



U.S. Department of Justice

Antitrust Division

Liberty Place Building
325 Seventh Street NW
Washington, DC 20530

February 24, 2004

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

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Re: Finance Docket No. 34424

Dear Secretary Williams:

We have enclosed an original and twenty copies of the Reply of the United States Department of Justice, and a computer diskette of this document. We are submitting only a public version of the Reply, as it includes no confidential data. The Reply is convertible to WordPerfect. The attachments are in a PDF format.

In addition, we have included an additional copy of the Reply, which we request be date-stamped and returned to our messenger.

Sincerely,

Robert L. McGeorge
Attorney

Enclosure

cc: Parties of Record (with enclosure)

– Public Copy –

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DOJ 3

BEFORE THE
SURFACE TRANSPORTATION BOARD



Canadian National Railway Company, and
Grand Trunk Corporation

– Control –

Duluth, Missabe and Iron Range Railway Company,
Bessemer and Lake Erie Railroad Company, and
The Pittsburgh & Conneaut Dock Company

Finance Docket No. 34424

REPLY OF
THE UNITED STATES DEPARTMENT OF JUSTICE

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R. Hewitt Pate
Assistant Attorney General

Roger W. Fones, Chief
Donna N. Kooperstein, Assistant Chief

J. Bruce McDonald
Deputy Assistant Attorney General

Robert L. McGeorge
Attorney

U.S. Department of Justice
Antitrust Division
Transportation, Energy & Agriculture
Section
325 7th Street, N.W.
Washington, D.C. 20530

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REPLY OF
THE UNITED STATES DEPARTMENT OF JUSTICE

I. Introduction

The Department of Justice hereby replies to the submissions of other parties in this proceeding, and urges the Surface Transportation Board (“the Board”) to impose conditions on any approval of Canadian National’s acquisition of railroad assets from Great Lakes Transportation to preserve the potential competition that Canadian National’s build-out opportunities provide to Great Lakes’ customers.

Our review of the competitive effects of this merger has focused on its acquisition of the Duluth, Missabe and Iron Range Railway Company (“DMIR”).¹ In our investigation, we have reviewed the comments and requests for conditions submitted by shippers (including Cleveland-Cliffs, Inc. and Ispat Inland Inc.), other railroads (including Burlington Northern Santa Fe (BNSF) and CSX) and other parties of record. We have also consulted public sources of relevant information, interviewed other shippers and met with representatives of the merging railroads.

¹ We refer to railroads by their common names in this reply. References to the primary railroads include their subsidiary railroads.

The proposed merger would combine the only railroad that transports iron ore and taconite moving from several sites in the Mesabe Range of Minnesota to U.S. steel mills in the Great Lakes region via rail/water and all rail services (DMIR), with the potential rail competitor who can enter these markets with the shortest build-outs to the Mesabe Range sites (Canadian National).² It is likely, therefore, that this transaction would reduce competition unless approval is conditioned to preserve potential competition from pre-merger build-out opportunities.

II. Possible Build-Out Opportunities

Based on comments filed by other parties, and our own investigation, it appears that the merger could eliminate potential competition from three possible Canadian National pre-merger build-out opportunities:

The EVTAC Taconite Processing Plant at Fairlane.³ The Department of Justice relies on the comments of Cleveland-Cliffs – one of the new owners of the former EVTAC taconite pellet processing plant and iron ore mine – for a detailed description of possible pre-merger build-out opportunities at this plant.⁴ In summary, the record in this proceeding indicates that DMIR is the only railroad that currently has access to the plant's ore/taconite loading facilities. Canadian National can provide general freight service to the plant, and its track stops only about 500 feet

² In this reply, we refer to “build-outs” and “build-ins” interchangeably.

³ All cities, rail stations and other geographic references in this reply are in Minnesota unless otherwise indicated.

