



**U.S. Department of
Transportation**

Office of the Secretary
of Transportation

ORIGINAL

GENERAL COUNSEL

400 Seventh St., S.W.
Washington, D.C. 20590

208814

September 2, 2003



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

Re: Finance Docket No. 34342

Dear Secretary Williams:

Enclosed please find the original and twenty-five copies of the Reply Comments of the United States Department of Transportation (DOT-4) in the above-referenced proceeding. I have included a computer diskette containing the above document in WordPerfect, and an additional copy that I request be date-stamped and returned to the messenger delivering these materials.

Thank you for your assistance in this matter.

Respectfully submitted,

Paul Samuel Smith
Senior Trial Attorney
(202) 366-9280

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Enclosures

cc: Parties of Record

ORIGINAL

DOT-4

Before the
Surface Transportation Board
Washington, D.C.



_____)
Kansas City Southern -- Control -- The Kansas City)
Southern Railway Company, Gateway Eastern)
Railway Company, and The Texas Mexican)
Railway Company)
_____)

Finance Docket No. 34342

Reply Comments of the
United States Department of Transportation

ENTERED
Office of Proceedings

SEP 02 2003

Part of
Public Record

Introduction

The Surface Transportation Board ("Board" or "STB") in this proceeding is considering whether to approve the application of the Kansas City Southern Railway Company and related entities (collectively referred to herein as "KCS") to acquire control of the Texas Mexican Railway Company ("Tex Mex"). The combination of these two carriers, together with KCS's potential acquisition of a major Mexican railroad (TFM, S.A. de C.V. ("TFM")), would form a coordinated international rail system called NAFTA Rail.¹ The Board has recognized that this latter transaction could have important implications for competition within the United States and has determined to examine this issue.

¹/ KCS and Tex Mex are referred to herein collectively as "Applicants." The first transaction above is referred to herein as the "Tex Mex transaction" and the second as the "TFM transaction." The details of all the relevant corporate relationships and the complicated series of interrelated transactions among the corporations involved are summarized in Decision No. 2 (served June 9, 2003) at 3-7.

The United States Department of Transportation (“Department” or “DOT”) believes that both the Tex Mex and TFM transactions present, in the abstract, classic end-to-end combinations. The record is replete with arguments and evidence about the competitive implications of such combinations, which focus on issues of vertical foreclosure. Traditionally, in these circumstances competitors may be harmed by the loss of a neutral connection but competition is not; consequently, relief has not generally been granted. Standards applicable to mergers of Class I railroads, however, now require that major gateways at which such connections take place continue to remain “open” to other carriers. These standards do not in the first instance apply to KCS, but the STB may decide otherwise in a given case.²

DOT has considered at some length whether the central factor in this case -- competition through the pivotal rail gateway between the U.S. and Mexico at Laredo, Texas -- warrants the application of this new standard. We have concluded that, assuming the TFM transaction takes place, the Board should strive to the extent its authority allows to require the Applicants to maintain an open gateway. We recognize that there are limits to the STB’s jurisdiction over certain aspects of international rail transportation, but the Applicants have made commitments that (although they require clarification) may approach the new standard’s requirements in some significant respects. In these circumstances the Board should as a first step require the Applicants to clarify and honor their commitments. The Board should also establish an oversight period both to enforce that condition and to entertain evidence of merger-related harm. An

^{2/} This open gateways obligation generally applies only to combinations of Class I railroads. Major Rail Consolidation Procedures, Ex Parte No. 582 (Sub-No. 1), (served June 11, 2001) (“New Merger Standards”); 49 C.F.R. § 1180.0(b). Were TFM a U.S. carrier it would be a Class I railroad. Decision No. 2 at 10. KCS has a unique “waiver” from these standards, although in any given case the Board may be “persuaded” to apply the new rules to KCS. New Merger Standards at 15-16.

evaluation of the facts and applicable law in each case would determine whether mitigation was warranted and available.

Safety

The Department also wishes to update the record on the safety aspects of this proceeding. Previously we had informed the Board that significant additional work on the Safety Integration Plan was required in order to complete the necessary planning and resource commitments, but that the Applicants continued to cooperate with the Federal Railroad Administration ("FRA") in this regard. DOT-2 at 5-6. DOT is pleased to report that this remains the case and progress is evident. We anticipate that this close cooperation will continue until all outstanding issues are addressed. FRA will of course work closely with the Applicants to ensure a safe implementation of any approval that is granted. FRA will also inform the STB of appropriate developments.

