. They contain much more than simple traffic restrictions. They contain many rights, as well. And they have been amended and supplemented through the years. From a Class II railroad's perspective, the sanctity of these contracts seem exceedingly more important when the Class I claim their rights as opposed to acknowledging their obligations.

DM&E initiated the discussions at issue here long before we filed for common control or terminal trackage rights. We offered compensation in excess of commercial market rates and what we reasonably anticipated would be required through terminal trackage rights or existing contract provisions. Even though we believed that more than one of the various alternatives for full implementation of the control benefits could be achieved without UP's consent, years of struggling with getting other contract provisions enforced provided tremendous incentive for us to pursue a negotiated resolution. Our primary motivation was to eliminate uncertainty, preserve a good working relationship, and avoid unnecessary legal fees and the headache and delay associated with battling someone with the resources of UP. In keeping with a practice I have tried to follow over the years, we put our strongest offer forward up front, recognizing the time value of money and diminishing rewards as time moves on. As we told UP sometime after initial discussions bore no fruit, we continued to work on a negotiated resolution but simultaneously initiated other alternatives, including the terminal trackage case. We continued negotiations towards a settlement after the terminal trackage case was filed, but approximately one month before the STB formally handed down its decision, UP suspended negotiations and unilaterally decided to wait until after the STB decision was announced before deciding what it would do. At that time, we made it exceedingly clear that a "settlement" after the court verdict did not appeal to us, and that we would pursue other options in addition to terminal rights. Several days after the STB decision was handed down, UP submitted a counter offer that would give UP control over an unrelated part of our combined system near Kansas City. In the alternative it requested a trackage fee that we believe is significantly above market and requested \$500,000 in addition. There is no reasonable means for us to pay that much money without significantly affecting our capital budget, and undermining the safety of this railroad. Indeed, the amount of money spent pursuing this matter to date has and continues to create problems. We are not the UP, and do not have its staying power to continue this drain on our resources.

We and UP have fundamentally different views of the underlying contract obligations, and as to the basis for compensation claims. To be fair to UP, if the cost of constructing a new connection at Owatonna is truly the measure by which these negotiations should be decided, then \$500,000 would be a fair "avoidance" cost. We appreciate the fact that the Board's Decision No. 7 analysis lends some credence to this notion, but for the reasons stated above (and in our Petition for Reconsideration) we respectfully disagree that it is a rational basis in today's setting. Additionally, so long as UP respects our bridge rights under the 1986 contract we have a "half-loaf" alternative immediately available. While that do not get us where we feel we need be, it does provide for reasonable and immediate implementation of many common control benefits for

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the shipping public. In that context, the \$500,000 fee *in addition* to above-market trackage fees we have agreed to pay is not justifiable.

We agree with the Board's desire to encourage private sector dispute resolution whenever possible, but to date it appears to be quite impossible in this case. We cannot and will not make sweeping claims to the Board that this is owing to UP's bad faith or misrepresentations. The fact is that neither UP nor DM&E has adopted an unreasonable position if you accept our respective views as to compensation basis and contract rights. As a practical matter, however, I expect UP knows the compensation being requested is out of our reach. And its primary objective of trading control over one part of the system at Owatonna for more control over another part of our system in the more congested Kansas City corridor – which it holds out with a smile as the sole alternative – for us trades a broken arm for a broken leg.

Proposed Action. We encourage the Board to grant our Petition for Reconsideration and Reopening, and grant the terminal trackage rights originally requested. In Decision No. 7 the Board made clear that establishing a connection between the DM&E and IC&E is absolutely necessary to achieve the considerable shipper and other public benefits of common control. It also recognized that the overwhelming majority of shipper, labor, political and other public interests are best served by achieving this objective. While it provided strong leadership in articulating the need to achieve this end, it apparently disagreed with our requested means in saying “[w]e disagree that terminal trackage rights are *necessary* or *appropriate* to provide the *full* benefits of common control.”⁶ Parsing through the nuances of this single sentence hopefully provides insight as to our reasoning for seeking terminal trackage rights and pursuing our petition for reconsideration.

