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August 11, 2008

BY HAND

Honorable Anne K. Quinlan
Acting Secretary
Surface Transportation Board
395 E Street, SW
Washington, DC 20423-00001

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Re Docket No 42104, *Entergy Arkansas, Inc and Entergy Services, Inc v Union Pacific Railroad Company and Missouri & Northern Arkansas Railroad Company, Inc*
Finance Docket No 32187, *Missouri & Northern Arkansas Railroad Company, Inc - Lease, Acquisition and Operation Exemption - Missouri Pacific Railroad Company and Burlington Northern Railroad Company*

Dear Acting Secretary Quinlan

Enclosed for filing *under seal* are an original and ten copies of the HIGHLY CONFIDENTIAL version of Union Pacific's Reply Evidence and Argument. This filing consists of one volume containing argument of counsel and witness statements, and a separate volume containing counsel's exhibits. We also have enclosed disks containing electronic versions of these highly confidential materials and supporting workpapers.

We have separately enclosed for filing in the Board's *public docket* an original and ten copies of a REDACTED version of Union Pacific's Reply Evidence and Argument, along with disks containing electronic versions of these redacted materials.

Additional paper copies of this filing are also enclosed. Please return date-stamped copies to our messenger.

Thank you for your attention to this matter.

Sincerely,

Michael L. Rosenthal

Enclosures

REDACTED – TO BE PLACED ON PUBLIC FILE

**BEFORE THE
SURFACE TRANSPORTATION BOARD**



ENTERGY ARKANSAS, INC and
ENTERGY SERVICES, INC , Complainants,

v

UNION PACIFIC RAILROAD COMPANY and
MISSOURI & NORTHERN ARKANSAS
RAILROAD COMPANY, INC., Defendants.

MISSOURI & NORTHERN ARKANSAS R R –
LEASE, ACQUISITION AND OPERATION
EXEMPTION – MISSOURI PACIFIC R R
and BURLINGTON NORTHERN R R

Docket No 42104

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Finance Docket No 32187

UNION PACIFIC'S REPLY EVIDENCE AND ARGUMENT

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Verified Statement of F M "Rick" Gough

Verified Statement of Michael R. Baranowski

Verified Statement of Daniel L Rubinfeld

TABLE OF ABBREVIATIONS

AECC	Arkansas Electric Cooperative Corporation
BN	Burlington Northern Railroad Company
BNSF	BNSF Railway Company, or its predecessor, Burlington Northern & Santa Fe Railway Company
CN	Canadian National Railway Company
CNW	Chicago & North Western Railway and its predecessors
Entergy	Entergy Arkansas, Inc , and Entergy Services, Inc.
Independence	Entergy's Independence Generating Station
KCS	Kansas City Southern Railway Company
M&NA	Missouri & Northern Arkansas Railroad Company
MRL	Montana Rail Link, Inc.
NCTA	National Coal Transportation Association
PRB	Powder River Basin
RailTex	RailTex, Inc., M&NA's parent company at the time of the UP/M&NA Lease
UP	Union Pacific Railroad Company and its predecessors
UP/M&NA Lease	Lease Agreement by and between Missouri Pacific Railroad Company and M&NA, dated December 11, 1992, as amended
UP/SP merger	Transaction approved in 1 S T B. 233 (1996)
URCS	Uniform Rail Costing System
White Bluff	Entergy's White Bluff Generating Station
WRPI	Western Railroad Properties, Inc

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**MISSOURI & NORTHERN ARKANSAS R R. –
LEASE, ACQUISITION AND OPERATION
EXEMPTION – MISSOURI PACIFIC R R
and BURLINGTON NORTHERN R R**

Finance Docket No 32187

UNION PACIFIC'S REPLY EVIDENCE AND ARGUMENT

Entergy has not shown that UP's enforcement of the UP/M&NA Lease's interchange commitment is, or would be, unlawful, contrary to the public interest, or unreasonable. Nor has it shown that the interchange commitment has reduced competition or produced higher rates or poorer service for any shipper. That is not surprising because the interchange commitment did not eliminate any competitive rate or routing options that were available to shippers before the lease. The interchange commitment thus does not increase UP's market power or give UP more control over shippers' rates or routes than if UP had never leased its lines to M&NA. Instead, the interchange commitment has allowed M&NA to use UP's lines for the past fifteen years without paying a single dollar of rent to UP.

In this proceeding, Entergy presents the same basic challenge to the UP/M&NA Lcase's interchange commitment that the Board has considered and rejected on many other occasions.

namely, that the lease did not create new competition. The agency has repeatedly held that railroads are not required to create new competition when they spin off lines to new short lines, leases containing interchange commitments are not anticompetitive or contrary to the public interest as long as the lessor obtains no greater market power or control over rates and routes than it would have had absent the transaction. Moreover, as the Board has recognized, leases containing interchange commitments produce public benefits even when they do not increase intramodal competition, indeed, Entergy's own expert economists conclude that such leases are consistent "with the social interest in efficient production" and "socially desirable."

Entergy tries to hide the weakness of its complaint by criticizing certain aspects of the lease as "unreasonable." Entergy claims that UP has earned more from the lease than it expected to earn by operating the lines itself, that M&NA's rent payments to UP for interchanging traffic moving to and from the leased lines with UP's competitors could exceed UP's lost contribution from that traffic, and that Entergy would be better protected against service failures if UP were precluded from enforcing the interchange commitment. But even if those claims were accurate, they would be irrelevant. Entergy never shows that UP has used, or could use, the interchange commitment to charge higher rates or force more traffic over its lines than if it had never entered into the lease.

In fact, the interchange commitment leaves UP with less control over rates and routes than if it had never leased its lines to M&NA. If UP had never entered into the lease, it would have controlled 100% of the traffic on the lines. The interchange commitment, however, covers

only 95% of through traffic, and UP surrendered all control over local traffic ¹ Similarly, UP cannot use the lease's contingent rent provision to achieve greater control over traffic on the leased lines than if it had never entered into the lease, the rent provision merely protects UP from uncompensated use of its lines by M&NA, which has never actually paid any rent In short, if UP has benefited from the lease (as it hoped it would when it entered into the transaction), its increased earnings are attributable to cost savings or other efficiencies from the spin-off itself, not the interchange commitment or the rent provision.

Entergy's complaints about UP service also have no connection to the interchange commitment Entergy claims that the interchange commitment has made it more difficult to obtain coal when UP was suffering service problems because UP refused to allow other carriers to provide service in conjunction with M&NA Entergy's claims are inaccurate, but even more important for this proceeding, none of the service problems that Entergy describes were caused by, or exacerbated by, the interchange commitment In each situation, Entergy would have been in the same position if UP had never leased its lines to M&NA

Entergy's real complaint is that the interchange commitment could be restructured to transfer more of the lease's benefits to Entergy, but that is no basis for relief Even if the Board were to deem the UP/M&NA Lease's interchange commitment somehow improper, the appropriate remedy would not be to preclude UP from enforcing it Such a remedy would essentially grant M&NA free use of UP's lines with no obligation to interchange traffic with UP or pay any compensation for the use of UP's property That would be grossly unfair to UP It

¹ "Through traffic" refers to traffic that M&NA originates or terminates on the leased lines and interchanges with another carrier "Local traffic" refers to traffic that both originates and terminates on the lines that UP leased or sold to M&NA

also would be disproportionate to the narrow criticisms of the interchange commitment actually offered by Entergy – *i.e.*, that UP used it to earn modestly more than the pre-transaction going concern value of its lines, that the contingent rent payment should more closely reflect potential lost contribution from traffic interchanged with other carriers, and that UP should have waived it during severe service disruptions.

If the Board finds that an interchange commitment is causing a violation of the Interstate Commerce Act, or is contrary to the statutory provision under which approval or exemption was sought, it can order a focused remedy to address the specific violation. But if the remedy would effectively change the terms of a lease or sale agreement, then the Board must give the parties the opportunity to unwind their transactions if either party is unwilling to accept any new requirements established by the Board.

In the Parts below, UP elaborates on the points discussed above and responds to other, more peripheral, points raised by Entergy and AECC. Specifically, Part I discusses the history and background of the lease. Part II describes how the lease preserves and enhances competition for shippers on the affected lines. Part III demonstrates that the lease is lawful and consistent with the public interest. Part IV refutes Entergy's arguments for revoking the exemption authorizing the lease and for holding that the lease constitutes an unauthorized pooling arrangement. Part V explains why the Board should reject each of the specific remedies proposed by Entergy.

UP's reply evidence includes:

- the Verified Statement of Mr. Warren C. Wilson, who describes UP's reasons for entering into the UP/M&NA Lease and the development of the lease terms, including the interchange commitment,

- the Verified Statement of Mr F. M. “Rick” Gough, who describes the effects of the UP/M&NA Lease on Entergy and refutes claims by Entergy and AECC that the lease has impeded Entergy’s ability to obtain coal deliveries,
- the Verified Statement of Michael R. Baranowski, who discusses the flaws in Entergy’s evaluation of the economic impact of the UP/M&NA Lease, and
- the Verified Statement of Dr. Daniel L. Rubinfeld, who discusses the competitive impacts of the UP/M&NA Lease and responds to the testimony of Entergy’s competition experts

UP’s reply evidence and argument demonstrate that the UP/M&NA Lease’s interchange commitment is lawful, consistent with the public interest, and otherwise reasonable and that Entergy has not established any basis for relief.

I. BACKGROUND AND HISTORY OF THE UP/M&NA LEASE

The UP/M&NA Lease was one part of a larger transaction in which UP leased and sold three portions of its Carthage Subdivision to M&NA. Specifically, UP leased M&NA its lines and connecting branches on the western end between Pleasant Hill, Missouri, and Bergman, Arkansas, sold its line in the middle between Bergman and Guion, Arkansas, and leased its line on the eastern end between Guion and Diaz Junction, Arkansas. UP also granted M&NA trackage rights over its line from Pleasant Hill to Kansas City, Missouri, to interchange traffic with UP. Entergy’s Independence plant is located on the leased line between Guion and Diaz Junction, approximately nine miles west of Diaz Junction. (Wilson VS at 5-9; *see also* UP Counsel’s Exhibit Nos. 1 & 2)²

Prior to UP’s transaction with M&NA, Entergy’s Independence plant and almost all of the other shippers on the affected lines were served exclusively by UP. Thus, if UP had never

² UP Counsel’s Exhibit No. 1 is a copy of the lease. UP Counsel’s Exhibit No. 2 is a map depicting the lines affected by the transaction. The Independence plant’s rail station is technically Newark, but we will refer to it as Independence throughout this filing.

leased its lines to M&NA, Entergy's Independence plant still would be served exclusively by UP (Wilson VS at 9-10)

A. UP's Decision To Spin Off The Carthage Subdivision

UP's motivation for entering into the M&NA transaction was similar to its motivation for entering into many other spin-offs that occurred during the same time period. UP was seeking a lower cost option for operating and maintaining relatively light density lines so it could make more effective use of capital and other resources, while preserving the revenue stream from the traffic it was serving on the lines. UP considered the Carthage Subdivision as a spin-off candidate because UP had shifted a significant amount of the traffic that had once traversed the lines, including traffic to Entergy's Independence plant, to a more efficient route (*Id* at 6). By the time UP was considering the spin-off, Independence coal traffic was moving over UP's lines to Kansas City, then south through Parsons, Kansas, and east to Little Rock, Arkansas, before turning north to Diaz Junction. The traffic moved over the Carthage Subdivision for only the 9.3 miles between Diaz Junction and Independence (*Id* ; *see also* UP Counsel's Exhibit No. 3.)³

UP ultimately decided to seek bids for a package that included a lease of the Pleasant Hill-Bergman and Guion-Diaz Junction lines and a sale of the Bergman-Guion line. UP asked interested parties to assume that the transaction would include an interchange commitment for traffic on the leased lines and would exclude traffic moving to Independence (Wilson VS at 7). UP asked bidders to specify (i) the amount they would require to handle traffic on the Pleasant Hill-Bergman and Guion-Diaz Junction lines to and from interchanges with UP, (ii) the amount they would pay for the Bergman-Guion line, without any obligation to interchange traffic on that

³ UP Counsel's Exhibit No. 3 is a map depicting the route used for traffic to Independence.

line with UP, and (iii) the amount they would require UP to pay for trackage rights between Diaz Junction and Independence, so UP could continue providing service to Entergy (*Id* at 7-8)

After reviewing the bids, UP entered into discussions with M&NA to develop the specific terms of the transaction, including a schedule of UP's payments to compensate M&NA for handling traffic to and from interchanges with UP. (*Id* at 8)

B. UP's Analysis Of The Potential M&NA Transaction

As part of its internal approval process, UP analyzed what it regarded as the two alternatives for the Carthage Subdivision. The first was to continue operating the Pleasant Hill-Bergman and Guion-Diaz Junction lines itself and abandon the Bergman-Guion line. The second was to lease the Pleasant Hill-Bergman and Guion-Diaz Junction lines and sell the Bergman-Guion line to M&NA. UP concluded that the lease/sale alternative would be preferable, as long as it could maintain its revenue stream from through traffic on the leased lines. UP estimated that the present value of the lease/sale alternative would exceed the present value of the operate/abandon alternative by { } to { }, depending on how quickly it could realize certain labor cost savings, as long as M&NA interchanged the traffic originating and terminating on the leased lines with UP. (*Id* , *see also* UP Counsel's Exhibit No. 4)⁴

UP initially did not intend M&NA to handle coal traffic to Independence. In 1991, UP and Entergy had entered into a ten-year contract for UP to transport 100% of Entergy's PRB coal requirements to Independence, and UP planned to provide this service itself using trackage rights over the leased lines between Diaz Junction and Independence. (Wilson VS at 8-9) UP's analysis of the transaction expressly excluded Entergy's traffic and assumed that UP would pay

⁴ UP Counsel's Exhibit No. 4 is a copy of UP's "Approval for Line Disposition" and accompanying analyses

M&NA \$60,000 per year for trackage rights – the amount M&NA had requested in its bid (See UP Counsel's Exhibit No 4.)

C. UP's Decision To Include Entergy Traffic In The Lease

UP's plans with respect to Entergy's traffic changed late in the process of negotiating a final agreement with M&NA, {

}. (Wilson VS at 8)⁵ After

UP recognized this issue, UP and M&NA agreed to treat Entergy's traffic like other traffic on the leased lines they established a division that UP would pay M&NA for handling Entergy's coal trains between Diaz Junction and Independence (*Id*)

UP and M&NA also agreed that UP would retain an option to acquire trackage rights between Diaz Junction and Independence and resume its exclusive service to Entergy for \$60,000 per year – the amount M&NA previously requested for those rights (*Id* at 9) Indeed, {

} (*Id* , see also UP Counsel's Exhibit No 5)⁶

D. The Lease's Interchange And Contingent Rent Provisions

The UP/M&NA Lease's interchange and contingent rent provisions reflect the parties' expectations that M&NA would interchange most traffic on the leased lines with UP, and they

⁵ {

}. (*Id* at 8 n.4)

⁶ UP Counsel's Exhibit No. 5 is a copy of a letter agreement between UP and Entergy relating to the UP/M&NA Lease

were designed to preserve UP's revenue stream from traffic that UP would have originated or terminated on the leased lines absent the transaction. (Wilson VS at 1-2)⁷

When M&NA handles traffic under the interchange commitment, UP establishes the linehaul rate (just as it would have done before the lease) and pays M&NA a division to handle the traffic over the leased lines to or from an interchange with UP. (Wilson VS at 15-16; Lease § 22 01) UP and M&NA negotiated the specific divisions based on M&NA's bid for the right to operate the leased lines – *i.e.*, based on the amount M&NA had told UP it wanted to handle traffic to and from interchanges with UP (Wilson VS at 17)

Under the lease, M&NA pays no rent for using more than 400 miles of UP's rail lines as long as it interchanges 95% or more of the traffic originating or terminating on the lines with UP. (*Id.* at 5, 12-13, Lease § 4 01) That figure excludes local traffic and traffic from industries that were open to reciprocal switching before the transaction (Lease § 4.02.) UP also agreed to consider additional exceptions on a case-by-case basis (*Id.*) If M&NA interchanges more than 5% of the traffic originating or terminating on the lines with other carriers, UP is entitled to rent payments that increase in graduated increments, from \$10 million if M&NA interchanges 6% to 15% with other carriers, to a maximum of \$90 million if M&NA interchanges 96% or more of its through traffic with carriers other than UP (*Id.* § 4.03)

UP never expected to collect rent from M&NA. UP entered into the lease expecting M&NA to interchange most of its through traffic with UP and to obtain its compensation through costs savings associated with M&NA's handling the traffic on the leased lines rather than UP

⁷ UP's sale of the Bergman-Guion line to M&NA did not include an interchange commitment. M&NA purchased the Bergman-Guion line outright and may interchange traffic moving to or from shippers on those lines with any railroad that connects with its system (*Id.* at 11)

(Wilson VS at 1-2, 13) Under the lease, however, M&NA has full and exclusive use of the leased premises for the operation of rail freight service, as well as the right to interchange traffic with all present and future railroads at Springfield, Joplin, Carthage, Lamar, Aurora and Nevada, Missouri, and Ft. Scott, Kansas. (Lease § 3.01) Thus, if the lease did not include a contingent rent provision, M&NA could have used UP's lines for free while interchanging its through traffic with other railroads, which plainly would have been unfair to UP (Wilson VS at 13)

UP can never force M&NA to pay rent, because M&NA can always chose to interchange 95% or more of its through traffic with UP (*Id*) UP's only objective was to set the contingent rent high enough to preserve its revenue stream from through traffic on the lines for the life of the lease. (*Id* at 13-14) In fact, M&NA has never paid UP any rent (*Id*. at 13)

UP has used similar interchange commitments in most of its short line leases (*Id* at 4) UP believes that such arrangements provide the best opportunity to generate a fair return on the value of its property, while maximizing the short line's prospects for long-term success (*Id* at 4-5) In UP's experience, short lines cannot afford to pay a purchase price or lease rental reflecting the full going concern value of lines with significant traffic (*Id* at 5) Even if financing were available, the short line would be saddled with debt, which could force it to raise rates or curtail maintenance. (*Id*) Moreover, by accepting a percentage of traffic interchanged rather than requiring a set rent payment, UP relieves the short line of much of the risk associated with any future reductions in traffic by continuing to bear that risk itself (*Id*)

Under this arrangement, M&NA never will acquire ownership of the leased lines. M&NA never will pay UP the lines' going concern value, no matter how long the lease lasts Under the interchange commitment, UP either retains the traffic it would have handled if it had never leased its lines, plus a share of any cost savings from M&NA's performing service on the

leased lines rather than UP, or receives rent. The interchange commitment is thus necessary to the transaction, and it must remain in place for the life of the lease. Otherwise, M&NA could use the lines to divert traffic to UP's competitors without compensating UP. UP never would have agreed to such an arrangement. (*Id.* at 2-3.)

E. ICC Authorization Of The Lease

The UP/M&NA Lease was neither novel nor controversial.⁸ The lease was authorized under a class exemption the ICC adopted as a result of its experience with the many short line spin-offs that occurred following enactment of the Staggers Act. *See Class Exemption for the Acquisition and Operation of Rail Lines Under 49 U.S.C. § 10901*, 11 C.C.2d 810 (1985).

In *Class Exemption*, the agency exempted most short line spin-offs from regulation based on its understanding that they "generally will maintain the *status quo* and will not change the competitive situation." *Id.* at 817. It concluded that the exemption would foster the national rail transportation policy by facilitating transactions that benefit both shippers and railroads.

"The transfer of abandoned or underused rail property for more efficient use by a railroad can be beneficial to the shippers on the line, to the community that the line runs through, and to the selling railroad. When a transfer occurs, shippers receive continued, if not enhanced service, while the selling railroad continues to receive the feeder traffic generated by the line at its junction point with the new operator." *Id.* at 813.

The ICC explained that if a shipper believed that a spin-off was or would be anticompetitive, the proper course was to petition for revocation of the exemption, and the agency specifically

⁸ Rail labor interests petitioned to revoke the exemption that authorized the transaction on the grounds that the transaction had been structured to avoid labor protection – an objection that was often raised in spin-off transactions – but the ICC denied the petition. *Missouri & N. Arkansas R.R. – Lease, Acquisition & Operation Exemption – Missouri Pac. R.R. & Burlington N.R.R.*, Finance Docket No. 32187 (ICC served May 4, 1993).

reserved “the right to require divestiture to avoid abuses of market power resulting from the transaction ” *Id* at 812

The ICC approved the use of interchange commitments in spin-offs shortly after adopting the class exemption, and several years before the UP/M&NA transaction. In *Montana Rail Link, Inc – Exemption Acquisition and Operation – Certain Lines of Burlington Northern Railroad*, Finance Docket No. 31089 (ICC served May 26, 1988), the ICC addressed a claim that BN’s spin-off of certain lines to MRL was anticompetitive because MRL had agreed to pay BN such a high fee for interchanging traffic with other carriers that it rendered the use of competing carriers “economically prohibitive.” *Id* at 8. The agency rejected arguments that the interchange commitment reduced competition or increased BN’s market power. “BN’s transfer of these lines that it formerly owned and operated to a new, separate, independent carrier will not result in more control or any new power by BN over transportation involving those lines ” *Id* at 20. The agency explained that BN’s retention of rate and routing control over traffic on the affected lines could not be anticompetitive. “Prior to the transfer, as owner, BN exercised total control over the rates and routes on the [leased line], including the power to discourage shippers from interlining at certain BN-controlled gateways. Consequently, BN’s control over this traffic after the transfer, *even if MRL were totally precluded from offering competitive options to its shippers via-a-vis the BN*, would not lead to the conclusion that competition would be reduced ” *Id* at 20 (emphasis added). The agency also emphasized that there was “no new condition imposed upon the traffic by this transaction that would cause a shipper to pay rates exceeding the levels it would have otherwise faced with the prior, single carrier ” *Id*

The ICC specifically rejected concerns that a lessor’s right under the interchange commitment to extract added charges for traffic interlined with other carriers would discourage

the lessee from offering new interline routes: "BN's control over MRL interline traffic subject to such charges is no greater, and cannot be greater, than when BN was the sole carrier." *Id* The agency also expressly rejected arguments that the transaction could not qualify for an exemption unless it actually increased the level of competition existing prior to the transaction, observing that the exemption applied to transactions that "will maintain the *status quo* and will not change the competitive situation." *Id* (quoting *Class Exemption*, 1 I.C.C 2d at 817)

The ICC ultimately concluded, based on its experience with similar spin-offs, that the transaction, including the interchange commitment, was likely to be pro-competitive:

"Rather than being anticompetitive, we conclude that this transaction will likely promote competition, as well as various other rail transportation policy goals. As we have stated in the past, it has been our experience with transactions of this type that the acquiring firm will bring new vitality to the line. Typically, the new operator has closer ties to local communities and will provide better service, often at lower rates, and will work closely with shippers on the line." *Id* at 21

The ICC followed the same reasoning when it approved a spin-off containing a similar interchange commitment in *South Carolina Central Railroad – Purchase & Lease – CSX Transportation, Inc. , Lines in Georgia & Alabama*, Finance Docket No. 31360 (ICC served May 4, 1989) at 8 ("At present, CSXT is the sole carrier serving Lynn. As a consequence, it effectively controls both the Columbus-Lynn and the Bainbridge-Lynn routings. Approving this transaction will not change Amoco's competitive transportation alternatives, its negotiating leverage at Lynn will remain the same.")

