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September 22, 2003

The Honorable Vernon A. Williams
Secretary
Surface Transportation Board
1925 K Street, NW
Washington, DC 20423-0001

208953

Re: *Kansas City Southern-Control-The Kansas City Southern Railway
Company, Gateway Eastern Railway Company, And The Texas Mexican
Railway Company; Finance Docket No. 34342*

Dear Secretary Williams:

Pursuant to Decision No. 2, I am enclosing herewith an original and 27 copies of a Reply to Comments of the U.S. Department of Transportation (**KCS-19/TM-18**), filed on behalf of Kansas City Southern, The Kansas City Southern Railway Company, Gateway Eastern Railway Company, and The Texas Mexican Railway Company. This filing is a public document; there is no confidential or highly confidential version. A copy of this document in WordPerfect format is enclosed on each of the accompanying three diskettes. As can be seen on the Certificate of Service, a copy of this filing has been served today upon all parties of records to this proceeding.

Please date-stamp the twenty-sixth and twenty-seventh copies of this letter and the accompanying filing, and return them to the courier for our files.

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Sincerely,

SEP 22 2003

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Public Record

William A. Mullins

Enclosure

cc: Parties of Record

KCS-19
TM-18

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

**THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
And
THE TEXAS MEXICAN RAILWAY COMPANY**



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REPLY TO COMMENTS OF THE U.S. DEPARTMENT OF TRANSPORTATION

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REPLY TO COMMENTS OF THE U.S. DEPARTMENT OF TRANSPORTATION

As authorized by the Surface Transportation Board ("STB" or "Board") in *Decision No. 2*,¹ Kansas City Southern ("KCS" or "Applicant"), The Kansas City Southern Railway Company ("KCSR"), Gateway Eastern Railway Company ("Gateway") and The Texas Mexican Railway Company ("Tex Mex") hereby reply to the comments of the U.S. Department of Transportation ("DOT" or the "Department") filed September 2, 2003 ("DOT Comments"). KCS submits that the Department's comments, which confirm that vertical foreclosure and increases in shipper rates will not occur and that private agreements and commitments are preferable to heavy-handed regulation sought by KCS's competitors, support granting the Application in this proceeding without imposing conditions.

¹ *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, Decision No. 2 (served June 9, 2003) ("*Decision No. 2*") at 13, n. 27.

SUMMARY OF REPLY

KCS concurs with DOT that Board precedent applicable to this case consistently holds that end-to-end transactions will not increase shipper rates or result in vertical foreclosure of efficient interline carriers. No party has made any convincing argument as to why that precedent should not apply here. There are no anticompetitive effects of the transaction that is before the Board. Despite agreeing that there are no anticompetitive effects, DOT still suggests that the Board apply the principles of the *Major Rail Consolidation Procedures*² to this minor transaction and impose a condition to preserve gateways and existing interchanges between Tex Mex, TFM, S.A. de C.V. (“TFM”), and other carriers. While KCS disagrees with this suggestion, KCS agrees with DOT’s ultimate conclusion that private agreements and oversight, rather than heavy-handed regulation, are the proper ways for the Board to address concerns alleged, but not proven, by KCS’s competitors. As KCS and Tex Mex have said a number of times, there are no anticompetitive effects of the transaction before the Board, even if the effects of the TFM transaction are also considered, so no conditions on the grant of this application are warranted. Finally, KCS agrees with DOT’s tacit acknowledgement that the Board cannot reach across the border into Mexico to regulate TFM’s operations.

BACKGROUND

The schedule issued in *Decision No. 2* granted the Department’s request to be allowed (as it has been in other recent merger and control proceedings) to submit its substantive comments on the Application on the date set for other parties to submit replies to comments and requests for conditions and rebuttal in support of the Application. In recognition of an applicant’s right to

² *Major Rail Consolidation Procedures*, STB Ex Parte No. 582 (Sub-No. 1), 2001 STB LEXIS 546 (served June 11, 2001) (“*Major Rail Consolidation Procedures*”).

respond to all substantive comments, however, the Board authorized “Applicants” to close the record by replying to DOT’s comments. KCS, KCSR, Gateway and Tex Mex hereby reply to those comments.

DISCUSSION

I. DOT CONFIRMS THAT THE BOARD’S PRECEDENT ON VERTICAL INTEGRATION AND THE ONE LUMP THEORY APPLY HERE, ELIMINATING ALLEGED CONCERNS ABOUT RATE INCREASES OR FORECLOSURE OF EFFICIENT INTERLINE ROUTES.

