

WILMER, CUTLER & PICKERING

2445 M STREET, N.W.

WASHINGTON, DC 20037-1420

TELEPHONE +1 (202) 663 6000

FACSIMILE +1 (202) 663 6363

WWW.WILMER.COM

WASHINGTON
NEW YORK
BALTIMORE
NORTHERN VIRGINIA
LONDON
BRUSSELS
BERLIN

NICOLE TELECKI BERRY
(202) 663 6505
NICOLE.BERRY@WILMER.COM

August 4, 2003



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VIA HAND DELIVERY

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

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Re: Kansas City Southern -- Control -- The Kansas City Southern Railway Company, Gateway Eastern Railway Company, and the Texas Mexican Railway Company, STB Finance Docket No. 34342

Dear Mr. Williams:

In accordance with the Board's Decision No. 2 in this matter, please find enclosed an original and 25 copies, as well as one electronic copy submitted on a 3.5 inch IBM-compatible floppy diskette, of Pacer International, Inc.'s Comments On The Application of Kansas City Southern And The Texas Mexican Railway Company. This filing has been marked "PI-4."

Please acknowledge receipt of this filing by date-stamping the extra copy and having the courier return it to me.

Please do not hesitate to call if you have any questions.

Sincerely,


Nicole T. Berry

Enclosures

cc: Service List

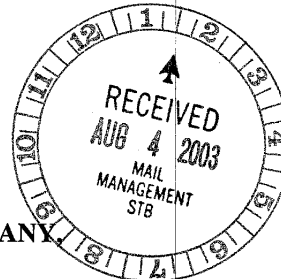
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**BEFORE THE
SURFACE TRANSPORTATION BOARD**

STB Finance Docket No. 34342

**THE KANSAS CITY SOUTHERN
--CONTROL--
THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
AND
THE TEXAS MEXICAN RAILWAY COMPANY**

**PACER INTERNATIONAL, INC.'S COMMENTS
ON THE APPLICATION OF KANSAS CITY SOUTHERN
AND THE TEXAS MEXICAN RAILWAY COMPANY**



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Michael F. Killea
Executive Vice President and
General Counsel
Pacer International, Inc.
225 Water Street, Suite 2050
Jacksonville, FL 32202

(904) 485-1004 (telephone)
(904) 485-1019 (fax)

James W. Lowe
Nicole T. Berry
Wilmer, Cutler & Pickering
2445 M Street, N.W.
Washington, D.C. 20037

(202) 663-6000 (telephone)
(202) 663-6363 (fax)

Counsel to Pacer International, Inc.

August 4, 2003

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AND
THE TEXAS MEXICAN RAILWAY COMPANY**

**PACER INTERNATIONAL, INC.'S COMMENTS
ON THE APPLICATION OF KANSAS CITY SOUTHERN
AND THE TEXAS MEXICAN RAILWAY COMPANY**

Pacer International, Inc. ("Pacer"), respectfully submits its Comments concerning the application seeking the approval of the Surface Transportation Board (the "Board") for the acquisition of The Texas Mexican Railway Company ("Tex Mex") and of the International Rail Bridge at Laredo ("Laredo Bridge") by Kansas City Southern ("KCS").¹ As explained in its application, KCS has executed a series of agreements with the Grupo TMM ("TMM") and TFM, S.A. de C.V., that would create NAFTA Rail, a single-route railroad running from the central United States into Mexico, by combining KCS (to be renamed NAFTA Rail), Tex Mex, the Laredo Bridge and the TFM railroad, which connects the Laredo Gateway to much of central and eastern Mexico -- including the important manufacturing, distribution and commercial centers around Mexico City and Monterrey.

¹ Pacer does not oppose approval assuming the safeguards adopted by the Board in granting approval are sufficient to address the real competitive concerns presented by the proposed transactions.

I. Introduction

Pacer is concerned about the potential anticompetitive impact of KCS's proposed acquisition on cross-border traffic flowing through the Laredo Gateway. KCS admits that it will have economic incentives to maximize single-route traffic over its own lines.² In fact, KCS may be required to prioritize the traffic handled by the NAFTA Rail companies over that traveling over other railroads in order to increase revenues and net income, not only to eventually achieve a return on its investment in the NAFTA Rail companies but also to meet the more immediate debt service and covenant maintenance requirements of its highly leveraged capital structure.³ In seeking to maximize single-line traffic over its tracks, the combined KCS/Tex Mex/TFM ("NAFTA Rail") would be forced to favor its traffic over that of other U.S. carriers where bottlenecks exist, such as at the Laredo Bridge. Moreover, under the combined NAFTA Rail

² As explained by KCS Chairman and CEO Michael Haverty, KCS anticipates the completed transactions will provide it with "the opportunity to flow more traffic over the combined system." Final Event Transcript of KSU Conference Call (April 29, 2003) at 9 (Exhibit A to Union Pacific Railroad Co.'s Reply to Canadian Nat'l's Petition to Reopen Decision No. 2 (UP-4). Indeed, the purpose of the transactions is to provide "new opportunities for single line service," *Kansas City Southern -- Control -- The Kansas City Southern Rwy. Co.*, Finance Docket No. 34342 (May 14, 2003) (KCS-3/TM-3) (hereinafter "Application") at 23; increase traffic over KCS/Tex Mex, *id.* at 24, and make the KCS/Tex Mex/TFM an alternative to the UP/TFM. Supplement to Application, *Kansas City Southern -- Control -- The Kansas City Southern Rwy. Co.*, Finance Docket No. 34342 (June 23, 2003) (KCS-10/TM-10) (hereinafter "Supplemental Application") at 18. See also NAFTA Rail Transaction Summary presentation, http://www.kcsi.com/pdf/nafta_rail.pdf, at 4-5 (hereinafter "NAFTA Rail Transaction Summary") (attached as Exhibit A).

³ In the past several months, major U.S. credit rating agencies have downgraded KCS's credit rating, KCS Press Release, see "S&P, Moody's Rate KCS' Redeemable Cumulative Convertible Perpetual Preferred Stock Offering," (May 5, 2003) at <http://notes.kcsi.com/WebApps/kcspress.nsf/626e6035eadbb4cd85256499006b15a6?OpenView> (attached as Exhibit B), and KCS has indicated in its filings that it may incur even more leverage to finance the cash portion of the purchase price to be paid to acquire control of the other NAFTA Rail companies. Application at 54 (explaining that the TFM transaction is "contingent upon obtaining . . . adequate financing," among other things).

ownership, TFM, which to date has dealt with U.S. carriers and shippers on a non-discriminatory basis, will have the same economic pressures and incentives post-merger to favor U.S. traffic that uses KCS and/or Tex Mex over other carriers.

The negative impact of these economic pressures and incentives and KCS's resultant actions could have severe consequences on NAFTA trade and on competing railroads' customers, such as Pacer. Therefore, Pacer requests that the STB only approve this application with certain conditions. Specifically, if the Board determines that the transaction is in the public interest, despite the likely anticompetitive consequences, then Pacer requests that the Board grant such approval subject to certain conditions and post-transaction monitoring and oversight. The KCS should at least be required (1) to develop, publish and provide to all participants in traffic over the Laredo Gateway protocols for the operation of the Laredo Bridge that are consistent with railroad industry standards, (2) to operate the Laredo Bridge in accordance with such protocols, and to treat the operation of all railroads using it in a nondiscriminatory manner with respect to rates, scheduling, dispatching and all other operating conditions, and (3) to operate the Tex Mex subject to the requirement that it treats shipments from all railroads at the Laredo connection and traveling over the Tex Mex in a nondiscriminatory manner as to rates, scheduling, dispatching and all other operating conditions.⁴

⁴ See *Canadian Nat'l Rwy. Co. -- Control -- Wisconsin Central Transp. Corp.*, STB Finance Docket No. 34000, 2001 STB LEXIS 711, at *8 (STB served Sept. 7, 2001) (approving transaction and imposing condition "holding applicants to their representations. . . that the unified [company] will keep all existing active gateways affected by the transaction open on commercially reasonable terms."); *Canadian Nat'l Rwy. Co. -- Control -- Illinois Central Corp.*, STB Finance Docket No. 33556, 1999 STB LEXIS 305, at *10 (STB served May 25, 1999) (approving transaction and imposing condition "holding CN to its commitment not to exercise unfairly any rights it may have" with respect to joint venture with CP controlling major gateway to Canada).

Moreover, since operation of the vital Laredo Gateway and critical Tex Mex and TFM connections post-merger will be operated by KCS using its Management Control System (“MCS”) operating system, which KCS plans to install immediately after its acquisition of control, while at the same time it aggressively seeks to increase traffic over the NAFTA Rail system,⁵ the Board should (1) require KCS to submit to the Board and the other parties of record for their review and comment and final Board approval, detailed project plans including time frames for the installation of the MCS System on the Tex Mex and TFM, and to adhere to the project plan approved by the Board,⁶ (2) oversee and monitor the adequacy of KCS’s installation of the MCS system on the Tex Mex and TFM, including monitoring average transit times for trains running in the NAFTA Rail system and the reliability of actual transit times for trains

While KCS’s purchase of the Tex Mex is technically a minor transaction, the Board has noted that it may have significant effects when viewed in the context of KCS’s simultaneous acquisition of the TFM, which is effectively a major transaction. *See Kansas City Southern -- Control -- Kansas City Southern Rwy. Co.*, STB Finance Docket No. 34342, Board Decision No. 2, at 10-11 (STB served June 9, 2003) (hereinafter “Board Decision No. 2”). Therefore, the fact that much of the authority regarding remedies, cited herein, is to decisions concerning major or significant transactions is appropriate. The KCS/Tex Mex transaction is not materially different from the transactions in the cited decisions given the importance to U.S.-Mexican trade of the competitive bottleneck facilities at issue in this case, especially the Laredo Bridge which is the premier gateway to Mexico.

⁵ Application at 28; Operating Plan/Minor (Exhibit 15 to Application) at 228-29; Supplemental Application at 32.

⁶ In the purchase of Conrail by CSX and Norfolk Southern, the Board went even further and required that the parties were to have management information systems in place prior to the start of post-acquisition operations, because that is one of the “most important prerequisites for successful implementation” of a combination. *CSX Corp. -- Control and Operating Leases/Agreements -- Conrail Inc.*, 3 S.T.B. 196, 1998 LEXIS STB 243, at *111-12 (Part 1) (1998). Indeed, the critical nature of train operations management systems lead the Board to adopt a rule requiring major merger applicants to submit a Service Assurance Plan, recognizing that “the accurate and timely integration of applicants’ information systems is vitally important to service.” 49 C.F.R. § 1180.10 (e) *cited in Major Rail Consolidation Procedures*, STB Ex Parte No. 582 (Sub-No. 1), 2001 STB LEXIS 546, at * 148 (Part 1) (STB served June 11, 2001).

running in the NAFTA Rail system to the currently scheduled transit times for trains currently running in the KCS/Tex Mex/TFM network (or mutually acceptable post-merger scheduled transit times for trains running in the NAFTA Rail system), and (3) require KCS to establish sufficiently detailed and adequate service recovery plans⁷ in the event of service failures flowing from the implementation of the MCS system on the Tex Mex and TFM.⁸

Similarly, since KCS has stated its intentions to implement capital improvements on the Tex Mex while at the same time it will aggressively seek to increase traffic over that same railroad,⁹ the Board should require similar conditions to those described immediately above, as applicable to the implementation of the capital improvement plan.¹⁰

These requirements are critical to ensure that KCS's ownership and control over the Laredo Gateway, including the Laredo Bridge itself as well as the Tex Mex and TFM-controlled access to the Laredo Bridge, are not used unfairly against, and to the competitive disadvantage of, other railroads and their customers who ship their freight over the Laredo Gateway. The

⁷ In the case of major mergers, the Board requires applicants to prepare "[c]ontingency plans for merger-related service disruptions" in order to prepare for potential service disruptions that include the establishment of problem resolution teams and "the specific procedures to be utilized for problem resolution." 49 C.F.R. § 1180.10(i). Although this is not technically a major merger, the logic behind such a requirement is no less compelling in this case where the potentially affected traffic crosses "the most important U.S.-Mexican rail gateway." *Union Pacific Corp. -- Control and Merger -- Southern Pacific Rail Corp.*, 1 S.T.B. 233, 422 (1996).

⁸ See e.g., *CSX Corp. -- Control and Operating Leases/Agreements -- Conrail Inc.*, 3 S.T.B. 196, 1998 STB LEXIS 243, at *99 (Part 2) (requiring applicants to report on a weekly basis the "on time delivery of run through trains" at certain operations and on time performance at major gateways) and *101(Part 2) (requiring applicants to report on performance in major corridors according to shipment type, and provide reasons for any delays).

⁹ Operating Plan/Minor at 229 and 230 (Exhibit 15 to Application).

¹⁰ *CSX Corp. -- Control and Operating Leases/Agreements -- Conrail Inc.*, 3 S.T.B. 196, 1998 STB LEXIS 243 (Part 2), at * 95 (requiring applicants to report immediately on construction and other capital projects).

requirements are also necessary to prevent KCS's ownership and control from creating major service disruptions and failures to all rail traffic that must rely on this gateway to service the freight transportation needs of the Canadian, U.S. and Mexican economies.

A. Pacer's Interest In The Proposed Merger

Pacer International is one of the largest intermodal transportation and logistics services providers in North America.

Pacer International's retail segment, known as Pacer Global Logistics ("PGL"), provides a comprehensive portfolio of freight transportation, logistics and other related services directly to shippers and other beneficial owners, including (1) retail intermodal transportation services (consisting of the local truck transportation, or drayage, of the loaded container from the origin point to the origin rail ramp, the transportation by rail of the container from the origin ramp to the destination ramp, and the drayage of the loaded container from the destination rail ramp to the ultimate destination point), (2) trucking services, including drayage, regional trucking, long-haul full truckload transportation services and specialized and heavy haul flatbed truck transportation, (3) warehousing services, and (4) international ocean carrier, freight forwarding, logistics and customs brokerage services. In 2002, Pacer Global Logistics moved approximately 16,000 intermodal container loads of freight between the United States and Mexico utilizing the services of its underlying rail carriers, including the KCS railroad.