⁴ Cleveland-Cliffs, Inc.'s Comments and Requests for Conditions (Jan. 26, 2004). Cleveland-Cliff's description of possible build-out opportunities and routings for the EVTAC mine and plant generally conforms to our independent analysis.

short of the ore/pellet loop track. With a short build-out, Canadian National could compete for the movement of taconite pellets from the plant over one or both of the following routes:

- a. **The “Virginia Routing.”** Currently, Canadian National, with the agreement of BNSF, could participate in a joint move from the taconite plant at Fairlane to BNSF’s ore dock at Superior, Wisconsin on the route described by Cleveland-Cliffs at page 16 of its comments (part of which would be via existing trackage rights on DMIR track between Virginia and Emmert Junction).⁵
- b. **The “Spirit Lake Routing.”** Pre-merger, Canadian National, with the agreement of BNSF, might be able to participate in a joint move from the taconite plant southward to BNSF’s ore dock at Superior (described at pages 16 - 19 of Cleveland-Cliffs’ comments). This routing, however, would depend on a successful challenge by Canadian National to the iron ore exclusion on its existing trackage rights agreement with DMIR for the Nopeming Junction/South Itaska track.

It does not appear that any other railroad could gain access to the Fairlane plant with a relatively short build-out (BNSF appears to be the next closest railroad, with a line about ten miles away from the Fairlane plant). Consequently, this appears to be a possible “two-to-one” competitive situation (*i.e.*, the number of railroads that have access to the facilities or that appear to be best-positioned to gain access to the facility with a build-out would decrease from two to one).

The EVTAC Thunderbird North Mine. The record in this proceeding also indicates that DMIR is currently the only railroad with access to the Thunderbird North mine near Shelton

⁵ The rail map that the parties provided at page 326 of their merger application does not show BNSF’s trackage rights on the DMIR track between the vicinity of Shelton and BNSF’s line west of Hibbing, but they subsequently confirmed the existence of these trackage rights.

Junction; but it appears that a build-out of about a mile could connect the mine to Canadian National's main line. With this build-out and the build-out to the Fairlane taconite processing plant described above, it appears that Canadian National could become the second railroad with the ability to compete for the movement of iron ore from the Thunderbird North mine to the Fairlane taconite processing plant.

This also appears to be a possible "two-to-one" competitive situation, as no railroad other than Canadian National could gain access to the Thunderbird North mine with a relatively short build-out to its track. Canadian National could provide single line service between the Thunderbird North mine and the Fairlane plant with these build-outs.

The U.S. Steel Minntac Mine. Finally, the record in this proceeding indicates that DMIR is the only railroad that currently has access to the Minntac mine near Mt. Iron; but it appears that a build-out of approximately four or five miles could connect the mine to Canadian National's main line in the vicinity of Minorca Junction. With this build-out, Canadian National and BNSF might be able to provide a joint line service from the mine to BNSF's ore dock at Superior via the Virginia Route, or possibly the via the Spirit Lake Route.

Again, this appears to be a possible "two-to-one" competitive situation. The next shortest build-out possibility appears to be a fifteen mile connection to BNSF's interchange at Emmert (but since it appears that BNSF might be able to reduce construction costs on this line by using an abandoned rail line, it may be appropriate to consider this as a possible "three-to-two").

III Conditions Required to Avoid the Loss of Potential Competition

It is a settled principle of antitrust law and economics that potential entrants can constrain the ability of actual competitors to exercise market power. Consequently, mergers and other

consolidations of actual entrants and potential entrants that eliminate the procompetitive effects of potential competition can harm competition – particularly if the potential entrant is one of a relatively small number of firms with the capacity and incentive to enter the market, the market is concentrated, and high barriers to entry are likely to deter other new entrants. In appropriate circumstances, the courts have enjoined such consolidations to preserve the procompetitive benefits of potential competition. *Yamaha Motor Co., Ltd. V. Federal Trade Commission*, 657 F.2d 971 (1981), *cert. den'd* 452 U.S. 915 (1982); *see also United States v. Marine Bancorporation*, 418 U.S. 602 (1974), *Engine Specialties, Inc. V. Bombardier Ltd*, 605 F.2d 1 (1979).