At the time UP and M&NA entered into their lease, UP understood that the interchange commitment was lawful based on clear agency precedent. (Wilson VS at 2 n 1.)

II. THE UP/M&NA LEASE PRESERVED AND ENHANCED COMPETITION FOR SHIPPERS ON THE CARTHAGE SUBDIVISION

Entergy's basic complaint in this proceeding is that the UP/M&NA Lease's interchange commitment prevents M&NA from offering through rates and routes to the Independence plant with carriers other than UP. However, the lease did not reduce Entergy's competitive options, instead, it maintained, and even slightly improved, the competitive *status quo*.

Before turning to a detailed analysis of Entergy's claims, it is important to set out the competitive consequences of the UP/M&NA Lease: the transaction preserved and enhanced competition for shippers on the affected lines. UP did not, and could not, gain any market power or any additional control of rates or routes as a result of the lease. Prior to the spin-off, Entergy and almost all other shippers on the lines were served exclusively by UP. Neither Entergy nor any other shipper lost a competitive rate or routing option as a result of the transaction. In fact, the transaction increased their competitive options.

A. No Shipper Lost A Competitive Option Because Of The Lease

UP and M&NA structured the interchange commitment so that no shipper lost a competitive option. Almost all of the shippers on the affected lines – including Entergy – have always been served exclusively by UP. (Wilson VS at 9-10.) For those that were served exclusively by UP before the spin-off, the interchange commitment did not eliminate any competitive options. (*Id.* at 10.) However, some of the stations on the leased lines had industries that were open to reciprocal switching. In order to preserve those shippers' pre-transaction opportunities to obtain competitive through rates and routes with third-party carriers, UP and M&NA expressly excluded traffic to and from those industries from the interchange commitment. (*Id.*, Lease § 4.02.)

B. Shippers Gained New Competitive Options Because Of The Lease

The UP/M&NA Lease also created new competition. Because M&NA has no obligation to pay rent unless it interchanges less than 95% of its through traffic with UP, M&NA can interchange up to 5% of its through traffic with UP's competitors and still pay no rent. The lease thus created new competition for 5% of the traffic that UP would have served exclusively if it had not leased its lines to M&NA. (Wilson VS at 10) The 5% figure represents a substantial amount of traffic. Based on M&NA's traffic in 2007, {

} (*Id* at 11)

In addition, UP's sale of its Bergman-Guion line preserved rail competition for shippers on that line. If UP had not sold the line, it likely would have abandoned it, which would have left shippers without rail service. The sale thus preserved rail as a competitive option. (*Id*) Also, there are no restrictions on M&NA's ability to interchange traffic to and from that line with carriers other than UP. (*Id*)

C. The Lease Did Not Reduce Entergy's Competitive Options

The UP/M&NA Lease did not reduce Entergy's competitive options. Before the lease, Entergy's Independence plant was served exclusively by UP. As a practical matter, Entergy is in the same position today – the interchange commitment preserved the competitive *status quo*. The reason Entergy does not have intramodal competition at Independence has nothing to do with the lease, Entergy does not have intramodal competition at Independence because it decided to build its plant at a location served by only one railroad.⁹

Moreover, UP never would have leased lines to M&NA if it could not have maintained the revenue stream associated with providing exclusive service to Independence. UP's analysis

⁹ See *Coal, Wyoming to Redfield, Arkansas*, 364 U.S. 988, 989 (1981)

of the transaction shows that the lease made financial sense only if UP could maintain its revenue stream from through traffic on the leased lines. If UP had ever thought that entering into the lease would place that revenue stream at risk, UP would have continued to operate the lines itself. (Wilson VS at 2-3)

In fact, Entergy does not even attempt to show that the lease has resulted in higher rates for traffic moving to Independence. Any attempt would be futile. Entergy's rates for PRB coal moving to Independence actually { } after UP leased its lines to M&NA. Immediately prior to the lease, Entergy was paying approximately { } per net ton. (Gough VS at 2) By December 2007, Entergy was paying just { } per net ton. (*Id*) Entergy's rates in 2008 { } (*Id* at 2-3)

D. The Lease Enhanced UP's Ability To Serve Entergy

In addition, contrary to Entergy's claim that it has not benefited from the UP/M&NA Lease, the spin-off has allowed UP to provide better service to Independence. If UP had not sold the Bergman-Guion line to M&NA, it likely would have abandoned the line, thus severing the through route between Kansas City, Independence, and Diaz Junction. (Wilson VS at 12) That abandonment would not have had immediate consequences for Entergy because UP was not using the line to serve Independence, but it would have precluded service improvements that are now benefiting Entergy. (*Id*)

During its service problems in 1997-1998, UP developed a plan that allowed it to improve service by routing Entergy's empty coal trains over M&NA's Bergman-Guion line between Independence and Kansas City. (Gough VS at 5) That routing proved successful and

remains in place today (*Id*) The routing would not have been available if UP had abandoned the Bergman-Guion line rather than selling it to M&NA

Furthermore, Entergy has claimed an interest in sourcing coal originated on M&NA at mines in western Missouri. (*See Review of Rail Access and Competition Issues*, STB Ex Parte No 575, Comments of Entergy, Herndon VS at 8 (Mar 8, 2008)) There would be no direct route for moving that coal between those western Missouri mines and Independence if UP had abandoned the Bergman-Guion line rather than sold it to M&NA ¹⁰

Entergy and AECC incorrectly claim that the interchange commitment has prevented them from obtaining alternative service when UP was having difficulty supplying coal to Independence UP addresses those claims in detail and refutes them in Section III F However, the overriding point is that the lease could not, and did not, reduce Entergy's ability to obtain alternative service. Entergy would have been in the same position if UP had never leased its lines If UP had never leased its lines, Entergy's Independence plant would have been served exclusively by UP. In that case, Entergy would have had no greater opportunities to obtain alternative service than are available under the lease

In short, Entergy has not demonstrated – nor could it – that the spin-off of the Carthage Subdivision to M&NA has harmed competition or was not in the public interest

¹⁰ Entergy and AECC have asserted in prior proceedings that UP could block Entergy from using western Missouri coal by asserting its right under the UP/M&NA Lease to reestablish exclusive service to Independence (*See, e g , Review of Rail Access and Competition Issues*, STB Ex Parte No 575, Comments of Entergy at 4 (Mar 8, 2008)) However, UP could not prevent Entergy from moving western Missouri coal by reestablishing exclusive service to Independence UP still would have a statutory obligation to establish a through route with M&NA. *See* 49 U S C § 10703.

III. THE UP/M&NA LEASE'S INTERCHANGE COMMITMENT IS LAWFUL AND CONSISTENT WITH THE PUBLIC INTEREST

The Board and the ICC have concluded repeatedly over the past two decades that short line spin-offs containing interchange commitments are lawful and consistent with the public interest. The Board reaffirmed that conclusion most recently in *Review of Rail Access and Competition Issues – Renewed Petition of the Western Coal Traffic League*, Ex Parte No. 575 (STB served Oct. 30, 2007) (“*Ex Parte No. 575*”).

Entergy's fundamental challenge to the UP/M&NA Lease's interchange commitment – that the lease did not expand its competitive options – has been considered and rejected in other Board proceedings. The agency has repeatedly held that railroads are not required to create new competition when they spin off lines to new short lines and that leases containing interchange commitments are not unlawful or contrary to the public interest as long as they do not give the lessor greater market power or control over rates or routes than if it had never leased its lines.

Recognizing the weakness of its challenge, Entergy tries to shift focus by criticizing certain aspects of the lease as “unreasonable.” Entergy claims that UP has earned more from the lease than it expected to earn by operating the leased lines itself, that M&NA's contingent rent payments are too high, and that Entergy would be more confident about receiving reliable service if M&NA could freely interchange traffic with other carriers. Those claims are irrelevant, as well as spurious. Entergy never shows that UP has used, or could use, the interchange commitment to increase its market power or gain greater control over rates and routes than if it had never entered into the lease.

Moreover, Entergy essentially concedes the public interest benefits of the interchange commitment. Entergy “does not question that interchange restrictions in agreements relating to the lease or sale of a rail line can play an important role in the development of short-line carriers,

and can play an important role in allowing Class I carries to rationalize their systems and to improve overall service to customers ” (Entergy Argument at 2) In fact, Entergy’s experts conclude that spin-offs containing interchange commitments are in the public interest even though shippers may not immediately recognize the benefits They explain that the transactions produce gains “in production efficiency” that represent “a socially desirable outcome” and that they also may allow railroads to free up “scarce management and capital resources ” (Kwoka/Warren-Boulton VS at 6 & 7 n 2) Entergy, which bears the burden of proof in this proceeding, offers no evidence to contest the conclusion that the challenged interchange commitment’s benefits outweigh any potential for harm.

A. The Board’s Legal Standard For Evaluating Interchange Commitments

In *Ex Parte No 575*, the Board instructed shippers seeking to challenge an existing interchange commitment to identify substantive statutory provisions that were being violated or present valid grounds for reopening the proceeding under which the transaction was authorized Specifically, the Board stated that shippers could challenge an existing interchange commitment in two ways First, they could try to show that it “is causing, or would cause, a violation of the Interstate Commerce Act ” *Ex Parte No 575* at 15 As examples, the Board cited Sections 10703, 10705, 10742, and 11101(a) of Title 49 *Id* at 15 & n.38 Second, they could move “to reopen a proceeding authorizing a prior transaction or to partially revoke an exemption granted under 49 U S C 10502 ” *Id* at 15 In that case, they would have to show material error, new evidence, or substantially changed circumstances, *see* 49 C F R. § 1115.3(b), and then present “reasonable, specific concerns demonstrating that reconsideration of the exemption is warranted and regulation of the transaction is necessary ” *I&M Rail Link LLC – Acquisition & Operation*

Exemption – Certain Lines of Soo Line R R, Finance Docket No 33326 (STB served Apr 2, 1997) at 7, *aff'd sub nom City of Ottumwa v STB*, 153 F 3d 879 (8th Cir 1998).¹¹

The Board's *Ex Parte No 575* decision did not change the agency's basic approach to analyzing interchange commitments. After reviewing extensive testimony from Class I railroads, short lines, and shippers, the Board reaffirmed its long-held view that interchange commitments have significant, pro-competitive benefits. "Generally, interchange commitments have facilitated the creation and growth of short line railroads, which in turn has benefited the public by lowering transportation costs, improving service, and in some cases preserving rail transportation to localities and communities that might otherwise have seen service over their lighter-density line deteriorate or be lost altogether " *Ex Parte No 575* at 7

The Board rejected claims that "interchange commitments are inherently anticompetitive and contrary to the public interest because they discourage or prevent short lines from offering existing shippers competitive through routes with third-party carriers " *Id* at 8 The Board explained that interchange commitments are not anticompetitive as long as shippers were "no worse off as a result of the interchange commitment " *Id* It also illustrated why a rail carrier would have no greater control of a shipper's rates or routes than if it never entered into a lease with an interchange commitment *Id* at 8-9 It observed that opponents of interchange commitments were seeking "to create a new competitive option that did not exist prior to the sale

¹¹ The Board also discussed several factors it would consider when it evaluates whether an interchange commitment is in the "public interest," but those factors expressly apply only when the Board is asked to consider a "*proposed* interchange commitment " *Ex Parte No 575* at 15 (emphasis added) Thus, Entergy is incorrect when it claims that the UP/M&NA Lease's interchange commitment is subject to a "higher level of scrutiny" because it goes on "in perpetuity " (Entergy Argument at 18, quoting *Ex Parte No 575* at 15) In any event, the challenged interchange commitment does not go on "in perpetuity," or any longer than necessary to serve its purpose, it expires when the lease expires.

or lease,” and that the competitive effects of interchange commitments had to be “viewed *ex ante* (i.e., before the sale or lease of the facilities)” *Id.* at 9

The Board also rejected claims that long-term interchange commitments are inherently suspect. The Board noted that interchange commitments were merely one way for carriers considering the sale or lease of lines with traffic that makes a revenue contribution to preserve the value of their revenue stream. *Id.* at 10. It also recognized that money has a time value, and a carrier that uses an interchange commitment to maintain its revenue stream in lieu of rent will never receive the going concern value of the revenue stream that it would have demanded in a sale. *Id.* at 10 & n.26

Finally, the Board rejected suggestions that short lines were unable to protect their own financial interests in negotiating spin-offs. “As regulators, the Board must be very wary of the temptation to override the determination of reasonable compensation as negotiated by informed private parties.” *Id.* at 11

The Board’s only change in its approach to interchange commitments was to expose *proposed* interchange commitments to scrutiny before transactions were exempted, rather than rely on the revocation procedure discussed in *Class Exemption*. With respect to existing interchange commitments, the Board merely reaffirmed what the ICC had recognized in *Class Exemption*: they take varying forms and some might possibly cause a violation of the Interstate Commerce Act or produce anticompetitive effects that would be inconsistent with the exemption established in *Class Exemption*. The Board’s *Ex Parte No. 575* decision did not call into question the legitimacy of the form of interchange commitment used in the UP/M&NA Lease.

In Section III B, we address Entergy’s legal argument that UP’s enforcement of the interchange commitment would constitute an “unreasonable practice.” Then, in the remainder of

the section, we address Entergy's claims that particular features of the lease are "unreasonable " Specifically, in Section III C , we show that the interchange commitment does not increase UP's market power, in Section III D , we show that UP is not being overcompensated for the value of the leased lines, in Section III E, we refute Entergy's claim that the lease's contingent rent provision acts as a "penalty". in Section III F, we refute Entergy's claims that the interchange commitment has harmed service to Independence, and in Section III G, we refute Entergy's claim that Entergy's interests are consistent with the interests of M&NA and other shippers on the leased lines.

B. UP's Enforcement Of The Lease's Interchange Commitment Would Not Constitute An "Unreasonable Practice"

Entergy's primary legal claim in this case is that enforcement of the UP/M&NA Lease's interchange commitment would constitute an "unreasonable practice " (Entergy Argument at 33-37) It is doubtful that the terms of a transaction authorized under a class exemption could ever be challenged as an "unreasonable practice," but even if they could, Board precedent establishes that it "is not an unreasonable practice for a carrier to act in a manner, as here, designed to protect its profits and its market share from diversion to its competitors " *DHX, Inc v Matson Navigation Co* , Docket No WCC-105 (STB served Dec 15, 2004) at 5, *aff'd sub nom DHX, Inc v STB*, 501 F 3d 1080 (9th Cir 2007)

The Board did not appear to have "unreasonable practice" claims in mind when it stated that a shipper could attempt to show that an interchange commitment "is causing, or would cause, a violation of the Interstate Commerce Act " *Ex Parte No 575* at 15 It did not list Section 10702(2) among the examples of statutory provisions that a shipper might invoke *Id* at 15 n.38 The Board's examples all involve more clearly defined duties related to establishing

through rates and routes, rather than the general principle that “practices” must be “reasonable ”
Compare 49 U S C § 10702(2) with 49 U.S.C. §§ 10703, 10705, 10742, 11101(a) ¹²

Indeed, Entergy’s claim makes no sense the challenged interchange commitment is a term of an agency-authorized transaction, and merely enforcing the terms of such a transaction cannot be considered an “unreasonable practice ” Not surprisingly, Entergy does not cite a single case in which the agency has used its unreasonable practice jurisdiction to invalidate terms of an authorized transaction

Moreover, Entergy’s attempt to invoke the Board’s authority over unreasonable practices is perfunctory and ignores relevant precedent, none of the cases cited by Entergy comes close to addressing the issues in this proceeding Entergy never even mentions the Board’s holding, recently affirmed by the U.S. Court of Appeals for the Ninth Circuit, that it “is not an unreasonable practice for a carrier to act in a manner, as here, designed to protect its profits and its market share from diversion to its competitors ” *DHX* at 5

Even if the *DHX* decision were not dispositive, there would be no basis for the Board to conclude that enforcing the challenged interchange commitment would be an “unreasonable practice ” Determining whether a railroad practice is “unreasonable” requires an analysis of “the congressional directions embodied in the various relevant provisions of the [Interstate Commerce] Act ” *Shippers Committee, OT-5 v Ann Arbor R R* , 5 I.C.C. 2d 856, 863 (1989)

¹² Thus, Entergy never claims that the interchange commitment has caused M&NA to refuse to establish common carrier rates (in violation of 49 U.S.C. § 11101(a)) or to refuse to establish reasonable through routes and facilities for interchange of traffic with carriers other than UP (in violation of 49 U.S.C. §§ 10703, 10705, or 10742)

To the contrary, Entergy states that M&NA has been willing to quote common carrier rates for movements that it would interchange with carriers other than UP (Entergy Argument at 31-32) Entergy’s complaint is that the rates are higher because M&NA has to consider rent payments it might have to make if it does not interchange a sufficient percentage of through traffic with UP

Entergy never provides any such analysis. To the extent Entergy even addresses congressional directives, it concedes that interchange commitments advance the government's rail transportation policies. Entergy "does not question" that the use of interchange commitments in spin-offs "can play an important role in the development of short-line carriers, and can play an important role in allowing Class I carriers to rationalize their systems and to improve overall service to their customers." (Entergy Argument at 2.)

Entergy thus fails to meet its burden to prove that enforcing the interchange commitment would constitute an "unreasonable practice." See *North Am. Freight Car Ass'n v. BNSF Ry.*, Docket No. 42060 (Sub-No. 1) (STB served Jan. 26, 2007) at 5 ("[T]he burden has consistently been placed on complainants to prove the merits of an unreasonable practice claim"), *aff'd sub nom. North Am. Freight Car Ass'n v. STB*, 529 F.3d 1166 (D.C. Cir. 2008), *Cities Serv. Oil Co. v. Soo Line R.R.*, 356 U.S. 838, 842 (1977) ("Complainant has the burden of establishing by competent evidence that the assailed [practices] are unjust and unreasonable.")

C. The Lease's Interchange Commitment Does Not Increase UP's Market Power Or Give UP More Control Over Rates Or Routes

The UP/M&NA Lease's interchange commitment is lawful and consistent with the public interest because it did not reduce or eliminate any competitive rate or routing options available to Entergy or any other shipper on the lines UP leased to M&NA. If UP had never entered into the lease, Entergy's Independence plant and all the other shipper facilities on the lines that had been served exclusively by UP still would be served exclusively by UP. Thus, the interchange commitment did not increase UP's market power or give UP more control over rates and routes available to shippers on the leased lines.

Entergy never expressly claims that the interchange commitment gives UP greater control over rates and routes than if it had never leased its lines to M&NA, despite having

retained two experts to analyze the interchange commitment's "competitive effects" (Kwoka/Warren-Boulton VS at 2) Entergy's experts are careful to avoid any claim that the interchange commitment increases UP's market power or control over rates or routes. Instead, they criticize the interchange commitment because it prevents M&NA from interchanging traffic with carriers other than UP and thereby creating additional competitive through service to Entergy. (*Id* at 8) They acknowledge that short line spin-offs produce gains in "production efficiency" that represent a "socially desirable outcome" (*id* at 6), but lament that those efficiency gains likely are not passed through to Entergy (*id* at 7-8)

As discussed above (in Section I.E), Board precedent recognizes the significant distinction between transactions that reduce competition and those that merely do not increase competition. As the ICC made clear in *Class Exemption* and *Montana Rail Link*, short line spin-offs are consistent with the public interest as long as they maintain the competitive *status quo* – there is no requirement that they create new competition. *Class Exemption*, 11 C C 2d at 817, *Montana Rail Link* at 20. A lease accompanied by an interchange commitment is not considered "anticompetitive" as long as it "will not result in more control or any new power by [the lessor] over transportation involving those [leased] lines," or in other words, as long as there is "no new condition imposed upon the traffic by [the] transaction that would cause a shipper to pay rates exceeding the levels it would have otherwise faced with the prior, single carrier." *Montana Rail Link* at 20. *see also Ex Parte No. 575* at 8 ("[A]ffected shippers may not have had competitive options before the sale or lease and thus may be no worse off as a result of the interchange commitment.")