First, we are not able to achieve the *full* benefits of common control with the more limited bridge moves in place today. While current operations provide significant competitive opportunities, they are less efficient than they could be with full interchange and crew operating flexibility, as detailed in my verified statements in opposition to UP's emergency petition.

To realize the *full* benefits of common control, we need some means of achieving that degree of flexibility and efficiency. Not having the ability to make decisions for UP, the Board or the courts, it is impossible for us to know with certainty whether or which of the various other alternatives would provide an effective means to the end sought. So I cannot say that terminal trackage rights are absolutely *necessary* to provide the *full* benefits of common control because not all other alternatives have been pursued. And there is risk in pursuing any of them before the issue of terminal trackage rights is resolved. To our understanding of the law, if terminal rights are not granted as part of common control implementation, they become impractical to obtain in any subsequent stand-alone proceeding. So pursuing another course now, in lieu of terminal trackage rights, would eliminate this alternative. Therefore we have been convinced of the need

⁶ *Id.*, at 18 (emphasis added).

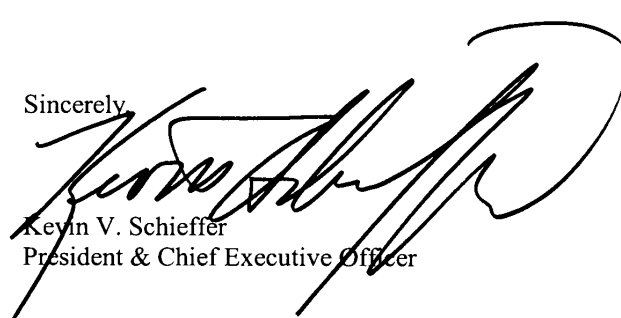
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to fully exhaust the terminal rights issue before seeking other means to achieve the remaining benefits to be achieved from common control.

While it is impossible for DM&E to say with certainty today that we disagree with the Board's conclusion that terminal trackage rights are not necessary to achieve the full benefits of common control, we respectfully disagree with the Board's conclusion that such rights are not *appropriate* in this case. DM&E's original terminal rights application and the petition for reconsideration make those arguments and there is no need to repeat them here.

I hope this report provides the necessary elements sought in the Report requested pursuant to Decision No. 7 as it considers this matter. We stand ready to provide any additional information the Board may desire. Thank you for your consideration.

Sincerely,



Kevin V. Schieffer
President & Chief Executive Officer

KVS:nb (STB report - UT Negotiations)

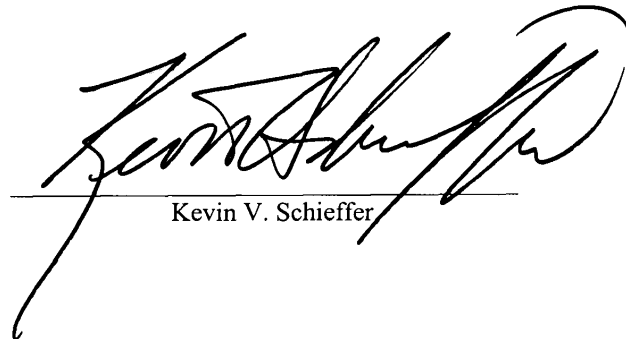
CERTIFICATE OF SERVICE

I hereby certify that on this 3rd day of April, 2003, a copy of the foregoing **Reply of Dakota, Minnesota & Eastern Railroad Corporation to Petition for "Emergency Order"** (DME-17) was served by overnight delivery upon:

Robert T. Opal, Esq.
General Commerce Counsel
Union Pacific Railroad Company
1416 Dodge Street, Room 830
Omaha, NE 68179

David L. Meyer, Esq.
Michael L. Rosenthal, Esq.
Covington & Burling
1201 Pennsylvania Avenue, N.W.
Washington, DC 20004-2401

and by first class mail, postage prepaid, upon all other known parties of record in Finance Docket No. 34178.



Kevin V. Schieffer