Currently, one railroad (DMIR) moves all of the iron ore from the Thunderbird North mine and all of the taconite from Fairlane and Minntac, and only one railroad (Canadian National) can constrain their market power by threatening to gain access to the EVTAC and Minntac sites through relatively short build-outs or build-ins. The relevant market, therefore, is heavily concentrated (and remains so even if we consider Minntac to be a “three-to-two”), and barriers to entry, other than possible Canadian National build-outs, are formidable. The threat of potential entry by a second railroad, therefore, must be preserved to constrain the merging railroads’ market power.

The proponents of build-out conditions are not required to prove that possible build-outs will necessarily be constructed. As noted in the *Conrail* merger case, it is sufficient that the build-out appears to be feasible. *CSX Corp. – Control and Operating Leases/Agreements – Conrail Inc.*, 1998 WL 456510 at 79 (1998).

All of the build-outs discussed in this reply certainly appear to be feasible. Reference to the railroad map in Canadian National’s merger application shows that the distance from each facility to the Canadian National line is a fraction of the distance to the next closest railroad (about 500 feet

versus about 10 miles for the Fairlane taconite processing plant, about a mile versus 12 or 13 miles for the Thunderbird North mine, and about four or five miles versus about 15 miles for the Minntac mine). And, the new owners of the former EVTAC facilities have spent considerable time, effort and money in this proceeding to preserve their build-out opportunities.⁶

Moreover, even where there is arguable doubt that an apparently feasible build-out will actually be constructed, the Board should strike the balance in favor of preserving potential competition. If a build-out that now appears to be feasible nonetheless proves infeasible later, the Board's preservation of that build-out opportunity imposes few if any costs.⁷

The Board, therefore, should preserve the current competitive discipline arising from Canadian National's presence as a potential entrant with rail lines a short distance away from the Thunderbird North mine, the Fairlane taconite plant and the Minntac mine by adopting conditions that put a replacement railroad in the same position as Canadian National before the merger. Those conditions should: (a) give a replacement railroad trackage rights over Canadian National's line from the vicinity of Minorca Junction to its connection with DMIR near Nopeming Junction; and (b) authorize it to connect that line to the Mesabe Range facilities through build-outs or build-ins.

⁶ No negative inference should be drawn from U.S. Steel's silence, as we understand that it is contractually prohibited from publicly advocating build-out conditions for its Minntac facility.

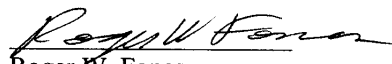
⁷ Likewise, if the Board gives a replacement railroad trackage rights over the Canadian National line from the Mesabe Range facilities to Nopeming Junction, and the opportunity to challenge the iron ore exclusion on DMIR's Nopeming Junction/South Itaska line, but that legal challenge is unsuccessful, it is unlikely that the condition will impose substantial costs on the merging parties. But, if the challenge is successful, and the new railroad (in conjunction with BNSF) is able to move iron ore and taconite from the Mesabe Range facilities to BNSF's docks at Superior, the benefits of preserving potential competition will almost certainly exceed whatever little costs might conceivably occur.

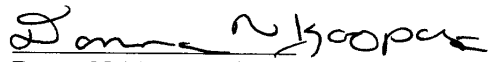
We leave the precise details of these trackage rights and build-out conditions to the Board (including the determination of whether the settlement agreement that we understand Cleveland-Cliffs has reached with the merging railroads adequately preserves potential competition and satisfies all other applicable public interest standards). We reiterate that the trackage rights fees to be paid by a replacement railroad should be set in a way that allows it to compete with the same marginal costs as the merged-out railroad. Otherwise, the Board's grant of build-out rights might be made irrelevant by Canadian National's unconstrained ability to price trackage rights in a way that the replacement railroad could not compete for the business. This is likely to be a particularly serious problem in this instance as the price of trackage rights may be a larger than usual share of the total cost of providing service, forcing the replacement railroad to be very sensitive to the marginal cost of these rights. We have appended relevant portions of the expert testimony of Peter Woodward and Robert Majure in previous railroad merger proceedings (with confidential information redacted) where they discuss this issue in more detail.