Legal Standards

Applicable federal law requires the Board to approve the common control of KCS and Tex Mex unless

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

49 U.S.C. § 11324(d).

The Board has deemed the Tex Mex transaction a "minor" one, which reduces the evidentiary burden upon the proponents generally. *See* 49 C.F.R. § 1180.6(a), (c). The STB also

appreciates the reality that the Tex Mex and TFM transactions “are two components of a single, large transaction with broader potential implications” for competition in the U.S. Decision No. 2 at 11. The Board accordingly required the Applicants to submit “full system” competitive analyses and operating plans of all of NAFTA Rail. *Id.*³

The Record

NAFTA Rail

KCS is a Class I railroad that owns or operates approximately 3,100 miles of track in a mostly north-south configuration through the Midwest and South. Its principal lines extend from Kansas City via Shreveport, Louisiana, to New Orleans, east to Alabama, and west to Dallas, and Port Arthur/Beaumont, Texas. KCS-3/TM-3 at 18-19, 36. The Tex Mex is a Class II railroad that owns and operates 157 miles of track between Laredo and Corpus Christi, Texas. KCS-3/TM-3 at 18. It also operates over trackage rights on the Union Pacific railroad (“UP”) to connect with KCS at Beaumont, Texas. Tex Mex is wholly owned by Mexrail, a noncarrier whose other asset is the U.S. portion of the International Railroad Bridge at Laredo that crosses into Mexico. *Id.* at 10, note 1.

TFM is a large railroad located entirely within Mexico. KCS-10/TM-10 at 22 note 15. It operates to Matamoros and Nuevo Laredo, on the U.S./Mexican border, and then south to Mexico City; it also reaches to Veracruz and Tampico, on the Gulf of Mexico, and to Lazaro Cardenas on the Pacific Ocean. KCS-10/TM-10, Exhibit 1. KCS and Grupo TMM (a Mexican company) purchased 80 percent of TFM from the Government of Mexico in 1996. KCS-10/TM-

³/ Parties have objected to the adequacy of that submission, KCS-10/TM-10. UP-4; CN-3.

10 at 8.⁴ At the conclusion of a complicated series of transactions, this portion of TFM would be wholly owned by NAFTA Rail. *See* KCS-3/TM-3 at 14.

The Applicants contend that their transactions would advance the public interest in numerous ways. They urge that the result would be a seamless, financially stronger North American rail system that would introduce greater operating efficiencies and extend single line service to new markets, thereby enhancing intramodal and intermodal competition. KCS-3/TM-3 at 17-18, 23, 28, 30 and Verified Statement (“VS”) of Michael Haverty at 61-65, and VS of Curtis M. Grimm at 82; KCS-10/TM-10 at 8-19, and VS of Gerald K. Davies at 3-13, and Supplemental VS (“SVS”) of Grimm at 2.

The Applicants stress that both the Tex Mex transaction and the TFM transaction are entirely “end-to-end” in nature, that the three carriers interchange traffic and connect at only Beaumont and Laredo, and that no shipper would lose competitive rail service or access to routing options. KCS-3/TM-3, VS Grimm at 77-81; KCS-10/TM-10, at 10-19, and SVS Grimm at 2-3. They point out that KCS has owned significant equity interests in both Tex Mex and TFM for some time, and that the carriers have coordinated their operations to a significant extent already. KCS-3/TM-3 at 12-14, VS Haverty at 58; KCS-10/TM-10 at 7, 31, SVS Grimm at 2-3 and VS Davies at 16-18. Shippers, shipper representatives, and government agencies have agreed with the Applicants and support the formation of NAFTA Rail. *See* Comments of E.I. DuPont de Nemours and Co., DUPX-1 at 6-8; Port of Houston Authority, PHA-1 at 3; U.S.

⁴/ The Mexican government continues to own the remaining 20 percent of TFM, although it may sell that portion in the near future.

Department of Agriculture at 2; and National Industrial Transportation League (“NITL”), NITL-3 at 5-6.

Opposition to the Transactions

The most intense opposition in this proceeding has concerned the TFM transaction. The focus of most of this opposition is on Laredo, the primary rail crossing between the U.S. and Mexico. All the major Class I railroads in North America, and a few shippers, have asserted that the inclusion of TFM within the NAFTA Rail system will enable KCS, as the controlling entity of NAFTA Rail, to “close” the Laredo gateway to unaffiliated carriers. This encompasses both physical closure -- by discriminating against the handling of other trains at the International Bridge -- and economic closure -- by manipulating divisions or rate factors to the disadvantage of other railroads. *See* Comments of Burlington Northern and Santa Fe Railway Company (“BN”), BNSF-4 at 8-9, 11-12, 21-23; Union Pacific Railroad Company (“UP”), UP-7A at 6-11; Canadian Pacific Railway Company (“CP”), CPR-3 at 3-8; Norfolk Southern Railway Company (“NS”), NS-2 at 5-7; Pacer International, Inc. (“PI”), PI-4 at 11-15; CSX Transportation Company (“CSX”), CSX-2 at 1-5; Canadian National Railway Company (“CN”), CN-6 at 3; and AK Steel (nondenominated letter dated July 25).