As demonstrated in KCS’s September 2 Response and Rebuttal, the allegations raised by KCS’s competitors that KCS control of Tex Mex and TFM,³ would lead to increased rates for shippers and foreclosure of efficient interline routes contradict Board precedent on end-to-end mergers and, in reality, are merely attempts by those carriers to protect their revenue divisions, which is not a recognizable competitive harm under long-standing Board precedent. The DOT Comments support these same conclusions, arguing that the Board’s 20 years of precedents finding that an end-to-end merger with a bottleneck carrier (*i.e.*, TFM)⁴ will not increase rates to

³ As DOT correctly notes, DOT Comments at 6, the opposition to this application to control Tex Mex arises almost exclusively from the related transaction, already reviewed and approved by the U.S. Department of Justice and the Mexican Competition Commission, whereby KCS seeks to acquire control of TFM. The TFM transaction is not subject to the Board’s jurisdiction or approval. *Decision No. 2* at 7, n.15 (“the Board has no jurisdiction over the acquisition of control of a rail carrier--like TFM--that is located entirely outside the United States”); *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, Decision No. 7, slip op. at 2 (served September 8, 2003). Nevertheless, the record in this matter includes significant discussion of the TFM transaction. The Department’s comments imply that the Board should move forward to completion of consideration of this matter on the existing record. KCS agrees.

⁴ The DOT Comments state that “the DOT analysis here . . . treats the KCS’s combination with TFM as a merger of U.S. Class I railroads.” DOT Comments at 11. As explained in Section II herein, this premise leads DOT to misapply the Board’s *Major Rail Consolidation Procedures* and the fundamentally different statutory provisions for major mergers to this minor transaction,

shippers or foreclose efficient interline routings applies just as well to this proceeding, even if one considers the effects of the TFM transaction.

KCS's competitors such as Union Pacific Railroad Company ("UP") and The Burlington Northern and Santa Fe Railway Company ("BNSF") argued strenuously in their filings that the TFM transaction, in particular, would allow KCS to disadvantage them competitively and to raise prices to shippers. These arguments, as DOT points out, are arguments of vertical foreclosure,⁵ DOT Comments at 12, and are refuted by Board precedent in which "the agency consistently found that there would be no reduction in competition caused by vertical foreclosure." *Id.* Given the fact that much of the applicable precedent was established in proceedings wherein BNSF and UP were seeking approval to merge other carriers into their systems, it is nothing short of ironic that those carriers now find competitive issues in this transaction.

As shown in detail by the September 2 testimony of Dr. Andrew Kleit, KCS-18B/TM-17B, the evidence in this proceeding clearly supports long-standing Board precedent regarding vertical foreclosure, and contradicts claims by KCS's rivals that either of the two transactions

leading DOT to the erroneous conclusion that conditions could be imposed regardless of the lack of anticompetitive effects of the transaction before the Board. Even under this more stringent standard, however, the Department rejects the types of conditions proposed by KCS's rivals.

⁵ DOT points out that vertical foreclosure assumes that the "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." DOT Comments at 12 n. 10. As demonstrated in the September 2 testimony of Gerald K. Davies and Bengt Mutén, the points at which KCS offers service directly competitive with UP or BNSF are relatively few, and account for little cross-border traffic. KCS-18B/TM-17B, Rebuttal Verified Statement ("RVS") Davies at 10-12; RVS Mutén at 7-8. Also, Mr. Mutén rebuts BNSF's misinterpretation of Mr. Mutén's traffic diversion analysis, showing that the study projected diversions by shippers based upon newly-available efficiencies, not forced, inefficient diversions as BNSF contended. RVS Mutén at 2-4. On this factual basis, as well as on the basis of economic theory, competing railroads' vertical foreclosure arguments are ill-founded.

will raise prices to shippers or foreclose efficient interline routings. As reiterated in the September 2 testimony by Dr. Kleit, the Board's "one lump" theory holds that a bottleneck carrier is able to extract the maximum profit from an interline move by competitively bidding alternate connecting carriers against each other, while maximizing the overall rate that the traffic will bear without diverting to alternative transportation. Thus, as Dr. Kleit's testimony and the DOT Comments show, a bottleneck carrier will already have maximized the rate,⁶ and will gain the most profit from using the least-cost connecting carrier, regardless of its affiliation.

DOT also supports the position advocated by Dr. Kleit and supported by other KCS witnesses that efficient interline options, *i.e.* BNSF/TM routings or UP/TFM routings, will not be foreclosed.

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 [or BNSF] 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 [citing cases].

DOT Comments at 13.

⁶ "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. . . . If, as UP claims . . . 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." DOT Comments at 13. Also, as KCS's September 2 Reply and Rebuttal shows, if UP is correct that TFM is not taking the "one lump," UP almost certainly is, for UP, which provides the sole single line service between the border and many of the origins and destinations of U.S.-Mexico traffic, acts as a bottleneck carrier in the U.S. for much of the U.S.-Mexico traffic. To presume that neither UP nor TFM has already raised rates to shippers to their maximum level is to presume that they are leaving money on the table, an irrational economic decision and one not supported by the facts in this proceeding. *See* RVS Davies at 9-12; RVS Mut n at 4-8.

Accordingly, DOT squarely supports applying to this case the “one lump” theory and the Board’s precedent that end-to-end mergers will not lead to foreclosure of efficient interline connections:

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.