Pacer International's wholesale segment, known as Pacer Stacktrain, provides double-stack and related intermodal rail transportation services for full intermodal container loads of freight over a 50,000-mile North American railroad network, operating out of 54 terminal locations in the United States and 11 terminal locations in Mexico. Pacer Stacktrain operates its own fleet of intermodal equipment, including more than over 1,800 railcars, 21,000 containers

and 23,000 chassis.¹¹ Pacer Stacktrain moves more than 1,000,000 full container loads per year in the North American rail network, making it the largest, non-railroad owned stacktrain operator in North America. As a neutral stacktrain operator, Pacer Stacktrain offers high quality, reliable, cost-efficient intermodal rail transportation services to its customers, which consist primarily of intermodal marketing companies, large automotive intermediaries, and international steamship lines. Working on behalf of multiple shippers and other beneficial owners of cargo, these transportation companies control the movement of significant volumes of loaded freight containers.

As a non-railroad supplier of intermodal logistics, Pacer Stacktrain's relationships with the railroads and ability to deal with them on fair terms are critical to its customers and to its business, a significant portion of which is U.S.-Mexican trade. Pacer Stacktrain has a substantial amount of intermodal traffic between the United States and Mexico through the Laredo Gateway. In 1980, Pacer Stacktrain (then owned by APL) contracted to move Ford's Hermosillo traffic and Chrysler's Lago Albert and Toluca traffic using the intermodal Stacktrain method as part of its broader relationship with the Union Pacific Railroad ("UPRR"). Realizing the magnitude of the

¹¹ An intermodal container is a cargo container that is specifically designed to be transported by multiple modes, *e.g.*, truck (by attaching the container to a trailer chassis that is pulled by a truck tractor) and rail (by securing the container to a railroad flatcar). An intermodal trailer chassis is a specially designed trailer undercarriage on which an intermodal container may be mounted and transported over the road by a truck tractor. Double-stack rail transportation is the transportation by rail of intermodal freight containers stacked two-high on specially designed railroad flatcars, also called stackcars, that minimize damage to the cargo by reducing the longitudinal, lateral, and vertical forces exerted on the containers during transit. Double-stack rail service is distinguished from other types of rail intermodal transportation such as trailer-on-flatcar (TOFC) and container-on-flatcar (COFC) service, which subjects the freight to greater shock and stress during transit. Double-stack rail transportation of containerized freight is more economical and cost-efficient because up to twice as much freight can be moved using the same transit service while at the same time significantly reducing the risk of damage to the freight during transit.

developing transportation requirements to support emerging NAFTA trade, Pacer Stacktrain has made substantial additional investments in time, resources and relationship-building in Mexico and key U.S. and Mexican railroad companies.

Today, Pacer Stacktrain's U.S.-Mexico traffic travels primarily under contracts with the UPRR in the United States and the TFM in Mexico, with connections at the Laredo Bridge. Pacer Stacktrain runs continuous trains across the border with only the locomotive and/or crews changed at the crossing. These trains all run over the Laredo Bridge because it provides the safest and most direct -- and therefore fastest -- route for traffic from Pacer Stacktrain's customers (mostly from Chicago, Detroit and eastern Canada) to the manufacturing, distribution and commercial centers around Mexico City and Monterrey.

Over the last five years, Pacer has handled over 800,000 trans-border shipments with an average annual growth rate of 11%. In 2002, Pacer moved 137,000 loaded containers over the Laredo Gateway. It has 11 terminals within Mexico at key industrial centers and automotive plant locations, and on a daily basis, its operations and customer service personnel move over 600 loads, on five different trains that move on time-sensitive schedules, all operating over the Laredo Bridge owned by Tex Mex. Over the next few years, Pacer projects that at least 500,000 carloads can be converted from truck to intermodal rail assuming performance and pricing levels can continue to be improved at the rate they have in recent years.

The vast majority of Pacer containers crossing at Laredo were for the movement of auto parts and vehicle assembly components to various manufacturing facilities in central Mexico. These shippers require a tolerance of only one hour to support "just-in-time" factory materials requirement planning (MRP) programs. Stringent performance measures have been established with UPRR and TFM to ensure the accomplishment of "just in time" delivery of the freight for

Pacer Stacktrain's automobile and other customers. Pacer's 55 hour schedule from Chicago to Laredo for these shippers cannot be matched via potential alternative gateways such as Eagle Pass and Brownsville. Given the longer U.S. rail route to Eagle Pass, and from Eagle Pass to destination points in Mexico, transit of containers over the Eagle Pass Gateway will require an additional 6 hours of transit. Furthermore, the Customs Clearance infrastructure at Eagle Pass currently is inadequate. The gateway of Brownsville is not seen by Pacer as an alternative intermodal gateway given that TFM tracks from Brownsville are considered "secondary" quality branchline tracks. Nor are the other gateways, such as El Paso and Nogales, viable alternatives for Pacer Stacktrain's shipments. None of the gateways provides the necessary intermodal ramps and facilities, as well as track quality that the more time-sensitive and damage-sensitive intermodal freight requires. Moreover, none of them would be able to develop the needed improvements in a short enough period of time so as to prevent the loss of most, if not all, of Pacer Stacktrain's U.S.-Mexico intermodal traffic to truck.

With over 13,000 truck crossings per day -- 3,000,000 trips annually -- additional diversions to truck would result in further border congestion and potential delay to the movement of freight. If converted to truck, shippers would be required to redesign their logistics supply chains to ensure the adequate security of shipments and to account for the higher transportation costs.

Pacer Stacktrain recently negotiated a long-term partnership with TFM for the expansion of Pacer Stacktrain's intermodal services from the United States to Mexico. In 2002, Pacer Stacktrain selected the Laredo Gateway as the primary border crossing for its NAFTA trade traffic originating or terminating within Mexico's major markets because of its operational superiority. Based on this relationship, Pacer Stacktrain has developed and launched new

intermodal service products to meet customers' commercial requirements for containerized freight shipments from Canada and throughout the United States to Mexico, and has made substantial investments in the set-up and delivery of these products so that they can handle large volumes over the next three years.

II. KCS's Proposed Transaction Raises Several Anti-Competitive Concerns

In evaluating the proposed transaction, the Board must decide whether "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." 49 U.S.C. § 11324(d). When there exists the potential for competitive harm from a transaction that the Board nevertheless determines is in the public interest, the Board may approve the transaction subject to certain conditions "to alleviate [the] anticompetitive effects." *See id.* at (c). Conditions are particularly appropriate where the transaction would otherwise produce "significant loss of competition or the loss by another rail carrier of the ability to provide essential services." *See Canadian Nat'l Rwy. Co. -- Control -- Illinois Central Corp.*, 1999 STB LEXIS 305, at *42. Moreover, the Board often retains jurisdiction and imposes monitoring and oversight for a period of time to identify and correct deficiencies in the implementation of the transaction and the specified conditions.¹² In this case, if the Board finds that the transaction is in the public interest, it would

¹² *See, e.g., id.* at *10-12; *Union Pacific Corp. -- Control and Merger -- Southern Pacific Rail Corp.*, 1 S.T.B. at 367. *Cf. Dakota, Minnesota & Eastern Railroad Corp. Construction Into The Powder River Basin*, STB Finance Docket No. 33407, 2002 STB LEXIS 74 (STB served Jan. 30, 2002). The Board's imposition of "conditions in a variety of ways provided for significant post-merger oversight and monitoring that have permitted us to stay on top of both competitive and operational issues that might arise." Testimony of Linda J. Morgan, Chairman of the Surface Transportation Board to the Senate Committee on Commerce, Science and Transportation, Subcommittee on Surface Transportation and Merchant Marine, 2002 WL 1763667, at *7 (July 31, 2002) (attached as Exhibit C).

be appropriate to approve it only subject to certain conditions that would address the transaction's likely anticompetitive effects.

A. KCS As The Sole Owner Of The Laredo Bridge Should Be Required To Guarantee Non-Discriminatory Treatment

KCS's proposed acquisitions will necessarily have an impact on traffic over the Laredo Bridge -- the only trans-border crossing at what this Board has described as "the most important U.S.-Mexican rail gateway." *Union Pacific Corp. -- Control and Merger -- Southern Pacific Rail Corp.*, 1 S.T.B. at 422. For the first time in its history, the Laredo Bridge will be under common ownership with a U.S. Class I railroad that connects at the Laredo Gateway, eliminating the incentive that the Laredo Bridge formerly had to operate neutrally.¹³ Spanning the Rio Grande River from Laredo, Texas to Nuevo Laredo, Tamaulipas, Mexico, it handled 274,000 carloads in 2001 from the different railroads connecting there.¹⁴ The danger is that by acquiring the Laredo Bridge, as well as the Tex Mex, KCS will have the incentive and ability to operate the Laredo Bridge so as to favor and prioritize traffic from KCS/Tex Mex over that of all other railroads.

As KCS has made clear, a primary goal of the combined company will be to increase not only the amount of traffic flowing over the Tex Mex to improve its financial stability,¹⁵ but also over the larger system -- that is KCS/Tex Mex -- as well. In its Application, KCS states that it

¹³ Under independent ownership, the Bridge was not subject to any single railroad's parochial interests. Without any incentive to discriminate, the Bridge operated neutrally vis-a-vis all railroads and shippers that crossed at the Bridge from the United States.

¹⁴ Application at 28.

¹⁵ *Id.* at 27; Verified Statement of Michael R. Haverly (attached to Application) (hereinafter "Haverly V.S.") at 63-64.

expects to shift an additional 6,313 carloads per year -- or 17 to 18 carloads per day -- to the combined system.¹⁶ This will require “better coordination of marketing and rate practices,” because “[o]nly through combined control can KCSR and Tex Mex reach their true potential in developing international traffic moving between Mexico and the U.S.”¹⁷

KCS’s interest in maximizing KCS traffic over Tex Mex and the bridge will undoubtedly affect management in a manner that could wreak havoc for much of the cross-border NAFTA traffic, including Pacer Stacktrain’s time-sensitive intermodal traffic. KCS will be able to run the Bridge so that it favors shipments traveling on KCS/Tex Mex, including even less time-sensitive bulk shipments, to the detriment of shipments traveling on competing railroads, including the UPRR. KCS can accomplish this by setting schedules and other operating conditions so as to discriminate against competing railroads and their shippers, eventually making customers hostage to the KCS/Tex Mex. Furthermore, Pacer Stacktrain can gain no assurance from KCS’s empty or vague promises that it will “continue to work with UP and BNSF . . . to keep the Laredo Gateway open on commercially reasonable terms; and not to make any changes in the way the Laredo Bridge is dispatched and operated.”¹⁸ Whether the “commercially reasonable” standard is to be applied to KCS alone (*i.e.*, the standard against which KCS’ own conduct is to be judged), or to all participants via the Laredo Bridge (*i.e.*, the standard against which the rates, terms of service and other factors offered to all parties by KCS are to be judged), is unclear. This standard is simply too vague, and from a practical standpoint,

¹⁶ Application at 24.

¹⁷ Haverty V.S. at 64.

¹⁸ Supplemental Application at 4; *see also id.* at 26-27.

is legally unenforceable, and therefore useless to Pacer Stacktrain and other transportation service companies and other shippers. Upon completion of the transaction, when KCS is subject to conflicting interests, it will be critical that KCS's commitments can be enforced.

B. The Danger Of Discriminatory Treatment By The TFM¹⁹

The KCS's simultaneous acquisition of the TFM increases KCS's economic pressures and incentives and further enhances its ability to undertake conduct that will have anticompetitive effects on NAFTA trade. As the Board has observed, "the significance of the role played by TFM in the U.S.-Mexico NAFTA corridor cannot be ignored." *Id.* at 10. Because KCS's purchase of Tex Mex and of the TFM "are two components of a single, larger transaction with broader potential implications in the U.S.," the Board required the Applicants to supplement their application in order to address those implications and so that the Board may be prepared to take into account the transactions' effects in its final decision. *Id.*

As explained above, KCS's acquisition of Tex Mex, the Laredo Bridge, and the TFM (which is basically a Class I railroad in Mexico) will achieve its goal of creating a "NAFTA Railroad" connecting Canada (through KCS's marketing agreements with the Canadian National railroad), the United States and Mexico over the most important U.S.-Mexico border crossing, running as a single railroad. Competitive effects, as a practical matter, do not stop at the borders.²⁰ The integrated railroad's conduct could have substantial negative consequences for

¹⁹ Pacer understands there is a question about the Board's jurisdiction to order relief as to operations in Mexico, *see* Board Decision No. 2 at 7 n. 15. Pacer believes that if the Board determines that it cannot afford such relief, it is all the more critical that the Board impose conditions in the United States sufficient to ensure non-discriminatory treatment at the U.S. side of the Laredo Gateway.

²⁰ According to KCS, "[t]oday, there is no longer a Canadian market, a U.S. market, and a Mexican market. Instead, these economies have become interdependent." *Haverty V.S.* at 64.

U.S. trade crossing over the Mexican border, for U.S. shipping and intermodal companies that depend on that trade, and for U.S. consumers.²¹

KCS/TFM's incentives will be dramatically altered by the proposed combinations. In implementing the transaction, KCS has stated that it will seek to maximize single-route traffic over the extended KCS/Tex Mex/TFM by shifting TFM traffic to KCS/Tex Mex from competing railroads.²² To accomplish this, KCS will have to eliminate conflicting marketing and pricing practices, as it coordinates the management of KCS and TFM.²³ There is a real danger that once this is done, TFM's conduct will discriminate against railroads that compete with KCS and the shippers who do business with them. TFM could favor shipments that it picks up from the KCS/Tex Mex over those traveling on UPRR and other railroads, or hold up shipments traveling to the United States and bound for a connection at Laredo with a non-KCS/Tex Mex railroad. By exercising bottleneck control, or setting discriminatory rates, schedules and other operating

Therefore, KCS has outlined its plans to create integrated rail service by bringing KCS, Tex Mex and TFM under single ownership and running them as a highly integrated entity. It plans to install its own MCS operating system on the two additional railroads, *see* Application at 28; NAFTA Rail Transaction Summary at 5 (Exhibit A), to eliminate conflicting marketing and pricing plans and to coordinate closely all operations. *See* Application at 28; Supplemental Application at 7. Any discriminatory conduct by the TFM railroad with respect to shippers is bound to have profound effects on trade north of the border.