These parties overwhelmingly ask the Board to require the Applicants to maintain Laredo as an “open” gateway, with nondiscriminatory handling and commercially fair and reasonable rate and service terms. *Id.* Many also urge the STB to impose an oversight condition. *See* PI-4 at 18; NS-2 at 6; CSX-2 at 7; and CN-6 at 3.

BN has also identified a problem at Robstown, Texas. BN claims that it was given access to Robstown in Finance Docket No. 32760 (the merger of the Southern Pacific (“SP”) and UP railroads (“UP/SP”)) in order to connect with the Tex Mex, and so provide competition to the UP for traffic flowing through Laredo. 1 S.T.B. 233, 409-10, 421-26 (1996). BN now believes that the Tex Mex transaction will enable KCS to force the exchange of such traffic to take place at Kansas City. Competition would suffer in this event, BN argues, because KCS routes are assertedly less efficient, and because KCS’s smaller system cannot provide the breadth of competition demanded by the Board in its UP/SP decision. BNSF-4 at 3-4, 12-16.

The Applicants view concerns about the Laredo gateway as unfounded. They point to the much larger size of UP (the other U.S. railroad at Laredo), its domination of rail traffic there, its continuing importance to the carriers that would comprise NAFTA Rail, and to their own pledge to observe the terms of existing agreements with other railroads. KCS-10/TM-10 at 22, 24-27, and VS of Davies at 5-16.⁵

Applicants’ Commitments

The Applicants have made a number of commitments on the record. As noted, they have represented that they will honor existing contractual agreements with other railroads. KCS-10/TM-10 at 24-27, and VS of Davies at 14. These include commitments to abide by the terms of intercarrier agreements governing operations on the International Rail Bridge at Laredo, and to continue to cooperate in good faith toward efficient use of the Bridge. KCS-3/TM-3 at 27; KCS-10/TM-10 at 24-27; UP-7A, Exhibit 2 (letter from KCS counsel dated July 21, 2003). The

⁵/ They also stress pervasive intermodal competition. KCS-10/TM-10 at 13-19. Other parties dispute the effectiveness of this competition. See UP-7A at 10, 71-74; BNSF-4 at 17, note 10.

Applicants have also promised “to keep the Laredo gateway open on commercially reasonable terms,” (KCS-10/TM-10 at 24) and to “require TFM to cooperate” with UP and BN on logistical arrangements in Mexico and on “providing excellent service.” UP-7A, Exhibit 2; *see also* KCS-10/TM-10 at 24-27.⁶

The settlement agreement with the NITL contains undertakings entered into by Applicants for the protection of shippers. NITL-3, Attachment 1. The Applicants have committed therein “to establish and maintain commercially reasonable ... rates and charges over any existing interchange,” to honor existing rates or rate factors, to “negotiate in good faith to establish commercially reasonable rates going forward,” and to arbitrate disputes over these matters insofar as they apply “in whole or in part within the U.S.” *Id.* at § 2.⁷ The Applicants have also pledged to maintain service levels between Laredo and Beaumont, Texas, and to devise a “corrective action plan” in the event of service deterioration. *Id.* at § 4.

DISCUSSION

Prospects for the TFM Transaction

The Board has recognized that the TFM transaction “could be very significant” and that “the role played by TFM in the U.S.-Mexico NAFTA corridor cannot be ignored.” Decision No. 2 at 10. Now, however, it appears that KCS may not be able to proceed with that transaction: Published reports indicate that TFM shareholders have voted not to accept the KCS purchase

^{6/} Consistent with their view that the Board has no jurisdiction over TFM, the Applicants maintain that commitments related to that carrier and agreements it may enter into “would have to remain a matter of contract.” UP-7A, Exhibit 2.

^{7/} With respect to matters within Mexico, Mexican government requirements would apply. *Id.* at § 6.

offer.⁸ KCS subsequently announced its intention to pursue all possible avenues to complete this transaction, but there can be no assurance of success.