DOT Comments at 13. As DOT succinctly puts it, “Competition, therefore, will not be reduced by the merger.” *Id.*

As KCS and the other proponents of this transaction have said repeatedly, the transaction before the Board, even if the TFM transaction is also considered, will not result in anticompetitive effects. DOT supports that basic position, concluding that KCS’s end-to-end-to-end control of KCSR, Tex Mex and TFM will not lead to increased rates to shippers or foreclosure of efficient interline routes with UP or BNSF. Confirmation by DOT, a federal agency charged with protecting the public interest, of this central argument supporting the Application militates strongly against the arguments of the opponent carriers.⁷

II. ALTHOUGH DOT APPLIES THE PRINCIPLES OF THE MAJOR RAIL CONSOLIDATION PROCEDURES TO THIS PROCEEDING, DOT STILL FAVORS PRIVATE SECTOR SOLUTIONS AND OVERSIGHT RATHER THAN THE CONDITIONS SUGGESTED BY KCS’S COMPETITORS.

Even though DOT concludes that the transaction before the Board will not cause competitive harm, DOT nevertheless claims that the Board can and should still impose some conditions in this proceeding. That conclusion is based on DOT’s mistaken application of

⁷ The U.S. Department of Agriculture’s strong and unusual support for a transaction of this type is of similar effect.

Major Rail Consolidation Procedures, and its underlying statute, to this case. Because it applies the principles of those rules to this proceeding, DOT suggests that some protection of BNSF's right to interchange at Robstown may be in order, that UP's rights to use the International Bridge at Laredo should be preserved, and that the Laredo gateway should remain open on commercially reasonable terms. Of course, in principle KCS does not oppose the ends suggested by DOT. KCS merely disagrees with the means of accomplishing those goals. Ultimately, however, even if the Board were to conclude that conditions were necessary, DOT effectively concludes that existing private agreements and the Board's power of continuing oversight are more than adequate to achieve these objectives. Any conditions imposed should reflect those DOT conclusions.

A. DOT Misapplies *Major Rail Consolidation Procedures* To This Case.

DOT's conclusion that the Board could impose conditions in this case is based on a faulty analysis which treats this proceeding as subject to the Board's *Major Rail Consolidation Procedures* and the statute on which that decision is based. That misapplication leads DOT to the erroneous conclusion that the Board could impose conditions to preserve the public interest, without anyone first establishing that the transaction would have anticompetitive effects. In fact, the Board cannot, and should not, impose conditions because, as DOT recognizes, the transaction has no anticompetitive effects.

The analysis in the DOT Comments treats KCS's application to control Tex Mex as a major transaction, even though DOT recognizes that the transaction is minor.⁸ The DOT Comments state that "the DOT analysis here . . . treats the KCS's combination with TFM as a

⁸ "The Board has deemed the Tex Mex transaction a 'minor' one." DOT Comments at 3.

merger of U.S. Class I railroads.” DOT Comments at 11. This treatment flies in the face of the fact that the common control of KCSR and TFM by KCS is not a “major” transaction subject to the Board’s prior approval requirements and has not been submitted to the Board. In fact, as DOT admits, TFM is not a Class I carrier subject to the STB’s jurisdiction. “*Were TFM a U.S. carrier* it would be a Class I railroad,” (emphasis added) DOT Comments at 2, n.2, but “TFM is a large railroad located entirely within Mexico,” *id.* at 4.

By treating KCS’s acquisition of Tex Mex as a major transaction because of the possible parallel acquisition of TFM, DOT then applies the *Major Rail Consolidation Procedures* criteria to this case. DOT provides no legal authority for the application of those rules to a proceeding that is not subject to those rules, let alone to a proceeding that DOT itself admits will not have any anticompetitive effects. Furthermore, even if the KCS/TFM transaction were a major transaction subject to the Board’s authority, DOT also ignores the fact that any major transaction involving KCS is not subject to the new merger rules, but is to be treated under the same rules that were in effect when UP and SP or BN and ATSF merged.⁹ Unlike the new major merger rules, those rules do not require that gateways remain open. Thus, to condition the KCS/Tex Mex transaction in accordance with the rules contained in *Major Rail Consolidation Procedures*, a number of logical and legal hurdles must be overcome, requiring the Board to ignore the fact that no anticompetitive effects have been found; to convert a minor transaction to a major transaction by adding in a transaction that is not even subject to the STB’s prior approval and authorization requirements; and to ignore the fact that KCS is exempt from the new rules.

⁹ The Board will “waive application of the regulations contained in this subpart for a consolidation involving The Kansas City Southern Railway Company and another Class I railroad and instead will apply the regulations in this subpart A in effect before July 11, 2001.” 49 C.F.R. §1180.0(b)

The only basis for application of those rules is a belief by DOT that those rules should apply, nothing more or less. For example, DOT states that the Board “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.” DOT Comments at 15. Clearly, DOT is assuming that the “new merger rules” -- *i.e.*, *Major Rail Consolidation Procedures* -- should apply, and that the Board could lift the waiver granted KCS in those rules. DOT’s rationale should be rejected.