²¹ Pacer does not oppose KCS's efforts to increase traffic on its rail network nor to create an additional, competitive rail alternative. However, the Board should not permit KCS to accomplish this by discrimination in access to bottleneck facilities in its control thereby harming both competitive railroads and the shippers dependent on them.

²² *See* Union Pacific Railroad Co.'s Reply to Canadian Nat'l's Petition to Reopen Decision No. 2 (July 17, 2003) (UP-4) at 4-5 (citing statements by KCS management outside this proceeding highlighting its desire to shift TFM traffic to Tex Mex/KCS routes); NAFTA Rail Transaction Summary at 4 (stating that KCS will maximize traffic over the KCS/Tex Mex/TFM route to "lengthen hauls through an 'across the border view.'" (Exhibit A).

²³ Supplemental Application at 7.

conditions, TFM can leave shippers with no real option at the Laredo Gateway other than NAFTA Rail.²⁴

Of particular concern to Pacer is what, post-merger, will be TFM's willingness to observe non-discriminatory terms with shippers and wholesale logistics providers, such as Pacer, who do business with KCS/Tex Mex's competitors. Indeed, KCS has not ruled out the possibility of rearranging TFM's business relationships when the transaction is completed, and has affirmatively stated that it will discontinue, and perhaps seek to renegotiate in "good faith," those contracts that it does not deem to be profitable enough.²⁵ Again, KCS's vague and practically unenforceable commitment to deal in a "commercially reasonable" manner provides little comfort to Pacer, especially since, contrary to Decision No. 2, KCS has failed to explain with any particularity, or to commit with any specificity, how the combination with TFM will affect operations at the Laredo Bridge and on TFM.²⁶ Therefore, Pacer believes that if the Board determines it cannot reach conduct by the TFM in Mexico, it should impose stringent conditions on the operation of the Laredo Bridge in the United States and the Tex Mex railroad to act as a check on any potential discriminatory conduct of the TFM railroad.

²⁴ In the event the Board determines it has no jurisdiction over TFM, the need to ensure fair and neutral operation of the Laredo Bridge will be that much more urgent. A neutrally operating bridge would be the only check on the potential anticompetitive effects of TFM functioning under the control of KCS, while subject to Mexican (and not U.S.) laws.

²⁵ *Id.* at 26.

²⁶ *See generally*, Union Pacific Railroad Co.'s Reply to Canadian Nat'l's Petition to Reopen Decision No. 2; Canadian Nat'l's Petition to Reopen Decision No. 2 (July 17, 2003) (UP-4); Canadian Nat'l Rwy. Co.'s Petition to Reopen Decision No. 2 and to Reject Application (July 14, 2003) (CN-3).

C. The Manner Of The MCS System Implementation Could Threaten Laredo Gateway Traffic

In KCS's application to the STB, KCS explains that it will immediately install its train operations management system, MCS, on the Tex Mex and TFM railroads.²⁷ Pacer is concerned that KCS will encounter difficulties with the installation similar to some of the problems, acknowledged by KCS customers at the Board's July 31, 2003 hearing, that KCS experienced while attempting to install MCS on its own railroad,²⁸ *see* Hefley V.S. at 146 and Operating Plan/Minor at 228 (acknowledging that KCS had some "initial difficulties in deployment of the new system"), as well as similar problems encountered in connection with other railroad combinations.²⁹ Such problems could cause severe train delays and congestion throughout the new NAFTA Rail network and the networks of other carriers, including taking down the Laredo Bridge for periods of time. Unlike KCS, the Tex Mex and TFM railroads are bottleneck

²⁷ Application at 28; Verified Statement of Steven L. Hefley (hereinafter "Hefley V.S.") at 146-47; Operating Plan/Minor at 228-29; Supplemental Application at 32.

²⁸ In rolling out the MCS system over its own network, KCS and its customers experienced serious delays (especially at major interchanges such as Kansas City, Mo., Meridian, Miss., and Shreveport, La.), build-up of loaded cars with nowhere to go, loads that were damaged from sitting in yards for too long, congestion, lost cars, and "ping-pong" cars (cars that leave loaded and return labeled "empty" but are still fully loaded). *See* Bill Stephens, "KCS Plugged: Computer Change Jams System," *Trains Magazine*, 2002 WL 5705499 (Dec. 1, 2002) (attached as Exhibit D); John Gallagher, "Another Meltdown," *Traffic World*, 2002 WL 8044909 (Sept. 2, 2002) (attached as Exhibit E). These problems caused KCS lower revenues and higher expenses. *See* Kansas City Southern, 2002 Annual Report, http://www.kcsi.com/pdf/financial/annual_report2002.pdf, at 5 and 11-12 (attached as Exhibit F).

²⁹ *See Union Pacific Corp. -- Control and Merger -- Southern Pacific Rail Corp.*, 2 S.T.B. 703, 1997 STB LEXIS 275 at *30 (1997) (explaining that difficulties and delays in implementing UP's new system-wide computerized control network contributed to its own post-merger service problems and disruptions as well as to the rail transportation emergency in the western United States).

facilities for competing railroads, such as UPRR, and their shippers. Therefore, the smooth implementation of the MCS system on the Tex Mex and TFM -- even if better than what was achieved on the KCS -- is essential to overall rail competitiveness and all U.S.-Mexico rail traffic.

While Pacer does not object to, and indeed applauds, KCS's plans to improve the operational capabilities of the Tex Mex and TFM railroads, Pacer does believe that the Board should impose some discipline to the manner in which the MCS system implementation will occur, as well as oversight and monitoring of the implementation process to ensure minimal service disruptions affecting the Laredo Gateway.

D. Capital Plan for Track Upgrades on Tex Mex

KCS also describes in its engineering plans an accelerated capital investment program for track upgrades on the Tex Mex to capture and divert traffic currently moving over the Eagle Pass gateway (via FXE) to the Laredo Gateway (via Grupo TFM).³⁰ At the same time they plan to seek to get more business aggressively,³¹ increasing the stress on their system as they close down tracks for upgrades. Projects of this sort can cause substantial delays and severe congestion for all traffic operating over the Laredo Gateway. Similar problems have occurred in the context of capital improvements initiated after major combinations,³² and in this case could cause further delays and congestion throughout the NAFTA Rail network and over the Laredo Bridge.

³⁰ Operating Plan/Minor at 230 (Exhibit 15 to Application).

³¹ *Id.* at 229

³² See *Union Pacific Corp. -- Control and Merger -- Southern Pacific Rail Corp.*, 2 S.T.B. 703, 1997 STB LEXIS 275 at *3 (explaining that UP's efforts to rehabilitate the deteriorating SP system contributed to its own post-merger service problems and disruptions as well as to the rail transportation emergency in the western United States).

Again, although Pacer does not object to, and in fact applauds, KCS's plans to make capital improvements to the Tex Mex, Pacer does believe that the Board should impose some discipline to the manner in which the capital improvements are carried out, as well as oversight and monitoring of the improvements to ensure minimal service disruptions over the Tex Mex railroad and affecting the Laredo Gateway.

E. Conditions Should Be Imposed On Any Transaction Approved By The Board³³

If the Board decides to approve KCS's proposed transaction, it should only do so subject to certain conditions. Specifically, the Board should impose the following conditions on KCS:

1. Operation of the Laredo Bridge

- (1) Require KCS to develop, publish and provide to all participants in traffic over the Laredo Gateway protocols for the operation of the Laredo Bridge that are consistent with railroad industry standards.
- (2) Require KCS to operate the Laredo Bridge in accordance with such protocols, and to treat the operation of all railroads using it in a nondiscriminatory manner with respect to rates, scheduling, dispatching and all other operating conditions, and
- (3) Require KCS to operate the Tex Mex subject to the requirement that it treats shipments from all railroads at the Laredo connection and traveling over the Tex Mex in a nondiscriminatory manner as to rates, scheduling, dispatching and all other operating conditions.

2. Installation of MCS on Tex Mex and TFM

- (1) Require KCS to submit to the Board and the other parties of record for their review and comment and final Board approval, detailed project plans including time frames for the installation of the MCS System on the Tex Mex and TFM, and to adhere to the project plan approved by the Board.
- (2) Establish Board oversight and monitoring of the adequacy of KCS's installation of the MCS system on the Tex Mex and TFM, including monitoring average

³³ Following the initial announcement of the NAFTA Rail transactions, Pacer unsuccessfully tried to meet with KCS to discuss Pacer's concerns regarding the proposed transactions.

transit times for trains running in the NAFTA Rail system and the reliability of actual transit times for trains running in the NAFTA Rail system to the currently scheduled transit times for trains currently running in the KCS/Tex Mex/TFM network (or mutually acceptable post-merger scheduled transit times for trains running in the NAFTA Rail system).

- (3) Require KCS to establish sufficiently detailed and adequate service recovery plans in the event of service failures flowing from the implementation of the MCS system on the Tex Mex and TFM.

3. Capital Improvements on the Tex Mex

- (1) Require KCS to submit to the Board and the other parties of record for their review and comment and final Board approval, detailed project plans including time frames for the performance of capital improvements on the Tex Mex, and to adhere to the project plan approved by the Board.
- (2) Establish Board oversight and monitoring of the adequacy of KCS's capital improvements on the Tex Mex, including monitoring average transit times for trains running in the NAFTA Rail system and the reliability of actual transit times for trains running in the NAFTA Rail system to the currently scheduled transit times for trains currently running in the KCS/Tex Mex/TFM network (or mutually acceptable post-merger scheduled transit times for trains running in the NAFTA Rail system).
- (3) Require KCS to establish sufficiently detailed and adequate service recovery plans in the event of service failures flowing from the performance of capital improvements on the Tex Mex.

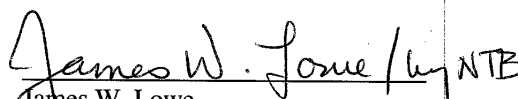
In addition, the Board should retain jurisdiction to monitor and oversee KCS's implementation of the conditions, to hear any claims that KCS is not complying and to correct any deficiencies in implementation that arise, and impose additional conditions if necessary.

III. Conclusion

For the reasons set forth above, Pacer requests that the Board impose appropriate conditions to alleviate the likely anticompetitive effects in the event it decides to approve the proposed KCS/Tex Mex merger.

Dated: August 4, 2003

Respectfully Submitted,

 NTB

James W. Lowe
Nicole T. Berry
Wilmer, Cutler & Pickering
2445 M Street, N.W.
Washington, D.C. 20037

(202) 663-6000 (telephone)
(202) 663-6363 (fax)

Counsel to Pacer International, Inc.

Michael F. Killea
Executive Vice President and
General Counsel
Pacer International, Inc.
225 Water Street, Suite 2050
Jacksonville, FL 32202

(904) 485-1004 (telephone)
(904) 485-1019 (fax)

CERTIFICATE OF SERVICE

I hereby certify that, on this 4th day of August, 2003, I caused the foregoing Pacer International, Inc.'s Comments On The Application Of Kansas City Southern And The Texas Mexican Railway Company to be served in the manner indicated on each of the following:

The Honorable John Ashcroft
Attorney General of the United States'
c/o Assistant Attorney General,
Antitrust Division, Room 3645
U.S. Department of Justice
10th Street and Constitution Ave., NW
Washington, DC 20530
(by Hand Delivery)

Scott N. Stone
Patton Boggs LLP
2550 M Street, NW
Washington, DC 20037
(by Hand Delivery)

Peter Gatti
The National Industrial Transportation League
1700 North Moore Street, Suite 1900
Arlington, VA 22209
(by First-Class Mail)

Paul A. Cunningham
Harkins Cunningham
801 Pennsylvania Ave, NW, Suite 600
Washington, DC 20006
(by Hand Delivery)

Richard H. Streeter
Barnes & Thornburg
750 17th Street, NW, Suite 900
Washington, DC 20006
(by Hand Delivery)

The Honorable Norman Y. Mineta
Secretary of Transportation
U.S. Department of Transportation
400 7th Street, SW
Washington, DC 20590
(by Hand Delivery)

Frederic L. Wood
Thompson Hine LLP
1920 N Street, NW, Suite 800
Washington, DC 20036-1600
(by Hand Delivery)

William A. Mullins
David C. Reeves
Baker & Miller PLLC
915 Fifteenth Street, NW, Suite 1000
Washington, DC 20005-2318
(by Hand Delivery)

Richard J. Schiefelbein
Woodharbor Associates
7801 Woodharbor Drive
Fort Worth, TX 76179-3047
(by FedEx)

Nicholas J. DiMichael
Thompson Hine LLP
1920 N Street, NW, Suite 800
Washington, DC 20036-1600
(by Hand Delivery)

Daniel R. Elliott, III
Assistant General Secretary
United Transportation Union
14600 Detroit Avenue
Cleveland, OH 44107-4250
(by FedEx)

Adrian L. Steel, Jr.
Erica Z. Jones
Robert M. Jenkins III
Mayer, Brown, Rowe & Maw
1909 K Street, NW
Washington, DC 20006
(by Hand Delivery)

J. Michael Hemmer
Lawrence E. Wzorek
Louise A. Rinn
Law Department
Union Pacific Railroad Company
1416 Dodge Street
Omaha, NE 68179
(by First-Class Mail)