In these circumstances the Department believes it is still appropriate to submit our views of the proper decision with respect to the two transactions originally envisioned. The record has been developed with respect to both, and it is possible that KCS may be successful in gaining control of TFM in the near future. We believe it the better course for us to share our views with the Board in the event it should wish to consider the implications of what is now only a potential TFM transaction.⁹

The Department's Assessment of Competition

The proposed acquisition of the Tex Mex by KCS, in itself, is a rather simple merger that the Board has already ruled qualifies as a minor transaction. That consolidation raises two issues with respect to competition: BN trackage rights to Robstown and Brownsville over UP lines, and control of rail operations over the International Rail Bridge at Laredo. Subject to the conditions discussed below with respect to these issues (as well as holding the Applicants to their representations), DOT believes that this transaction warrants approval.

However, it is the potential follow-on KCS acquisition of the TFM that has introduced complexity to the proceeding and has raised the concern of a large number of carriers and shippers that competition will be reduced over the Laredo gateway. That concern focuses on the

^{8/} Technically, Grupo TMM (a Mexican conglomerate) owns the portion of TFM that KCS wishes to acquire, and it is the shareholders of Grupo TMM that have apparently rejected KCS's offer.

^{9/} On the day this filing was due, DOT also learned of published reports indicating that Grupo TMM was making an effort to buy back from KCS a controlling interest in Tex Mex.

ability of a consolidated NAFTA Rail entity to physically and economically “close” the important Laredo rail gateway connecting the U.S. and Mexico. The Board has made clear it shares that concern, ordering Applicants to submit supplementary information on the implications of the TFM transaction for competition in the U.S., and stating that “the broader transaction incorporating the related KCS/TFM could be very significant,” and that “the role played by TFM in the U.S.-Mexico NAFTA corridor cannot be ignored.” Decision No. 2 at 10. The Department’s only concern with the TFM transaction is the prospect for closure of the Laredo gateway. Holding the Applicants to their commitments on this issue and establishment of an oversight proceeding is consistent with Board precedent and should help to mitigate any adverse effects.

A. The Laredo Gateway

Consistent with its perception of the Board’s intent, the Department has reviewed the acquisitions of Tex Mex and TFM by KCS for their effects on competition (as opposed to their effects on competitors) as if these carriers were operating entirely within the U.S. and subject in all respects to the Board’s jurisdiction.

The first, obvious, determination of that review is that the formation of NAFTA Rail through these two transactions is a classic end-to-end combination. Such consolidations have traditionally been found to raise few, if any, competitive problems, but also to provide relatively few public benefits -- largely the elimination of some transactions costs and the creation of (unquantifiable) single line service for shippers. *See, e.g.*, Finance Docket No. 33388 (STB

served July 23, 1998) ("Conrail Acquisition Case") at 50. That appears to be the case with NAFTA Rail as well.

However, many parties to the proceeding (most prominently UP) disagree, maintaining that KCS's acquisitions of the Tex Mex and TFM will allow a combined NAFTA Rail to gain market power to "close" the Laredo gateway to competitors operating in the U.S. They fear that NAFTA Rail will resort to rate and service discrimination at Laredo to divert traffic from UP to less efficient KCS/Tex Mex routings. Ultimately, these parties maintain that NAFTA Rail would reduce competition by raising rates to shippers in the U.S. and Mexico, and by degrading service that could be offered by UP at Laredo. UP-7B, VS of John Gray, at 23-24; CN-6, VS of Christopher A. Vellturo at 3-4; BNSF-4 VS of Peter J. Rickershauser at 11; PI-4 at 12-15.

Evaluation of the projected closure of Laredo would be straightforward if, indeed, a merger of U.S. Class I Railroads were under consideration. Under the Board's new merger guidelines a consolidated NAFTA Rail controlling the major rail connection between the U.S. and Mexico would be required to maintain an economically and physically "open" Laredo gateway -- and proffer an enhancement to competition, as well. 49 C.F.R. § 1180.1(c)(2)(iv). As noted, however, the Board has granted KCS an exception to the new guidelines as an initial matter, subject to revocation. New Merger Standards at 15 ("for a merger proposal involving KCS and another Class I Railroad, we will waive the new rules and apply the rules previously in effect unless we are persuaded otherwise") (emphasis added). For purposes of the DOT analysis here, which treats the KCS's combination with TFM as a merger of U.S. Class I railroads, the Board's waiver would require application of the previous rules, which mandated only that pre-merger competition not be reduced.

Under those rules, the threat of Laredo gateway closure would be considered an issue of vertical foreclosure.¹⁰ The Board, and the Interstate Commerce Commission (“ICC”) before it, established precedent addressing this issue beginning almost twenty years ago. The ICC’s decision approving the rail merger that created the present-day BN discusses the development of this precedent most thoroughly. Finance Docket No. 32549 (ICC served September 21, 1995) (“BN/SF”), at 70-78. In the cases noted therein and in subsequent proceedings the agency consistently found that there would be no reduction in competition caused by vertical foreclosure. *Id.*; *see also* Conrail Acquisition Case at 60-61, 69; Finance Docket No. 34178 (STB served February 3, 2003) (DM&E/IC&E) at 16.