In fact, the Board's *Ex Parte No. 575* decision expressly rejected the analytical approach adopted by Entergy's experts. In responding to claims that interchange commitments are

“anticompetitive” if they fail to create new competitive options, the Board criticized those claims as reflecting an “entirely *ex post* view ” *Ex Parte No 575* at 9. It explained that, “viewed *ex ante* (i.e., before the sale or lease of the facilities), the agreements may have been beneficial and furthered the public interest in a number of ways, including better service and/or better rates, and the creation and strengthening of short line railroads that have the potential to expand into other markets, and thereby ultimately add to competition ” *Id* The Board observed that courts reviewing restraints under the antitrust laws would also apply an *ex ante* approach and consider competitive conditions “*before and after the restraint was imposed*” *Id* at 10 (quoting *Chicago Board of Trade v United States*, 246 U S 231, 238 (1918)).

Dr. Daniel L. Rubinfeld, a former Deputy Assistant Attorney General in the U S Department of Justice’s Antitrust Division, confirms that Entergy’s experts take an inappropriately *ex post* and static view of interchange commitments. As Dr. Rubinfeld explains, interchange commitments that merely preserve the *status quo* should not be considered anticompetitive, even if the *status quo* allows the exercise of substantial market power (Rubinfeld VS at 7). Entergy’s experts focus entirely on arguments that existing interchange commitments could be modified to create *new* competition, and thus they ultimately end up in the awkward position of condemning transactions that they recognize are ““socially desirable ”” (*Id* at 8, quoting Kwoka/Warren-Boulton VS at 6).

D. The Lease’s Interchange Commitment Does Not Overcompensate UP For The Value Of The Leased Lines

Unable to show that the UP/M&NA Lease’s interchange commitment harms competition, Entergy claims that it is nonetheless “unreasonable” because UP has earned more by leasing the lines than it would have earned from operating the lines. (Entergy Argument at 49.) However, Board precedent does not preclude rail carriers from entering into leases that

increase their earnings, and even if it did, Entergy never explains how UP's increased earnings could be attributed to the *interchange commitment*, as opposed to costs savings and other pro-competitive efficiencies it created by leasing its lines to M&NA. As Dr. Rubinfeld concluded, Entergy's arguments have no valid economic foundation. (Rubinfeld VS at 14)

1. Board Precedent Allows Railroads To Benefit From Leases

Entergy's complaint that UP has obtained more than the pre-transaction going concern value of the leased lines borders on the absurd. UP would have had no reason to lease its lines unless it expected to come out ahead. (Wilson VS at 20.) Dr. Rubinfeld explains that such efforts to increase earnings are no cause for concern as long as the increased earnings do not result from actions that weaken competitive constraints imposed by rivals, and the UP/M&NA Lease's interchange commitment does not reduce the competitive constraints on UP. (Rubinfeld VS at 7, 10-13)

Entergy's own experts recognize that a rail carrier would not lease its lines unless it expected to benefit from the transaction. They explain that a railroad "will enter into a lease" with a short line "only if it benefits by an amount at least as great as it earns from continued ownership and operation." (Kwoka/Warren-Boulton VS at 6) Moreover, they never claim that the lessor's benefits reflect a reduction in competition, rather, they explain that the benefits reflect the short line's lower costs and that the resulting cost reduction "represents a gain in production efficiency," which is "a socially desirable outcome." (*Id.*)

Indeed, Entergy's experts acknowledge that short line spin-offs are socially desirable even if the lessor captures all the gains in production efficiency. They say that the lessor may not share such gains with the short line or shippers, but they conclude that, "[d]espite this imbalance of benefits, the outcome meshes the [lessor's] private interest in greater profitability

with the social interest in efficient production. It is socially desirable to have the short line take over operation of the [leased lines]." (*Id* at 7-8)¹³

At several points, Entergy appears to claim that, regardless of what its experts say about the social benefits of such transactions, the Board's *Ex Parte No 575* decision prohibits UP from enforcing its interchange commitment if it would earn more than its pre-transaction going concern value of its leased lines (Entergy Argument at 35.) In other words, Entergy's experts acknowledge that carriers enter into socially beneficial leases because they expect to benefit, but Entergy says it is unreasonable for carriers to realize those benefits. The Board never said that Entergy focuses on the Board's observation that the "revenue stream" from a lease containing an interchange commitment "should be no more than what the carrier would have received had it not divested or leased the rail facilities in question." *Ex Parte No 575* at 10. That statement, however, simply reflects the Board's recognition that a rail carrier could not use an interchange commitment to create more market power than if it had never leased its lines. The Board offered that observation in rejecting claims that interchange commitments lasting "longer than 5 years are likely to over-compensate the seller or lessor carrier." *Id*

The Board certainly never said that a carrier cannot benefit from cost savings and other efficiency gains that result from a lease of its lines. As Dr. Rubinfeld explains, allowing lessors the upside benefit of their leases is the economically sound approach, and eliminating those benefits would be inappropriate. (Rubinfeld VS at 14-16.) Allowing UP an upside benefit is

¹³ Entergy's experts are wrong to the extent they believe UP has not shared any of its efficiency gains. M&NA plainly benefited, or it never would have entered into the lease. Shippers on the leased lines benefited from M&NA's ability to divert 5% of its through traffic to other carriers without paying any rent to UP, and other shippers benefited because, as Entergy's experts recognize, the lease "free[d] up scarce management and capital resources" which allowed UP to concentrate resources on other parts of its network. (Kwoka/Warren-Boulton VS at 7 n 2.)

especially appropriate under the UP/M&NA Lease because UP bears a significant amount of risk. its compensation for leasing its lines to M&NA depends on the level of traffic that moves over the lines (*Id* at 15-16, *see also* Wilson VS at 5)

2. Entergy Fails To Distinguish Between Benefits From Efficiencies And Benefits From Interchange Commitments

Entergy's complaint about UP's earnings from leasing its lines is flawed for another reason. Entergy never explains how UP could be using the *interchange commitment* to generate the allegedly unreasonable returns. As discussed above, UP has not used, and could not use, the interchange commitment to obtain more revenue from shippers on the leased lines than if it had never entered into the lease (*See also* Rubinfeld VS at 13, 15). Indeed, UP surrendered its pre-transaction control over traffic that is local to the leased lines and five percent of the through traffic it would have served exclusively absent the transaction (*Id* at 18-19). Thus, any UP gains from the lease necessarily stem from the transaction's pro-competitive aspects, such as generating cost savings and other efficiencies or promoting traffic growth.

3. Entergy Never Actually Shows That UP Has Earned More Than The Pre-Transaction Value Of The Leased Lines

Moreover, Entergy never shows that UP actually has earned more than the pre-transaction going concern value of the lines it leased and sold. Entergy claims that it compared the lines' pre-transaction value to UP with the lines' actual value under the lease. (Entergy Argument at 49) However, Entergy's comparisons are based on UP's analysis of the lines' *expected* pre-transaction value. (Baranowski VS at 2.) If UP earned more than expected, it may mean no more than that UP's estimate of the lines' pre-transaction value was too low. Entergy, which has the burden of proof, never addressed this issue.

In addition, Entergy's attempt to compare UP's "expected" pre-transaction value to the "actual" value under the lease is entirely unreliable for several reasons. For example, UP

developed its “expected” pre-transaction analysis using costs from its internal management costing system, while Entergy used URCS costs to calculate the “actual” value. This disconnect makes any meaningful comparison impossible (*Id* at 5) As another example, UP’s “expected” pre-transaction analysis did not include coal traffic moving to Independence because the parties did not contemplate that M&NA would handle that traffic until late in their discussions Thus, in developing its comparison, Entergy merely speculates that UP would have “expected” the same cost and revenue projections for the traffic it actually analyzed to apply to the high-volume, unit-train coal traffic moving to Independence (*Id* at 3, 5)

Finally, even if Entergy’s calculations were correct, they would not show that the transaction resulted in “substantial overcompensation of UP.” (Entergy Argument at 49) Entergy claims that UP has earned approximately { } more than the pre-transaction going concern value of the past 15 years, which is less than { } a year (*Id*, see also Baranowski VS at 3-4)¹⁴ Those gains are extremely modest, especially when compared with the contribution that would be put at risk if M&NA were allowed to use UP’s lines without any requirement that it interchange traffic with, or pay rent to, UP – almost { } in 2007 alone, according to Entergy (Crowley VS, Exhibit (TDC-4) Att. 1 at 6)

E. The Lease’s Interchange Commitment Does Not “Penalize” M&NA Or Allow UP To Obtain “Windfalls”

Entergy also argues that the UP/M&NA Lease’s interchange commitment is “unreasonable” because the lease’s contingent rent provision would “penalize” M&NA for

¹⁴ Entergy’s calculation of UP’s “actual” gains from the lease would be even lower except that Entergy included { } from UP’s sale of the Bergman-Guion line to M&NA (Crowley VS, Exhibit (TDC-4) Att. 1 at 6, Item 10) Without those sales proceeds, Entergy’s estimate of UP’s gains is only { }, or about { } per year (*Id* , see also Baranowski VS at 4)

interchanging traffic with carriers other than UP. Specifically, Entergy claims that M&NA's rent payments would exceed UP's lost contribution from the traffic. Entergy's characterizations of the rent provision are not accurate: the rent provision reflects a good faith effort by UP and M&NA to agree to terms that would protect the parties' interests for the life of the lease, which could be as long as 80 years. But even if Entergy's characterizations were accurate, they would be irrelevant. UP could not increase its market power by deterring M&NA from interchanging traffic with other carriers – it could never gain more control over the affected traffic than it would have had absent the lease.

1. The Contingent Rent Provision Does Not Increase UP's Market Power

Entergy's complaints about the potential size of M&NA's rent payments are irrelevant. No matter how high UP and M&NA agreed to set the rent, UP could have no greater control over rates and routes than if it had never entered into the lease. (Rubinfeld VS at 21 (rent payment "cannot be deemed anticompetitive – regardless of its level")), *see also Montana Rail Link* at 8, 20 ("economically prohibitive" rent did "not result in more control or any new power" by Class I railroad). As a practical matter, whether UP and M&NA expressly agreed that M&NA would interchange most of its through traffic with UP, or whether the parties obtained the same result by establishing a high contingent rent payment, shippers could be no worse off as a result of the lease. (Rubinfeld VS at 19 n 4 & 21), *see also Montana Rail Link* at 20 (rent not anticompetitive even if it "totally precluded" MRI, "from offering competitive options to its shippers")¹⁵

¹⁵ Entergy suggests that it would be an "unreasonable practice" to identify something as a rent payment if the parties never intended to pay rent. (Entergy Argument at 37.) The rent payment provision is not mislabeled: if M&NA does not interchange 95% of its through traffic with UP, it must pay rent in accordance with that provision.

2. The Contingent Rent Provision Is Not A “Penalty”

Moreover, contrary to Entergy’s claims, the contingent rent provision was not designed to “coerce interchange with UP and/or to punish traffic diversion.” (Entergy Argument at 46) Both parties entered into the lease voluntarily (Wilson VS at 17) UP expected that M&NA would choose to interchange at least 95% of its through traffic with UP because the parties had negotiated mutually acceptable divisions. (*Id*)

Moreover, the rent provision plainly is not “coercive” or “punitive ” The lease permits M&NA to interchange up to 5% of its through traffic with carriers other than UP without paying any rent. (Lease § 4 01) If M&NA interchanges more than 5% of its through traffic with other carriers, the rent payment increases in 10% increments, beginning at \$10 million if M&NA interchanges 6% to 15% of through traffic with other carriers (Lease § 4 03.) M&NA would not be required to pay the maximum rental of \$90 million unless it interchanged nearly all of its through traffic with carriers other than UP. (*Id*) The rent provision thus allows M&NA to do a portion of its business with other railroads, if it chooses to do so

3. UP Has Not Used, And Could Not Use, The Contingent Rent Provision To Obtain A “Windfall”

In addition, contrary to Entergy’s suggestion, UP has not, and could not, use the contingent rent provision to obtain a “windfall” – that is, UP never could force M&NA to pay more in rent than UP lost in contribution (Entergy Argument at 46-47) The suggestion is preposterous M&NA can always avoid paying rent by interchanging its traffic with UP. In fact,

Entergy concedes that UP's pre-transaction analysis assumed that UP would not collect any rent (*Id* at 50)¹⁶

Moreover, as Dr Rubinfeld points out, the contingent rent provision actually is a pro-competitive feature of the lease. (Rubinfeld VS 19) It allows M&NA to take advantage of situations in which its contribution from interchanging traffic with other carriers would exceed the rent it would owe UP (*Id*) UP would not receive a windfall in those situations M&NA would be paying *less* in rent than the contribution that would have been available to UP, if UP had handled the traffic. (*Id* at 21 n 16)

4. The Board Should Not Second-Guess The Parties' Agreed-Upon Contingent Rent Payment Amounts

The Board should decline Entergy's invitation to override UP's and M&NA's determination of reasonable rent payments under the lease In *Ex Parte No 575*, the Board recognized that the parties were in the best position to make such assessments "We will not presume that short line railroads, in negotiating arms-length and voluntary contracts, are unable to protect their own financial interests As regulators, the Board must be very wary of the temptation to override the determination of reasonable compensation as negotiated by informed private parties " *Ex Parte No 575* at 11

The Board's caution is particularly appropriate in this case Entergy tries to portray M&NA as a helpless victim that "was in no position to place demands upon UP regarding the

¹⁶ In fact, in 2006, UP voluntarily { } because its service difficulties were precluding it from interchanging traffic with M&NA, and M&NA was concerned that it might inadvertently exceed the 5% threshold because of pre-existing commitments to interchange traffic with other carriers (Wilson VS at 11) UP also has waived the interchange commitment and allow M&NA to interchange traffic with other carriers without affecting the 95% commitment in certain situations in which it would have been inefficient for UP to provide the service itself (*Id* at 11-12)

proper level of the rental obligation.” (Entergy Argument at 48) Nothing could be further from the truth M&NA was a willing bidder for the Carthage Subdivision If M&NA did not like the terms, it could have walked away from the deal (Wilson VS at 17)¹⁷ M&NA’s parent company, RailTex, had previously acquired other lines from UP. (*Id*) In fact, the M&NA vice president who signed the lease was a former UP employee who had supervised UP’s analysis of short line spin-offs until he left the company in 1991 (*Id* at 17-18)

The parties’ agreement to use \$90 million as the maximum rent payment was guided by UP’s concern for preserving the revenue stream from traffic it would have handled if it had not leased its lines to M&NA (*Id* at 13) UP recognized that the contingent rent had to be set high enough to preserve the revenue stream for the life of the lease, which could be as long as 80 years. (*Id* at 13-14) UP thus applied a rule of thumb it had developed in prior spin-offs and based the maximum rental amount on gross revenues from traffic on the lines, adjusted by changes in the Producer Price Index (*Id* at 13, Lease § 4 04)

Entergy argues that the contingent rent payment amounts are “unreasonable” because they exceed UP’s potential lost contribution, but an approach based on lost contribution could

¹⁷ Entergy falsely suggests evidence of coercion in the “striking disparity” between the \$60,000 per year that UP would pay M&NA for trackage rights to serve Independence and the rent that M&NA would pay if it interchanged the Independence traffic with a carrier other than UP (Entergy Argument at 8) The two numbers reflect very different issues. The \$60,000 is what M&NA requested when the parties expected UP would serve Independence, presumably, it reflects M&NA’s estimate of UP’s share of maintenance costs for the trackage rights segment The rent amount, on the other hand, reflects the value of Entergy’s traffic to UP – which is obviously much more than the costs to maintain the short segment from Diaz Junction to Independence (Wilson VS at 15)

Entergy also falsely suggests evidence of coercion in M&NA’s agreement to reduce its division for handling Entergy’s trains shortly after entering into the lease (Entergy Argument at 26 & 48 n 15) However, Entergy never explains why UP would have agreed in the first place to a higher division if it could have coerced a lower one In fact, UP and M&NA have since agreed to increase the division, and UP has agreed voluntarily to share other revenues with, and provide other assistance to, M&NA (Wilson VS at 18-19)

have put UP in a worse position than if it had never entered into the lease. According to Entergy's calculations, UP's contribution from traffic on the line in 1993 was { }. (Crowley VS, Exhibit (TDC-4) Att 1 at 6) However, in 2007, UP's contribution from that traffic was { } (*Id*, see also Baranowski VS at 7) Thus, UP would have lost approximately { } in contribution if M&NA interchanged that traffic to another carrier and paid the maximum rent. Even adjusting to reflect changes in the Producer Price Index, a 2007 rent payment based on lost contribution would have been just { }, and thus UP could have lost approximately { } in contribution under Entergy's overly restrictive view of reasonable rent payments. (Baranowski VS at 7)

In short, the Board should not revisit the lease's rent terms. A high rent payment could not harm competition; it could do no worse than maintain the pre-transaction competitive *status quo*. However, if the Board were to mistakenly impose a rent payment that proves too low, UP would be left in a worse position than if it had never leased its lines.

5. The Lease Would Be Enforceable Under Missouri Law

The Board need not address Entergy's arguments about the lease's "reasonableness" under Missouri state law. (Entergy Argument at 40-46) The Board should abide by its precedent and address any "reasonableness" issues based on "the congressional directions embodied in the various relevant provisions of the [Interstate Commerce] Act." *Shippers Committee, OT-5*, 5 I C C 2d at 863. Moreover, Entergy's analysis of Missouri law is flawed. Missouri courts would enforce the rent provision, and they would not treat the interchange commitment as a covenant not to compete.

a) Missouri Courts Would Enforce The Contingent Rent Provision

Entergy is wrong to assert that Missouri law would treat the lease's contingent rent provision as an unenforceable liquidated damages provision

First, Entergy misconstrues fundamental principles of Missouri law. Missouri courts would treat the rent provision as part of an alternative performance contract, not as a liquidated damages provision. A liquidated damages provision fixes a set amount of compensation to represent damages in case of breach. *See, e.g., State ex rel Schoenbacher v Kelly*, 408 S.W.2d 383, 392 (Mo. Ct. App. 1966). By contrast, an alternative performance contract presents a party with the option of choosing between two alternative obligations, either of which could conceivably prove more desirable. *See, e.g., Godwin v Graham*, 228 S.W.2d 789, 794 (Mo. 1950), *see also* 24 Williston on Contracts § 65:7 (4th ed. 2008). The lease provides M&NA with two different methods to compensate UP for the value of the leased lines: interchange traffic or pay rent. Neither is a form of liquidated damages because either is bargained-for performance. Alternative performance contracts such as the UP/M&NA Lease are perfectly legal and enforceable under Missouri law.

Second, even if the rent provision were considered a liquidated damages provision, Missouri courts would enforce the provision because it is "reasonable and the parties agreed in good faith upon a sum as damages that would likely ensue." *Warstler v Cibrian*, 859 S.W.2d 162, 165 (Mo. Ct. App. 1993). Especially in light of the inherent difficulties in projecting the value of affected traffic some 80 years in the future, the provision would pass muster under Missouri law as "a reasonable forecast for the harm caused by the breach." *Paragon Group, Inc. v Ampleman*, 878 S.W.2d 878, 881 (Mo. Ct. App. 1994). Moreover, unlike the damages provisions in the cases cited by Entergy, the lease's rent provision uses a sliding scale that

endeavors to match the rent payment to the amount of traffic lost – it does not create a substantial forfeiture unrelated to the size of the loss (*compare Abrams v St Louis County Library Dist Bd*, 258 S W 2d 672 (Mo 1593)) or ever-increasing damages designed to coerce performance (*compare Muehlebach v Missouri & K I Ry*, 148 S.W 453 (Mo Ct App 1912))¹⁸

b) Missouri Courts Would Not Treat The Interchange Commitment As A Covenant Not To Compete

Missouri courts also would not treat the interchange commitment as an unenforceable covenant not to compete. Under Missouri law, covenants not to compete are agreements that are “ancillary to the sale of a business or employment contract.” *Schnucks Twenty-Five, Inc v Bettendorf*, 595 S W 2d 279, 285 (Mo. Ct. App 1979). In sales of businesses, they are designed to protect a buyer “from the seller’s encroachment on the good will transferred in the sale.” *Id*. In the employment context they serve a similar purpose – to protect an employer’s interest in “the company’s goodwill.” *Systematic Bus Servs, Inc v Bratten*, 162 S W 3d 41, 49 (Mo Ct App 2005). A covenant not to compete binds parties despite the fact that they have gone their separate ways – the seller has divested its interest to the buyer, the employee has left his or her employer. The law permits such covenants because they facilitate beneficial transactions – buyers are more willing to acquire a business if they know the seller cannot immediately reopen across the street; employers are more willing to hire employees and share sensitive information with them if they know that the employees will not be able to take that information and steal away customers – but the law imposes limits on agreements that restrict competition between parties once they are no longer in an ongoing business relationship.

¹⁸ As the cases Entergy cites make clear, even when a liquidated damages clause is deemed unenforceable, the non-breaching party is not precluded from recovering damages – it is merely limited to recovering the “actual loss sustained.” *Muehlebach*, 148 S W. at 457. But Entergy is seeking to eliminate completely UP’s right to collect rent.

By its plain terms, the UP/M&NA Lease does not involve a covenant not to compete. UP and M&NA are still engaged in an ongoing business relationship, and nothing in the lease binds the parties not to compete after they terminate their relationship. Moreover, the interchange commitment and rent provision plainly are not “ancillary” to the parties’ relationship – they are essential terms of the lease itself. UP has given M&NA the exclusive right to use its rail lines and agreed to pay M&NA for handling interchanged traffic, and in return, M&NA has agreed to compensate UP by interchanging traffic or paying rent. *Cf. Texaco Inc. v. Dagher*, 547 U.S. 1, 8 (2006) (ancillary restraint doctrine has “no application” where “the business practice being challenged involves the core activity of the joint venture itself”). Moreover, there is no possibility that the interchange commitment or rent provision could last longer than is necessary to protect UP’s legitimate interests. UP has a legitimate interest in receiving compensation, whether from interchanged traffic or rent, as long as M&NA is leasing UP’s lines.