Michael L. Rosenthal
Carolyn F. Corwin
David L. Meyer
Covington & Burling
1201 Pennsylvania Avenue, NW
Washington, DC 20004
(by Hand Delivery)

Paul R. Hitchcock
CSX Transportation, Inc.
500 Water Street
Jacksonville, FL 32202
(by First-Class Mail)

Sean Finn
Canadian National Railway Company
P.O. Box 8100
Montreal, PQ H3B 2M9 Canada
(by First-Class Mail)

E.C. Wright
Rail Transportation Procurement Manager
DuPont Logistics
E.I. Du Pont de Nemours and Company
D-3100
1007 Market Street
Wilmington, DE 19898
(by First-Class Mail)

Theodore K. Kalick
Canadian National Railway Company
601 Pennsylvania Avenue, NW
Suite 500 North Building
Washington, DC 20004
(by First-Class Mail)

Peter J. Shultz
CSX Corporation
1331 Pennsylvania Avenue, NW
Suite 560
Washington, DC 20004
(by First-Class Mail)

James A. Squires
George A. Aspatore
John V. Edwards
Norfolk Southern Corporation
Three Commercial Place
Norfolk, VA 23510-2191
(by First-Class Mail)

G. Paul Moates
Paul A. Hemmersbaugh
Sidley Austin Brown & Wood LLP
1501 K Street, NW
Washington, DC 20005
(by Hand Delivery)

Barbara C. Robinson
Deputy Administrator
Transportation and Marketing
Agricultural Marketing Service
U.S. Department of Agriculture
1400 Independence Avenue, SW
Room 2510-South Building
Washington, DC 20250-0266
(by Hand Delivery)

Christopher Tully
Transportation Communications Int'l Union
3 Research Place
Rockville, MD 20850
(by FedEx)

Donald F. Griffin
Director of Strategic Coordination and Research
Brotherhood of Maintenance of Way Employees
10 G Street, NE, Suite 460
Washington, DC 20002
(by Hand Delivery)

Jeffrey R. Moreland
Richard E. Weicher
Sidney L. Strickland, Jr.
Michael E. Roper
The Burlington Northern and
Santa Fe Railway Company
2500 Lou Menk Drive, Third Floor
Fort Worth, TX 76131-0039
(by FedEx)

Gordon P. MacDougall
1025 Connecticut Avenue, NW
Suite 410
Washington, DC 20036
(by Hand Delivery)

Joseph R. Pomponio
Federal Railroad Administration
400 Seventh St, SW, RCC-20
Washington, DC 20590
(by Hand Delivery)

Paul Samuel Smith
U.S. Department of Transportation
400 Seventh St, SW, Rm 4102 C-30
Washington, DC 20590
(by Hand Delivery)

John Jay Rosacker
Kansas Department of Transportation
217 SE 4th Street
Second Floor
Topeka, KS 66603
(by FedEx)

William W. Whitehurst, Jr.
W.W. Whitehurst & Associates, Inc.
Economic Consultants
12421 Happy Hollow Road
Cockeysville, MD 21030-1711
(by FedEx)

Marcella Szel
Paul Guthrie
Canadian Pacific Railway Company
401 9th Avenue, SW
Gulf Canada Square, Suite 500
Calgary, Alberta T2P 4Z4 Canada
(by First-Class Mail)

Terence M. Hynes
Gabriel S. Meyer
Sidley Austin Brown & Wood, LLP
1501 K Street, NW
Washington, DC 20005
(by Hand Delivery)

Robert T. Johnson
3040 Post Oak Boulevard
Houston, TX 77056
(by FedEx)

John P. LaRue
The Port of Corpus Christi
222 Power Street
Corpus Christi, TX 78401
(by FedEx)

Edward F. O'Callaghan
CMA-CGM (America) Inc.
300 Lightning Way, 2nd Floor
Secaucus, NJ 07094-3688
(by FedEx)

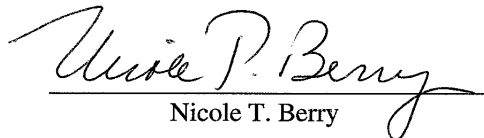
Mark Panych
Millar Western Forest Products Ltd.
Bag Service 2200
Edmonton AB T5J 4W2 Canada
(by FedEx)

E.T. Sprock
Daimler Chrysler
800 Chrysler Drive
Auburn Hills, MI 48326
(by FedEx)

Jack B. Weaverling
Shrieve Chemical Company
1717 Woodstead Court
Woodlands, TX 77380
(by FedEx)

Donald A. Welch
4030 Vincennes Road
Indianapolis, IN 46268-0937
(by FedEx)

Milus Wright
Wright Materials Inc.
5706 FM 3088
Robstown, TX 78380-5248
(by FedEx)


Nicole T. Berry

A

**NAFTA
Rail**

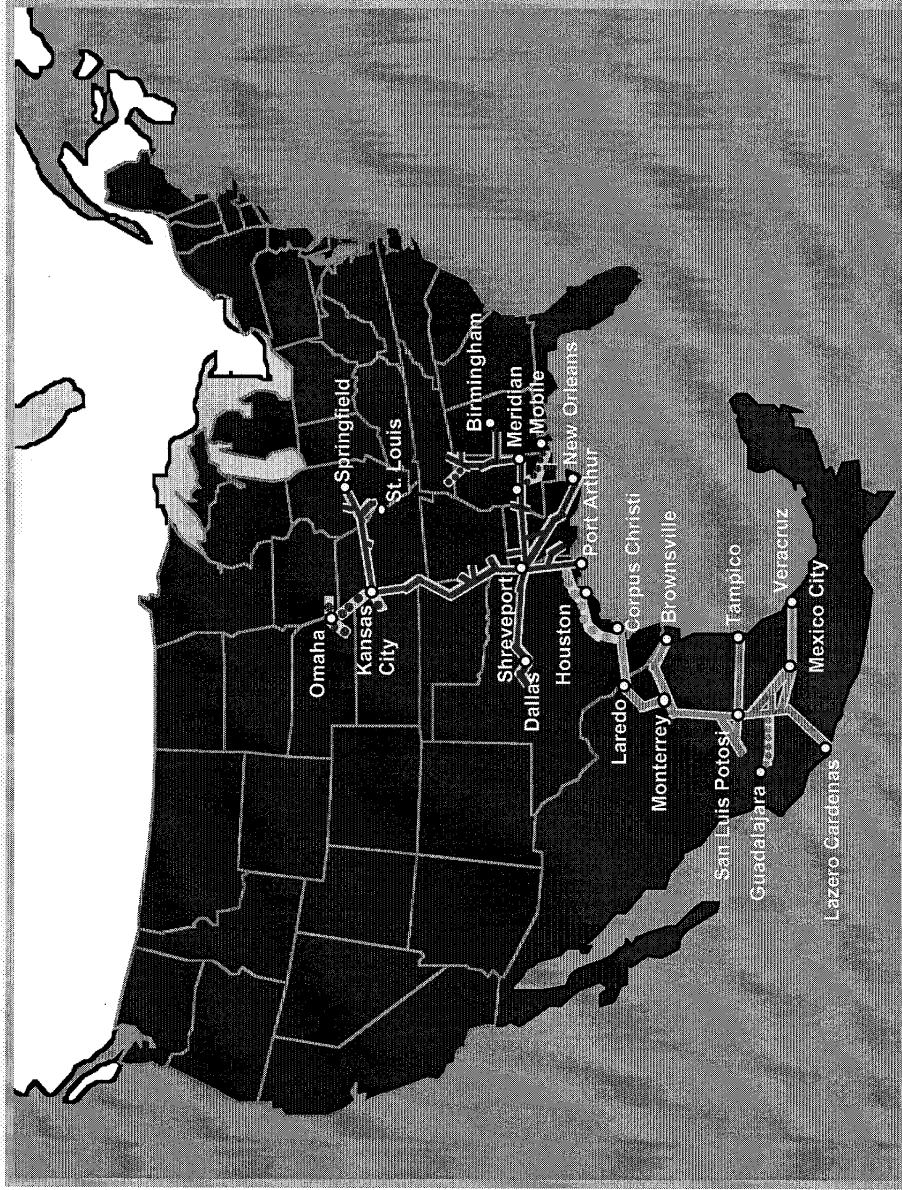


transaction summary

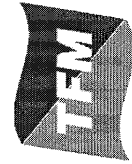
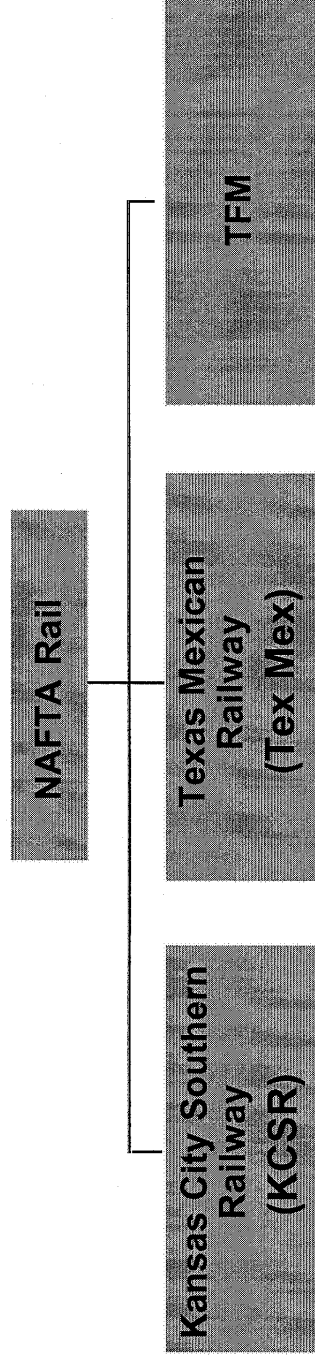
NAFTA
Rail



KCSR, Tex Mex, TFM Operating Under Common Control



Common Control



- NAFTA Rail will be a U.S. corporation, headquartered in Kansas City, with three separate railroad companies that connect end to end and operate under integrated managements
 - KCS and Tex Mex are U.S. corporations
 - TFM is a Mexican corporation
- Surface Transportation Board approval of the common control of KCSR and Tex Mex is required
- Mexico's Foreign Investment Commission will review the foreign control of TFM
- Mexico's Competition Commission will review the transaction for competitive effects

Strategic Rationale for NAFTA Rail

- Enhance shareholder value by achieving consolidation of rapidly expanding TFM affiliate in Mexico, with U.S. ownership
- Accretive from day one
- Improve Tex Mex infrastructure and operations to better link the Kansas City Southern Railway with TFM
- Strengthen KCSR/Tex Mex/TFM as the “NAFTA Railroad” in North America
- Increase EPS contribution from faster-growing rail operations in Mexico
- Lengthen hauls through an “across-the-border” view



Enhanced Competition

- **Three railroad companies connecting end to end to end**
 - Maintain the unique culture of each company
 - Operating under integrated management
 - Only *enhances* competition—no reduction of competitors in any market
 - No “2 to 1 points”
 - No overlaps
- **Common operating platform, MCS: planned implementation on Tex Mex in September 2003, and on TFM in Q1 2004**
 - MCS now operating smoothly at KCSR
 - Common customer access
 - Pro-active service management
- **Tightly managed service across U.S.-Mexico border**
- **Seamless service**
 - Southern Mexico to the heart of the U.S.
 - Integrated operating system
 - Integrated customer service



Enhanced Competition (continued)

- Combined resources lead to enhanced product offerings
 - 965 locomotives
 - 25,206 freight cars
 - 140 transload/reload locations
 - 14 intermodal ramps
 - 13 ports
 - 181 interchange points with other railroads



NAFTA RAIL Governance and Management

- **Board of Directors, initially ten members:**
 - Mike Haverty, Chairman
 - Pepe Serrano, Vice-Chairman
 - Seven (in addition to Mike Haverty) current KCS Board members; plus Javier Segovia, President of TMM
- **Management of NAFTA RAIL**
 - Chairman, President & CEO: Mike Haverty
- **Management of Kansas City Southern Railway**
 - Chairman, President & CEO: Mike Haverty
- **Management of TFM**
 - Chairman: Pepe Serrano
 - CEO: Mario Mohar



Transaction Summary



- **To NAFTA RAIL from GTMM**
 - 38.8% of effective ownership of TFM
- **To GTMM from NAFTA RAIL**
 - 18 million shares of NAFTA RAIL
 - \$200 million cash
 - Potential incentive payment of \$100 million-\$180 million based on a resolution of certain contingencies
- **51.0% of Mexrail acquired by NAFTA RAIL for \$32 million**

Financial Summary

Income statement data *

(US\$mm)

	KCS consolidated	Grupo TFM consolidated	combined
2002 Revenue	\$ 566	\$ 712	\$ 1,278
growth vs. '01	(1.9 %)	6.6%	2.7%
2002 EBITDA	\$ 109	\$ 259	\$ 368
margin	19.3%	36.4%	28.8%
2002 EBIT	\$ 48	\$ 176	\$ 224
margin	8.5%	24.7%	17.5%

*** NOTES:**

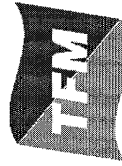
KCS consolidated 2002 EDITDA and EBIT exclude KCS' equity in earnings of Grupo TFM, resulting from existing 37.3% of effective ownership in TFM.

Combined amounts are presented only to demonstrate the relative size of NAFTA Rail if the transaction is consummated. The combined amounts do not reflect the impacts of the application of purchase accounting and do not purport to reflect *pro forma* financial results as if the transaction had been consummated at the beginning of 2002.



Financial Summary (continued)

Balance Sheet data *
(US\$mm)



	KCS consolidated	Grupo TFM consolidated	combined
Cash	\$ 19	\$ 30	\$ 49
Debt	\$ 583	\$ 1,023	\$ 1,606
Net debt	\$ 564	\$ 992	\$ 1,556

* NOTES:

Balance sheet data before acquisition financing. Source: Balance sheet data as of 12/31/02.
Combined amounts are presented only to demonstrate the relative size of NAFTA Rail if the transaction is consummated. The amounts do not reflect the impacts of the application of purchase accounting and do not purport to reflect *pro forma* balance sheet data as if the transaction had been consummated at December 31, 2002.