III. Conclusion

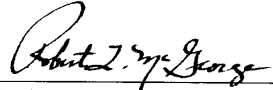
The Department of Justice opposes unconditional approval of the proposed merger. If the Board determines that the transaction otherwise meets the applicable approval standards, it should adopt appropriate conditions to preserve potential existing build-out opportunities.

Respectfully submitted,


Roger W. Fones
Chief



Donna N. Kooperstein
Assistant Chief



Robert L. McGeorge
Attorney

U.S. Department of Justice
Antitrust Division
Transportation, Energy & Agriculture Section
325 7th Street, N.W.; Fifth Floor
Washington, DC 20530

VERIFIED STATEMENT

OF

W. ROBERT MAJURE

1. Introduction

My name is W. Robert Majure. I am an economist with the Antitrust Division of the United States Department of Justice. During my tenure at the Antitrust Division, I have analyzed the competitive effects of mergers in numerous industries, including telecommunications, banking, computers and electronics. I have also analyzed joint ventures among competitors and business practices of firms with control of essential facilities. Attached is a copy of my curriculum vitae.

This statement evaluates the competitive effects of the proposed merger of the Union Pacific Corporation, Union Pacific Railroad Company and Missouri Pacific Railroad Company (collectively the UP) and the Southern Pacific Rail Corporation, Southern Pacific Transportation Company, St. Louis Southwestern Railway Company, SPCSL Corp. and The Denver and Rio Grande Western Railroad Company (collectively the SP) in ICC Finance Docket No. 32760.

My major conclusions are: First, this merger would create a rail monopoly in a large number of markets, representing \$ in commerce, where non-rail alternatives are unlikely to provide shippers an economic alternative. Second, the Applicants' proposed trackage rights "fix" involving the Burlington Northern/Santa Fe (BNSF) will not provide shippers with competition equivalent to that between the UP and SP. Third, this merger would create a duopoly in a much larger set of markets involving a substantially larger volume of affected commerce, nearly \$ annually. Rates are likely to rise significantly to shippers in these

(1) The Compensation Scheme Will Impair BNSF's Ability to Offer Competitive Rates to Shippers in Two-to-One Markets.

One of the most fundamental principles of microeconomics is that prices are an increasing function of marginal costs. The higher the marginal costs, the higher the price. And where there is an increase in the marginal cost of one of only two firms in a market, this will almost always lead to both charging higher prices. This principle is one of the key reasons why economists separate costs into those that are fixed and those that vary with output. Fixed costs are relevant to a firm's decision whether or not to participate in a market, they are not relevant to its pricing decisions once it has elected to operate in the market. Pricing decisions, on the other hand, are driven by whether an incremental unit of output contributes more to revenues than it contributes to costs. The variable costs associated with this incremental unit are the firm's marginal costs.

What does any of this have to do with the terms of the trackage rights agreement? The trackage rights agreement presented here shifts costs that are currently fixed costs for UP and SP to costs that are variable for BNSF. BNSF, to the extent it elects to provide service over the UP/SP lines, incurs a substantial trackage rights charge per gross ton mile. In other words, replacing SP with BNSF operating over the trackage rights will for many moves represent a

significant increase in this element of BNSF's marginal cost of providing service.¹⁹ This charge, really a "tax" on the BNSF, is substantially in excess of the variable cost to the UP and SP of operating over that same track today. As a result, I would expect that BNSF would be less committed to participate in any particular market and, where it does participate, the rates offered by both UP/SP and BNSF will likely be higher than they are today.