F. The Lease’s Interchange Commitment Has Not Harmed UP’s Service To Entergy Or Reduced Entergy’s Routing Or Sourcing Options

Entergy ultimately identifies only one harm that it has allegedly suffered because of the UP/M&NA Lease’s interchange commitment: Entergy complains that UP has refused to waive the lease’s rent provision to allow other carriers to provide service in conjunction with M&NA at times when UP’s service has not been adequate. (Entergy Argument at 27-32; Gray VS at 5-11.) Entergy has its facts wrong, and we set the record straight below. But even if Entergy had described the facts accurately, they would not show any harm resulting from the interchange commitment. Entergy would have had no greater ability to obtain service from other carriers, or coal from other sources, if UP had never leased its lines to M&NA. The lease’s only impact on service to Entergy has been a positive one: the lease allowed UP to improve service to Entergy.

by preserving a route for moving empty cars between Independence and Kansas City – a routing that would not have been possible if UP had abandoned its Bergman-Guion line

1. The Lease Has Not Harmed UP's Service To Entergy

Entergy discusses three periods over the past 15 years in which UP had difficulties delivering coal to Independence. None of UP's difficulties during these three periods were caused by – or even exacerbated by – the lease. Moreover, UP has never refused a request by Entergy to waive the interchange commitment when UP could not provide the requested service to Independence.

a) The 1993-1994 Service Problems Were Not Caused By, Or Exacerbated By, The Lease

Entergy incorrectly claims that UP refused to waive the interchange commitment to allow coal deliveries to Independence via a BN/M&NA routing when UP was experiencing service problems following record Midwest flooding in 1993. (Entergy Argument at 28.) Entergy witness Daniel B. Gray says he asked UP to waive the interchange commitment in a letter dated May 17, 1994. (Gray VS at 6 & Exhibit DBG-3.) But as the parties' correspondence shows, UP reacted promptly to Entergy's concern by developing a program to increase coal deliveries to Entergy's Independence and White Bluff plants, and Entergy responded that it was "pleased with the railroad's efforts" and was "withdrawing its request, stated in Dan Gray's letter of May 17, 1994, that the BN and M&NA be allowed to transport coal into ISES [Independence] from SPRB mines currently served by WRPI." (Gough VS at 4, UP Counsel's Exhibit Nos. 6 &

7)¹⁹ Mr Gray is thus incorrect when he claims that UP refused to waive the interchange commitment to allow alternative service to Independence

b) The 1997-1998 Service Problems Were Not Caused By, Or Exacerbated By, The Lease

Entergy also incorrectly claims that UP refused to waive the interchange commitment to allow coal deliveries to Independence via a BNSF/M&NA routing during UP's service problems following the UP/SP merger. (Entergy Argument at 28) Entergy's correspondence shows that Entergy actually did not want BNSF to serve Independence, as Mr Gray claims (Gray VS at 8) Instead, it wanted BNSF to serve Entergy's plant at White Bluff, which was served by UP, not M&NA, and which is located approximately 125 miles south of M&NA (Gough VS at 4, *see also* UP Counsel's Exhibit No 3) The relevant correspondence between Entergy and UP, which Mr. Gray cites and attaches to his testimony, shows that Entergy asked "that Union Pacific allow BNSF to utilize [its] trackage rights to serve *White Bluff*" (Gray VS, Exhibit DBG-5, emphasis added, *see also* Gough VS at 4; UP Counsel's Exhibit No 8)²⁰ Thus, once again, Mr Gray is plainly wrong when he claims that UP refused to waive the interchange commitment to allow alternative service to Independence.

In fact, as mentioned above, the M&NA transaction actually allowed UP to improve its service to Entergy during this period. UP and M&NA developed and implemented a plan to reroute trains carrying Entergy's empty cars returning from Independence via Kansas City (Gough VS at 5) This new routing remains in place today (*Id*) The improved routing would

¹⁹ UP Counsel's Exhibit No 6 is a letter from UP's Steve Jensen to Entergy's Roy Giangrosso, dated May 24, 1994 UP Counsel's Exhibit No 7 is a letter from Mr Giangrosso to Mr Jensen, dated June 1, 1994

²⁰ UP Counsel's Exhibit No 8 is a copy of Exhibit DBG-5, a letter from Entergy's Charles W Jewell, Jr to UP's Arthur W Peters, dated April 7, 1998.

not have been possible if UP had abandoned the Bergman-Guion line rather than sold it to M&NA as part of the overall lease/sale transaction.

c) The 2005-2006 Service Problems Were Not Caused By, Or Exacerbated By, The Lease

Entergy also claims that UP's refusal to waive the interchange commitment prevented coal deliveries to Independence via alternative M&NA routings during UP's service problems in 2005-2006 (Entergy Argument at 28) However, as Entergy has previously acknowledged, a BNSF/M&NA routing was not a viable alternative at that time because "BNSF was also having difficulty meeting its commitments " (*Review of Rail Access and Competition Issues*, STB Ex Parte No 575, Comments of Entergy, Herndon VS at 8 (Mar 8, 2008).) One of Entergy's experts in this proceeding, Thomas D. Crowley, testified to the Arkansas Public Service Commission that the tonnage shortfalls experienced by Entergy were actually part of "an industry wide problem" and that "nearly all PRB supplied utilities" had been "adversely affected by BNSF's and UP's poor service " (UP Counsel's Exhibit No 9, *see also* Gough VS at 5-6.)²¹

Entergy implies that UP's refusal to waive the interchange commitment prevented it from moving foreign coal to Independence using a routing involving CN, KCS, and M&NA in order to mitigate the harm from UP's service problems. (Entergy Argument at 31-32, Gray VS at 9-10) However, its witness and documents tell a different story; namely, that the movement was unrelated to UP's service problems and that Entergy decided to deal instead with UP

Documents that Entergy produced in discovery show that when Entergy first approached M&NA about a possible routing involving CN and KCS, {

²¹ UP Counsel's Exhibit No. 9 is an excerpt from *In the Matter of an Investigation into Entergy Arkansas, Inc 's Interim Revision to Its Energy Cost Recovery Rider*, Arkansas PSC Docket No 05-116-U, Rebuttal Testimony of Thomas D Crowley at 10-11 (Mar 15, 2006)

} . (UP Counsel's

Exhibit No. 10.)²² {

}

(UP Counsel's Exhibit No. 11)²³ {

} . (UP Counsel's Exhibit No 12.)²⁴ {

} Instead, as Entergy's Mr Gray testifies, Entergy decided to "abandon discussions with CN/KCS/M&NA and to deal with UP" for a CN/UP/M&NA move (Gray VS at 10)

Indeed, at the same time it was seeking a rate for a CN/KCS/M&NA routing, Entergy asked UP to quote a rate for the same traffic. (Gough VS at 7, *see also* UP Counsel's Exhibit No 13)²⁵ Entergy did not tell UP that the movement was part of an effort to mitigate UP's service problems Instead, Entergy told UP that {

²² UP Counsel's Exhibit No 10 is a letter from M&NA's Anita Horton to Entergy's Daniel B Gray, dated June 2, 2006

²³ UP Counsel's Exhibit No 11 is an email from Entergy's Mr. Gray to M&NA's Ms Horton and others, dated September 22, 2006

²⁴ UP Counsel's Exhibit No 12 is a letter from M&NA's Ms. Horton to Entergy's Mr Gray, dated October 6, 2006

²⁵ UP Counsel's Exhibit No 13 is an internal Entergy email from Mr Gray dated September 27, 2006

} (Gough VS at 7)

UP worked diligently to develop an acceptable rate and routing for the test movement (*Id* at 8) Entergy seems to imply otherwise by asserting that it “unfortunately” did not move the test shipment until 2007 (Gray VS at 11) But UP did nothing to delay the process, and it always understood that Entergy’s plan was to move the test shipment in 2007 (Gough VS at 8.)²⁶

Thus, yet again, Mr Gray is wrong when he claims that UP’s refusal to waive the interchange commitment prevented Entergy from obtaining alternative service to Independence

d) Entergy’s Claims Regarding Capital Investment And Future Service Problems Are Without Merit

UP takes strong exception to Entergy’s claim that UP has been reluctant to make capital investments to handle coal traffic and that removing the interchange commitment would be an appropriate method of increasing Entergy’s options for alleviating any future service problems (Entergy Argument at 28-31, Mohl VS at 5-9.)

First, Entergy does not claim that UP’s past service problems have been caused by, or exacerbated by, the interchange commitment, and thus its service concerns do not provide any basis for awarding the relief it seeks in this proceeding Entergy is not entitled to relief from an

²⁶ Entergy’s communications with M&NA {
} (UP Counsel’s Exhibit No 11.)

interchange commitment as a remedy for problems that were not caused or exacerbated by the interchange commitment ²⁷

Second, UP has made, and continues to make, substantial investments in its coal business, and those investments have directly benefited Entergy. Since entering the PRB market in 1984, UP set annual coal tonnage records in 21 of the 23 following years. Between 2000 and 2004, UP increased its PRB coal tonnage transported roughly 23 percent, from 144 million tons to 177 million tons annually. From 2004 through 2006, including the period covered by Entergy's complaints about UP's recent force majeure claims, UP-transported PRB tons increased by roughly another 10 percent, to 194 million in 2006 versus the 177 million in 2004 (Gough VS at 8-9)

UP's consistent, strong growth in coal traffic is the result of UP's substantial investments in expanding and sustaining its coal network. From 1997 through 2007, UP invested more than \$8 billion in its Energy business, including approximately \$1.3 billion in new capacity, \$5.7 billion in track maintenance, and \$1.1 billion in locomotives (*Id* at 9). Entergy has benefited substantially from this investment. For the period from 2000 through 2006, Entergy's 1,300-mile route, which represents approximately 4% of UP's 32,339 mile system, received { } of total coal-related capacity spending and { } of total infrastructure capacity spending (*Id*)

²⁷ AECC asserts that shippers claiming to have suffered harm from service failures caused or exacerbated by an interchange commitment need not exhaust other potential avenues of relief before challenging the interchange commitment (AECC Argument at 6). However, none of the service problems described by AECC and Entergy were caused or exacerbated by the challenged interchange commitment. The Board's *Ex Parte No. 575* decision plainly did not invite shippers to seek relief from an interchange commitment as a remedy for alleged service problems that were *not* caused by interchange commitments. When an interchange commitment has neither caused nor exacerbated the alleged harm, shippers must pursue other remedies.

Third, Entergy's service concerns are plainly exaggerated. Despite significant weather-caused disruptions to operations on the Joint Line, torrential downpours in October 2005 that washed out track and bridges in Kansas, and a blizzard followed by weeks of rail-shattering cold, UP delivered nearly { } of Entergy's NCTA demand to Independence in 2005, and { } in 2006. (*Id*)²⁸ UP delivered more than { } of Entergy's NCTA demand to Independence in 2007, and more than { } of Entergy's NCTA demand through June 2008. (*Id*)²⁹

Moreover, Entergy demonstrated its faith in UP service when it {

} . (*Id* at 11)

Entergy's actions should speak louder than its words.

Finally, Entergy complains that UP's actions have forced it to take matters into its own hands and construct a build-out from Independence to BNSF. (Mohl VS at 8) Entergy argues that removing the interchange commitment would be a less costly means of achieving the same result. But any person who wanted to enter into a business could make the same claim: it would always be cheaper to grant access to a competitor's facility than to build a new one. As Dr. Rubinfeld points out, Entergy's attempt to "free-ride" off of UP's investments is contrary to sound economic principles and harmful to overall welfare. (Rubinfeld VS at 13, 20-22, 23-24.) Entergy's build-out is an appropriate, market-based method of advancing Entergy's goal of

²⁸ NCTA demand refers to the process for planning Joint Line train operations by allocating train slots between UP and BNSF based on customer demand. NCTA demand matches the amount of coal shippers want with the amount producers have available for that customer. (*Id* at 6 n 2)

²⁹ As UP witness Rick Gough explains, Entergy has significantly exaggerated both the number and the effect of UP's force majeure declarations. (*Id* at 10 & n.4.) Indeed, as discussed in the text, UP has delivered { } of Entergy's NCTA demand to Independence from 2005 to the present despite its force majeure declarations.

increasing rail competition at Independence: Entergy would be paying its own money for the rights it seeks rather than seeking to free-ride on UP.

2. The Lease Has Not Reduced Entergy's Routing Or Coal Sourcing Options

Intervenor AECC makes a different service argument than Entergy, but it is equally flawed. AECC argues that the lease leaves Entergy worse off than before the spin-off because it reduced UP's incentives to cooperate with BNSF or other carriers on interline routings over the Carthage Subdivision when UP was unable to provide service to Independence. (AECC Argument at 4.) AECC claims that UP now has no incentive to cooperate because the revenues for handling the traffic between the interchange point and Independence would flow to M&NA, not UP. (*Id.*)³⁰ AECC is wrong for several reasons.

First, if the M&NA spin-off had not occurred, UP would not have been able to offer alternative routings from connections with other carriers on the western portion of the Carthage Subdivision to Entergy's plant at Independence. As discussed above, UP likely would have abandoned its Bergman-Guion line, severing the through route over the Carthage Subdivision. Thus, Entergy is no worse off than if UP had never spun off its lines to M&NA.

Second, even after the spin-off, in the unlikely event that a BNSF/UP interline routing to Independence would ever make sense, there are many locations where BNSF could interchange traffic with UP that would provide UP with an opportunity to obtain contribution for delivering coal to Independence. The interchange could take place in Kansas City, or Northport, or at any

³⁰ AECC also claims it is "not a coincidence" that the service problems described above – the Midwest flooding in 1993, the UP/SP merger problems in 1997-1998, and problems delivering PRB coal in 2005-2006 – "coincide[] closely with the introduction of MNA as the serving carrier" at Independence. (AECC Argument at 4.) AECC never explains this bizarre, and entirely inaccurate, assertion.

number of points from which UP could then route the coal over its own lines to Diaz Junction and then via M&NA to Independence. Thus, the lease did not significantly reduce opportunities for interchanging traffic between BNSF and UP.

Third, AECC's argument does not make economic sense. If before the lease, UP could have been induced to cooperate with BNSF by handling traffic over the Carthage Subdivision in exchange for a share of the revenues, then after the lease, UP also could be induced to cooperate with BNSF by allowing M&NA to handle traffic in exchange for a share of the revenues. UP would have the same incentive to cooperate in both situations. The lease does not create any barriers to such joint routes.

AECC also claims that UP would have no incentive to participate in interline movements of coal from origins that it cannot serve, such as KCS-served mines in Oklahoma or Texas (AECC Argument at 4). However, UP always would have an incentive to try to participate in movements when it could not provide the service itself – some revenue is better than none. Moreover, UP already has represented that it would waive the interchange commitment if Entergy approached UP with a feasible plan to source substitute coal using a non-UP connection with M&NA in a situation in which UP was unable to meet its obligations to deliver PRB coal to Independence and unable to offer a reasonable through route for the substitute coal. (*Review of Rail Access and Competition Issues*, STB Ex Parte No. 575, Reply Comments of Union Pacific, Gough RVS at 3 (Mar. 28, 2006))³¹

In fact, UP has demonstrated that it will cooperate with Entergy to move substitute coal to Independence when its own PRB coal service is disrupted. During the 2005-2006 time period,

³¹ The UP/M&NA Lease expressly contemplates the possibility of such waivers. (Lease § 4.02)

when neither UP nor BNSF could transport as much PRB coal as shippers were demanding, UP cooperated with Entergy's efforts to move Colorado coal to White Bluff, as AECC has previously acknowledged (*Review of Rail Access and Competition Issues*, STB Ex Parte No 575, AECC Comments at 7 (Mar 8, 2006)) Also, Entergy's evidence in this proceeding shows that UP cooperated to move foreign coal to Independence using a CN/UP/M&NA routing in 2007. (Gray VS at 10-11; *see also* Gough VS at 7-8)

Neither Entergy nor AECC offers any reason to believe that the interchange commitment reduces Entergy's routing or coal sourcing options

G. Entergy's Interests Are Not Consistent With The Interests Of M&NA Or Other Shippers On M&NA's Lines

The Board should reject Entergy's suggestion that M&NA's financial prospects would improve if UP were precluded from enforcing the UP/M&NA Lease's interchange commitment (Entergy Argument at 50-53) Entergy's interest in creating new competition to drive its own costs even lower is fundamentally at odds with any public interest in providing more revenue to M&NA. Entergy's gains could come only at the expense of the railroads that would be competing to provide service, including M&NA ³² And Entergy has no real stake in M&NA's long-term health Entergy knows that if M&NA were to fail because of this gambit to reduce rates, UP would resume service between Diaz Junction and Independence, in which case Entergy would be no worse off than it is today The Board cannot rely on Entergy to speak for the public interest

³² Entergy's request that the Board "confirm" that Entergy can force M&NA to quote a bottleneck rate from an interchange with a carrier other than UP to Independence makes clear that Entergy has no interest in giving more revenue to M&NA – Entergy wants to have the Board force M&NA's rates down even further. (Entergy Argument at 65-66) UP explains why the requested relief is not supported by law in Section V C

The Board also should reject Entergy's misleading attempt to imply that UP entered into the lease believing that no one would maintain the lines (Entergy Argument at 50-53.) UP's documents show that UP expected to avoid rehabilitation expenses on the leased lines, but the reason is obvious: M&NA would be paying such expenses out of the divisions it received from UP (Wilson VS at 19) As discussed above, M&NA's bid for the leased lines was based on the amount of money M&NA would need to maintain and operate the lines in order to interchange traffic with UP (*Id*) In fact, the lease expressly obligates M&NA to maintain the leased lines so they remain capable of operating at the speeds shown in UP's then-current timetables (*Id* at 19-20, Lease § 6 01) M&NA is only *leasing* the lines; UP retains a strong interest in ensuring that they are maintained adequately during the term of the lease

IV. THE BOARD SHOULD REJECT ENTERGY'S ALTERNATIVE CHALLENGES TO THE UP/M&NA LEASE'S INTERCHANGE COMMITMENT

The Board should reject Entergy's alternative theories for obtaining relief in this proceeding Entergy has not established any basis for partially revoking the exemption authorizing the UP/M&NA Lease, and it has not established that the lease constitutes an unapproved pooling arrangement

A. Entergy Has Not Established Any Basis For Partially Revoking The Exemption Authorizing The Lease

"When, as here, an exemption has become effective, a revocation request is treated as a petition to reopen and revoke and, under 49 CFR 1115.3(b), must state in detail whether revocation is supported by material error, new evidence, or substantially changed circumstances " *New York Central Lines, LLC – Abandonment Exemption – In Montgomery & Schenectady Counties, NY*, Docket No. AB-565 (Sub-No 14X) (STB served Jan 22, 2004) at 3; *accord Indiana Hi-Rail Corp – Lease & Operation Exemption – Norfolk & W Ry Line Between Rochester & Argos, IN, and – Exemption From 49 U.S.C. 10761, 10762, & 11144*, Finance

Docket No 32162 (STB served Jan 30, 1998) at 4; *Southern Pac Transp Co – Trackage Rights Exemption – Houston Belt & Terminal Ry*, Finance Docket No 33461 (STB served Dec 21, 1998) at 7

In addition, “the party seeking revocation has the burden of proof” and must present “reasonable, specific concerns demonstrating that reconsideration of the exemption is warranted and regulation of the transaction is necessary” *Alabama & Gulf Coast Ry – Acquisition & Operation Exemption – Burlington N & Santa Fe Ry*, Finance Docket No 33438 (STB served Sept 11, 1998) at 2, *accord CSX Transp. Inc Abandonment – In Randolph County, WV*, 9 I C C.2d 447, 449 (1992), *I&M Rail Link LLC – Acquisition & Operation Exemption – Certain Lines of Soo Line R R*, Finance Docket No 33326 (STB served Apr 2, 1997) at 7, *aff’d sub nom City of Ottumwa v STB*, 153 F.3d 879 (8th Cir. 1998) When revocation is sought, the Board’s inquiry is similar to the one it uses to determine if an exemption is appropriate, it focuses on the rail transportation policy sections related to the underlying statutory sections from which the exemption was sought *See Bulkmatc R R – Acquisition & Operation Exemption – Bulkmatc Transp Co*, Finance Docket No 34145 (STB served Nov 19, 2002) at 8 & n.15, *accord Missouri Pac R R – Abandonment Exemption – Counties in Oklahoma*, 9 I.C C 2d 18, 25 (1992), *Minnesota Commercial Ry – Trackage Rights Exemption – Burlington N R R*, 8, I C C 2d 31, 35 (1991), *I&M Rail Link* at 7

Entergy does not even attempt to meet its burden of proof Entergy does not identify any material error, new evidence, or substantially changed circumstances that justify reopening the exemption that authorized the lease Entergy does not even try to dispute that the M&NA transaction qualified for the exemption adopted in *Class Exemption for the Acquisition and Operation of Rail Lines Under 49 U S C § 10901*, 1 I C C 2d 810 (1985)

In *Class Exemption*, the ICC invited shippers to petition for revocation of an exemption if they believed that a particular transaction was anticompetitive and thus would conflict with the agency's expectation that transactions covered by the exemption would "maintain the *status quo* and will not change the competitive situation " *Id* at 817. This type of petition appears to be what the Board had in mind when it suggested that shippers seeking to challenge an existing interchange commitment could move "to partially revoke an exemption granted under 49 U S C. 10502 " *Ex Parte No 575* at 15 However, Entergy makes no claim that the M&NA transaction did not maintain the competitive *status quo*, and UP has explained in detail why it could not use the transaction to gain greater control over rates and routes than it had before entering into the transaction

Entergy also fails to demonstrate in any other way that revocation of the exemption "is necessary to carry out the transportation policy of section 10101 [of Title 49] " 49 U S C § 10502(d) Here, the statutory provision from which the transaction was exempted is 49 U S C § 10901 Under Section 10901(c), the Board would be required to issue authority for the M&NA lease unless it affirmatively found that such authority would be "inconsistent with the public convenience and necessity " The ICC identified the provisions of the rail transportation policy that relate to the public convenience and necessity in *Class Exemption* "minimizing the need for Federal regulatory control over the rail transportation system, ensuring the development and continuation of a sound rail transportation system, fostering sound economic conditions in transportation, reducing regulatory barriers to entry, and encouraging efficient railroad management " *Class Exemption*, 1 I C C 2d at 817.