Value Added Tax (VAT) Update

- TFM filed a lawsuit against the Mexican Government in 1997 alleging that the Government failed to make a value added tax refund in the amount of \$206 million
- October 11, 2002: the Mexican Magistrates Court (the appellate court) unanimously ruled in favor of TFM and ordered the lower Fiscal Court to issue a new ruling consistent with the appellate court's opinion
- December 10, 2002: the lower Fiscal Court issued a ruling denying TFM the right to receive the VAT refund
- TFM appealed the December 10th ruling to the Mexican Magistrates Court on January 29, 2003





Purchase Price Summary

No VAT/ No Put

18.0M shares issued @ \$11.77 (closing 4/17/03)

Cash

\$ 211.9

\$ 200.0

Purchase total

\$ 411.9

Total value for TMM's interest

\$ 411.9

TMM's interest in TFM

38.8%

Implied equity value of TFM

\$ 1,061.5

TFM debt

\$ 1,023.1

TFM cash

\$ 30.2

Implied Total Enterprise Value

\$ 2,054.4

Implied multiples:

TFM metrics

2002 revenue

\$ 712.1

2.9x

2002 EBITDA

\$ 259.2

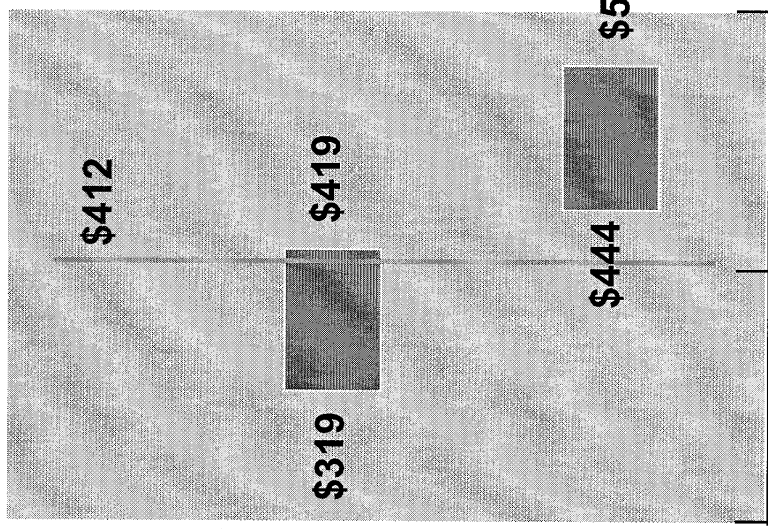
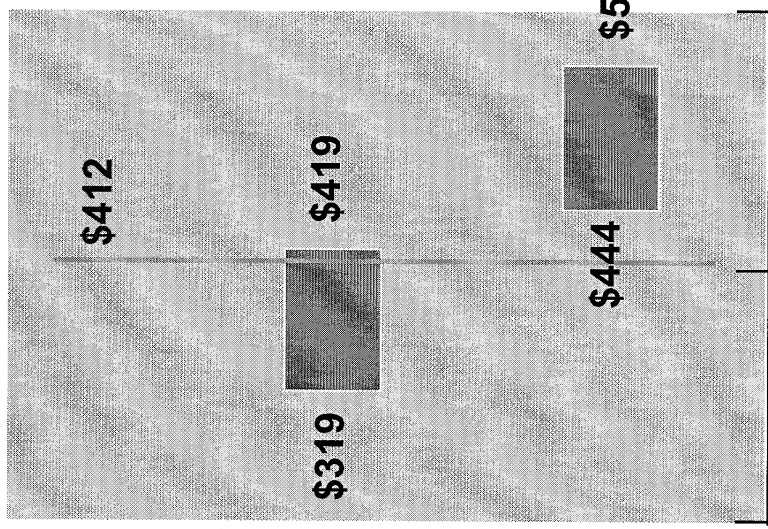
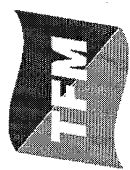
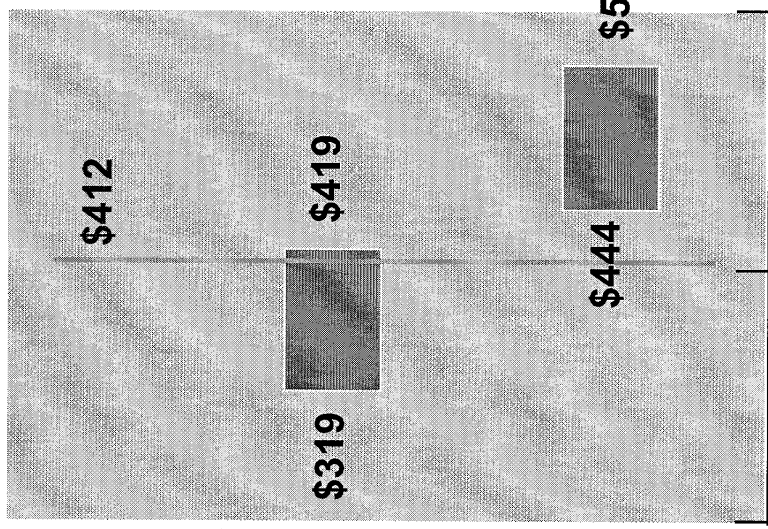
7.9x

2002 EBIT

\$ 176.1

11.7x

Valuation Summary: 38.8% of GTFM

<u>Valuation Method</u>	<u>Valuation Range</u>	<u>Relevant Parameter</u>
 Purchase Price		\$200 million plus 18 million shares @ \$11.77 per share
 Rail Industry Trading Comparables		LTM EBITDA multiple: 7.0x – 8.0x
 Rail Industry Transaction Comparables		LTM EBITDA multiple: 8.25x – 9.25x
	\$200 \$400 \$600	

Earnings Impact

No VAT/ No Put



	<u>2003E *</u>	<u>2004E *</u>
KCS standalone EPS	\$ 0.79	\$ 1.05
NAFTA Rail EPS	Higher	Higher
Benefit to NAFTA Rail shareholders	Accretive	Accretive

* First Call Estimates 4/17/03

NAFTA Rail



North American Rail Coverage with marketing alliances and connections



B



For Immediate release:
May 5, 2003

For additional information contact:
William Galligan - 816-983-1551

S&P, Moody's Rate KCS' Redeemable Cumulative Convertible Perpetual Preferred Stock Offering

[Previous Release](#) / [Next Release](#) / [Press Release Menu](#)

Standard & Poor's Ratings Services (S&P) has assigned its "B" rating to KCS's Redeemable Cumulative Convertible Perpetual Preferred Stock offering. S&P also announced that KCS and The Kansas City Southern Railway Company (KCSR), including the "BB" corporate credit rating, remain on CreditWatch. Moody's Investor Services assigned its B3 rating to KCS's Redeemable Cumulative Convertible Perpetual Preferred Stock offering, and downgraded the ratings of KCS's senior implied and senior unsecured debt to Ba3 from Ba2.

KCS is comprised of, among others, The Kansas City Southern Railway Company and equity investments in Grupo TFM, Southern Capital Corporation, and the Panama Canal Railway Company.

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2002 WL 1763667 (F.D.C.H.)

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Testimony
July 31, 2002

Senate
Commerce, Science and Transportation
Surface Transportation and Merchant Marine

Rail Shipping Issues

Statement of Linda J. Morgan
Chairman of the Surface Transportation Board

Committee on Senate Commerce, Science and Transportation
Subcommittee on Surface Transportation and Merchant Marine

Hearing on the Surface Transportation Board

July 31, 2002

Introduction

My name is Linda J. Morgan, and I am Chairman of the Surface Transportation Board (Board). I am appearing today at the Subcommittee.s request to discuss issues of concern to railroad shippers. As I have testified about these and other Board matters numerous times before Congress in the past several years, my testimony today will offer a brief summary of the Board and its recent activities, with a particular emphasis on certain issues that are of concern to shippers.1

Overview of the Board

I first came to the Board.s predecessor, the Interstate Commerce Commission (ICC), in the Spring of 1994, just before the House voted to terminate funding for the ICC. While legislation eliminating the ICC was not approved that year, Congress the next year did pass the ICC Termination Act of 1995 (ICCTA), which became effective on January 1, 1996. The ICCTA continued the trend toward less economic regulation of the surface transportation industry by eliminating the ICC and, with it, certain regulatory functions that the ICC had administered. The ICCTA established the Board as a three-member, bipartisan, decisionally independent adjudicatory body organizationally housed within the Department of Transportation (DOT). It transferred to the Board core rail adjudicative functions and certain non-rail adjudicative functions previously performed by the ICC, and provided it with limited resources to carry out

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2002 WL 1763667 (F.D.C.H.)

Page 2

these responsibilities.

The Board continues to be funded on an annual basis, operating at essentially the same resource level since its establishment in 1996, although, largely because of the debate over how the railroad industry ought to be regulated, the agency has not been reauthorized. Nevertheless, the Board has adapted to its mission and its resources. Even with limited resources, it has worked through its significant caseload, resolved many cases that had languished at the ICC, and tackled head-on the many hard issues that have confronted the rail sector in the last several years. In order to continue to perform its duties expeditiously and effectively, the Board's principal focus for the foreseeable future continues to be on hiring new employees capable of replacing the many experienced employees eligible to retire from the agency.

The Board's Approach to Its Work

The Board, I believe, has been a model of "common sense government," looking "outside of the box" for creative solutions to the serious regulatory issues entrusted to it, and promoting private-sector initiative and resolution where appropriate while undertaking vigilant government oversight and action in accordance with the law where necessary to address imperfections in the marketplace. This approach has been successful for addressing in a timely and effective manner a variety of difficult matters involving the rail sector.

For example, this approach worked in resolving the rail service crisis in the West during the late 1990s, which, as I have discussed with Members of this Committee on various occasions, had to be handled in such a way as to not inadvertently hurt some shippers in an effort to help others. The approach proved successful in addressing the less extensive disruptions associated with the Conrail transaction, and it has helped the Class I railroads in improving the operations of the Chicago terminal, a major gateway between the East and the West. Because of the Board's prodding, we now have industry-wide operational reporting that allows us to monitor carrier performance in a way that we could not before; we have more cooperation among carriers with a view toward expanding and improving rail service; and we have private-sector agreements and other mechanisms in place to address issues that arise between various segments of the rail sector. And the Board's pragmatic approach also has worked in many individual cases in which the Board has facilitated private-sector solutions. Such an approach can produce the best solution to a problem: a private agreement will more likely reflect the interests of the parties to the agreement; the parties who have negotiated the agreement have a real stake in its success; and a private-sector resolution can provide more benefit to the parties involved than the Board can provide, given the limits of its authority. As a result of the efforts of the last several years, interactions among the various stakeholders are more constructive

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and rail service is more responsive overall than in past years.

Sometimes a private-sector solution is not forthcoming, however, and in those cases we do intervene aggressively when appropriate. Thus, after holding extensive hearings on access and competition in the railroad industry, in 1998, in addition to promoting private-sector initiatives, we pursued a variety of government actions, including the revision of the "market dominance" rules to eliminate "product and geographic competition" as considerations in rate cases. Similarly, although some rate cases have settled, others have not, and in those cases the agency has acted decisively, in decisions that were more often than not favorable to shippers, to establish the rules of the road for the disposition of these important matters. And beyond the resolution of individual cases, I should note that the Board has handled tough problems by issuing rulings of broad applicability. As an example, in its "bottleneck" decisions, the agency read the law creatively so that it could give shippers an opportunity for relief while respecting the rate and routing freedoms that the law provides for railroads. I know that certain shipper interests consider the bottleneck relief illusory, but in fact a number of bottleneck complaints have been filed before the Board.

Rail Rate Cases

Overview. When I came to the ICC, the agency had rate guidelines in place, but it had decided virtually no cases under these guidelines. One of my main goals as Chairman was to resolve these cases with a view toward clarifying how the guidelines would be applied so that parties would know where they stood, and leveling the playing field by ensuring that the formal process would not be used simply as a delaying tactic. Also, by setting up fair and understandable procedures, and focusing on timely case disposition, I hoped to encourage private-sector resolution whenever possible. I believe that we have achieved those objectives, as many rate disputes have been resolved without Board intervention, and several cases that had been brought to the agency were settled before the agency issued a decision.

Of course, not all cases are settled, and we are actively moving forward with several rate cases at this time. Rate regulation, however, is not a simple exercise, and so the cases take time. Market Dominance. Congress has decided that there should not be rate regulation where there is effective competition, and so the first step in a rate case is the determination of market dominance (defined as an absence of effective competition for the transportation to which the rate applies). The first component of a market dominance inquiry is to determine the "variable costs" of providing the service. The statute establishes a conclusive presumption that a railroad does not have market dominance over transportation if the rate that it charges produces revenues below 180% of the "variable costs" of providing the service, which means that this 180% revenue-to-variable cost (r/vc) percentage is the floor for regulatory scrutiny.

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For situations in which the 180% threshold is met, the second component of a market dominance inquiry involves a qualitative analysis in which the Board must determine whether there are any feasible transportation alternatives that could be used for the traffic involved. Currently, in its market dominance determination, the Board considers actual or potential direct competition, that is, competition either from other railroads (intramodal competition) or from other modes of transportation such as trucks, pipelines, or barges (intermodal competition) for the same traffic moving between the same points. For many years, the ICC (and later the Board) also considered two other types of indirect competitive alternatives: geographic competition (the ability to use other railroads or modes to ship from or to other locations) and product competition (the ability to use other railroads or modes to ship substitute products). As referenced earlier, the Board no longer considers these forms of indirect competition because it found that they are unduly complicated for the Board to assess, that they prolonged the handling by the Board of rail rate cases, and that they discouraged shippers from pursuing legitimate rate complaints. (The Board's decision is still under judicial review.)