The ICC’s decision in BN/SF explained the basis for these findings in terms of the “one lump” theory. That theory holds that in a “bottleneck” situation (that portion of a rail movement for which no alternative rail route is available) the incumbent bottleneck railroad has market power over all movements over the bottleneck segment and will extract the maximum profit the market will bear from shippers (in the through rate) and from connecting railroads (in rate divisions). The combination of the bottleneck carrier with another railroad may change the corporate entity exercising that power, but does not reduce or enhance the power itself. BN/SF at 72-78.

In the instant case, TFM, as the only railroad in Mexico serving Laredo, is currently the bottleneck carrier. It therefore already holds the market power to extract the maximum profit

^{10/} Vertical foreclosure as used here occurs when a carrier that previously cooperated with a connecting railroad to move traffic merges with another carrier, and their combined route structure now allows the merged railroads to carry that traffic either on its entire journey or for a longer portion of that journey. Post-merger, the combined railroad prefers its own route to that of the carrier with which it previously offered joint line service.

from shippers and from all railroads connecting to it at Laredo. The acquisition of TFM by KCS/Tex Mex does not change that basic situation, it merely shifts the market power organizationally to NAFTA Rail. Since the “one lump” presumption is that maximum profit is already being extracted, it follows that market forces will not permit rates to be raised post-merger. Competition, therefore, will not be reduced by the merger. If, as UP claims (UP-7B, VS Gray at 23-24 and VS of Jerry A. Hausman at 12), rates have not been established as high as they could be, that merely attests to incomplete information on the part of TFM, and has no bearing on the question of its market power to raise rates to those levels. BN/SF at 74; Conrail Acquisition Case at 69.

Moreover, the above precedent also instructs that it is logical from a profit maximization standpoint for a vertically integrated railroad such as NAFTA Rail not to “foreclose” unaffiliated railroads, UP in this case, from participating in more efficient routings to and from points in the U.S. KCS/NAFTA Rail would have an incentive, instead, to use a more efficient joint line routing to increase its profits, and the Board has so found. See BN/SF at 71-74 and cases cited therein; Conrail Acquisition Case at 60-61.

The Department supported application of the “one lump” theory in the BN/SF case and in subsequent merger proceedings. We continue to believe that the theory is valid with regard to the effects on competition of the prospective acquisition of TFM, and by extension to potential vertical foreclosure issues in the Tex Mex transaction.

Nevertheless, DOT believes that control of the Laredo gateway is a unique issue and that, the neutral competitive effects of vertical foreclosure notwithstanding, the Board should takes

steps available to it to assure that the gateway remains physically and economically open.¹¹ Laredo is a major gateway of particular importance. In its UP/SP decision the Board reaffirmed a finding made by the ICC in 1986 in Finance Docket No. 30400 (the SP/SF merger case) that “Laredo clearly occupied a position of separate and surpassing economic significance.” 1 STB at 422. Since then Laredo has become even more significant as the primary rail gateway for burgeoning NAFTA trade with Mexico. That growth trend is expected to continue for the foreseeable future.

Moreover, the Board has recognized its role in promoting NAFTA trade policy, remarking that it is sensitive to its responsibility to foster the goal of North American economic integration embodied in the NAFTA agreement. 1 STB at 421. In part, the Board awarded BN trackage rights connecting with Tex Mex in the UP/SP decision in order to ensure competitive transportation options at Laredo for NAFTA trade, agreeing with the U.S. Department of Agriculture that “affordable rail rates and access to service are critical.” *Id.* There is thus a strong, established national policy argument for assuring that Laredo remains an open gateway.

Additionally, in adopting the new merger guidelines, the Board noted that it “does not favor consolidations that reduce the transportation alternatives available to shippers unless there are substantial and demonstrable public benefits to the transaction.” New Merger Standards at 14. That policy was prompted by the present environment of U.S. railroading, where the number of major railroads, and therefore shipper transportation alternatives, has been greatly reduced, and may further decline if additional major mergers are approved.

^{11/} If only the Tex Mex transaction takes place, a combined Tex Mex/KCS cannot itself effect such control of Laredo. In that event, DOT urges the STB to take remedial action only with respect to the International Rail Bridge and BN trackage rights issues, as discussed *infra*.