Entergy never tries to explain how the authorized transaction is inconsistent with those policies, and thus, why regulation would produce a different result than exemption Entergy

plainly recognizes that it faces an insurmountable hurdle, especially in light of the long line of agency precedent expressly approving the use of interchange commitments in spin-offs, beginning with *Montana Rail Link*

Entergy's only attempt to address the rail transportation policy is to assert that the relief it seeks "would help to foster the national rail transportation policy . . . by alleviating the need to construct redundant rail facilities." (Entergy Argument at 55) Entergy's assertion is far from a demonstration that revocation of an exemption is "necessary " Moreover, Entergy never explains how the rail transportation policy would be advanced by substituting government regulation for a privately funded build-in to create new competition. In fact, the rail transportation policy reflects a clear preference for private, market-based initiatives 49 U S C §§ 10101(1), (2), (4) & (7) Entergy has not demonstrated that revocation is necessary here

B. The Lease Does Not Constitute An Unapproved Pooling Arrangement

Entergy's claim that the UP/M&NA Lease constitutes an unapproved pooling agreement is meritless. The lease is not a pooling agreement governed by Section 11322 In response to a petition to revoke the M&NA transaction that was filed by rail labor, the ICC expressly held that the transaction is governed by Section 10901 *Missouri & N Arkansas R R – Lease, Acquisition & Operation Exemption – Missouri Pac R R & Burlington N R R* , Finance Docket No 32187 (ICC served May 4, 1993) at 2 ("The law is well-settled that the acquisition of a line of railroad and incidental trackage rights by a noncarrier, as here, is governed by Section 10901, not 11343.")

Entergy asserts that UP and M&NA are engaged in pooling because they divide revenues from traffic they interchange But for an agreement to be considered pooling, "the arrangement must be between competitors " *Union Pac R R & Missouri Pac R R – Trackage Rights Over Lines of Chicago & North W Transp Co Between Fremont, NE/Council Bluffs, IA, & Chicago,*

IL (“*CNW Trackage Rights*”) 71 C C 2d 177, 184 (1990) UP and M&NA are not, and have never been, competitors for the traffic they interchange. Like the carriers in *CNW Trackage Rights*, their relationship “is essentially vertical (or end-to-end) in nature.” *Id.* at 185.³³ They were not competitors before they entered into the lease because M&NA had no access to shippers on the leased lines. They are not competitors now because UP has no access to shippers on the leased lines: M&NA has “full and exclusive use of the Leased Premises for the operation of common carrier rail freight service.” (Lease § 3.01.)

Entergy’s sole authority for its position is a case that has no plausible relevance to the UP/M&NA Lease. The case involved two railroads that had competed to provide switching service in a terminal area until they entered into an agreement that “would prohibit [one] from serving industries accessible to its lines” and thus to “reserve to [the other] all terminal and intermediate switching service.” *Chicago & North W Ry v Peoria & Pekin Union Ry*, 319 F 2d 117, 121 (7th Cir. 1963). The court concluded that such an agreement between “competitors” to create a “monopoly” constituted pooling that required agency approval. *Id.* The UP/M&NA Lease is not an agreement between competitors to stop competing and create a monopoly that required approval as a pooling arrangement; it was a properly authorized spin-off that preserved the competitive *status quo*.

³³ The Board and the ICC have consistently recognized that transactions between connecting carriers are “vertical” in nature. *See, e.g., Union Pacific/Southern Pacific Merger*, 1 S T B. 233, 365 (1996) (“Vertical effects occur where the merging parties connect end-to-end . . .”); *Burlington Northern, Inc. – Control & Merger – St. Louis-San Francisco Ry*, 360 I C C 788, 917 (1980) (“[B]ecause BN and Frisco interchange traffic, primarily at St. Louis and Kansas City, DOJ considers them to be in a vertical customer-supplier relationship”), *Kansas City Southern – Control – The Kansas City Southern Ry, Gateway Eastern Ry, & The Texas Mexican Ry*, Finance Docket No. 34342 (STB served Nov. 29, 2004) at 17 (discussing the “vertical integration of KCS and TM”).

V. THE BOARD SHOULD DENY ENTERGY'S REQUESTS FOR RELIEF

Entergy has not established a basis for any relief, and certainly not for the relief it seeks. The Board has no authority to (i) require UP to allow M&NA to use the leased lines without any obligation to interchange traffic with UP or pay rent to UP, (ii) delegate to shippers the decision whether a proposed transaction is inconsistent with the public convenience and necessity, or (iii) order a "bottleneck" carrier to quote a separately challengeable "bottleneck" rate, so long as the carrier provides the origin-to-destination service the shipper seeks under a common carrier through rate with another carrier.

A. The Board Could Not Prevent UP From Enforcing The Lease's Interchange Commitment While Also Preventing UP From Terminating The Lease

The Board should reject Entergy's demand that it modify the UP/M&NA Lease to prevent UP from enforcing the interchange commitment or collecting rent while also preventing UP from terminating the lease (Entergy Argument at 60-61). That remedy would essentially allow M&NA to use UP's lines without any obligation to compensate UP for the use of its property. There is no basis to change the terms of a consummated transaction in a way that would be so grossly disproportionate to the issues that have been identified by Entergy and so patently unfair to UP.

1. The Board Has No Authority To Modify The Lease Terms As Demanded By Entergy

Not surprisingly, Entergy cites no authority for its aggressive demand that the Board rewrite the terms of the UP/M&NA Lease and impose the new terms on UP and M&NA. The agency has always recognized that mergers, trackage rights agreements, line sales, and similar transactions between carriers must be the product of voluntary agreement. Thus, although the Board may impose conditions on its approval of such transactions, the parties always retain the right to walk away from the transaction if they deem the conditions too burdensome. In fact, UP

and M&NA expressly reserved the right to terminate the lease “in the event a court or other body determines that all or any of the provisions of Section IV [the rent and interchange provisions] are unlawful or otherwise unenforceable ” (Lease § 15 01(f))³⁴

In *Ex Parte No 575*, the Board appeared to recognize that it could not force parties to accept modifications to their interchange commitments. It observed that many short line sale and lease agreements “include clauses allowing the entire transaction to be rescinded if the Board were to find the interchange limiting provision unlawful,” and that “[i]f such provisions were invoked, shippers could find themselves being served by the former operator and losing the benefits provided by the short line carrier ” *Ex Parte No 575* at 12

Entergy never even tries to explain where the Board could find the authority to grant the relief it requests. The only statute that allows the Board to impose new conditions on administratively final proceedings is Section 11327, which permits supplemental orders in transactions approved under Sections 11322 through 11326. However, the UP/M&NA transaction was not approved under any of those sections, it was exempted from Section 10901 ³⁵

Moreover, the Board could not grant the relief Entergy seeks by partially revoking the class exemption and requiring the parties to seek approval under Section 10901 Even to the extent that the Board has the authority to impose conditions on transactions under Section 10901,

³⁴ Entergy’s claim that “UP designed Section 15 01(f) to insulate itself from the consequences of the brinksmanship in which it had engaged” (Entergy Argument at 61) is absolutely false and ignores the rather obvious point that no “brinksmanship” was involved – the ICC had approved the use of interchange commitments well before UP and M&NA entered into the lease agreement. See, e g , *Montana Rail Link* at 20-21, *South Carolina* at 8-9. UP was well aware of those ICC decisions (Wilson VS at 2 n 1)

³⁵ See *Missouri & N Arkansas* at 2 (“The law is well-settled that the acquisition of a line of railroad and incidental trackage rights by a noncarrier, as here, is governed by Section 10901, not 11343 ”) Sections 11322 through 11327 were formerly 49 U S C §§ 11342-11347

it still cannot compel the parties to go through with the transaction if they deem the conditions to be too burdensome. The Board's "grants of authority . . . for the conveyance of rail property . . . are permissive." *Western Fuels Serv Corp v Burlington N & Santa Fe Ry*, Docket No. 41987 (STB served July 28, 1997) at 10 (citing *St Joe Paper Co v Atlantic Coast Line R R*, 347 U S 298, 306 (1954)). "Thus, should a rail carrier find that any conditions that [the Board] impose[s] upon granting . . . authority are unacceptable to it, it can forgo" the transaction. *Id*, see also *Guilford Transp Indus, Inc – Control – Boston & Maine Corp*, 5 I.C.C.2d 202, 206 (1988) ("If the carriers do not accept the conditions imposed by the Commission, they need not consummate the transaction"). *Boston & Maine Corp, Trackage Rights Over Conrail*, 360 I.C.C. 239, 241 (1979) ("This power to condition approval, however, does not absolve the requirement that an agreement must be reached.")

Board precedent firmly establishes the fundamental principle that an applicant always "has the right to walk away from a transaction if it deems the conditions too burdensome." *Canadian Nat'l Ry, Grand Trunk Corp, & Grand Trunk W R R – Control - Illinois Central Corp, Illinois Central R R, Chicago, Central & Pac R R, & Cedar River R R*, Finance Docket No. 33556 (STB served Dec. 23, 2002) at 4. Granting Entergy's request to prevent UP from enforcing the interchange commitment while also preventing UP from terminating the lease would deprive UP of its fundamental "right to walk away."

Finally, any relief that prevented UP from enforcing the interchange commitment or collecting rent while also preventing it from terminating the lease plainly would constitute a taking of UP's property under the Fifth Amendment. See, e.g., *Nollan v California Coastal Comm'n*, 483 U S 825, 831 (1987) ("[T]he right to exclude [others is] one of the most essential sticks in the bundle of rights that are commonly characterized as property.") (internal quotations

omitted) The Board has correctly declined to find authority to take railroad property absent an express delegation of power from Congress. See *Rail Abandonments – Use of Rights-of-Way as Trails* (49 CFR Parts 1105 & 1152), 2 I.C.C.2d 591, 596-98 (1986), *aff'd sub nom National Wildlife Fed'n v ICC*, 850 F.2d 694 (D.C. Cir. 1988), *Chicago & North W. Transp. Co. – Abandonment – Between Clintonville & Eland, WI*, 363 I.C.C. 975, 977 (1981). Congress has expressly defined the few circumstances in which the Board is authorized to require one carrier to open its property to others. See 49 U.S.C. §§ 10901(d); 10907, 11102. Entergy has not invoked any of those provisions in this case.³⁶

2. Even If The Board Had The Authority To Modify The Lease, It Should Reject Entergy's Request For Relief

Even when the Board has the authority to revisit the terms of consummated transactions by reopening an administratively final action or invoking Section 11327, it has recognized that such actions are inappropriate except in very narrow circumstances, none of which apply here.

The Board has long recognized that “principles of administrative finality and commercial certainty” generally preclude the agency from reopening consummated transactions to impose new conditions on prior grants of authority. *Western Fuels* at 10. Even in transactions where Section 11327 provides authority to make supplemental orders, the Board has recognized the “obvious” unfairness associated with imposing additional conditions “long after the control transactions were consummated and consolidated operations were effected.” *Gulford*, 5 I.C.C.2d at 206. “[O]nce the period for administrative reconsideration has passed, carriers that

³⁶ AECC suggests that Entergy might be able to pursue relief under § 11102 or § 10907 (AECC Comments at 7). UP strongly disagrees. Moreover, Entergy has not invoked those provisions or met its burden of proof under those provisions, and even if it had, the available relief would be very different than the relief it is seeking – neither provision would allow M&NA to use UP's lines to interchange traffic with UP's competitors without compensating UP.

have decided to move forward with their transaction are entitled to rely on the assumption that the basic terms and conditions of administratively final decisions are not likely to be altered ” *Canadian National* at 4 Thus, the Board has stated that “absent some failure of a condition that we imposed or some specific reservation of jurisdiction through oversight or otherwise, it would generally not be appropriate for us to impose new conditions on our approval of a transaction that has already been consummated ” *Major Rail Consolidation Procedures*, 5 S T B 539, 583 (2001)

In this case, the unfairness to UP of Entergy’s proposed relief is “obvious ” *Gulford*, 5 I C C.2d at 206 UP never would have leased its lines if it could not have preserved the revenue stream from traffic it otherwise would have handled by requiring M&NA to either interchange a substantial percentage of through traffic with UP or pay substantial rent to UP. (Wilson VS at 2-3)

In addition, Entergy has not argued, and could not argue, that there has been a failure of a condition or a frustration of the agency’s expectations regarding the UP/M&NA Lease’s effect on competition As discussed above, the ICC carefully considered the competitive effects of interchange commitments in short line spin-offs and sanctioned their use several years before the UP/M&NA Lease See *Montana Rail Link* at 20-21, *South Carolina* at 8-9 And, as the agency expected, the UP/M&NA Lease’s interchange commitment has either maintained or increased shippers’ pre-transaction competitive options. See *Class Exemption*, 1 I C C 2d at 817 (“Proposals under this class exemption generally will maintain the *status quo* and will not change the competitive situation ”)

Moreover, the relief Entergy seeks would be inappropriate and grossly disproportionate to the concerns it has actually identified Entergy claims that the lease’s contingent rent payment

is set too high and that UP refused to waive the interchange commitment when it was having severe service problems. But Entergy is not arguing that the rent should be reduced or that UP should be required to waive the interchange commitment when its service is severely disrupted, Entergy is arguing that UP should be required to allow rent-free use of its lines at all times. Nothing in Entergy's claims would justify allowing M&NA to use UP's lines for free – that is, without any obligation to interchange through traffic with UP or pay rent to UP. As described in detail by Dr. Rubinfeld, such a result would have adverse effects on long-term efficiencies and social welfare. (Rubinfeld VS at 13, 21-23)

The relief Entergy seeks also would be patently unfair to UP. According to Entergy's own calculations, the lease has generated just { } more than UP expected to earn from continuing to operate the lines itself over a 15-year period. Entergy argues that "UP has already obtained a greater financial benefit through its lease and paper barrier restriction than the pre-transaction [going concern value]" (Entergy Argument at 61), but Entergy cannot seriously suggest that UP's receipt of { } over 15 years justifies allowing M&NA to use UP's lines for free. According to Entergy's own calculations, traffic from the leased lines generated almost { } in contribution for UP in 2007. UP's lost contribution in just the first year could dwarf any past gains from entering into the lease.

B. The Board Should Reject Entergy's Proposed "Shipper Right of Approval"

Entergy appears to recognize that its primary request for relief is inappropriate, and it suggests that, alternatively, the Board could preclude UP from enforcing the UP/M&NA Lease's interchange commitment while allowing UP "the option to terminate the lease and return to its pre-transaction status quo with respect to the leased property" (Entergy Argument at 62).

No relief of any type is appropriate in this case, but for the reasons discussed in the preceding section, UP must have the option to terminate the lease and reacquire the line it sold to M&NA if it is precluded from enforcing the interchange commitment and rent provision

Entergy also proposes that the Board adopt a “Shipper Right of Approval” to ensure that the terms of any renegotiated (i.e., post-termination) lease are “reasonable ” (Entergy Argument at 62-65) Entergy’s proposal reveals what this case is really about – Entergy wants to extract a larger share of benefits from any transaction between UP and M&NA. As Dr. Rubinfeld explains, the proposal is a classic example of free-riding. Entergy wants to hold the transaction hostage until it receives a pay-off from the parties that are risking their own resources (Rubinfeld VS at 24-25) Entergy’s proposal is especially inappropriate in light of its own expert economist’s concession that, even if a spin-off’s benefits are not shared with the short line or the shipper, it “is socially desirable to have the shortline take over [the] operation ” (Kwoka/Warren-Boulton VS at 7)³⁷

If UP and M&NA were to negotiate a new lease, then even if the transaction were not exempt, the Board would be required to authorize the spin-off as long as it was not “inconsistent with the public convenience and necessity.” 49 U.S.C. § 10901(c) Entergy, of course, would have an opportunity to make its own views known to the Board during approval proceedings, but the Board could not avoid its statutory obligation to make that legal determination by putting the question to a vote of self-interested shippers

³⁷ Entergy suggests that its Shipper Right of Approval proposal is consistent with the private-sector resolution of disputes (Entergy Argument at 64), but its effort to increase its competitive options by having a regulatory agency invalidate the UP/M&NA Lease is the antithesis of private-sector action. Entergy has already proposed a market-based approach to increasing rail competition at Independence – it can construct its planned build-out to BNSF

C. The Board Should Reject Entergy's Request To "Confirm" M&NA's Obligation To Provide "Bottleneck" Rates

Because Entergy is not entitled to any relief in this proceeding, the Board need not address hypothetical questions about Entergy's right to require M&NA to quote a separately challengeable "bottleneck" rate from a point of interchange with a carrier other than UP to Independence (Entergy Argument at 65-67)

However, the answer to Entergy's hypothetical is clearly set forth in *Central Power & Light Co v Southern Pacific Transportation Co* , 1 S T B 1059 (1996) ("*Bottleneck I*"), and *Central Power & Light Co v Southern Pacific Transportation Co* , 2 S T B 235 (1997) ("*Bottleneck II*"), and it is not the answer suggested by Entergy Entergy *cannot* require M&NA to quote a "bottleneck" rate "so long as the bottleneck carrier provides the origin-to-destination service that the shipper seeks – by single-line rates or through rates with other carriers." *Bottleneck II*, 2 S T.B at 237 Even if the shipper "already has a contract with the second carrier in hand," the law is the same "where a bottleneck carrier already serves the origin, either directly or in interline service, it need not provide, on request, an additional rate for transportation over the bottleneck segment of an alternative interline route from the origin " *Id* at 240-41 "Instead, the shipper must first proceed under [the Board's] competitive access regulations to obtain an order requiring the opening of that route " *Id* at 241 (citing *Bottleneck I*, 1 S T B at 1065-72)

Thus, for example, Entergy could not force M&NA to quote a bottleneck rate for PRB coal moving via BNSF to an interchange with M&NA, so long as M&NA could deliver that coal using a through rate with UP M&NA "is not required to open an additional route through a different interchange simply because the shipper asks it to do so " *Bottleneck I*, 1 S T B at 1065 If Entergy wants a different route than the one offered by M&NA, "it must invoke [the Board's]

‘competitive access’ regulations and demonstrate that the bottleneck carrier’s refusal to establish such a route would foreclose more efficient service.” *Bottleneck II*, 2 S T B at 238 “[A] shipper-carrier contract for service over the non-bottleneck segment of its desired route would not by itself relieve the shipper of its obligation to satisfy the competitive access obligations to obtain an alternative route ” *Id* This leaves Entergy in precisely the same position it would have been in before UP entered into the UP/M&NA Lease, when UP could have provided origin-to-destination service between the PRB and Independence

Even if Entergy were seeking service from an origin served only by a carrier other than UP and it had a contract with the origin carrier for service to an interchange point with M&NA, M&NA would not necessarily be obligated to quote a separately challengeable rate from that interchange point In these circumstances, the choice of an interchange “cannot be dictated unilaterally by either the bottleneck carrier or, through its contract with the shipper, the origin carrier ” *Id* at 243 Thus, for example, M&NA might suggest that the origin carrier interchange traffic with UP so M&NA can interchange with UP at Kansas City, in order to protect its long haul and avoid triggering the contingent rent under the lease. If the origin carrier and M&NA cannot agree, the Board would and could determine an appropriate route and interchange point, and the shipper contract could be a factor in its determination, but the shipper cannot dictate the outcome through its contract *Id* at 243-44 Again, that leaves Entergy in precisely the same position as before the lease

Finally, Entergy asks the Board to rule that M&NA would be excused from any rental obligation under the lease if it were required to quote a bottleneck rate in the future However, that would be just another way of providing M&NA free use of UP’s lines, which would be inappropriate for the reasons discussed above Moreover, if the Board were to rule as Entergy

requests, such a determination that the contingent rent provisions were unenforceable would trigger UP's right to terminate the lease (Lease § 15 01(f))

VI. CONCLUSION

The UP/M&NA Lease's interchange commitment has not caused, and could not cause, any harm to competition. It does not increase UP's market power or give UP more control over rates or routes than if it had never leased its lines to M&NA. Entergy thus is not entitled to any relief.

Respectfully submitted,



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August 11, 2008

CERTIFICATE OF SERVICE

I, Michael L Rosenthal, certify that on this 11th day of August, 2008, I caused copies of Union Pacific's Reply Evidence and Argument to be served on counsel as follows

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**VERIFIED STATEMENT
OF
WARREN C. WILSON**

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My name is Warren C. Wilson. I am Senior Director-Rail Line Planning for Union Pacific Railroad Company ("UP"). I have worked in the railroad industry for 41 years and have worked in UP's short line group since 1987, when UP completed its first short line transaction in the post-Staggers era. Prior to 1987, I held various marketing and operating positions with the Missouri Pacific Railroad ("MP") and the Pennsylvania Railroad.

In my current position, I am responsible for UP's relationships with short line and regional railroads, including short line "spin-off" transactions. In 1993, I was the project leader for the negotiations that ultimately resulted in the creation of the Missouri & Northern Arkansas Railroad ("M&NA").

In this statement, I discuss the important role interchange commitments play in UP's short line transactions, UP's reasons for entering into the UP/M&NA lease and sale, and the development of the lease terms, including the interchange commitment. I then respond to some of the claims made about this transaction by Entergy in its July 11, 2008 filing. First, however, I want to make an overall comment about this proceeding and its potential effects on future short line transactions.

I. PRELIMINARY COMMENT

The UP/M&NA lease and sale was made over 15 years ago. There were five key elements, each of which was essential to the economics of the transaction.