Rate Reasonableness Standards. Thus, although the market dominance inquiry is still not easy, we have tried to simplify it. And even assuming that the elimination of product and geographic competition will be upheld in court, the remainder of the rate review process is quite complex. Although a cost-of-service approach might be relatively simple, we cannot use such a methodology for two reasons. First, the full costs of serving each individual shipper cannot be measured directly, due to the high degree of shared costs (e.g., overhead costs) and sunk costs (e.g., costs for tunnels, bridges, etc.) in the rail industry that cannot be attributed to individual traffic. And second, railroads are not able to price their services based on preset cost allocations because they serve a mix of captive and competitive traffic, and the competitive traffic would not pay a pro rata share of costs assigned by a formula if the resulting rate is any greater than the rate for using competitive transportation alternatives.

Thus, a preset allocation formula would drive away those shippers with less costly competitive options, and the remaining captive shippers would then have to pay even higher cost-based rates once the departed shippers would no longer be contributing to shared costs.

Accordingly, to limit the rates on captive rail traffic to reasonable levels while affording railroads the opportunity to cover all of their costs and earn a reasonable profit, the Board uses demand-based differential pricing principles. In other words, the Board expects railroads to apply differing markups (amounts by which rates exceed variable costs) based on the price sensitivity (degree of captivity) of the traffic. Shippers with more choices are offered lower markups in order to keep their

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traffic in the rail network and thus minimize the overall contributions to the railroads. shared costs needed from those shippers with few, if any, choices.

These pricing principles, which apply in many industries in addition to railroads, make determining the reasonableness of an individual rate a complex task. Neither attributable costs nor degree of captivity (demand elasticity) -- the bases for demand-based pricing -- can be measured directly. Therefore, to assess whether market dominant rates are reasonable, the Board uses a well established concept known as "constrained market pricing" (CMP) whenever possible. CMP principles recognize that, in order to earn adequate revenues, railroads need the flexibility to price their services differentially by charging higher mark-ups on captive traffic, but the CMP guidelines impose constraints on a railroad's ability to price differentially.

The most commonly used CMP constraint is the "stand-alone cost" (SAC) test. Under the SAC test, a railroad may not charge a shipper more than what a hypothetical new, optimally efficient carrier would need to charge the complaining shipper if such a carrier were to design, build and operate -- with no legal or financial barriers to entry into or exit from the industry -- a system to serve only that shipper and whatever group of traffic is selected by the complaining shipper to be included in the traffic base. The ultimate objective of SAC in particular, and CMP in general, is to eliminate unwanted cross-subsidies from one shipper to another and to have optimal efficiency reflected in the rate base.

Thus, the SAC test allows railroads to price differentially, but it limits rates through the hypothetical efficient new railroad model by assuring that a captive shipper not be required to unreasonably subsidize a carrier's competitive traffic by being forced to bear the costs of any facilities or services from which the shipper derives no benefit.

The Board has used this test to resolve five rate complaints since the agency was established at the beginning of 1996 (cases brought by West Texas Utilities Company, Arizona Public Service Company, McCarty Farms, Inc., FMC Corporation, and Wisconsin Power and Light Company), and the test is being used to evaluate the reasonableness of rates in several ongoing cases. The Board has also established procedures for expediting these cases. While presenting a SAC case is not inexpensive, large rail shippers have used it to obtain substantial rate relief (with decisions favorable to the shippers in 4 out of the 5 cases cited above).

The Board also resolved during this period a complex pipeline rate case in a judicially affirmed decision that resulted in substantial rate reductions and reparations. over \$10 million in reparations for past shipments, and obtained a rate prescription that lowered its rate for future shipments by 30%. Another shipper was awarded over \$20 million in reparations and obtained

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a 40% rate reduction.

Timing Issues. Some parties argue that it takes the Board too long to decide rate cases. I understand their concern. However, the review is an inherently complex one. And the parties themselves add to the time needed for resolution by asking the agency to resolve numerous discovery disputes, many of which they ought to be able to settle themselves, as well as other preliminary matters.

With respect to the cases themselves, we must make hundreds of "calls" on the many substantive issues that come up in each proceeding. As these cases are data-intensive and quite technical, we have to be very careful, because a mistake on even one of these issues could result in a remand by a reviewing court. And we also have to spend considerable time on administrative petitions for reconsideration that are frequently filed, as well as court challenges to our rate decisions. All of this is handled by a small cadre of highly skilled and dedicated employees, who I can assure you are focused on producing a defensible product in these and the many other cases on which they work.

Additionally, I should note that the nature of the calls that we are required to make has changed with the recent filings. In the past, the questions that arose -- even the theoretical questions -- typically concerned more confined issues such as how to value property, the configuration of the hypothetical railroad's network, and the projections of the tonnage and revenues associated with the hypothetical railroad. More recently, however -- now that many of those matters have been resolved -- parties have attempted to test the boundaries of a SAC case, and so we have been faced with a series of issues that go to the broad principles underlying the SAC analysis. Rather than resolving these questions after the parties and their consultants have made their entire cases, we have been called upon to address them at an earlier stage in order to guide the parties in presenting their evidence and arguments.

Thus, late last year, we published a decision providing guidance on certain fundamental issues outstanding in several pending cases, including the Arizona Electric case. The Arizona Electric parties asked for further guidance, and we expect to issue a further decision in the very near future on that matter. Small Rate Cases. In 1996, the Board issued simplified guidelines for the disposition of those rate cases where the amount of money involved does not justify pursuing the more complex method used in larger cases. No case has been filed seeking application of those guidelines, as some may view them as not being simplified enough, and not worth bringing given the amount of money at stake. In December 1998, I wrote to the Committee on a number of matters and suggested that, if Congress shared that view, legislation would be necessary to establish another approach. In May of this year, I again wrote the Committee summarizing the

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mixed record developed in a Board proceeding that explored whether legislatively mandated arbitration might be an appropriate approach to handling these cases.

Rail Mergers and Competition

Background on Past Rail Mergers. The trigger for much of the debate over access and competition was the move during the 1990s toward continued consolidation in the railroad industry. Since I came to the ICC, four Class I rail mergers have been approved, with substantial Board-imposed competitive and other conditions. The conditions in a variety of ways provided for significant post-merger oversight and monitoring that have permitted us to stay on top of both competitive and operational issues that might arise. They provided for the protection of employees and the mitigation of environmental impacts, and our recent decisions employed a "safety integration plan" that draws on the resources of the Board, the Federal Railroad Administration, and the involved carriers and employees.

In varying degrees, these mergers have had the support of segments of the shipping public, as well as employees and various localities, and were considered by a number of interested parties to be in the public interest. A variety of shippers actively supported the Burlington Northern/Santa Fe (BN/SF) merger, the inherently procompetitive Conrail acquisition, and the Canadian National (CN)/Illinois.

I appeared before this Committee in the Spring of 2000 to discuss the moratorium and the merger policy rulemaking. Central merger. While the Union Pacific/Southern Pacific (UP/SP) merger was opposed by certain segments of the shipping community (although it was supported by others), the Board believed that merger was necessary not only to aid the failing SP, but also to permit the development of a second rail system in the West with enough presence to compete with the newly merged BN/SF. I should note that the conditions that the Board imposed in approving the UP/SP merger made it possible for UP/SP's main competitor, BNSF, to participate in several "build-outs" designed to produce new competitive service that did not exist before the merger, and that would not have been possible without the Board's conditions.

Some have said that rail mergers are inherently anticompetitive, that they cause service problems, and that the agency should have more actively discouraged them. But our approvals were based on public interest determinations made on extensive records and were conditioned to preserve and promote competition, ensuring that no shipper's service options were reduced to one-carrier service as a result of a merger.

New Major Rail Merger Policy and Rules. These recent mergers have changed the way the rail system now looks. In the United States, we now have two competitively balanced systems in the West and two competitively balanced systems in the East. Future merger

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proposals would likely result in a North American transportation system composed of as few as two transcontinental railroads.

Given this prospect and the service disruptions associated with the most recent round of mergers, when the BNSF and CN rail systems announced their intention to merge in late 1999, the Board issued a 15-month "moratorium" designed to prevent the filing of merger proposals pending the development of new rules.³ Before the moratorium ended, the Board revised its rail merger policy with a view toward more affirmatively enhancing competition, and ensuring that the benefits of a future merger proposal truly outweigh any potential harm. Given that the next round of mergers would put in place the rail network of the future, applicants under the new rules bear a substantially heavier burden in demonstrating that a merger proposal is in the public interest. Key provisions in the rules require applicants to more clearly show that the transaction would promote competition and improve service, and indicate that enhanced intramodal competition would be viewed as a benefit weighing in favor of approval. The rules also direct more accountability for benefits that are claimed and a showing that such benefits could not be realized by means other than a merger. And they require more details up front regarding the service that would be provided, as well as contingency planning and problem resolution in the event of service failures.

Some say that, if the current industry structure warrants conditioning any new merger on the enhancement of competition, then it also ought to warrant across-the-board competition-enhancing actions -- in particular, revision of the competitive access rules and the bottleneck rate challenge procedures -- outside of the merger context. The new merger rules were adopted to address a scenario in which the industry would be moving toward two transcontinental systems. Absent any new major mergers, I believe that it would be difficult to defend actions reversing the longstanding competitive access rules or the more recent bottleneck procedures -- both of which have been judicially affirmed -- essentially to provide for two rail competitors upon request.

Rail Service. The merger integration process over the last few years has produced serious service disruptions. However, after significant efforts on the part of the rail carriers and extensive oversight by the Board, those service problems have been alleviated and rail operations overall are much improved. The performance metrics provided by the carriers show clear improvement, and the Board's Rail Consumer Assistance Program shows a steady decline in service issues brought to us for informal resolution. The 15-month merger moratorium imposed by the Board has ensured that the railroads have focused on running better the businesses that they now have in place without the distraction of more mergers.

Rail Line Construction Cases

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The market, through new construction activities, is directing where new competitive services will be introduced. In addition to the build-outs initiated as a result of the Board's UP/SP merger conditions that I referenced earlier, during the past few years, railroads have pursued several new construction cases. The largest, and most controversial, has been the case involving the application of the Dakota, Minnesota and Eastern Railroad to extend its coal-hauling capability into the Powder River Basin, which the Board approved earlier this year with substantial environmental mitigation conditions, and which is now in court. The Board has also approved, or is in the process of reviewing, several other rail construction cases geared to produce new competition where the market will support it.

While these projects are typically supported by shippers, they are often opposed by local groups with concerns about environmental and community impacts. The Board must balance these concerns against the transportation benefits that the new projects are designed to produce in resolving these matters in a timely and judicially defensible manner.

The Rail Sector Today

The last few years have presented many challenges for the rail sector, and the Board has likewise been challenged. However, I do believe that good progress has been made in meeting these challenges. Service overall is much better and more customer-focused; the railroads are stronger operationally; and there is much more constructive commercial communication among the various segments of the rail sector. And the Board has done its part. It has brought parties together informally to resolve their differences in a way that ensures that rail service is more responsive to the needs of the customers. And it has moved cases before it to resolution as expeditiously and effectively as possible.

Of course, there is always more work to be done. The industry must continue to strive to be a customer-focused industry that can remain a vital part of our Nation's transportation system. And the Board must continue its efforts toward that end, working formally and informally to resolve disputes in a timely and effective manner. While I know concerns still remain, we must work to ensure that the progress that has been made will be sustainable into the future.

LINDA J. MORGAN

Chairman of the Surface Transportation Board

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KCS plugged: Computer change jams system
Bill Stephens

Yards clogged, service plummets after summer switchover

A summer computer system conversion caused congestion and service problems on Kansas City Southern, which by late September was still struggling to return operations to normal.

Although KCS made big strides in cleaning out backlogged traffic in yards over Labor Day weekend, by late September the system had not returned to the fluidity it had before the July 14 cutover to the new computer system.

"I wouldn't want anyone to think we're healed," said Jerry Heavin, KCS senior v.p.-operations. The computer system, which generates work orders and assigns cars, essentially works as designed, he said, but it has taken KCS workers longer than anticipated to get familiar with it.

After the cutover, production at yards and local switching fell to 50 to 75% of normal levels, Heavin said. That quickly plugged most KCS yards, particularly its hub, Deramus Yard in Shreveport, La., and outlying points where industrial switching relies on the computerized work orders.

Said Ed Rastatter, director of policy at the National Industrial Transportation League, "We've heard from a few members who say it's been pretty bad. But they've had good help from company representatives in getting help for their problems."

Shippers reported delays, missing cars, and "pingpong" cars, which depart fully loaded only to return a few days later listed as empties but still containing their original loads.

Congestion peaked during the last week in July, when the average

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terminal delay ranged from 48 to 72 hours and the average time cars spent at some yards nearly doubled.

The congestion plugged KCS' already capacity-constrained main lines, particularly its east-west line linking Dallas-Fort Worth with Meridian, Miss., via Shreveport, which has few sidings. To make something move, KCS began fleeting trains in directionally.

Congestion causes power shortages, so KCS leased 15 locomotives from TFM, giving it more than 430 units. It set up a "war room" in its Customer Service Center to coordinate responses to problems; added crews; built trains to bypass yards; and sent additional trainers to help crews learn the MCS system.-Bill Stephens

---- INDEX REFERENCES ----

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Monday, September 2, 2002

Another Meltdown.
By JOHN GALLAGHER.

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service meltdown on Kansas City Southern Railway is being blamed on the July 14 cutover of a new management control system, with shippers comparing the problem to similar situations occurring during the Union Pacific Railroad-Southern Pacific merger and the Norfolk Southern-CSX takeover of Conrail.

"I think it's worse than the UP meltdown" that occurred in 1997, said a third-party service provider who works with lumber shippers. "UP was a big railroad. They could run those cars up and out, as far away as the Pacific Northwest. KCS is attempting to do the same thing but they don't have the room. They've really got a clamp-down. This is major."