Finally, in that same proceeding the Board determined that future Class I merger applicants would have to keep open major gateways largely because the rail industry had already closed most all inefficient gateways. New Merger Standards at 25. The extent of the rationalization process has thus left little or no private savings or public benefit to be gained by additional closures of major gateways like Laredo.

As noted above, DOT considers that the pending transactions, particularly the possible acquisition of TFM, amount to classic end-to-end mergers, and as such they predictably will provide few demonstrable public benefits, in terms of resource savings. *See* KCS-3/TM-3, VS of Haverty at 61. On that basis alone we believe the transactions would fail to justify reducing shipper transportation alternatives at Laredo. Taken together with the U.S. commitment under NAFTA to ensure the smooth flow of international trade across the borders with Mexico and Canada and the lack of any efficiencies lost to the NAFTA Rail carriers from keeping open this gateway, we urge the Board to require the Applicants to maintain a physically and economically open gateway at Laredo to the extent the Board's jurisdiction allows.

The Board has more than one means to accomplish this. It could be "persuaded" that the waiver to the new merger rules granted KCS should not apply in this case -- at least insofar as major gateways are concerned. Alternatively, even if the Board decides to observe KCS's waiver and applies previous merger rules generally, it could nonetheless find that an exception to its vertical foreclosure precedent is merited. Such exceptions to the vertical foreclosure logic have been made in recent mergers in similar circumstances. We discuss these cases below.

Pages 18-19, *infra*.

B. BN at Robstown and Brownsville

BN points to the diversion analysis performed by KCS and asserts that, after the Tex Mex transaction, KCS intends to refuse to receive BN Laredo-bound traffic at the Robstown connection with Tex Mex, forcing this traffic to interchange with KCS at Kansas City. KCS-3/TM-3, VS of Bengt Muten at 122; BNSF-4, VS Rickershauser at 11. This “short-hauling” would not be an unusual development in mergers. In this case, however, BN is operating over trackage rights granted in the UP/SP merger to sustain competition at Laredo by a second major railroad, and to preserve two-railroad competition for shippers along the former SP line between Houston, Robstown-Corpus Christi, and Brownsville. 1 STB at 409-10, 423-24. The issue with regard to Laredo is whether that BN role becomes moot if the Tex Mex transaction is approved and KCS attempts to supplant the role of BN in providing that competition. Even then, the BN trackage rights would remain, if not vacated by the Board, to maintain the ordered two-railroad competition along the SP line.

In this situation, closure of the BN connection with the Tex Mex at Robstown is not a determination that KCS is free to make, in DOT’s view. Since it was the Board’s decision to grant BN these trackage rights to sustain competition, only the Board can decide whether that purpose can be met through the substitution of KCS for BN. If KCS believes that the rights granted to BN are no longer necessary to provide competition to UP for Laredo traffic, the Department believes KCS should request the Board to reconsider that condition pursuant to its continuing oversight authority of the UP/SP merger in Finance Docket No. 32760 (Sub-No. 21). Barring such action by KCS, the Department believes the Board must assure the BN connection to Tex Mex at Robstown is not closed.

C. International Rail Bridge

Control of the International Rail Bridge at Laredo is a related aspect of the gateway closure issue, and raises concerns related to the potential physical denial of access, or degradation of service, to competitors that use the Bridge. The Tex Mex transaction alone (without any subsequent acquisition of TFM) would give KCS control of access to, and operation of, the U.S. side of the Bridge. UP contends that, although operations on the U.S. side of the bridge are governed by an equitable 1951 agreement between UP and Tex Mex, a shift in control of the bridge would allow KCS to manipulate operations to give preference to KCS/Tex Mex trains. UP-7B, VS of Stephen R. Barkley at 9-14.

Resolution of this threat appears to be eminently achievable through negotiations of the parties to the agreements, the Board's regulatory review, and oversight of the commitments made with respect to Bridge operations by the Applicants. The particulars of this process are discussed below.

Appropriate Conditions

A. The Laredo Gateway

The most critical question in this proceeding is whether and to what extent the Board should impose a condition that would require NAFTA Rail to maintain Laredo as an open gateway. For the reasons already discussed, the Department believes that the STB should do so to the extent consistent with its jurisdiction.

Although KCS and Tex Mex are wholly subject to the Board's authority, the Board has said that the TFM transaction is not. Decision No. 2 at 10. Nevertheless, it may be possible for

the STB to address the effects in the U.S. of TFM's activities post-merger. For example, the Board clearly has jurisdiction over operations and agreements regarding the International Bridge at Laredo,¹² and over the reasonableness of international through rail rates.¹³ On the other hand, the Applicants have correctly pointed out that other government agencies, foreign and domestic, have already passed upon this transaction. See KCS-3/TM-3 at 21, VS of Michael R. Haverty at 54.