The *Major Rail Consolidation Procedures* simply do not apply to this case. First, the regulations themselves, established through notice and comment rulemaking, by their terms apply only to transactions involving two Class I carriers. *See* 49 C.F.R. §1180.1, “General policy statement for merger or control of at least two Class I railroads.” Application of those rules to a situation which all agree does not involve 2 Class I carriers would be improper. The Board cannot simply apply regulations to this proceeding which by their explicit terms do not apply here. Doing so would violate the statute under which this transaction is to be considered (*i.e.*, 49 U.S.C. §11324(d)), and would violate the Administrative Procedure Act by changing the scope of a regulation without notice and comment procedures. *See generally* 5 U.S.C. 553(c) (2000).

More fundamentally, the Board’s *Major Rail Consolidation Procedures* are based on a statute where the primary standard is consistency with the public interest, which is not the standard that applies in this proceeding. Section 11324(c) states that the Board shall approve a transaction involving two Class I carriers “when it finds the transaction is consistent with the public interest.” That standard, however, does not apply to this case. *See Illinois v. Interstate Commerce Commission*, 687 F.2d 1047, 1053 (7th Cir. 1982) (holding that former Section 11344(c) did not apply to minor transactions). Rather, the Board has conclusively determined

that this proceeding involves a minor transaction; therefore, the Board must approve the transaction unless opponents of the transaction¹⁰ prove that the transaction is likely to have substantial anticompetitive effects. Even if that is proved, the Board still can disapprove the transaction only if those effects outweigh the public benefits of the transaction. Thus, both the statutory test and the burden of satisfying that test are different in this transaction than under the *Major Rail Consolidation Procedures* principles that DOT applies in its analysis.

The requirement that applicants in major mergers keep gateways open derives from the burden on applicants in those transactions to establish that their transaction is in the public interest:

Our revised rules reflect a significant change in the way in which we will apply *the statutory public interest test* to any major rail merger application. . . . [W]e believe that future merger applicants should bear a heavier burden to show that a major rail combination is consistent with the public interest. . . . Toward this end . . . [a]pplicants also will be expected to include measures for preserving competition wherever feasible, including effective plans to keep open major existing gateways and to preserve opportunities to challenge segment rates in bottleneck situations.

Major Rail Consolidation Procedures, slip op. at 9-10 (emphasis added). That burden – proving consistency with the public interest and keeping gateways open - does not apply here, unless the Board finds that substantial anticompetitive effects are likely. But, as DOT itself confirms, no party has proven that such effects are likely. In the face of long-standing Board precedent on the competitive effects of end-to-end mergers, DOT's analysis, which places a burden on KCS and Tex Mex to keep gateways open, is erroneous.

¹⁰ “The burden of proof is on opposing parties to show an adverse competitive impact resulting from the transaction. See *Rio Grande Industries, Inc.-Purchase and Trackage Rights- Chicago, Missouri & Western Ry. Co.*, 5 I.C.C.2d 952, 969 (1989).” *Kansas City Southern Industries, Inc.-Control-Midsouth Corporation*, Finance Docket No. 32167, 1994 ICC LEXIS 75 at *5-*6 (served May 4, 1994).

DOT's misapplication of *Major Rail Consolidation Procedures* to this proceeding leads DOT to the incorrect conclusion that conditions can be imposed without finding anticompetitive effects of the transaction before the Board. Because the Board has held this to be a minor transaction, opponents of the transaction must provide substantial evidence which proves a likelihood of substantial competitive harm before the Board can consider imposing conditions. Having concluded that the Board's "one lump" theory and precedents on end-to-end mergers apply to this case, and thereby negating competing carriers' allegations of anticompetitive effects, DOT's comments support the contention that conditions cannot be imposed under the statute that applies here.

B. The DOT Conditions Are Not Necessary Because DOT's Concerns Are Addressed In Existing Private Agreements.

Even though DOT has determined that the KCS/TM transaction will not result in any anticompetitive effects, even when one considers the effects of the KCS/TFM transaction, DOT nonetheless has expressed two concerns about the KCS/TM transaction before the Board for which it believes conditions may be necessary: (1) maintenance of BNSF's interchange at Robstown,¹¹ and (2) physical access to and the quality of service at the International Rail Bridge at Laredo.¹² Neither of these concerns warrants a condition, nor could they as a legal matter, given that no party has shown that the transaction will result in competitive harm that is both

¹¹ With respect to BNSF's ability to provide competitive service in conjunction with Tex Mex, DOT states, "the Department believes the Board must assure the BN connection to Tex Mex at Robstown is not closed." DOT Comments at 16.

¹² With respect to the KCS/TFM transaction, the Department's sole concern is that the Laredo gateway be kept open on commercially reasonable terms. DOT Comments at 2. *See also* DOT Comments at 14 n. 11 ("If only the Tex Mex transaction takes place, a combined Tex Mex/KCS cannot itself effect such control [to make sure the Laredo gateway remains physically or economically open] . . . 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*.")

likely and substantial so as to justify a condition regarding these two issues. Nonetheless, both of these concerns are already addressed in existing private agreements which are more than sufficient to protect the public interest. In fact, when one carefully reviews DOT's comments, it will be seen that DOT eventually agrees with the foregoing conclusion.