KCS acknowledged that as a result of the cutover from its legacy system to a new management control system, the railroad has slowed. "We have taken a number of steps to improve the situation and are making steady progress," said KCS spokesperson Doniele Kane. "The computer system is working, just as it was designed to work. However, adapting to the discipline that MCS requires is a major business process change for our employees."

As was the case with previous Class 1 railroad control system computer cutovers, having essentially two computer systems in place at the same time has caused KCS customers to experience huge delays on the rail system, particularly at major interchanges such as Kansas City, Mo., Meridian, Miss., and Shreveport, La. "Cars coming out of the Houston area were getting to Shreveport and sitting three or four days on interchange with KCS going east," said Theo Freeman, a rail operations manager at OxyChem, a large chemical shipper. "There's no proper identification. Cars out of location get billed one way but they're not being recognized at interchange."

"The new system isn't recognizing the old system," said George Elking, vice president at Slay Industries. "As a result, a lot of cars are building up, with no place to go."

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Loaded cars with no place to go is alarming to his customers, said the third-party lumber shipper, because lumber, like food perishables, is a time-sensitive product. "When lumber sits in hot, humid weather, it tends to mold up," he said, noting that the economic impact could be devastating to smaller and midsize lumber shippers. "Customers are refusing loads because of mold. That, combined with falling lumber prices, can cause millions of dollars in damages. An International Paper or someone big can suck that up, but small lumber mills have nothing to suck up."

The meltdown has raised the question of the ability of railroads to learn from their competitors' mistakes. The railroads "don't talk to each other. They don't take each other's experiences and profit by them," said OxyChem's Freeman. "It's like raising your children: everyone has to learn through their own mistakes. It's very unfortunate but that seems to be the case. Every railroad feels they know how to do it better than anybody else."

"Any time you implement a computer cutover, you're going to run into that," Elking said, "and I don't know why they don't think it's going to occur. To me it would seem you would gear up operationally to have more people in the field to check on those cars."

KCS conceded that it was not totally prepared for the cutover. Prior to the cutover, "an extensive change management process was put into place," Kane said. "Combined with the learning curve that comes with a change of this magnitude, KCS may have underestimated the depth of the change."

"For whatever reason, whether its monetary or just the difficulty associated with implementation, railroads don't want to run parallel systems" while transitioning from one management system to another, Freeman said. "It bites them in the butt every time. And the shipping public feels the brunt of the failures," he said.

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---- INDEX REFERENCES ----

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MARKET SECTOR: Industrial (IDU)

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KCS





Kansas City Southern is a transportation holding company whose primary subsidiary, The Kansas City Southern Railway Company, is one of seven Class I railroads in the United States. KCS also has investments in Grupo TFM in Mexico and the Panama Canal Railway Company in Panama. The combined North American rail network comprises approximately 6,000 miles of rail lines that link commercial and industrial markets in the United States and Mexico.

Cover Story:

This year's annual report cover is highlighted by a photograph of a painting by Anthony Benton Gude, grandson of Thomas Hart Benton, a well-known Kansas City artist. The work celebrates Kansas City Southern's historic link between the oil fields of the Gulf region and the corn and grain fields of America's heartland. Silhouetted in the clouds is the facial profile of Arthur E. Stilwell, the founder of Kansas City Southern.



Curtis Wright, yard clerk, Shreveport terminal, monitors progress of rail cars at KCSR's main terminal. Having integrated the new MCS computer platform into operations, KCSR's rail terminals are fluid, with railcars moving through the yards faster than before the switchover.

Domestic Operations

Given a North American economy that for the third consecutive year displayed weakness in certain key sectors, Kansas City Southern's (KCS or the Company) 2002 financial performance was reasonably good. For the year, the Company's net income was \$57.2 million, or \$.91 per diluted share, compared to \$30.7 million, or \$.50 per diluted share, for 2001. The increase came primarily from a \$17.3 million increase in equity in earnings from its Mexican railroad affiliate, Grupo TFM, and a \$13.4 million increase in other income, principally from the sale of non-rail property.

Consolidated revenues for 2002 were \$566.2 million, a 3% decline from the previous year. Kansas City Southern Railway (KCSR) entered the year realizing that it had to make up for revenue that would be lost due to a rate reduction that would go into effect for its largest coal customer on January 1, 2002, and the expiration of a contract with a smaller utility at the end of the first quarter. In addition, an automobile contract would terminate in the middle of the second quarter. It was also projected that the impact on train operations from the planned July installation of the Management Control System (MCS), the new computer operating platform, would exert further pressures on revenues at KCSR.

Given these challenges, KCSR's 2002 revenues reflect its success in compensating for lower revenues in a few areas by achieving notable business growth in a number of other commodity groups. First, despite the rate reduction and loss of a customer, the coal group had a significantly better than expected year because of strong carloadings and efficient train operations. In addition, Chemical & Petroleum Products revenues increased 4.7% year-over-year; Paper & Forest Products revenues grew by 4.4%; and, Agriculture & Minerals revenues were up 3.6% over 2001. All ranked among the best performers in the railroad industry.

At \$518.2 million, 2002 consolidated costs and expenses declined \$9.6 million from the previous year. KCSR expenses declined \$6 million, which is especially impressive given the substantial costs that were incurred during the second half of the year that can be attributed to congestion related to the installation of MCS.

KCS also continued to reduce its overall debt level in 2002, a top corporate priority. By year-end, KCS's debt was at \$583 million, compared to \$658 million at the end of 2001, a \$75 million decrease. From September 31, 2001, through year-end 2002, KCS reduced its debt level by \$102 million. These reductions, along with favorable interest rates, lowered the Company's interest expense in 2002 by \$7.8 million. KCS also

strengthened its balance sheet by completing a successful bond offering, the proceeds of which were used to pay down floating rate debt and outstanding equipment trust certificates.

Having navigated through a challenging year, KCS domestic operations appear poised for improvement in 2003. There will be no planned contractual rate reductions, and costs and expenses should be further reduced, especially in the areas affected by MCS installation in 2002. The single major unknown will be the impact of fuel prices, which will be impacted by international conditions. As the three operations performance charts that appear in this year's report illustrate, the KCSR rail system is completely recovered from last year's congestion. The improvements evident at the end of the year have continued into 2003.

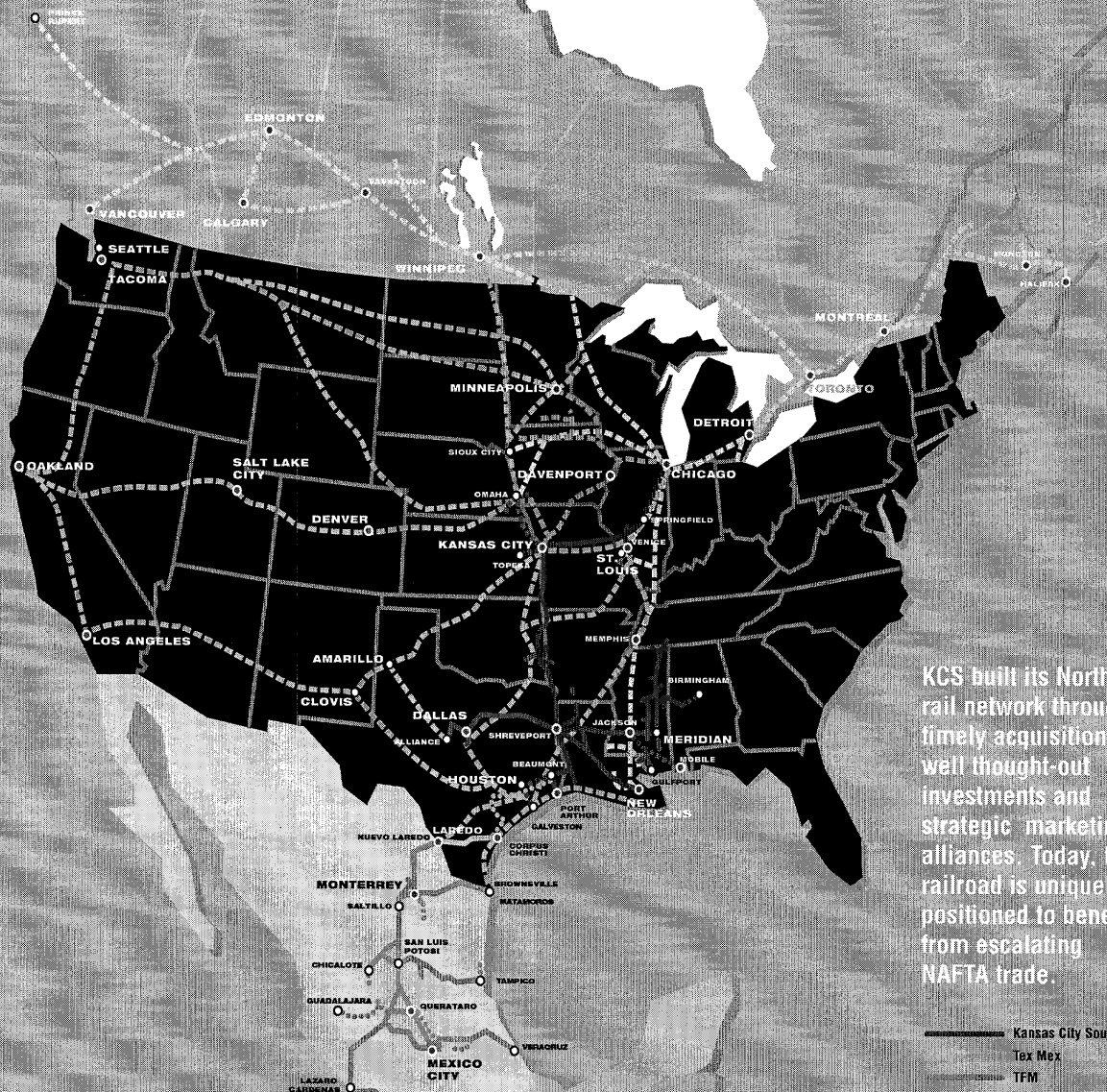
**KCS achieved
revenue growth
within a number
of key
commodity groups.**

Revenues should also improve in a number of areas. If the economy continues to improve, Chemical & Petroleum Products business should strengthen, as should many of the core commodities under the Forest & Paper Products group. Coal revenues will remain solid, and KCSR's domestic grain business, which is almost totally comprised of servicing poultry producers, should remain stable. KCSR also hopes to have some success increasing its export grain market as its traffic to Mexico grows.

In 2002, Intermodal revenues at KCSR suffered because of economic factors, and the MCS-related loss of business and train diversions along the Meridian Speedway. In addition, since 2001, KCSR has endeavored to move to container traffic from trailers, a move that reduces revenue but increases profitability. Intermodal traffic should climb in 2003, as the trains that had been diverted during the second half of 2002 return to the Meridian Speedway, and with the continued growth of business through the haulage agreement with Norfolk Southern (NS). Under the haulage agreement, KCSR bridges traffic between NS at Meridian, Mississippi, and Burlington Northern Santa Fe (BNSF) at Dallas, Texas.

Growth should also come from a new marketing alliance signed with BNSF in April 2002. The new agreement affords KCSR access to new grain originations and expanded Western markets for its chemical and petroleum customers. The two companies are discussing dual use of certain facilities and other means of facilitating service. The alliance with BNSF will complement our successful marketing alliance with Canadian National (CN) that was signed in 1998.

KCSR's transload initiatives have built momentum and will continue to expand its customer base. Transload or reload facilities allow railroads to connect with other transportation or product delivery modes, principally trucks, barges and



KCS built its North-South rail network through timely acquisitions, well thought-out investments and strategic marketing alliances. Today, the railroad is uniquely positioned to benefit from escalating NAFTA trade.

KCS Commodity Mix
(By revenue)

TFM Commodity Mix
(By revenue)

- Kansas City Southern
- Tex Mex
- TFM
- Iowa, Chicago & Eastern
- ANSF
(marketing agreement)
- CN-IC
(chartering agreement)
- Panama Canal Railway Company
- Intermodal Ramp

pipelines. For a company like KCSR, transload can expand markets into areas that are not directly served by rail. KCSR has developed transload facilities in Jackson, Mississippi; Baton Rouge, Louisiana; Spiro, Oklahoma; Dallas, Texas; Sauget, Illinois; and Kansas City, Missouri. In early 2003, KCSR joined in the opening of a new 408-acre transload facility in Beaumont, Texas, called the Triangle Marine Industrial Park. The facility is ideal for the movement of liquid and dry bulk materials, and KCSR will be the sole railway service provider.

There will be challenges in 2003. The economy, while gradually improving, still has pockets of weakness. International uncertainties will undoubtedly impact the rate of recovery as well as influence fuel prices. And, KCS operates within a very competitive industry. Nevertheless, there are very real opportunities for growth within the KCS core domestic system. KCSR operations are again extremely fluid and cost control remains a top goal. The Company believes it has the potential of achieving a rate of growth higher than that projected for the national economy.

International Operations

TFM

Revenues for Grupo TFM in 2002 were \$712.1 million, inclusive of Mexrail. KCS's equity in earnings contribution from Grupo TFM increased \$17.3 million to \$45.8 million, and its 2002 earnings per share contribution was \$.46 compared to \$.18 for the prior year.

While feeling the impact of the North American economy, Grupo TFM fared better than most of its U.S. railroad peers. Notable

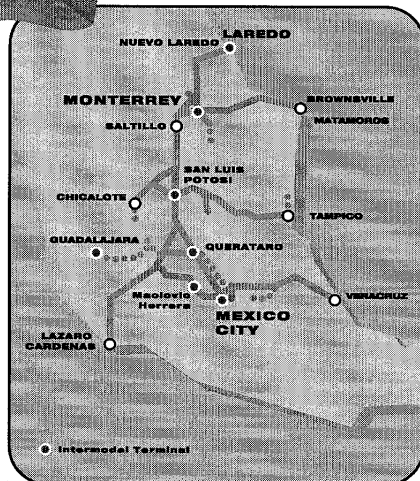
during the year was the heightened pace of truck-to-rail conversion within Mexico. During the first few years of operation, the rate of growth of TFM's intermodal business was limited by a lack of infrastructure. TFM has resolved that problem by developing a network of intermodal facilities throughout its service territory. With the infrastructure in place, not only will TFM be price competitive, but Mexico's lack of an integrated, well-maintained highway system makes rail an appealing alternative to truck service. Intermodal and conversion from truck-to-rail traffic is poised for double-digit growth in 2003.