- (1) UP would continue to handle most of the traffic originated or terminated on M&NA. As such, so long as M&NA interchanged this traffic with us, we would not require M&NA to pay rent for using the line.**

- (2) M&NA would, in fact, pay no rent to UP for the leased lines because M&NA would interchange most of its traffic with UP. Instead, UP's benefits would come from retaining the revenue stream produced by the lines and from the sale proceeds and savings described in "4"
- (3) UP would compensate M&NA for the services it performed based on an agreed division and escalation formula, which could not be unilaterally changed by either party
- (4) UP would derive an economic benefit from the transaction consisting primarily of
 - (i) the proceeds of the sale of the Bergman-Guion segment to M&NA, and
 - (ii) the amount by which the capital and operating costs UP saved by not operating the lines exceeded the division UP paid M&NA
- (5) M&NA would derive an economic benefit from the transaction consisting primarily of the amount by which the division it received from UP exceeded the operating and capital costs it incurred in running the property

UP's continued participation in the traffic generated by the M&NA lines was a crucial part of the transaction – it was the basic premise upon which the whole transaction was based. Had we any reason to believe in 1992 that the transaction would jeopardize our present or future participation in this traffic, we never would have even considered it.¹ And, had the ICC in 1992 required

¹ Entergy claims that the lease's provision allowing either party to terminate the lease if any of the interchange commitment provisions were found unlawful or enforceable shows that UP had a "significant concern" that their provisions would be found unlawful (Entergy Argument, p. 9). That is incorrect. We believed that the interchange commitments were entirely lawful and enforceable, particularly since we knew that the ICC had upheld similar arrangements in other transactions. Had we had a "significant concern" about the interchange commitments, we would not have done the transaction at all. The provision was simply designed to provide "just in case" protection for an agreement that could potentially be in effect for 80 years. Entergy no doubt has long-term agreements with similar provisions.

changes in the underlying agreements that jeopardized our present or future participation in the M&NA traffic (for example, by requiring that any interchange commitment would expire in 15 years), we would have walked away from the transaction in a heartbeat

What Entergy is now trying to do, over 15 years after the transaction was approved and consummated, is to force us into a radically different transaction we never would have made, in which we have no assurance of continued participation in the M&NA traffic, and no right to obtain any compensation from M&NA for its use of our property. I will leave it to the lawyers to address whether the Board has the authority to do something like this. But, from a business standpoint, it is an intolerable situation. The agreements we have with M&NA were entirely proper under ICC policy when they were made. There was no reason to believe that a regulatory agency would, 15 years later, even consider a radical rewriting of the deal that would leave UP with an unacceptable, confiscatory business arrangement that it cannot escape.

We cannot and will not enter into future arrangements with short lines that present this danger. Because of this, we are no longer even considering short line transactions where interchange commitments would be crucial to the economics of the transaction. This takes off the table potential efficiency enhancing deals that could be advantageous to UP, the short line and our mutual customers. It also limits the prospects for future short line development to less viable lines, where we are not as concerned about losing the traffic (essentially abandonment candidates) or lines that cannot physically connect with other

carriers. This is not a good outcome for us, the short line industry or our customers, but it is the inevitable result of threatened regulatory action that makes it impossible to rely on negotiated business arrangements. If the only way to avoid the risk is to avoid the transactions, then we have no alternative but to avoid the transactions.

II. THE ROLE OF INTERCHANGE COMMITMENTS IN UP'S SHORT LINE TRANSACTIONS

I discussed the role of interchange commitments at length in my testimony in Ex Parte No. 575,² but it is useful to review it here.

Most of our short line lease transactions have interchange commitments that are similar in structure to the one involved in this proceeding. UP and its predecessor roads have also built interchange commitments into short line sale transactions. These commitments are not peripheral features – they are key elements of the transactions. Without them, most of the short line transactions by UP and its predecessor roads would never have taken place.

The reason interchange commitments are so important is because they allow the transaction to be priced so that the short line can afford it. If we could not use interchange commitments to protect our revenue stream from the traffic generated by a short line spinoff, we would have to build the going concern value ("GCV") of this traffic into the lease rate or sale price. This would, in turn, require the short line to use much of its cash flow either for rental, or for principal and

² Ex Parte No. 575, Statement of Warren C. Wilson, March 8, 2006, Reply Comments of Union Pacific Railroad Company, Reply Statement of Warren C. Wilson, March 28, 2006.

debt service for the sale price. Few, if any, short line operators are in a position to do this, particularly on lines generating significant amounts of traffic.

Interchange commitments vastly improve a short line's economics. Since an interchange commitment means that UP will retain much of the business generated by a line, it is unnecessary to build the GCV of a line's traffic into the rental or sale price. This allows the short line to use its available cash to maintain the physical plant, provide service and provide a profit to the operator. Further, a commitment expressed in terms of a percentage of traffic, rather than an absolute volume requirement or a set rental amount, places most of the risk of traffic declines on UP rather than on a short line, which is less able to bear the loss. Most of UP's short line spinoffs have been leases, and the rental payments are typically "zero" if the short line fully meets the interchange commitment.

The M&NA provides a good example of the importance of interchange commitments. M&NA pays zero rent for its use of 400+ miles of UP trackage. It has never paid any rent because it has preserved UP's revenue stream from this traffic by interchanging a sufficient amount of traffic with UP to avoid any rental payments under the interchange commitment. By protecting UP's revenue stream from this traffic, M&NA pays no rent.

III. THE M&NA TRANSACTION

In this section, I describe the considerations that led us to do the M&NA transaction, and how the arrangement evolved.

The core of what is now M&NA consisted of UP's Carthage Subdivision, a former MP line extending from Pleasant Hill, MO (near Kansas City), where it

joined with the UP line between Kansas City and St Louis, and Diaz Junction, AR, where it joined with the UP line between St Louis and Little Rock, AR In 1989, UP shifted much of the Carthage Subdivision traffic to alternate routes, including the traffic to Entergy's Independence plant The Entergy traffic had originally moved from Kansas City through Pleasant Hill, MO, and over the Carthage Subdivision to Independence After the rerouting, the Entergy traffic avoided most of the Carthage Subdivision, moving on a route through Parsons, KS and Little Rock, AR, to Diaz Junction, and then moving only 9.3 miles over the Carthage Subdivision between Diaz Junction to Independence These routings can be traced on the map designated as UP Counsel's Exhibit No. 3 While the new route was longer than the old route, UP considered it a superior routing because it avoided the grades, curvature and track wear on the curved rail on the Carthage Subdivision

Since the Carthage Subdivision was no longer needed for through traffic, it became a candidate for redeployment We considered two alternatives The first was that UP would continue to operate the segments between Pleasant Hill and Bergman, and between Guion and Diaz Junction, but abandon the 102 miles of line between Bergman and Guion Under this scenario, the Carthage Subdivision would have been severed as a through route, and the two surviving segments would be served from the Pleasant Hill and Diaz Junction ends

The other was to spin off the entire subdivision to a short line This evolved into a plan for an arrangement where a short line would lease the Pleasant Hill-Bergman and Guion-Diaz Junction segments and purchase the

Bergman-Guion segment The reason it was structured this way was because we considered the Bergman-Guion line at the time to be an abandonment candidate which we wanted to liquidate. If a short line purchased this segment, we would be compensated for the value of the assets on this segment. The short line could then decide for itself whether to retain it or abandon it.

We ultimately concluded that this short line lease/sale approach was the preferable alternative, so long as we could retain the revenue stream from the traffic generated by the leased lines. As a result, we requested bids on a proposal that included a sale of the Bergman-Guion segment, a lease of the Pleasant Hill-Bergman and Guion-Diaz Junction segments, and a lease of some connecting line segments to Clinton, Joplin, and Springfield, MO, and Ft. Scott, KS.

When we put the proposals out for bid, we asked the interested parties to assume that the transaction would include an interchange commitment for traffic on the leased line segments, and that the traffic available to the short line would not include the traffic moving to the Independence plant. Instead, UP would itself provide exclusive service to the Independence plant, using trackage rights over short line between Diaz Junction and Independence. We also provided the bidders with traffic and engineering data for the lines included in the bid package.

The bidders were asked to submit bids that specified

- (i) The division they would require from UP to handle traffic
- (ii) The amount they would pay to purchase the Bergman-Guion line segment

- (iii) The amount they would require UP to pay for the trackage rights between Diaz Junction and Independence, by which UP would continue to serve the Independence plant

After reviewing the bids, UP determined that the M&NA (RailTex) bid provided the best overall economic package. We estimated that the present value of the M&NA transaction would exceed the present value of the operate/abandon alternative by { } to { }, depending on how quickly we could realize certain labor cost savings³. We then entered into discussions with M&NA to develop the specific terms of the transaction and a schedule of the divisions UP was to pay to M&NA for the traffic M&NA handled.

To this point, the transaction we were discussing assumed that UP would continue to serve the Independence plant, not M&NA. Very late in the negotiations, we realized that, {

}⁴ As a result, UP and M&NA agreed that M&NA, not UP, would provide service to the Independence plant, and be paid a division for the service, like other traffic on the leased lines.

³ The Authorization for Line Disposition and other analyses we performed all used UP internal costs.

⁴ {

}

As part of this new arrangement, UP retained an option to acquire trackage rights to resume exclusive service to the Independence plant either at UP's option, or at the option of Entergy. If this option were exercised (it never has been), UP would be required to pay M&NA \$60,000 per year – the same amount of compensation M&NA had proposed in its bid. An important reason for this option was that UP had a prior contract with Entergy requiring UP to transport coal to Independence, and {

} This was a 10-year contract made in 1991 under which UP was to deliver 100% of Entergy's Powder River Basis coal requirements at Independence.

IV. RESPONSES TO SPECIFIC ENTERGY CLAIMS

A. Competition

A theme that runs throughout the Entergy filing is that our arrangement with M&NA is “anticompetitive” because it has the effect of preventing M&NA from freely interchanging whatever traffic it chooses with railroads other than UP. But there's nothing “antitcompetitive” about this.

The M&NA transaction did not result in any lessening of competition. There has never been more than one railroad serving Independence or most other points on the M&NA lines. Prior to the transaction, the vast majority of shippers on the M&NA lines – including Entergy at Independence – were

exclusively served by UP⁵ UP, of course, naturally favored UP long hauls beyond the Carthage Subdivision

The M&NA transaction did not take away any of competitive options that customers on the lines had prior to the transaction, including Entergy It simply substituted M&NA for UP The provisions of the underlying agreement that gave M&NA an incentive to interchange traffic to UP simply replicated the pre-transaction incentives UP had to prefer UP long haul routes Where customers on the lines had alternatives to UP prior to the transaction through reciprocal switching, those alternatives were preserved in the transaction, and the affected traffic was excluded from the interchange commitments (Lease Agreement, section 4 02) These features were not an accident We deliberately structured the M&NA transaction to preserve all competitive options that M&NA customers had prior to the transaction

In fact, the transaction actually increased competitive options available to M&NA customers, though clearly not as much as Entergy would like First of all, M&NA is permitted to interchange up to 5% of its traffic with other carriers without triggering an obligation to pay rent⁶ This feature was designed to permit M&NA to freely interchange a portion of its traffic with other roads without payment of rental, and without securing any waivers from UP 5% represents a

⁵ Technically, the Carthage Subdivision was owned by the Missouri Pacific Railroad (MP) UP acquired control of MP in 1982 – 10 years prior to the M&NA transaction – and operated MP as an integral part of the UP system

⁶ The 5% is in addition to the traffic M&NA is already permitted to interchange with other railroads to preserve customers' pre-existing competitive options, as described in the preceding paragraph

significant amount of traffic {
}

Second, the transaction created new competitive options for shippers on the Bergman-Guion segment (the segment that UP sold to M&NA). There is no interchange commitment applicable to this segment, so M&NA may freely interchange the traffic on it to other roads without triggering any rental obligations.

Third, while not part of the terms of the original lease, the transaction has had the effect of creating additional competitive options through special agreements or waivers, which would not have been available had UP retained the lines. One example of this is the Tenth Supplemental Agreement in 2005, which {

}⁷ This change was made because the amount of Powder River Basin traffic UP was interchanging into M&NA had declined due to conditions on the PRB joint line. This was done to prevent the reduction in PRB traffic from inadvertently reducing the amount of traffic M&NA could interchange to other carriers under the 5% threshold.

Another example is the availability waivers under the Rail Industry Agreement. For example, in 2005, we granted a waiver for a movement between {

⁷ Technically, this was accomplished by changing the trigger point for rental payments { } A copy of this agreement is contained in Entergy Counsel's Exhibit No. 14

}

Finally, the M&NA transaction preserved rail service options that would likely have been lost. As I previously mentioned, UP would likely have abandoned the Bergman-Guion segment if it had retained the M&NA lines. The M&NA transaction saved it. This preserved (and enhanced) the rail service options of the shippers on the Bergman-Guion segment. By saving the Bergman-Guion segment, the transaction also benefited Entergy by preserving a through route between Kansas City, Independence, and Diaz Junction. This did not immediately affect Entergy, because its trains were being handled entirely on the Independence-Diaz Junction segment when the transaction was originally done. However, during our 1997-98 service problems, we found we could improve service to Entergy by using M&NA to move empty coal trains between Independence and Kansas City. This routing proved successful, and is still being used. But it would not have been possible had UP abandoned the Bergman-Guion segment.

B. Contingent Rental Schedule

The interchange commitment applicable to the M&NA transaction takes the form of a rental schedule, which provides varying levels of rent payments based on the percentage of M&NA's traffic which is interchanged with roads.

other than UP (Lease Agreement, section 4.03) Obviously, the lease agreement had to have a provision like this, or else M&NA could use the leased lines for free while interchanging the lines' traffic with other carriers As I read Entergy's filing, it is not claiming that a contingent rental schedule is improper as such Rather, Entergy is complaining that the rental amounts in the schedule are excessive because they are based on an estimate of the gross revenue UP would lose from traffic interchanged with other carriers, rather than an estimate of the contribution UP earns from this traffic (Entergy Argument, pp 46-50)

It is, of course, true that the rental schedule is based on gross revenues, as I stated in my deposition It is not clear to me, however, why Entergy believes this is of great significance

First of all, the contingent rental schedule does not overcompensate UP In fact, over the last 15 years it has not compensated UP at all M&NA has paid no rent to UP during the entire period it has operated That comes as no surprise, since both parties assumed going into the transaction that M&NA would interchange most of its traffic with UP, and it has done so We cannot force M&NA to pay rent either, since M&NA can always choose to interchange 95% of their traffic with us, as they have done in the past

Second, the rental was roughly based on gross revenues in 1991 subject to an escalation formula, a "rule of thumb" approach we have used in many other short line leases The underlying agreement could potentially be in effect as long as 80 years There is no reason to believe that rental based on 1991 gross revenue would overcompensate UP for a loss of traffic that could occur at any

time during this period. It could just as easily under-compensate UP. That is particularly true since the way the rental is calculated makes no allowance for the possibility that a particular segment of traffic diverted to another carrier may produce proportionally higher revenues and/or contribution than other traffic on the lines. Given everything that can happen over an 80 year period, a contingent rental schedule based on 1991 gross revenues was as reasonable as any. I would also point out that M&NA took no exception to the contingent rental schedule during our 1992 negotiations, so it apparently did not believe it unreasonable or particularly significant.

Third, Entergy's main concern seems to be that the contingent rental provisions disincent M&NA from interchanging traffic with other carriers. But, even if the rental discourages M&NA from interchanging all of the traffic to which it applies with other carriers, it would be of no competitive significance. It would simply replicate the competitive situation that existed prior to the M&NA transaction, where UP protected its own long hauls. It does not result in the elimination of any competitive options Entergy or other M&NA customers had.⁸

C. \$60,000 Trackage Rights

In another attempt to show that the contingent rental schedule is too high, Entergy points to what it calls the "striking disparity" between the rentals and the \$60,000 UP is obligated to pay M&NA if it resumes exclusive service to Entergy.

⁸ Further, while Entergy repeatedly criticizes the contingent rental charges as too high, it fails to show how a lower level of charges (presumably based on some measure of 1992 contribution) would have any competitive significance. M&NA would still have to pay substantial rental if it interchanged a large volume of its traffic with other carriers, and could still completely avoid the rental by interchanging the traffic with UP. Entergy obviously recognizes this, because the relief it is proposing involves complete elimination of the contingent rental.

The trouble is that the \$60,000 is the amount M&NA itself proposed for the trackage rights. There was never any relationship between the trackage rights fee and the contingent rental schedule. Recall that the transaction originally put out for bid assumed that UP would provide exclusive service to Entergy via trackage rights over the short line (which would not itself serve Entergy). The bidders then proposed the amount they would require for their trackage rights as part of their bids. M&NA bid \$60,000. When the trackage rights were subsequently changed to contingent rights, the \$60,000 charge remained in place.

D. UP- M&NA Rate/Division Arrangement

Entergy appears to be arguing that there is something improper with the rate and division features of the UP-M&NA agreement in that they supposedly give UP "control" over M&NA's pricing and compensation, thereby preventing M&NA from unilaterally increasing its revenues. (Entergy Argument, pp 50-53)⁹ If this is what Entergy is claiming, it is wrong.

The way the UP/M&NA agreement works is very similar to arrangements we have with many other short lines. UP has the right to establish the rates that apply to the short line customers for traffic interchanged with UP. UP is then obligated to pay M&NA a division for the service it provides. This division applies regardless of the rate level – M&NA gets the same division whether the rate to the customer is "high" or "low." The divisions are established in the underlying

⁹ I cannot tell exactly what Entergy is arguing because a large part of its argument on this point was redacted from UP's copy of its filing.

agreement, and neither UP nor M&NA can unilaterally charge them. Accordingly, M&NA does not set Entergy's rates.

This kind of arrangement is very advantageous to a short line like M&NA, because it protects the short line from the risks of reductions in its revenue that it cannot control. The Board's recent decision in the Kansas City Power & Light rate case is a good example of how this works. The KCP&L case involved a UP-M&NA move to a power plant at Ladue, MO, served by M&NA.¹⁰ The decision ordered a substantial rate reduction and payment of reparations. In a "traditional" price/divisions arrangement, M&NA would be required to bear a portion of the reparations through interline accounts and take part of the rate reduction through its divisions. But, under our rate/division arrangement, M&NA will not be required to pay any part of the reparations or to reduce its divisions. The decision will have no effect on its revenues. UP takes these risks, not M&NA.

With this background, I have several comments on Entergy's apparent suggestion that these arrangements are improper.

First, these are entirely legitimate, voluntary arrangements with short lines, for the reasons I've already described. No one is forcing short lines into these arrangements. Where the arrangement is an integral part of a short line transaction (as with M&NA), no one is forcing the short lines to bid on the transaction or to accept a particular level of divisions. Where the short line is not a spin-off, no one is forcing the short line to do business in this manner. They do it because they find it in their interests to do it.

¹⁰ STB Docket No. 42095, *Kansas City Power & Light Co. v. Union Pacific R.R.*, May 19, 2008.

Second, Entergy's argument has nothing to do with interchange commitments. We have this type of rate/division arrangement with many short lines that are not UP spin-offs, and have no interchange commitments. Many short lines consider these arrangements advantageous because they reduce risk, and eliminate the need for the short line to devote resources to rating, billing, collection and settlement of interline freight charges.

Third, I do not understand why Entergy seems to feel that giving short lines more "control" over their pricing would be of any benefit to Entergy. All it would mean is that M&NA could establish higher freight charges to Entergy than it now gets in divisions or could surcharge UP's rates. This should be the very last thing Entergy would want, unless its real objective is to bring rate complaints against M&NA's separately established rates.

Finally, I want to comment on Entergy's attempt to show that UP is somehow forcing inadequate divisions on M&NA. As I pointed out before, the divisions M&NA expected to be paid were part of its bid, and the final divisions and escalation formula applicable were included as part of the lease. M&NA was controlled by RailTex, an experienced short line operator which had previously acquired other lines from UP. No one forced M&NA/RailTex to bid on these lines, or to accept a particular level of divisions. They could have walked away from the deal any time prior to the signing of the agreement. Further, the UP-M&NA lease was signed by D.T. McShane, M&NA's Vice President. Mr. McShane was a former UP employee and had been my superior in UP's Rail Line Planning Department. He had plenty of experience analyzing short line

transactions He left UP in 1991 to take a position at RailTex, M&NA's parent company Clearly, he would not have approved the M&NA agreement had he believed that UP had foisted onerous terms on M&NA

Entergy goes on to claim that M&NA has a "complete lack of leverage" which is "evident" from an agreement it made with UP in April, 1993 reducing its division on Entergy traffic from { } to { } per train Entergy claims that M&NA obtained "no offsetting benefit," supposedly based on my deposition testimony (Entergy Argument, p 48 n 15) In fact, I did not testify that M&NA obtained "no offsetting benefit " I said that "I don't know what they got, I don't recall them getting anything " That means only that, 15 years later, I do not recall what they may or may not have received

More importantly, Entergy completely fails to mention in this part of its filing that UP & M&NA made another agreement the very next year (the Third Supplemental Agreement) that increased M&NA's division from { } per train to { } per car That works out to { } for a 100-car train, which is higher than the original { } division ¹¹ Entergy never explains how this increase fits in with its notion of M&NA's "complete lack of bargaining leverage " The reality is that UP and M&NA have agreed to several adjustments in the divisions from time to time, and will undoubtedly do so in the future ¹² The fact that these agreements have been made shows that the parties have been willing to negotiate responses to changed conditions, not that there is anything wrong with

¹¹ Entergy does mention this agreement 22 pages earlier in its filing, as part of a summary of various agreements between UP and M&NA (Entergy Argument, p 26)

¹² {

}

the basic division arrangement Further, UP is voluntarily sharing a portion of its fuel surcharge revenues with M&NA beyond what is required by the lease agreement's escalation formula That hardly demonstrates an abusive relationship

I also point out that, when M&NA experienced severe weather damage this spring, UP responded by providing emergency aid with unit ballast trains, locomotives, personnel and equipment to allow M&NA to restore service UP had no obligation to do this under its agreement with M&NA I do not want to suggest that Entergy had any such obligation either but, in view of Entergy's suggestions that UP is somehow bullying M&NA, I would simply note that M&NA knew who to call for help in a crisis It was not Entergy

Finally, Entergy implies that UP went into the M&NA transaction believing that M&NA would not maintain its lines (Entergy Argument, p 2) That would make no sense because, as I mentioned before, one of UP's principal goals in this transaction was to preserve the revenue stream produced by the M&NA traffic We did expect that UP would be able to avoid directly incurring capital and operating expenditures for keeping the lines in shape But that was because M&NA would be funding this work out of the division it received from UP ¹³ As I pointed out before, RailTex (M&NA's parent) was an experienced short line operator and certainly knew that divisions it proposed in its bid would need to be sufficient to both maintain and operate the lines Further, the lease specifically obligates M&NA to maintain the leased lines so that they could be operated at

¹³ Given differences in short line vs Class I railroad cost structures, we also anticipated that M&NA would be able to do this work for less than it would have cost UP

speeds shown in UP's then current timetables. There is simply no basis for any claim that UP or M&NA entered into this transaction expecting that the M&NA lines would not be maintained and M&NA would fail.