The Department believes that the Board's own precedent provides guidance on how to proceed amid these uncertainties. In past cases involving similar circumstances the STB has eschewed any direct exercise of its own regulatory authority to address alleged anticompetitive harms, either because it did not find such harms or because jurisdictional questions persisted. The Board relied instead upon the commitments and representations made by foreign-based merger applicants to resolve potential jurisdictional and policy controversies. We think the Board should do the same here, recognizing that in this case that may not result in a fully "open" Laredo gateway.

In Finance Docket No. 33556, CN proposed to acquire the Illinois Central railroad. A longstanding dispute concerned an international rail tunnel between the U.S. and Canada. There the Board declined to prescribe a specific condition with respect to that facility (partly owned by CN) because this issue was unrelated to the merger. Nonetheless, "because of the importance of

^{12/} 49 U.S.C. § 11323(a); International – G.N.R. Co. Trustee Trackage Rights, 282 ICC 30 (1951); Mexrail, Inc. v. Union Pacific Railroad Co., et al., Finance Docket No. 32980 (STB served July 13, 2000), and cases cited therein.

^{13/} 49 U.S.C. § 10501(a)(2)(F); Canada Packers v. Atchison, Topeka & Santa Fe Rwy, 385 U.S. 182, 183-84 (1966); see also Trailer Marine Transport v. Federal Maritime Commission, 602 F.2d 379 (D.C. Cir. 1979); Canadian Pacific Rwy Co. v. United States, 379 F.Supp. 128, 132-34 (1974) (three judge panel); and Brae Corp. v. United States, 740 F.2d 1023, 1066-68 (D.C. Cir. 1984) (re ICC actions with respect to U.S. railroads and different foreign law).

the [tunnel] to international trade” the STB “imposed a condition holding Applicants to their representations” about the tunnel. F.D. No. 33556 (STB served May 25, 1999) (slip opinion) at 35.

In the same case shippers were concerned about the prospective vertical foreclosure of the Chicago gateway to another carrier (CP). Again the Board refused to reverse its own “one lump”-based precedent, but held the applicants “to their representations to keep this gateway open and competitive.” *Id.* at 37. The mechanism by which the STB enforced this “condition” was an oversight proceeding.¹⁴

In Finance Docket No. 34000 CN proposed to gain control of the Wisconsin Central (“WC”) railroad. There the applicants signed a settlement agreement with NITL that (among other things) committed the carriers to keep gateways open and to arbitrate shipper disputes. The Board did not impose these as conditions to rectify merger-related harms to competition or the public interest; rather, it again held the applicants in that case to the commitments they had made in the settlement and elsewhere in the record. F.D. No. 34000 (STB served September 7, 2001) (slip opinion) at 12-13.¹⁵

The parallels between these cases and the instant proceeding are evident. In this case, KCS has responded to gateway concerns by voluntarily agreeing to terms that would govern even-handed operations for UP access to the Laredo International Rail Bridge. KCS has further represented that it is prepared to negotiate commercially reasonable rates and divisions with UP

¹⁴/ The Board noted that this oversight would also enable it to address other unanticipated merger-related harms (such as allegations in that case about unfair lumber practices in Canada). *Id.* at 39.

¹⁵/ It is significant that the Board there refused to prescribe the terms and conditions that would constitute an open gateway. *Id.* at 14.

covering traffic at Laredo. KCS-10/TM-10 at 24 and VS of Davies at 15 (“to keep the Laredo gateway open on commercially reasonable terms”).

DOT commends KCS for these initiatives, but notes a serious need for clarification in various regards. First, UP and other parties have raised issues with respect to the intent and formalization of the proposal for access to the Bridge. Second, KCS has proffered commercially reasonable rates (which representation the Board should, of course, require Applicants to honor), but some confusion in the record on that issue must first be cleared up.¹⁶ The Department does not support any prescription of those rates by the STB, as UP appears to recommend. Rather, parties should be free to negotiate rates privately and freely -- with the understanding that rates established, or unresolved disputes, will be subject to the Board’s oversight to protect the public interest.