2002 TFM Highlights

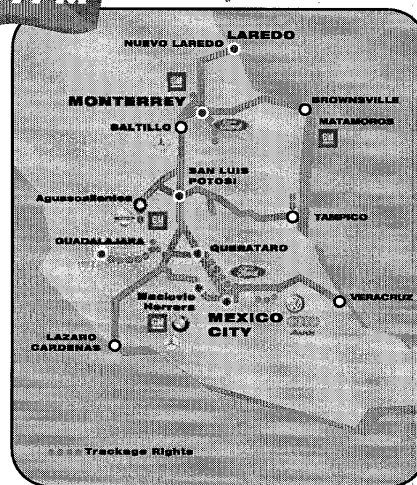
In March 2002, TFM acquired Mexrail, the holding company of the Tex Mex Railway and the northern half of the international bridge at Laredo, from KCS and Grupo TMM. KCS received approximately \$31.4 million for its 49% interest in Mexrail, which it used to reduce corporate debt. The Company retains indirect ownership of Mexrail through its ownership of Grupo TFM.

In July, KCS and Grupo TMM exercised their call option on the Mexican government's 24.6% ownership of Grupo TFM. The Mexican government's ownership interest was purchased by TFM for a price of \$256.1 million. The acquisition was completed utilizing a combination of proceeds from an offering of debt securities by TFM, a credit for the reversion of certain rail facilities, and other resources. This transaction resulted in an increase of the Company's ownership percentage of Grupo TFM from 36.9% to 46.6%.

TFM TFM Intermodal Terminals



TFM Finished Vehicle Assembly Plants





In late September 2002, a three-judge panel of the Court of the First Circuit in Mexico City (Circuit Court) issued a positive ruling in the lawsuit that Grupo TFM had brought against the Mexican government seeking a Value Added Tax (VAT) refund. Grupo TFM had argued that the VAT refund had been unconstitutionally denied to TFM. The three-judge panel remanded the case to the Federal Tribunal of Fiscal and Administrative Justice (Fiscal Court) with instructions to vacate its prior decision and issue a new ruling consistent with its directives. However, the Fiscal Court subsequently issued a ruling that again denied TFM the right to receive a VAT refund from the Mexican government. Grupo TFM has appealed this decision and the case is pending before the Circuit Court. KCS and Grupo TMM believe that Grupo TFM will prevail on this issue, however neither a timetable for the resolution nor the form of any final award can be projected at this time.

On October 31, 2003, the Mexican government has the right to sell the remaining portion of its ownership of TFM. It is anticipated that the responsibility for the acquisition of the remaining portion will fall to the partners, KCS and Grupo TMM. KCS has stated that it is prepared to purchase its additional share, which would bring the Company's ownership of TFM to 49%.

While the sluggish North American economy has resulted in a slowdown in the rate of NAFTA traffic from the double-digit growth in the late 1990s, economic activity along the north-south axis continues to grow at a rate faster than on the east-west U.S. corridor. Cross border traffic between KCSR and TFM grew by 18% in 2002, the best year since 1998. Traffic levels using the combined KCSR and TFM rail network should continue to grow at a significant rate as the two railroads further integrate marketing and operating strategies.

In 2002, as has been the case in every year since its commercial start-up in 1997, TFM's performance has increased both its financial and strategic value to KCS. Moreover, TFM's full growth potential has not come close to being realized. Even with the growth that has occurred over the last five years, the Mexican rail system only moves about 15% of that nation's freight tonnage compared to the near 40% that U.S. railroads move domestically. TFM has the infrastructure to substantially increase its percentage of the Mexican market. This intra-Mexican growth, coupled with the ever increasing significance of NAFTA trade to the United States, Canada and Mexico, virtually ensures that TFM will continue to be one of the fastest growing railroads in North America throughout the decade.

The Panama Canal Railway Company

This past year marked the first full year of both passenger and freight operations of the Panama Canal Railway (PCRC). PCRC's passenger operations are conducted through its wholly owned subsidiary Panarail Tourism Company. Commuter service

between Panama City and Colon has thrived from the first day of operations in July 2001. In addition to the commuter service, PCRC provides luxury train excursions for cruise ship passengers. The PCRC train trip was awarded the "best excursion of the year" award for 2001-02 by Princess Cruises. In all, the PCRC conducted 81 trips in 2002, with over 100 already scheduled for 2003.

Ultimately, the major source of PCRC's profitability will come from its freight operations, which began late in 2001. In 2002, PCRC's freight operations moved 17,500 containers, and will likely double that number in 2003. Business development will increase dramatically upon the completion of the facilities expansion at the Port of Balboa on the Pacific Ocean. The first phase of the expansion will be completed in late 2003, and the second and final phase is scheduled for completion for the second half of 2004. The expansion will more than double the capacity of the port and greatly enhance the PCRC's potential customer base.

Panama is developing into the distribution hub of the Americas both for goods moving from Asia to the Americas, and for goods moving from North America to South America. Increasingly, Asian shippers are using Panama for staging goods moving to the United States, Caribbean, and South America, and North American retailers are finding Panama the perfect distribution point for the goods moving to South America. As the Panama Canal infrastructure expands, the PCRC is being incorporated into the total logistics network and has been accepted as an important supplement to marine operations. By mid-decade, the PCRC's vast freight service potential will begin to be realized.

Providing the Right People The Right Resource – the Development of MCS

Change is by no means a rarity at KCS. The Company's ability to react quickly and opportunistically has been one of its principal strengths for over 100 years. In the 1990s, while one railroad mega-merger followed immediately on the heels of another, KCS management redirected its long-term growth strategy to take advantage of NAFTA. In the 1990s KCSR also invested over \$200 million into upgrading its east-west Meridian Speedway corridor, perceiving that it would become the most efficient rail route between the Southeast and Southwest. And, late in the decade, KCSR ushered in a new era of railroad marketing alliances that provided many of the benefits of consolidation without the attendant risks and costs. All these changes necessitated a nimble and motivated workforce willing to quickly move in new directions and think beyond conventional boundaries.



Wardell Jarrell, conductor, uses a BELTPACK unit to switch cars in the Baton Rouge yard. A single person on the ground using a remote control BELTPACK can direct the switching activities of a yard locomotive. BELTPACK, which is being used at KCSB's primary terminals, increases productivity, reduces expenses, and has an excellent record of reliability.

As sweeping as these changes were, they did not require a dramatic change in KCSR employees' day-to-day work functions. However, indicative of the pervasive effect of technology on contemporary business, the installation of the new computer operating platform in July 2002 did require significant changes to both work practices and the corporate culture at KCSR.

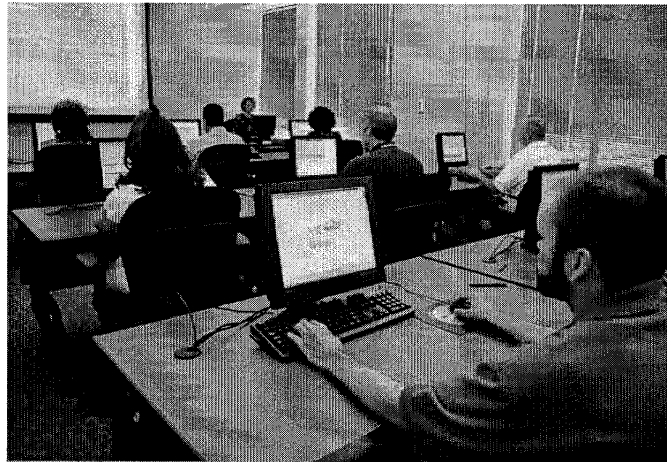
KCSR was one of the very first railroads to embrace computer technology. In fact, KCS was so advanced in the 1960s, the Company's software used for managing train operations became the basis for the back office computer software still used by much of the mutual fund industry. The primary function of KCSR's original Legacy system was, however, to get trains across the rail network in an orderly manner. It served as a tool to help with dispatch, crew scheduling, and, to an extent, system scheduling. It remained state-of-the art until the 1980s.

In the 1980s, the railroad business changed dramatically in the wake of the Staggers Act, which deregulated the industry and led to real market-based competition. As railroads faced heightened competition both within the industry and from trucks, the focus shifted from a preoccupation with charting the progress of the trains themselves to providing better customer service information.

Computer technology quickly began to mirror this attitudinal change. Instead of just managing trains, the newer software began to chart individual customer shipments. The philosophy behind this shift was based on the realization that customers do not particularly care about what trains their shipments are on, but whether the shipments will arrive within the timeframe promised. Customers also want to be able to follow the progress of their shipments from origination to destination.

KCSR's system could not efficiently provide this type of information. Meanwhile, KCSR's rail competitors were investing heavily in more sophisticated technology that was more customer information-friendly. By the 1990s, KCSR found itself following the pack in this important area.

Management determined that to remain competitively viable, KCSR had to have a new computer operating platform that addressed the expanded needs and expectations of customers and employees. It was clear that KCSR's existing Legacy system had reached its limit of possible modification – it simply was not robust enough to provide the kind of information that was needed. In addition, an internal task force concluded that it would be neither financially nor operationally practical to attempt to adapt another railroad's computer system to meet KCSR's specific requirements.



KCSR's employees have undergone extensive training on the new Management Control System (MCS). The state-of-the-art computer operating system will benefit customers through its ability to provide real-time shipment status reports. MCS will also provide expanded data to enhance train operation efficiencies and system-wide productivity.

In 1997, management gave the green light to the creation of a totally new system that would not only provide KCSR and its customers all the resources needed, but also would be specially designed for a moderately sized railroad.

MCS was designed over a five-year period. More than 27 million lines of code were written. In 2000, the system got its shakedown cruise when it was installed on KCSR's Gateway Western segment that runs from Kansas City, Missouri to East St. Louis and Springfield, Illinois. Design changes were made after this test installation and employee training on the new system intensified.

On July 14, 2002, the entire KCSR core railroad switched over to the new system. As expected, the implementation proved disruptive as management and employees sought to gain a comfort level with the new software. Throughout the Summer and Fall, a number of trains were delayed and areas of congestion persisted, especially along KCSR's east-west corridor. During the period, some traffic was diverted and revenue was lost. In addition, expenses were higher during the

third and fourth quarters due to the use of additional crews and equipment. By late October, the system began to improve and, by year-end, service had returned to normal levels.

Even while working through the implementation process, the multiple benefits of MCS began to be felt. Comprehensive railroad operations and information systems, automated shipment management, improved car velocity and train operations, recovery of revenues, and a high level of control in operations while simultaneously generating accurate data for implementing operations improvements – all of these began to be demonstrated even during the transitional phase.

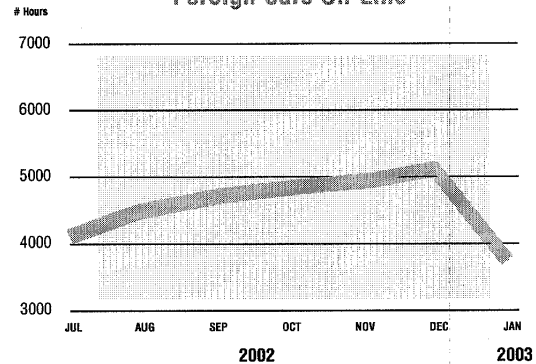
Of equal importance, even while they themselves grappled with the system change, KCSR's customers realized that MCS was providing new and better shipment data. Also, MCS provided easier and more efficient access to on-line services. With the system up and running, KCSR had, within a couple of months, moved from the back of the line to having one of the best computer operating systems in the railroad industry.

The process was by no means easy. Work habits gained over many years of experience had to be modified because of the demands of the new system. In many cases these changes required significant adjustments in the way employees viewed their jobs and their responsibilities. There was a learning curve as employees not only had to operate the new system, but also come to understand its importance to the future of their railroad. That this was all accomplished in less than six months is a testament to the commitment and resourcefulness of KCSR's employee base.

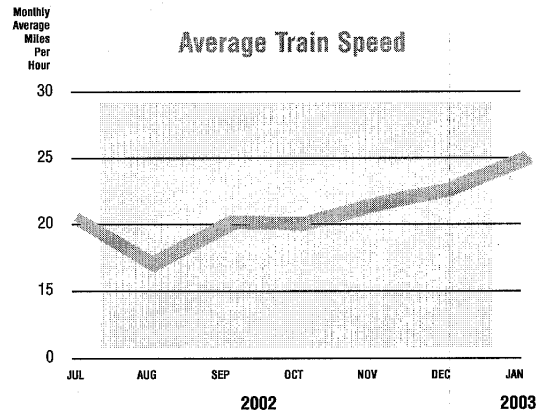
MCS was not the only new productivity enhancing resource provided to KCSR employees during the year. BELTPAK, a remote control device that allows a single employee on the ground to direct the switching activities of a locomotive, is now being used in all of KCSR's main terminals. And, the new corporate office located in Kansas City, Missouri, opened providing headquarter employees a functionally improved facility in which to work.

The pace of change is not going to slow down either for KCS or its 2700 employees. That's the price that must be paid to deliver innovative services to its customers, to remain competitive with other Class I railroads, and to perform as a profitable investment to its shareholders. KCS management is committed to investing in the technology and other resources necessary to assure that it maintains its ability to react decisively and effectively when presented with growth opportunities.

Foreign Cars On-Line



Average Train Speed



Total Cars Online

Average Daily System, Private & Foreign Cars On-Line