KCS, in voluntary compliance with the spirit of the new merger rules and the principles enunciated therein, has made both public and private commitments to continue to keep the Laredo gateway open on commercially reasonable terms, to continue to interchange with BNSF at Robstown, and to work with UP to develop new bridge dispatching protocols. To implement its commitments with respect to the Laredo gateway and BNSF's right to continue to interchange at Robstown, KCS entered an agreement with the National Industrial Transportation League ("NITL"). The reason for the agreement was not to ameliorate anticompetitive effects, which do not exist, but rather to implement KCS's commitments and to reassure the shipping public that KCS and Tex Mex are so confident that their transaction will not harm competition that they would agree to put those protections in writing.

The NITL Agreement requires KCS to use its control of Tex Mex to ensure that any shipper who uses a BNSF/Tex Mex routing to Laredo via an interchange at Robstown will continue to have that option in a post-transaction environment and that the rate to such a shipper must be commercially reasonable. As a result, the BNSF connection with Tex Mex at Robstown will not be closed.¹³ In the NITL Agreement, KCS and Tex Mex also agreed to quote

¹³ It is important to clarify that, contrary to BNSF's claims, BNSF was not the Board's "fix" to preserve competition at Laredo. Rather, BNSF's access to Robstown was granted by private agreement between UP and BNSF that the Board adopted as a condition of the UP/SP merger, at UP's request. Such BNSF access to Tex Mex was not considered sufficient to remedy the adverse affects of the UP/SP merger. The Board's UP/SP decision clearly shows that the STB was not confident that a BNSF/Tex Mex routing would be an effective replacement for the loss

commercially reasonable rates for traffic they interchange with other carriers at existing interchanges.¹⁴ Obviously, Robstown is such an interchange. Therefore, KCS has committed to ensuring that shippers have the option of a BNSF-Robstown-Tex Mex routing. Furthermore, KCS and Tex Mex have stated that they would honor existing contracts with other carriers for their current term. Section 2(b) of the NITL Agreement reinforces this commitment by requiring KCS and Tex Mex to honor rates and rate factors in existing agreements between KCS or Tex Mex and another U.S. carrier until their expiration.

While BNSF may be unhappy with that agreement because it does not protect BNSF's individual revenue divisions in perpetuity or impose a five year freeze on those divisions, the shippers, as represented by NITL, do not share BNSF's concerns. Instead, the shippers are satisfied by that agreement and believe that the agreement is more than sufficient to preserve competition. Accordingly, the Board need not impose a condition to require Tex Mex to

of competition that would occur at Laredo. BNSF argued in the UP/SP proceeding that Tex Mex need not be granted rights to connect with KCSR at Beaumont. However, the Board specifically found that it had "some reservations about BNSF's willingness and ability to attract sufficient traffic over the Laredo gateway." UP/SP Decision No. 44 at 138. Consequently, the Board held that Tex Mex trackage rights to connect with KCSR were "required to ensure the continuation of an effective competitive alternative to UP's routing into the border crossing at Laredo." UP/SP Decision No. 44 at 149. Accordingly, while the NITL Agreement will preserve BNSF's access at Robstown, it is important to recognize that the Board never considered the BNSF/Tex Mex routing as a sufficient replacement for the loss of competition that otherwise would have occurred at Laredo.

¹⁴ The NITL Agreement does not define "commercially reasonable," leaving that to case-specific, fact-based resolution rather than to abstract rules or definitions. As the Department notes, *see* DOT Comments at 19 n. 15, the Board has previously avoided drawing such abstract definitions on what constitutes keeping a gateway "open." However, it is NITL's and KCS's intent that the "rates" referred to are rates to shippers, not the individual divisions of the connecting carriers.

maintain an interchange with BNSF because there are enforceable private agreements in place that serve that purpose.¹⁵

DOT also states that it has concerns with respect to control of rail operations at the Laredo Bridge. DOT comments at 9. After expressing its concerns, DOT provides the remedy: “Resolution of this threat [that KCS would manipulate bridge access to favor KCS/TM trains over UP trains] 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.” *Id.* at 17. KCS agrees that no condition need be imposed to resolve concerns over the operations on the Bridge.

C. Despite Concluding That Conditions Could Be Imposed,
DOT Properly Concludes That Private Agreements,
Backed Up by Board Oversight, Suffice for This Case.

In the end and despite expressing concerns, DOT’s comments lead to the inevitable conclusion that the existing agreements for operation of the bridge, which DOT finds sufficient in the first instance, and the NITL Agreement are more than sufficient to address DOT’s concerns without further conditions. In fact, even though DOT erroneously concludes that the Board could impose conditions without finding anticompetitive effects of the KCS-Tex Mex transaction, DOT ultimately recommends only that the Board hold applicants to their representations on the record,¹⁶ and make itself available for oversight on an as-needed basis.