E. Pre-Transaction Going Concern Value

Entergy appears to be arguing that the interchange commitments are unreasonable because the total financial benefits UP obtained from the lease exceed the "pre-transaction going concern value" of the M&NA lines to UP – i.e., the financial benefits UP expected to obtain by abandoning the Bergman-Guion segment and continuing to operate the remaining segments. According to Entergy, UP has already obtained a greater financial benefit than the pre-transaction GCV, the implication being that UP is no longer entitled to protect the revenue stream produced by the M&NA traffic. (Entergy Argument, p. 61.) Other witnesses will discuss the defects in Entergy's methodology and assumptions. I will confine my remarks to the overall principle Entergy is espousing, which, frankly, is preposterous.

First, what Entergy is essentially saying is that there is something unreasonable about a transaction which leaves the participants better off than they would have been (or expected they would have been) had they not done the transaction. If that is a standard of unreasonableness, then the entire U.S. economy is unreasonable. Why, after all, would any business (including Entergy) enter into a business transaction unless it expected to be better off with the transaction than without it? Clearly, both UP and M&NA expected that they

would be better off with the transaction they made, or they would never have made it

Second, taking Entergy's numbers at face value, they show only that UP may have obtained somewhat greater benefits from the transaction than it expected. So what? How many business transactions ever turn out exactly as projected? There is always the risk they will turn out worse and the opportunity that they will turn out better. If UP really did obtain a somewhat greater benefit than it expected, it is entirely appropriate, since UP was taking the risk that it would turn out the other way.

Third, over 15 years have passed since this transaction was consummated. The "pre-transaction GCV" in 1992, whatever it may have been, is irrelevant today. M&NA has never paid UP the going concern value of the leased lines by any measure. In fact, it has never paid UP any "compensation" at all. UP's "compensation" has come from retaining the traffic it would have handled if there had been no transaction, plus a share of whatever cost savings have resulted from M&NA performing the service rather than UP. M&NA will never compensate UP for the lines' GCV under this arrangement. The interchange commitment must remain in effect for the life of the lease, otherwise M&NA will be able to use the lines without compensation to UP.

The absurdity of Entergy's position can be illustrated by an example. My cousin Frankie lives in a New Jersey apartment in the New York City area. He has lived in the same apartment for over 40 years, dutifully paying rent, month after month and year after year. Undoubtedly, the total amount of rent he has

paid over the years has covered the “pre-transaction GCV” of the apartment many times over (i.e., the sale value of the apartment when he first rented it in the mid 1960’s). Under Entergy’s argument, he should now be allowed to occupy the apartment for free as long as he chooses to live there. After all, according to Entergy, it is unreasonable for the building owner to continue to require Frankie to pay rent after he has paid the owner’s “pre-transaction GCV.” And, if the owner should decide tomorrow sell the apartment as a condo, he could not get the present value from Frankie – he would only be entitled to the “pre-transaction GCV.” Since Frankie has already paid this amount over the last 40 years, Frankie would get ownership of the apartment for free. Even Frankie couldn’t make that argument with a straight face.

VERIFICATION

I declare under penalty of perjury that the foregoing statement is true and correct to the best of my knowledge, belief and information.

Executed on August 7, 2008.


Warren C. Wilson

VERIFIED STATEMENT

OF

F. M. "RICK" GOUGH

My name is Rick Gough. I am Senior Business Director - Energy for Union Pacific Railroad Company ("UP"). I have been employed by UP for more than 29 years, and I have served as Senior Business Director - Energy since June 1, 2000. In my current role, I have primary responsibility for commercial aspects of relations with many of UP's customers that ship large quantities of coal from the Powder River Basin in Wyoming, including Entergy Arkansas, Inc., and Entergy Services, Inc. (collectively, "Entergy").

My direct dealings with Entergy date back to 1983, when UP, Western Railroad Properties, Inc., and Missouri Pacific Railroad Company first entered into long-term contracts to deliver PRB coal to Entergy, which was then named Arkansas Power & Light Company. As a result of my work, I am generally familiar with the 1992 UP/M&NA Lease, including the terms that affect M&NA's rights to handle unit-train coal traffic to Entergy's Independence plant.

This statement primarily responds to Entergy's claim that the existence of the UP/M&NA Lease's interchange commitment has been "a serious impediment to Entergy's ability to obtain all of the coal deliveries that have been needed at the Independence Station since the lease became effective in 1992." See Gray VS at 2. It also responds to Arkansas Electric Cooperative Corporation's claim that UP would use the interchange commitment unreasonably to prevent interline movements of coal from origins that it cannot serve, such as KCS-served mines in Oklahoma or Texas. See AFCC Argument at 4. Finally, I address Entergy's more general claim that UP has not invested adequately in its coal business. See Mohl VS at 6-9.

As a general matter, Entergy and AECC are wrong to suggest that the UP/M&NA Lease has reduced their ability to obtain rail service to Independence. Entergy's Independence plant has been served exclusively by UP since it first began operating in 1983. Entergy's Independence plant is located on a former Missouri Pacific line that runs between western Missouri and northeastern Arkansas. Missouri Pacific was not a neutral carrier when M&NA leased the line that serves Independence. UP acquired control of Missouri Pacific in December 1982, long before the 1992 UP/M&NA Lease, and even before Entergy had begun commercial operations at Independence. The lease thus did not extinguish any competitive routing options that had been available to Entergy.

Entergy is also wrong when it claims that the UP/M&NA Lease has been an impediment to obtaining all of the coal deliveries Entergy has needed at Independence. Entergy describes three situations over the past fifteen years in which service disruptions have affected Entergy, but none of those situations was caused by or exacerbated by the lease. In other words, Entergy would have been in the same position if UP had never leased its lines to M&NA. Moreover, contrary to Entergy's claims, UP has never refused a request by Entergy to waive the lease's interchange provisions when UP could not provide requested service to Independence. In fact, the lease's impacts on Entergy have been only positive. UP has worked with M&NA to improve its service to Independence by routing empty cars over the leased lines.

It is also worth noting at the outset of my statement that Entergy is careful not to complain that the UP/M&NA Lease has had any detrimental effect on rail rates to Independence. In fact, Entergy's rates have fallen since the lease. Entergy's net rates for PRB coal moving to Independence have fallen from approximately { } per net ton in 1992 to { } per net ton in 2007. Entergy's rates in 2008 {

} ¹

The 1993-1995 Midwest Flooding And Aftermath

Entergy is wrong to the extent it implies that UP's service difficulties following severe Midwest flooding in 1993 were related to the UP/M&NA Lease. UP and Entergy have long disputed the precise cause of UP's service problems in the 1993-1995 period, and there is no reason to rehash those disputes here other than to state that Entergy never claims that the problems were caused by or exacerbated by the UP/M&NA Lease. Entergy never claims the problems would not have occurred, or that it would have been better able to receive coal at Independence during that period, if UP had never leased its lines to M&NA.

Entergy also is wrong when it claims that UP refused to waive the UP/M&NA Lease's interchange commitment to permit delivery of additional coal to Independence using a Burlington Northern/M&NA routing. Entergy's witness, Daniel B. Gray, says he asked UP to waive the interchange commitment in a letter dated May 17, 1994. *See* Gray VS at 6 & Exhibit DBG-3. Mr. Gray is correct as far as that letter goes, but either he does not know all the facts, or he simply fails to tell the full story.

As the parties' correspondence shows, UP responded to Entergy's concerns by proposing a plan for increasing its coal deliveries to Entergy's Independence and White Bluff plants. *See* Exhibit FMG-1. After reviewing UP's proposal, Entergy withdrew its request that

¹ *See* http://www.bls.gov/data/inflation_calculator.htm

UP waive the interchange commitment. Specifically, Entergy's Roy A. Giangrosso wrote UP's Steve Jensen that Entergy was "pleased with the railroad's efforts" and was "withdrawing its request, stated in Dan Gray's letter of May 17, 1994, that the BN and M&NA be allowed to transport coal into ISES [Independence] from SPRB mines currently served by WRPI." See Exhibit FMG-2. To the best of my knowledge, Entergy never renewed its request.

The 1997-1998 Service Crisis

Entergy again is wrong when it claims that UP refused to waive the UP/M&NA Lease's interchange commitment to allow coal deliveries to Independence via a BNSF/M&NA routing during UP's service problems following the UP/SP merger. Mr. Gray bases his claim on an April 7, 1998 letter from Entergy's Charles W. Jewell, Jr., to UP's Art Peters. See Gray VS at 8 & Exhibit DBG-5. A review of the letter, however, demonstrates that Mr. Gray is mistaken. The letter shows that Entergy never asked UP to waive the lease's interchange commitment to allow a BNSF/M&NA routing to Independence. Instead, Entergy asked UP to waive restrictions on trackage rights BNSF obtained in the UP/SP merger so BNSF could "utilize these trackage rights to serve *White Bluff*." I have attached this correspondence to my statement as Exhibit FMG-3.

White Bluff is a different Entergy plant – one that is approximately 125 miles south of UP's connection with M&NA. M&NA does not serve White Bluff, and it would not have been involved in Entergy's proposal to allow a BNSF movement to White Bluff. Mr. Jewell's proposal was to have BNSF operate over UP's line from Pine Bluff, Arkansas, to Little Rock, Arkansas, and then to the plant. Thus, once again, Mr. Gray is wrong when he claims that UP refused to waive the interchange commitment to allow alternative service to Independence.

Moreover, the UP/M&NA Lease actually allowed UP to improve its service to Entergy during this service crisis. UP and M&NA developed and implemented a plan to route Entergy's empty cars from Independence to the PRB via Kansas City. This new routing proved beneficial and remains in place today. UP also took several other steps to increase the volume of coal being delivered to Independence and White Bluff, including acquiring additional rail cars and offering to grant relief from the minimum annual volume requirements in the parties' rail transportation contract to allow Entergy to take PRB coal deliveries by barge at White Bluff.

The 2005-2006 Service Problems

Entergy is wrong once more when it implies that a UP refusal to waive the UP/M&NA Lease's interchange commitment prevented PRB coal deliveries to Independence via an alternative BNSF/M&NA routing during UP's service problems in 2005-2006. Entergy never asked UP to waive the interchange commitment to allow service via a BNSF/M&NA routing. In fact, Entergy was unable to take advantage of UP's suggestion to use alternative BNSF service to White Bluff so that UP could increase its own deliveries to Independence. If BNSF could not provide additional service to White Bluff, where it already had access, it plainly was in no position to establish new BNSF/M&NA service to Independence.

During the disruption caused by the impairment of the Joint Line in 2005, I pointed out to Dan Gray that UP's declaration of force majeure relieved Entergy of its volume commitment to UP at White Bluff. More than once, I suggested to Mr. Gray the possibility of {

} Increased BNSF moves to White Bluff would have allowed UP to divert train sets from White Bluff service to Independence service and would have increased the total amount of coal delivered to Entergy's two plants in Arkansas. Such alternative service appeared

feasible because BNSF already had access to the White Bluff plant and there was an existing BNSF-Entergy agreement in place for White Bluff

However, BNSF apparently was not in a position to provide additional service to White Bluff. In fact, the available data show that, during 2005-2006, UP was performing at a higher level relative to NCTA target demand² than BNSF at White Bluff, approximately { } versus { }, and UP was performing at an even higher level at Independence – approximately { }.³ If BNSF could not provide better service than UP to White Bluff, where it already had access, it plainly was in no position to institute new service to Independence. Suggestions that Entergy could have received more PRB coal at Independence during 2005 and 2006 but for the supposed barrier of the M&NA lease have no basis in reality.

Moreover, Entergy is wrong when it claims that UP's refusal to waive the lease's interchange commitment prevented it from addressing delivery shortfalls by moving foreign coal to Independence in late 2006. UP's service to Entergy was essentially back to normal by that

² NCTA target refers to the process sponsored by the National Coal Transportation Association ("NCTA") for using customer demand to assign train slots for loading between rail carriers on the Joint Line. Shippers input the tons they demand by mine, by destination and by rail carrier. Producers separately input the number of tons they will supply from each mine by customer and by destination. The settled amount is used to determine the slot allocation for loading trains. As Entergy's suppliers experienced difficulties that limited their production, this provides a more accurate benchmark of UP's performance.

³ As my workpapers show, I derived these percentages by starting with FERC data to determine total PRB tons delivered. The UP performance was calculated by dividing the volumes we moved by the amount the mines were prepared to load in UP trains for Entergy. Tons delivered by UP were subtracted from the FERC data to determine the BNSF tons delivered. To determine the amount the coal mines could load in BNSF trains for White Bluff, I turned to {

} This method is conservative in estimating BNSF performance, as it assumes that Entergy did not increase its demand for BNSF trains after UP explained that Entergy was entitled to divert traffic to BNSF.

time. Despite the extended undercutting of the Joint Line and dramatic increase in demand by Entergy and other customers seeking to rebuild inventories, UP delivered approximately { } of Entergy's NCTA coal demand to Independence in 2006.

Mr. Gray describes a situation in which Entergy was considering moving a test shipment of foreign coal to Independence from a Canadian National-served terminal at Convent, Louisiana. I cannot comment on Mr. Gray's dealings with M&NA or other railroads, but I can comment on how this issue was addressed by UP.

Mr. Gray contacted me in late September 2006 about possible test moves of foreign coal. He did not tell me that the move was part of an effort to mitigate UP's service problems in 2005 and earlier in 2006. Instead, he told me that Entergy {

}. Mr. Gray told me that Entergy was currently contemplating moving a test shipment to Independence and that it was considering several different potential routing options, including CN/UP, CN/KCS/UP, and CN/KCS/M&NA. A few days later, UP received a request from M&NA to waive the lease's interchange commitment so M&NA could handle the test to Independence in a route that would not include UP.

UP was willing and able to handle the movement. Thus there was no reason to grant the waiver requested by M&NA. M&NA remained free under the lease to participate in the movement without UP – it could even do so without compensating UP for use of the leased lines if it would still interchange at least 95% of its traffic with UP – but I do not know if M&NA ever actually bid for the traffic.

UP worked diligently with Entergy to develop an acceptable rate and routing for the coal. Mr. Gray seems to imply otherwise by asserting that Entergy “unfortunately” did not move the test shipment until 2007, but UP did nothing to delay the process, and I always understood that Entergy’s plan was to move the test shipment in 2007.

In short, UP has never turned down a request by Entergy to waive the UP/M&NA Lease’s interchange provision when UP was unable to provide the requested service.

Arkansas Electric Cooperative Corporation

AECC is wrong when it argues that UP has used, or would use, the UP/M&NA Lease’s interchange commitment to prevent Entergy from obtaining substitute coal from mines that UP cannot serve, such as KCS-served mines in Oklahoma or Texas. *See* AECC Argument at 4. To the best of my knowledge, Entergy has never approached UP with a request to move such substitute coal using a non-UP interchange with M&NA. Moreover, as I stated in response to similar claims by AECC and Entergy in my March 28, 2006 reply verified statement in Ex Parte No. 575, UP would waive the lease’s interchange commitment if Entergy approached us with a feasible plan to source substitute coal for Independence using a non-UP connection with M&NA in a situation in which UP was unable to meet its service obligations and unable to offer a reasonable through route for the substitute coal. However, that situation has never arisen.

Future Service To Independence

I take exception to Entergy’s claims that UP has been reluctant to invest in its coal business. *See* Mohl VS at 6-7. UP is strongly committed to the expansion and growth of its coal network. Since entering the Southern PRB market in 1984, UP set a series of annual coal tonnage records in 21 of the 23 following years. More recently, between 2000 and 2004, UP increased its SPRB coal tonnage transported roughly 23 percent, from 144 million to 177 million

tons annually From 2004 through 2006, including the period covered by Entergy's complaints about UP's recent force majeure claims, UP-transported SPRB tons increased by roughly another 10 percent, to 194 million in 2006 versus the 177 million in 2004

The growth in UP coal traffic was the result of UP's business commitment to expand and sustain its coal network Between 1997 and 2007, UP invested more than \$8 billion in its Energy business, including approximately \$1.3 billion in new capacity, \$5.7 billion in track maintenance, and \$1.1 billion in locomotives Entergy has benefited substantially from this investment For the period from 2000 through 2006, Entergy's 1,300-mile route, which represents approximately 4% of UP's 32,339 mile system, received { } of total coal-related capacity spending and { } of total infrastructure capacity spending

I also take exception to Entergy's claim that it is pursuing a build-in because it has so little confidence in UP's ability to provide reliable service. *See Mohl VS* at 7-8. If Entergy is truly concerned about increasing its competitive options at Independence, a build-in seems to be an appropriate market-based response – as opposed to their effort in this proceeding to get something for nothing However, I doubt that the build-in has anything to do with service concerns Despite Joint Line constraints, UP delivered approximately { } of Entergy's NCTA demand to Independence in 2005 and { } in 2006 Moreover, despite dramatically increased demand, UP delivered more than { } of Entergy's NCTA demand in 2007, and more than { } of Entergy's NCTA demand through June 2008

Entergy seeks to sow doubts about future UP reliability with its allegations that excessive force majeure declarations by UP have deprived it of service Specifically, its witnesses claim that UP declared 27 force majeures which excused UP from serving Entergy for 487 days between April 2005 and April 2008. Entergy exaggerates the effect of force majeure

In fact, UP continued to deliver Entergy's coal during this period. Entergy demonstrated its honest view of UP service when it recently chose to increase its use of UP's services {

}

Entergy complains about the number of force majeure UP has declared, but even when a force majeure is in effect, the party declaring the force majeure must make all reasonable efforts to continue to meet its obligations under the contract. The force majeure provides relief only to the extent necessary. For most of the force majeure events, UP would have sought only to have the delays associated with the conditions excluded from the calculation of cycle time. Such adjustments would merely avoid or reduce the amount of deficit payment that UP would make. As a practical matter this is no different than when Entergy invokes an Unloading Disability to relieve itself of the obligation to pay UP a detention charge for its failure to unload a train within the time specified by the contract. Entergy claims numerous such disabilities. In both cases, the parties are exercising rights agreed to in their contract and not attempting to void the contract. Meanwhile, UP has every incentive to move as much coal as possible to Entergy since it only gets paid for the amount of coal it delivers.⁴

UP certainly continued to deliver as much coal as it reasonably could, even when it declared force majeure. In 2005 and 2006, UP delivered 21.3 million tons of coal to Entergy,

⁴ Entergy also has overstated the effect of force majeure declarations in several ways. First, its claim that 45% of the days during that period were subject to force majeure appears to double-count days where more than one force majeure declaration was in effect. For example, while the Joint Line was being restored in 2005, severe flooding in Kansas in October 2005 damaged two bridges and washed out track in several locations. UP declared a force majeure for the Kansas flooding for both its Colorado and SPRB coal customers. It lifted that force majeure 26 days later when the last bridge repair was completed. There was also a derailment-related force majeure that was in effect for four days during the same month. Adding the duration of each force majeure would make it appear that there 61 force majeure days in October 2005. Second, Entergy appears to include declarations that effect only Colorado coal and not the vast majority of its coal moving from the PRB.

including 12.2 million tons to Independence. This was { } of the amount available to UP during those two years for loading on the Joint Line to Independence. UP delivered all of this coal despite such profound obstacles as the May 2005 impairment of the Joint Line, blizzards that closed highways and freezing temperatures that snapped rail in hundreds of locations. The reality is that UP has delivered { } of the coal available for Entergy since the Joint Line was restored.

In 2007, UP moved { } of the combined NCTA target for Entergy and slightly more than { } for Independence. We moved { } trains compared to the { } planned for Independence. In the first half of 2008, UP moved { } trains out of { } for Independence. UP met all of Entergy's coal demand even though Entergy increased its volume on UP by more than { } tons annually beginning January 1, 2007.

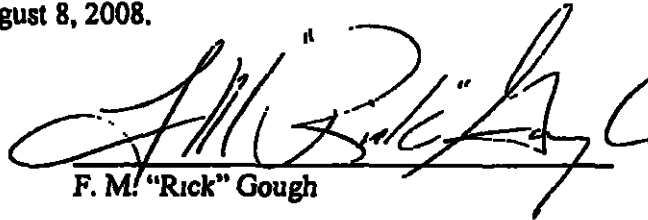
Entergy demonstrated its honest view of UP service when it chose to {

} Obviously, I am not privy to the terms that BNSF offered for a new contract, but if Entergy were seriously concerned about UP's ability and willingness to move its coal it had the opportunity to continue shipping via an alternative route.

VERIFICATION

I declare under penalty of perjury that the foregoing statement is true and correct to the best of my knowledge, belief and information.

Executed on August 8, 2008.