The NITL has petitioned the Board to impose as a condition the terms of an agreement it has reached with KCS, which proposes a private-sector solution to access problems and ratemaking post-merger. NITL-3. DOT believes the agreement holds promise for resolution of some disputes respecting commercially reasonable rates, short of the Board’s formal adjudication processes. However, DOT’s reading of the agreement, and the exchange of correspondence to clarify its intent, indicates that the agreement appears to fall short of ensuring effective transportation alternatives for shippers using the Laredo gateway for traffic to and from Mexico. NITL and KCS have clarified that the agreement would not apply to rates provided UP for movement over TFM in the event it is acquired by KCS. NITL-4/KCS-17. Even for routings

^{16/} There seem to be real differences on this point between the undertakings in the NITL settlement and other commitments by Applicants that appear to go further. Compare UP-7A, Exhibit 2 and KCS-10/TM-10 at 24 and VS of Davies at 15.

and through rates using a TFM interchange with KCS/Tex Mex, the dispute resolution procedures would allow an arbitrator to rule on the “through rate as a whole,” and separately on the part of the through rate for movement in the U.S. -- but not for the part of the rate for movement in Mexico. In all likelihood, this arrangement simply reflects the jurisdictional complexity over international movements, a reality with which all must cope. The question of the implications of a possible acquisition of TFM for ratemaking and resolution of disputes with UP for joint UP/TFM movements remains open, however, indicating a risk for loss of shipper transportation alternatives at Laredo should the TFM transaction be consummated.

Therefore, the Department urges the Board to impose, as a condition to any approval it may grant, the requirement that Applicants honor the representations and commitments they have made on the record in this proceeding. We recognize that such commitments may fall short of complete protection of an open gateway. However, the STB may not be able effectively to mandate a completely open gateway due to jurisdictional limitations. In the face of this possibility, we also recommend that the Board monitor the availability of shipper options through Laredo by allowing parties to proffer evidence of merger-related harms during the oversight proceeding. Should any such cases arise, the individual facts and applicable law would determine the extent to which mitigation would be available.¹⁷

¹⁷/ The oversight DOT envisions would not be like that initially imposed in Finance Docket No. 33388 (the Conrail Acquisition Case), with comprehensive reporting requirements. Rather, as in Finance Docket No. 34000 (the CN/WC merger) parties would be free to bring before the Board evidence of alleged violations of commitments. The Applicants should also be required to inform the Board and the parties if and when it appears the TFM transaction may become more likely.

B. The International Rail Bridge

Operations on the Bridge have been governed by agreements among affected railroads since at least 1951. KCS-6/TM-6; Note 12, *supra*. These agreements fix the terms under which trains are handled unless and until they are changed or, failing a contractual resolution, the Board is forced to exercise its own jurisdiction. *Id.* The Applicants have pledged not only to honor all existing agreements generally (including these), but they have specifically committed to extend fair and nondiscriminatory treatment of other carriers' trains at the Laredo bridge. KCS-10/TM-10 at 26; KCS-11/TM-11 at 8.

DOT believes that the Board should first rely upon the signatories to the operational agreements to abide by their terms or to negotiate appropriate adjustments. The STB should also hold the Applicants to their commitments in this regard. Finally, the Board should reaffirm its authority over the agreements/operations at the Bridge, so as to forestall any disputes should the parties fail to resolve matters among themselves.

Conclusion

The formation of NAFTA Rail through two separate transactions raises issues that are both simple and complex. The Tex Mex transaction is a typical end-to-end combination with few public benefits and few adverse consequences. The issues that it presents -- operations at the International Rail Bridge in Laredo and connections with the BN at Robstown -- are well within the Board's ability to address if the parties do not resolve matters themselves. Progress continues on the SIP, and FRA will report on the safety aspects of this transaction as appropriate.

The TFM transaction is more problematic. It may never take place at all. If it does, although it is also an end-to-end merger, the importance of the Laredo gateway and the prospect of reducing shipper options without concomitant benefits present substantive concerns. Whether the STB has authority to fully redress such concerns is in question. The Department believes that the Board should strive to keep open the Laredo gateway to the extent that its jurisdiction allows. The Applicants' commitments provide some measure of relief in this regard, and the Board should hold the Applicants to them. Beyond that, DOT urges the STB to establish an oversight proceeding to consider evidence of harms traceable to the TFM transaction. The facts and the law of each such case will determine whether the STB can or should do more.

Respectfully submitted,

A handwritten signature in dark ink, appearing to read "Rosalind A. Knapp", written over the typed name.

ROSALIND A. KNAPP
Deputy General Counsel

September 2, 2003

CERTIFICATE OF SERVICE

I hereby certify that on this date I caused a copy of the Reply Comments of the United States Department of Transportation in STB Finance Docket No. 343432 to be served by first class mail, postage prepaid, upon all Parties of Record in this proceeding.

A handwritten signature in black ink, appearing to read "Paul Samuel Smith", with a stylized, cursive script.

Paul Samuel Smith

September 2, 2003