¹⁵ It is important to note that neither DOT nor NITL nor any other shipper or shipper group supports BNSF’s request for a five year freeze on existing interchange rates and rate factors. While such a request was part of the CN/NITL agreement in the CN/WCL merger, NITL did not require such a commitment in this proceeding nor did KCS believe it was necessary.

¹⁶ DOT identifies these as: (1) honoring existing contractual agreements with other railroads, including contracts concerning the Bridge; (2) cooperating in good faith toward efficient use of the Bridge; (3) keeping the Laredo gateway open on commercially reasonable terms; and (4) requiring TFM to cooperate with UP and BNSF on logistical arrangements in Mexico and on

This recommendation, in the face of DOT's belief that these transactions should be treated as if the new merger rules were applicable to this proceeding, speaks powerfully to DOT's conclusion that the transaction before the Board is not anticompetitive. Such a conclusion is entirely consistent with the findings of the other government agencies that have reviewed the transactions, the MCC, DOJ, and USDA.

As noted, DOT expressed two concerns about the KCS/TM transaction before the Board: (1) maintenance of BNSF's interchange at Robstown, and (2) physical access to and the quality of service at the International Rail Bridge at Laredo. The interchange and rate-quoting provisions of the NITL Agreement resolve the Department's concerns with BNSF's interchange at Robstown. The second concern is addressed through the existing private agreement governing operations over the Bridge. KCS has no objection to DOT's suggestion that the Board "reaffirm its authority over the agreements/operations at the Bridge." DOT Comments at 22.¹⁷

KCS agrees with DOT's conclusion that issues involving the proceeding before the Board are best resolved under existing private agreements. Aside from the impropriety of imposing conditions when likely, substantial anticompetitive effects have not been shown, KCS wholeheartedly agrees that the Board should not accept any party's request to intervene in the operation of the Bridge, especially when operational improvements made possible by new technology and enhanced cooperation of the affected parties (including U.S. and Mexican

providing excellent service. DOT Comments at 7-8. Unlike UP, BNSF and some others, the Department does not try to convert every word uttered in this proceeding into a "commitment," and then seek to require KCS to negotiate agreements with UP and BNSF, with STB imposition of an agreement if the parties fail to agree. Instead, DOT finds it sufficient that a general condition, requiring KCS to abide by its commitments, combined with oversight, be imposed.

¹⁷ KCS does not dispute that the Board has full authority to review whether or not KCS control of Tex Mex will result in anticompetitive effects on the U.S. portion of the International Rail Bridge. Such a review is within the proper scope of the KCS/TM transaction.

Customs agencies) have continued to improve operating efficiency of this complex facility. As a result of that cooperation, there is increased capacity, a significant portion of which is unused, allowing flexibility to meet future needs. Imposing a regulatory mandate on the operation of this facility would be counterproductive. Regulatory mandates by their nature are inflexible, and inflexibility is inimical to the flexibility needed for efficient bridge operations. *See generally* RVS Riney at 2-5.

KCS is also in agreement with DOT that the Board should not impose conditions that would in effect regulate divisions between carriers or impose government oversight of division agreements between connecting carriers. As DOT said, “The Department does not support any prescription of those [commercially reasonable] rates by the STB, as UP appears to recommend. Rather, parties should be free to negotiate rates privately and freely.” DOT Comments at 20. Indeed, the freedom to negotiate divisions between interlining carriers is a fundamental tenet of deregulation and the rail industry in a post-Staggers Act environment.

In this same vein, the Board should also refrain from imposing a 5-year freeze on rates, revenue divisions and service applicable to traffic in which BNSF participates, as BNSF suggests. DOT’s opposition to rate prescription clearly would apply to BNSF’s request as well. Moreover, with respect to BNSF’s request that revenue division arrangements and rate factors be frozen beyond their contractually-agreed expirations, DOT recognizes that it is the effect on competition, not competitors, which must guide the Board’s decision. *See* DOT Comments at 10. DOT also recognizes that the TFM and Tex Mex transactions will not adversely affect competition. DOT Comments at 13. Accordingly, the BNSF request for a freeze on rates and revenue divisions, even if “only” for “a temporary five-year period,” *see* BNSF August 4

Comments at 6 and 28, clearly contradicts DOT's view that private agreements, not government mandates, should be allowed to meet service needs of shippers.

Finally, it is somewhat unclear to KCS and Tex Mex what clarification DOT seeks of the commitments given by KCS in this proceeding. The parties to the NITL Agreement have no misunderstandings as to its application and it has been clarified in writing by counsel for NITL and KCS. The bridge agreements are likewise written documents and can be interpreted in light of over 50 years of use.¹⁸ With respect to operations of TFM, KCS has said that when it obtains control of TFM, it will continue to cooperate with BNSF and UP on a number of operational areas, and to work to improve service. As Mr. Davies stated at the Board's July 31 hearing, "On TFM there's no changes envisioned from what's there today, so if you requested an operating plan from TFM post-merger, it would be what's operating today." July 31 Hearing Transcript at 175, Lines 12-16. KCS and Tex Mex agree with DOT that private agreements, supported by oversight if needed, are far preferable to heavy-handed regulation.