To best preserve competition, the independent competitor lost as a result of the merger should be replaced by another firm with incentives that are not substantially different. Divestiture is one way to ensure this similarity of incentives. This is not part of the Applicants' proposal. To preserve competition through a trackage rights arrangement one would have to structure a compensation scheme unlike the one being proposed. The compensation scheme put forth by the Applicants presents BNSF with too high a marginal cost of providing service in these two-to-one markets. The Applicants claim that this is appropriate because BNSF ought to be required to reimburse the track's owner (UP/SP) not simply for the costs incurred as BNSF runs over the track (the variable costs), but also for the costs of building, operating and maintaining these lines (a substantial share of which are fixed, rather than variable). Even if one were to agree with UP/SP on this point, there are ways of accomplishing these objectives without at the same time distorting BNSF's incentives and impairing its competitiveness. An economically correct approach would be to have the BNSF reimburse UP/SP for these two types of costs with two types of rates. If BNSF were to pay a fee up front for the rights to use the track (what

¹⁹ Other elements of marginal cost would include "above-the-wheel" costs such as train crew and fuel. Another element of marginal cost is the opportunity cost associated with allocating a locomotive or other equipment to provide the service on a given move rather than on another potentially profitable move.

economists call a "fixed fee") together with a usage charge calculated as the true marginal cost of exercising these rights, then UP/SP could be compensated for both types of costs without distorting BNSF's incentives.²⁰

Under the agreement, however, BNSF pays UP/SP nothing up front. Instead, BNSF pays a rate as the trackage rights are used that ranges from to mills per gross ton-mile. This rate is substantially greater than the true variable cost of using the track (i.e., substantially greater than the variable cost faced today by UP and SP). On page 306 in his verified statement (as corrected), John Rebensdorf (the Applicants' expert on the trackage rights agreement) states that this per-usage rate would be between % and % of a weighted average of the UP and SP average variable costs (based on the Uniform Rail Costing System figures for system-wide maintenance and operation of tracks). Rebensdorf points out that the costs to UP/SP of providing this service to BNSF would include not only these variable costs, but also most of the fixed costs of the track itself, which UP/SP would recover by charging BNSF on a per-use basis. As a result, the BNSF would have a drastically different cost structure than either the UP or SP has currently. Rebensdorf's numbers argue, therefore, that the BNSF would have variable cost as much as % higher than UP/SP and fixed cost 100% lower.

The difference in the cost structure would likely dampen significantly BNSF's incentives

²⁰ It is perhaps not surprising that the UP/SP did not choose an arrangement along these lines. Had it done so, the BNSF would become, by virtue of its now-lower marginal costs, a more serious and competitive rival. Under such a scheme, the question of what return UP/SP should receive on its prior investment in the track could be left to the negotiations between UP, SP and BNSF over the size of the up-front fee.

In sum, even in those markets where BNSF could use and did use the trackage rights, BNSF would always incur the averaged fixed cost as an increment to its marginal cost, which would likely make it less aggressive in pricing and in pursuing new business opportunities.

VERIFIED STATEMENT

OF

PETER A. WOODWARD.

My name is Peter A. Woodward. I am an economist with the Antitrust Division of the United States Department of Justice (DOJ). On May 10, the DOJ filed my testimony on the competitive effects of the proposed merger¹ of the Burlington Northern (BN) and The Atchison, Topeka, and Santa Fe (SF) railroads. This testimony included a verified statement which identified geographic areas in which the merger was likely to lead to higher prices for the transportation of many products.

This statement evaluates how the anticipated reduction in transportation competition in these areas is likely to be affected by private agreements granting trackage and haulage rights on parts of the BN and SF to the Union Pacific (UP) and Southern Pacific (SP) railroads.

The BN and SF have signed agreements² with the UP and SP which give these railroads access to many customers currently served by the BN and SF. These agreements add a railroad to most areas of BN/SF overlap. But this addition may not provide a

¹I.C.C. Finance Docket No. 32549.