III. DOT'S COMMENTS WITH RESPECT TO TFM HAVE SOME MERIT.

With respect to the KCS/TFM transaction, DOT admits that there are no anticompetitive problems with either of the end-to-end transactions but then points to the new merger rules and argues that the Board should impose a condition to require KCS to keep the Laredo gateway open on commercially reasonable terms because that is what the new merger rules require. As

¹⁸ As Mr. Davies said at the Board's hearing, "We need to make sure that the operation at the bridge remains fluid, because you've got the three railroads coming together at that throat. And you need to work together as a three-party team to make sure that the traffic doesn't get backed up. And frankly, if it does, it doesn't take very long for everybody in the world to see it happen. You're operating in a fishbowl on both sides of the border, so it will be managed in a neutral fashion, not to the benefit of one or the other, but to make sure the entire gateway works." July 31 Hearing Transcript at 174, Line 18 through 175, Line 6.

noted, there is no legal basis for applying those rules to the KCS/TM transaction, let alone to the KCS/TFM transaction, which is not subject to the Board's jurisdiction.

DOT appears to recognize the problem of applying the "open gateway" requirement contained within the new merger rules to the TFM transaction. It therefore suggests that the solution is for the Board to simply hold KCS to its commitments and use its oversight authority if particular problems arise. As DOT has noted:

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 [of the applicants] . . . [T]he Board should do the same here.

DOT Comments at 18. Moreover,

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.

DOT Comments at 21.

KCS is in basic agreement with DOT's approach. KCS's control of Tex Mex, even if considered in light of the possible KCS acquisition of control of TFM, will not result in competitive harms. Moreover, it is clear that the Board has no statutory authority to regulate activities of a foreign carrier in a foreign country. Therefore, KCS and Tex Mex believe that DOT's recommendation is in line with those beliefs. The Board should deal with a particular problem on its facts and applicable law, if a problem indeed ever arises, rather than to attempt to reach beyond the Board's jurisdiction to construct a complicated regulatory fix for problems that don't now exist and are not likely to arise in the future. Consequently, DOT's suggestion that

the Board conduct proceedings under its oversight authority only if a competitive problem arises, rather than requiring burdensome periodic reporting by the applicants, has merit.

The DOT comments go no further than these suggestions and in fact actually lend support to the KCS view that the Board cannot regulate TFM rates, divisions or services, as requested by UP, BNSF and those who support their position. Indeed, the Department's ultimate conclusion that the Board should leave matters to existing private agreements, and review competitive problems if any arise, is based in part on the explicit recognition that the Board's authority does not extend into Mexico. This is yet another good reason why the Department's recommendation that the Board rely upon private agreements and as-needed oversight should be followed.

No party has offered any authority that would support any effort by the Board to reach across the border to regulate rail rates and services in Mexico.¹⁹ DOT recognizes that the Board should act within the bounds of its jurisdiction and its precedent in responding to the instant application. *See, e.g.*, DOT Comments at 18 and 21.²⁰ As KCS and Tex Mex explained in their September 2 Response and Rebuttal, what UP and BNSF (and those who echo their comments, such as Canadian Pacific Railway Co.) ask the Board to do with respect to TFM vastly exceeds what Board authority and judicial precedent would allow.

¹⁹ As the Board said in *Major Rail Consolidation Procedures*, slip op. at 32, it may not impose conditions on carriers that are not applicants or controlled by applicants. This must hold even more firmly for carriers that are not even subject to the Board's jurisdiction. Similarly, the DOT Comments do not support the idea that the Board can tell TFM what information it can or cannot share with connecting carriers, such as by ordering elimination of Section 3 of the NITL Agreement as requested by UP.

²⁰ Likewise, DOT does not endorse the opposition's suggestion that the Board can regulate TFM by ordering KCS to order TFM to behave in certain ways. Apparently DOT recognizes that such a charade is no less an exercise of regulation than would be the Board's issuing its own directives to TFM.

Board and judicial precedent state that the Board can judge the reasonableness of an international through rate, but can impose a remedy only on the U.S. carrier participant in that rate. Here, however, by asking for a five year rate freeze or a matrix of TFM rate factors, UP and BNSF are asking the Board to regulate the rate *only of the foreign carrier*. This is the exact opposite of what precedent says the Board may do, particularly because many cross-border moves are handled on separate billings and separate rates on each side of the border. Thus, the Department's suggestion that the Board act within the scope of its authority and precedents again contradicts the types of sweeping cross-border regulatory action which UP and BNSF ask of the Board.²¹

²¹ As shown by the September 2 Response and Rebuttal, KCS and Tex Mex are not asking the Board to treat this situation any differently than it would treat a similar situation involving a large Canadian railroad. For example, if CN operated solely in Canada, there is no question that UP could acquire control of CN without Board approval. Similarly, if British Columbia Rail ("BCRail"), which is currently on the market, owns a small shortline somewhere in the U.S., it is highly unlikely that the parties seeking to acquire BCRail would present a full system analysis of the operation in Canada just because a small U.S. carrier was involved. In all likelihood, parties would proceed by exemption on the small U.S. transaction and then complete the Canadian transaction after Canadian government review.

As shown in the September 2 Response and Rebuttal, cases involving Canadian carriers that are cited by opponents of this transaction are different because of their facts, not merely because of the border which connects the involved carriers. Those cases have involved CN and CP, which operate their own lines in the U.S. and have long been subject to Board jurisdiction. TFM operates no lines in the U.S. and is not subject to Board jurisdiction. Moreover, the transactions involving Canadian carriers often involved their takeover of a significant U.S. carrier – Illinois Central, Wisconsin Central or Delaware & Hudson, for example. Again, the opposite is true here. And even when dealing with Canadian carriers that were subject to the Board's jurisdiction, the Board and its predecessor have refused to attempt to control rates, property, or operations in Canada. See September 2 Response and Rebuttal at 123. Thus, while cases cited by UP and others involved Canadian carriers taking over and operating U.S. carriers, the TFM transaction involves a U.S. carrier holding company acquiring a controlling interest in a Mexican carrier, which will continue to be operated from Mexico. This is quite the opposite of transactions such as CN/IC, CN/WC, or CP/D&H.

In short, KCS and Tex Mex merely request that the Board recognize that the facts of the TFM transaction are almost opposite those of the transactions involving Canadian carriers, and yet,

KCS and Tex Mex also read DOT's comments as opposing UP's and BNSF's requests to regulate TFM's divisions of international rates. It is of course ironic that BNSF and UP ask the Board to regulate revenue division, as well as rates, when the Board just recently eliminated its regulations on handling divisions disputes due to disuse of that remedy. *Removal of Divisions of Revenue Regulations*, STB Ex Parte No. 637 (Sub-No. 1), slip op. at 2 (served Aug. 29, 2003) (eliminating regulations governing division of revenue cases because "agency records indicated that there had not been a divisions of revenue complaint in over 20 years"). Clearly a principal purpose of BNSF's and UP's requests in that regard is to cause the Board to exert authority to control TFM's divisions. Aside from being purely a request for protection of competitors -- something which the Board and its predecessor have repeatedly eschewed in merger cases -- asking the Board to tell TFM not only what it can charge but what revenue it can earn may be even a greater intrusion into the business of another country than asking the Board to regulate TFM's rates. The Board's jurisdiction under 49 U.S.C. §10501(a)(2) "applies only to transportation in the United States." Clearly, regulating TFM's rates or divisions is beyond this grant of authority.

DOT also offers no support for UP's and BNSF's position that the Board should regulate TFM's operations by setting service levels or by other means. While each of these carriers in its August 4 comments requested that the Board regulate TFM's services, *see* UP-7A at 98-100 and BNSF-3 at 6 (asking that "Applicants be required to maintain the existing Tex Mex and TFM rates *and services*" (emphasis added)), DOT offers no support to such a remedy. Instead, DOT

even in the Canadian cases, the Board and the I.C.C. refused to regulate the rates and operation of facilities in a foreign country. That same result should apply here.

limits its statements about the Board's authority with respect to rail operations to "operations and agreements regarding the International Rail Bridge at Laredo." DOT Comments at 18.

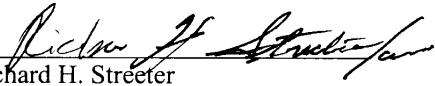
CONCLUSION

In general, while KCS and Tex Mex disagree with the idea that conditions need to be imposed on the transaction or that the policies underlying the new merger rules should govern, they nonetheless believe DOT's comments provide some meaningful insight. DOT found that the evidence in this proceeding clearly shows that no party has presented evidence that would allow this Board to find that a competitive problem is likely so as to justify treating the KCS/TM and KCS/TFM transactions any differently than previous end-to-end transactions. DOT's comments fully support the notion that long-standing precedent on vertical foreclosure and "one lump" are applicable here and that the transactions will not increase shippers' rates or cause vertical foreclosure of efficient interline routes. KCS and Tex Mex agree.

While DOT mistakenly applies *Major Rail Consolidation Procedures* to conclude that the Board may impose conditions without finding a likelihood of substantial competitive harm, DOT is correct in its ultimate conclusion that the Board should allow private agreements, accompanied by as-needed oversight if alleged competitive problems arise, to govern this proceeding. Such agreements are not limited by the scope of the Board's jurisdiction, and properly address the only potential problems which DOT foresees even possibly arising from the Tex Mex transaction. Furthermore, such agreements, combined with Board oversight, are more

than adequate to ensure that the Laredo gateway remains open to shippers on commercially reasonable terms.

Respectfully submitted,



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September 22, 2003

CERTIFICATE OF SERVICE

I have this day served a copy of the foregoing Reply To Comments of the U.S. Department of Transportation filed on behalf of KCS upon all other parties of record by depositing a copy in the U.S. mail in a properly addressed envelope with adequate first-class postage thereon prepaid or by other expeditious means.

Dated: September 22, 2003



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