²BNSF 0162738-771 (UP); BNSF 0163590-612 (SP); attached BN and SF press releases. The BN and SF have also signed trackage or haulage rights agreements with other railroads. Since these agreements do not affect those areas identified in my May 10 statement, I do not consider them here.

complete offset to the anticompetitive effects of the merger. I recommend that the ICC carefully consider the terms of these agreements.

Even if the tenant UP and SP can provide service which is adequate operationally for shippers, the level of the trackage rights fees remains a critical issue. Since the fees are based on the number of railcars or tons moved along the landlord's lines and sometimes also on the number of cars switched by the landlord, the higher the level of these fees, the less likely the tenant is to make low price offers to shippers in order to gain new business. Economic theory suggests that the tenant will consider the marginal cost of transporting a particular commodity in its pricing decision.⁵ As this cost increases, the price the tenant proposes will likely also increase since trackage rights fees are a component of marginal cost for the tenant. If the trackage rights fees are too high, the tenant will not make any offers to shippers in competition with the BN/SF's pre-merger prices. Recognizing this, BN/SF could profitably raise its own price after the merger. A high trackage rights fee, however, does not necessarily prevent the SP or the UP from competing with the BN/SF post-merger, provided BN/SF prices are higher post-merger than pre-merger. For this reason, the SP or UP might agree to high fees since all competing railroads could earn

⁵See, for example, J. Tirole, The Theory of Industrial Organization, (1988), p. 66 and p. 210, and D. Carlton and J. Perloff, Modern Industrial Organization (1990), p. 68 and p. 99.

profits at a higher price. This higher price harms shippers, however.

If the ICC uses trackage rights as a solution to competitive harm caused by a merger, the price of the rights should be set to restore as completely as possible the competitive conditions existing before the merger. In my earlier statement, I identified particular commodities and areas in which the number of railroads decreased from 2 to 1 or from 3 to 2, and where there was not sufficient intermodal competition to prevent a price increase post-merger. The agreements granting access to these areas by the SP or the UP can restore this lost competition only if the tenant railroad faces a pricing situation similar to that faced by either the BN or the SF pre-merger. That is, the tenant railroad, in deciding what price offers to make to shippers, should, to the degree feasible, have to pay only the costs of trackage or switching service from the BN or SF which these railroads themselves incurred from handling this traffic pre-merger. The tenant should be required to pay only those trackage costs which are generated by its actual track use, not those which would occur independently of the tenant's trains. Of course, the inherent efficiency of the tenant will (and should) dictate its railcar, locomotive, crew, and marketing costs, just as each firm competing in a market will prosper or decline according to its own efficiency. But in the special case of trackage rights granted to solve a competitive problem, the tenant railroad, if it is expected to replicate pre-merger

competition, should be granted the merging parties' track resources at their costs, and nothing higher.

In addition to the direct costs imposed on the BN/SF by the wear of the tenant's locomotives and cars, there is an additional, indirect cost imposed by the tenant. To the degree that the prices in the market exceed costs, all traffic carried by the SP or UP causes a reduction in profit for the BN/SF. This may properly be considered an appropriate cost for the BN/SF to bear, as it is caused by the remedy for the merger's anticompetitive effects.⁶ But this loss of traffic could cause a disincentive for the BN/SF to maintain the track, if it is denied an adequate return on its track investment. Even if the BN/SF were prohibited from abandoning the lines over which tenants operate, it could have an incentive to allow the track to deteriorate so much that the service offered by all railroads operating on the track declines. For this reason, any trackage rights fees should allow the landlord a return on its track investment sufficient to maintain the track at pre-merger levels. This return is also cost-based, as the landlord should receive a payment equal to the opportunity cost of the funds needed to maintain the track. The appropriate cost measure, then, should consist of both the direct cost imposed by the SP or UP trains on

⁶An asset divestiture required to remedy an anticompetitive effect caused by a merger can cause a similar wealth transfer. If a firm already in the market would have bid more than the ultimate asset acquirer, then the firm making the divestiture loses some of that asset's value.

BN/SF track, and a return on the investment in maintaining the track.