F. M. "Rick" Gough

FMG-1

REDACTED

FMG-2

REDACTED

FMG-3

REDACTED

VERIFIED STATEMENT
OF
MICHAEL R. BARANOWSKI

My name is Michael R. Baranowski. I am a Senior Managing Director of FTI Consulting. I provide a wide range of economic and consulting services, primarily to clients in the transportation and telecommunications industries. I have submitted written expert testimony in before the Surface Transportation Board, the Federal Communications Commission, federal courts, arbitrators, and a number of state agencies. A complete listing of my prior testimony is included in my curriculum vitae, which is attached to this statement as Exhibit 1.

I have been asked by Union Pacific Railroad Company ("UP") to address two series of analyses performed for this proceeding by Thomas D. Crowley on behalf of Entergy Arkansas, Inc., and Entergy Services, Inc. (collectively, "Entergy"). Those analyses relate to a transaction in which UP leased and sold lines comprising its Carthage Subdivision to Missouri & Northern Arkansas Railroad ("M&NA"). In the first series, Mr. Crowley attempts to show that UP has earned more from the lease/sale transaction than it would have earned had it not entered into the lease/sale transaction with M&NA. In the second series, Mr. Crowley attempts to show that UP potentially could collect more in rent under the terms of its lease agreement with M&NA than UP would have earned in contribution had it not entered into the transaction.

Mr. Crowley's Net Present Value Analyses

Mr. Crowley's first series of analyses purports to show that UP's net present value ("NPV") of the lease/sale transaction has exceeded what UP would have received had it not entered into the transaction. (Crowley VS at 7-11.) Those analyses lead Mr. Crowley to the

unremarkable conclusion that UP earned more by entering into the lease/sale transaction than if it had not entered into the transaction. However, Mr. Crowley's analyses cannot support even that conclusion. Mr. Crowley shows at most that UP earned more than it *expected* to earn if it had not entered into the transaction, and even that limited conclusion is based on a speculative "recreation" of UP calculations and apples-to-oranges comparisons of cost and revenue data that preclude any reliable comparison of UP's pre-transaction expectations with its post-transaction results.

I describe Mr. Crowley's conclusion as "unremarkable" because I cannot imagine why any party would enter into a transaction such as the one at issue in this proceeding unless it expected to benefit. Indeed, Mr. Crowley's first analysis in the series consists of nothing more than reciting the numbers contained in UP's own pre-transaction analysis of whether to engage in the transaction. UP's analysis shows that UP expected the NPV of cash flows from the lease/sale transaction to exceed the NPV of cash flows from its next best alternative – *i.e.*, continuing to operate the lines it would lease and abandoning the line it would sell. As Mr. Crowley reports, UP expected that the NPV of cash flows from entering into the transaction could be as high as { } over a 15-year period, compared with { } if it did not enter into the transaction, and thus that it might gain as much as { } over a 15-year period by entering into the lease/sale with M&NA. (Crowley VS at 8)

Mr. Crowley's second analysis builds on his recreation of UP's actual pre-transaction analysis to account for the fact that UP had not originally intended M&NA to handle Entergy's coal moving to the Independence Plant as part of the deal. UP's workpapers supporting the analysis contained information about the revenues and operating costs associated with Entergy's coal traffic, so Mr. Crowley took those figures and added them to UP's actual pre-transaction

analysis. In doing so, Mr. Crowley simply assumed that UP would have applied the same projections regarding revenue and cost changes to the Entergy traffic that it applied to the traffic it actually analyzed (Crowley VS at 9 & n 9, Crowley Exhibit (TDC-4) at 3-4). This strikes me as a questionable assumption with regard to both revenues and costs. All of the Entergy traffic is coal, while much of the other traffic on the line was a mix of other commodities, including sand, grain, soybean oil, scrap, and chemicals. Moreover, Entergy's traffic moves in unit-train service, while the majority of the other traffic moves in carload service. In addition, Mr. Crowley had to impute a special measure of UP's "on-branch" costs for Entergy's coal traffic because M&NA utilizes UP locomotives and fuel to deliver the coal from an interchange with UP to the Independence Plant (Crowley Exhibit (TDC-4) at 4). In short, it is not clear to me that Mr. Crowley's calculations accurately reflect what UP would have "expected" if it had included the Entergy traffic in its analysis.

In any event, based on his assumptions, Mr. Crowley concluded that UP "expected" that the NPV of cash flows from entering into a transaction that included Entergy traffic was { } over a 15-year period, compared with { } if it did not enter into the transaction. In other words, Mr. Crowley calculated that UP's "expected" gain from entering into the transaction fell when UP decided to include the Entergy traffic – from { }, to { }, over a 15-year period. (Crowley VS at 9)

Mr. Crowley's third analysis in the series attempts to calculate UP's actual earnings from entering into the transaction. He ultimately concludes that the NPV of UP's cash flows from entering into the transaction was { }, which he then compares with the { } that UP "expected" if it did not enter into the transaction, and concludes that UP gained { } from entering into the transaction, which equates to about { } per

year for the past 15 years (Crowley VS at 11) The { } would be even smaller – just { } – if Mr Crowley had excluded the { } that M&NA paid UP to buy the portion of the Carthage Subdivision between Bergman and Guion, Arkansas (Crowley Exhibit (TDC-4) Att 1 at 6)

As I observed at the outset, Mr Crowley's conclusion that UP increased its earnings by entering into the transaction is unremarkable, but it is also unreliable. For example, although he asserts that his "recreation" of the UP NPV calculations uses the same economic parameters as UP's original analysis, in order to come close to matching the UP results, Mr Crowley was forced to change a key component of the UP NPV calculation – the assumed discount rate. Specifically, the UP NPV calculation use an annual discount rate of 13.0 percent, while Mr Crowley's replication uses a 12.5 percent rate (Crowley Exhibit (TDC-4) at 3). Although a difference of 0.5% may appear small, over time it can account for significant differences in NPV results. Substitution of the 13.0 percent discount rate actually used by UP for the 12.5 percent rate assumed by Mr Crowley would mean that instead of being able to recreate UP's NPV after-tax cash flow within 1.4 percent as Mr. Crowley claims (*id.* at 2), he was only able to get within 4.3 percent. Because of the small NPV differences actually calculated by Mr Crowley, even a shift of plus or minus 4.3 percent can have a material effect on his results. For example, if the results of Mr Crowley's third analysis were modified to reduce the NPV of UP's cash flows from entering into the transaction of { } by 4.3 percent and increase his calculated { } that UP "expected" if it did not enter into the transaction, the calculated UP gain from entering into the transaction would drop from { } to { }, or less than { } per year for the past 15 years.

Further, when he calculated the NPV of UP's actual cash flows from entering into the transaction, Mr Crowley used URCS Phase III costs to develop UP's costs of handling traffic that moved over the leased lines (Crowley VS at 10) However, UP used its internal costing methodologies in its original pre-transaction analysis (Wilson VS at 8 n.3) That means Mr. Crowley's calculations are based on an apples-to-oranges comparison of revenues to costs Moreover, as I noted above, Mr. Crowley developed UP's "expected" revenues and costs for Entergy coal traffic based on speculation Thus, there is no reason to believe that his combination of methods and assumptions produced results that resemble reality Indeed, a comparison of Mr Crowley's tables supporting the { } and { } figures show that revenues and costs diverge substantially from the very beginning of the analysis period (*Compare* Crowley Exhibit (TDC-4) Att 1 at 3 *with id* at 6)¹

I understand that Entergy's counsel have argued that Mr Crowley's calculations of UP's increased earnings would support allowing M&NA to use the leased lines in the future without any requirement to interchange traffic or pay rent to UP Even if Mr Crowley's calculations were accurate and reliable, that claim would be absurd As I understand the lease terms, UP allows M&NA free use of the leased lines as long as M&NA interchanges at least 95% of through traffic with UP, and under that arrangement, M&NA has never paid any rent In other words, UP's only "compensation" for leasing its lines to M&NA for the past 15 years has been retaining the traffic it would have handled if it had never leased the lines in the first place, plus a share of whatever cost savings resulted from having M&NA handle the traffic on the leased lines

¹ I have not attempted to audit all of the many assumptions and calculations Mr Crowley made to calculate the { } figure (or any of the other figures he uses) to detect errors they may contain

rather than UP. Under this situation, UP has not been compensated for its ownership rights – and it would not be compensated for those rights, no matter how long the lease terms remain in place. If M&NA wanted to acquire the line today, UP would be expected to set the sale price based on its expected future earnings from the line. UP's past earnings are entirely irrelevant. Entergy's argument is no different than a claim that someone who has leased a house for 30 years is entitled to take title to the property if her rent payments over that period allowed the lessor to pay off the mortgage. Unless the lessee had entered into a special deal in which part of her payments were going toward acquiring an ownership interest, the lessor would be entitled the present day market value if the lessee wanted to buy the property.

Mr. Crowley's Rent Payment Analysis

Mr. Crowley's second series of analyses illustrates that UP potentially could collect more in rent under the terms of its lease agreement with M&NA than UP would have earned in contribution had it not entered into the transaction. However, Mr. Crowley's analyses seem to have little to do with how the UP/M&NA lease actually works. Again, as I understand the lease, M&NA pays no rent as long as it interchanges at least 95% of through traffic with UP. Thus, M&NA would never elect to trigger a rent payment if the rent payment would exceed its gains from interchanging the traffic with another carrier. In other words, the rent payment provision merely gives M&NA an option to interchange more traffic with other carriers if it determines that the interchange would be advantageous. Moreover, since all the traffic that M&NA interchanges with UP is traffic that UP would have served exclusively if it had never leased its lines to M&NA, shippers are not any worse off in terms of competitive routing options if M&NA interchanges 95%, or even 100%, of its through traffic with UP.

I understand that UP and M&NA established the rent payment based on UP's revenue from traffic to be handled by M&NA and that Entergy's counsel have argued that it was improper not to base the rent payment on the contribution UP would have lost in the event that M&NA were to interchange more than 5% of through traffic with carriers other than UP. The UP/M&NA approach does not appear to be especially scientific, but makes sense in the context of the lease – particularly one that might remain in place for as long as 80 years. UP and M&NA had to agree upon a figure that would remain high enough so that UP would not lose earnings if M&NA elected to interchange more than 5% of through traffic with carriers other than UP. While a figure based on lost revenue might appear high in relation to lost contribution in the early years of the lease, there is no guarantee that the rent amount will remain high relative to lost contribution for the next 80 years.

It is easy to see how UP could end up in a very disadvantageous position under the approach advocated by Entergy. For example, assuming that Mr. Crowley's calculations are correct, if the parties had based the rent payment on lost contribution at the outset, then the maximum rent payment would have been approximately { } (Crowley Exhibit (TDC-4) Att. 1 at 6).² However, by Year 15, UP's contribution from the traffic had grown to approximately { }, while the escalated lease payment would have grown to only { } (*Id.*)³ Thus, if M&NA interchanged 100% of its through traffic with carriers other than UP, UP would have lost { } in contribution and received only { } in rent, for a net loss of { }.

² The { } reflects Year 1 Revenues minus Year 1 Off-Branch Costs as shown in Mr. Crowley's Exhibit (TDC-4), Attachment No. 1, page 6.

³ { } indexed by the current maximum rent charge of \$114 million over the initial rent charge of \$90 million ($42.8 \times 114 / 90 = 54.2$).

UP and M&NA had a difficult task in developing a rent payment that would serve their mutual interests for the life of the lease. Although I have no basis for saying that using revenues was the best approach, I have no basis for criticizing it either. Moreover, from the standpoint of shippers on the line, even if the rent payment is too high, they would not be any worse off from a competitive standpoint than if UP had never leased its lines to M&NA.

I declare under penalty of perjury that the foregoing is true and correct. I further certify that I am qualified and authorized to sponsor and file this testimony.

Executed on August 8, 2008


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Education

B S in Accounting,
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Mike Baranowski provides financial and economic consulting services to the telecommunications and transportation industries. He has special expertise in analyzing and developing complex computer costing models, operations analysis, and transportation engineering. Much of his work involves providing oral and written expert testimony before courts and regulatory bodies.

Some of Mr. Baranowski's representative accomplishments include:

- Overseeing the development of computer cost modeling tools designed to simulate the cost of competitive entry into local telecommunications markets and directing the efforts of a nationwide team of testifying experts presenting the cost model results in multiple proceedings across the country
- Directing the analysis, critique and restatement of a variety of complex cost models developed by major telecommunications companies designed to simulate the forward-looking cost of competitive entry into local telecommunications markets
- Designing multiple PC-based spreadsheet models for use in calculating the stand-alone cost of competitive entry into the railroad and pipeline markets. These models have been used to assist clients in all three network industries in making internal pricing decisions that are in compliance with governing regulatory standards
- Conducting detailed analyses of railroad operations and developing the associated capital requirements and operating expenses attributable to specific movements and the incremental capital and operating expense requirements attributable to major changes in anticipated traffic levels
- Calculating marginal and incremental costs for a major petroleum products pipeline company, an approach that is now used regularly by the company in making internal day-to-day pricing decisions

Mr. Baranowski holds a B S in Accounting from Fairfield University in Fairfield, Connecticut and has pursued supplemental finance studies at Kean College in Union, New Jersey.

TELECOMMUNICATIONS TESTIMONY

Federal Communications Commission

February 1998	File No. E-98-05 AT&T Corp v Bell Atlantic Corp Affidavit of Michael R Baranowski
March 13, 1998	File No. E-98-05 AT&T Corp v Bell Atlantic Corp Supplemental Affidavit of Michael R Baranowski
June 10, 1999	CC Docket No. 96-98 Implementation of the Local Competition Provisions of the Telecommunications Act of 1996 Reply Affidavit of Michael R Baranowski, John C. Klick and Brian F. Pitkin

Michael R. Baranowski

- July 25, 2001 CC Docket No 00-251, 00-218 In the Matter of Petition of AT&T Communications of Virginia, Inc and WorldCom, Inc , Pursuant to Section 252(e)(5) of the Communications Act, for Preemption of the Jurisdiction of the Virginia State Corporation Commission Regarding Interconnection Disputes with Venzon-Virginia, Inc Panel
- June 13, 2005 WC Docket No 05-25,RM-10593 In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, AT&T Corp Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, Joint Declaration on Behalf of SBC Communications, Inc
- July 29, 2005 WC Docket No 05-25,RM-10593 In the Matter of Special Access Rates for Price Cap Local Exchange Carriers, AT&T Corp Petition for Rulemaking to Reform Regulation of Incumbent Local Exchange Carrier Rates for Interstate Special Access Services, Joint Reply Declaration on Behalf of SBC Communications, Inc

Public Service Commission of Delaware

- February 4, 1997 PSC Docket No 96-324 In the Matter of Bell Atlantic - Delaware Statement of Terms and Conditions Under Section 252(F) of the Telecommunications Act of 1996 Testimony of Michael R Baranowski

Public Service Commission of the District of Columbia

- March 24, 1997 Formal Case No 962 In the Matter of the Implementation of the District of Columbia Telecommunications Competition Act of 1996 Testimony of Michael R Baranowski
- May 2, 1997 Formal Case No 962 In the Matter of the Implementation of the District of Columbia Telecommunications Competition Act of 1996 Rebuttal Testimony of Michael R Baranowski

Public Service Commission of the State of Maryland

- March 7, 1997 Docket No 8731, Phase II In the Matter of the Petitions for Approval of Agreements and Arbitration of Unresolved Issues Arising Under Section 252 of the Telecommunications Act of 1996 Direct Testimony of Michael R Baranowski
- April 4, 1997 Docket No 8731, Phase II In the Matter of the Petitions for Approval of Agreements and Arbitration of Unresolved Issues Arising Under Section 252 of the Telecommunications Act of 1996 Rebuttal Testimony of Michael R Baranowski
- May 25, 2001 Case No 8879 In the Matter of the Investigation into Rates for Unbundled Network Elements Pursuant to the Telecommunications Act of 1996 Panel Testimony on Recurring Cost Issues

Michael R. Baranowski

Public Service Commission of the State of Michigan

- January 20, 2004 Case No U-13531 In the Matter, on the Commission's Own Motion to Review the Costs of Telecommunication Service Provided By SBC Michigan Initial Testimony of Michael R Baranowski and Julie A Murphy
- May 10, 2004 Case No U-13531 In the Matter, on the Commission's Own Motion to Review the Costs of Telecommunication Service Provided By SBC Michigan Final Reply Testimony of Michael R Baranowski and Julie A Murphy

New Jersey Board of Public Utilities

- December 20, 1996 Docket No TX 95120631 Notice of Investigation Local Exchange Competition for Telecommunications Services Rebuttal Testimony of John C Klick and Michael R Baranowski

North Carolina Utilities Commission

- March 9, 1998 Docket No P-100, Sub 133d In the Matter of Establishment of Universal Support Mechanisms Pursuant to Section 254 of the Telecommunications Act of 1996 Rebuttal Testimony of Michael R Baranowski

Pennsylvania Public Utility Commission

- January 13, 1997 Docket Nos A-310203F0002 et al MFS-III Application of MFS Intelenet of Pennsylvania, Inc et Al (Phase III) Rebuttal Testimony of Michael R Baranowski
- February 21, 1997 Docket Nos A-310203F0002 et al MFS-III Application of MFS Intelenet of Pennsylvania, Inc et Al (Phase III) Surrebuttal Testimony of Michael R Baranowski
- April 22, 1999 Docket Nos P-00991648, P-00991649 Petition of Senators and CLECs for Adoption of Partial Settlement and Joint Petition for Global Resolution of Telecommunications Proceedings Direct Testimony of Michael R Baranowski
- January 11, 2002 Docket No R-00016683 Generic Investigation of Verizon Pennsylvania, Inc 's Unbundled Network Element Rates Panel Testimony on Recurring Cost Issues

State Corporation Commission Commonwealth of Virginia

- April 7, 1997 Case No PUC970005 Ex Parte to Determine Prices Bell Atlantic - Virginia, Inc Is Authorized To Charge Competing Local Exchange Carriers In Accordance With The Telecommunications Act of 1996 And Applicable State Law Affidavit of Michael R Baranowski
- April 23, 1997 Case No PUC970005 Ex Parte to Determine Prices Bell Atlantic - Virginia, Inc Is Authorized To Charge Competing Local Exchange Carriers In Accordance With The Telecommunications Act of 1996 And Applicable State Law Direct Testimony of Michael R Baranowski

Michael R. Baranowski

June 10, 1997 Case No PUC970005 Ex Parte to Determine Prices Bell Atlantic - Virginia, Inc Is Authorized To Charge Competing Local Exchange Carriers In Accordance With The Telecommunications Act of 1996 And Applicable State Law Rebuttal Testimony of Michael R Baranowski

Washington State Utilities and Transportation Commission

December 22, 2003 Docket No UT-033044 In the Matter of the Petition of Qwest Corporation To Initiate a Mass-Market Switching and Dedicated Transport Case Pursuant to the Triennial Review Order Direct Testimony of Michael R Baranowski

February 2, 2004 Docket No UT-033044 In the Matter of the Petition of Qwest Corporation To Initiate a Mass-Market Switching and Dedicated Transport Case Pursuant to the Triennial Review Order Response Testimony of Michael R Baranowski

Public Service Commission of West Virginia

February 13, 1997 Case Nos 96-1516-T-PC, 96-1561-T-PC, 96-1009-T-PC, 96-1533-T-T Petition to establish a proceeding to review the Statement of Generally Available Terms and Conditions offered by Bell Atlantic in accordance with Sections 251, 252, and 271 of the Telecommunications Act of 1996 Testimony of Michael R Baranowski

February 27, 1997 Case Nos 96-1516-T-PC, 96-1561-T-PC, 96-1009-T-PC, 96-1533-T-T Petition to establish a proceeding to review the Statement of Generally Available Terms and Conditions offered by Bell Atlantic in accordance with Sections 251, 252, and 271 of the Telecommunications Act of 1996 Rebuttal Testimony of Michael R Baranowski

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Michael R. Baranowski

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Michael R. Baranowski

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Michael R. Baranowski

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VERIFIED STATEMENT
OF
DANIEL L. RUBINFELD

I. INTRODUCTION

My name is Daniel L. Rubinfeld. I am the Robert L. Bridges Professor of Law and Professor of Economics at the University of California, Berkeley and a Senior Consultant at Compass Lexecon. I received a B.A. degree from Princeton, and M.S. and Ph.D. degrees in Economics from M.I.T. I have served as Deputy Assistant Attorney General at the U.S. Department of Justice, Antitrust Division, and have consulted for both the Antitrust Division and the Federal Trade Commission on numerous occasions.

My current research relates directly to the economics of competition policy and antitrust enforcement, law and economics, and the political economy of federalism. I have published or edited six books and over 100 articles on economics topics, and I am the author of two textbooks, *Microeconomics* and *Econometric Models and Economic Forecasts* (both with Robert Pindyck). I am a past President of the American Law and Economics Association and a fellow of the American Academy of Arts and Sciences and the National Bureau of Economic Research. My CV is attached as Exhibit No. 1 to this Verified Statement.

I have been asked by counsel for Union Pacific Railroad Company ("UP") to address the competitive effects of the interchange commitment contained in a lease agreement between UP and Missouri & Northern Arkansas Railroad ("M&NA"), and the

issues raised by John Kwoka, Jr. and Frederick R. Warren-Boulton (collectively “Kwoka/Warren-Boulton”) in a verified statement filed on behalf of Entergy Arkansas, Inc. and Entergy Services, Inc. (“Entergy”) in this proceeding on July 11, 2008

As I discuss in greater detail below, it is my opinion that the interchange commitment contained in the UP/M&NA lease is neither economically harmful to competition nor anticompetitive. The lease and interchange commitment are designed to allow UP to extract (i.e., earn) greater returns from its investment in the leased lines by having them operated by M&NA. Economists view such efforts as appropriate and socially desirable as long as any greater returns do not result from harm to competition. Here, the lease has not harmed competition because Entergy and other shippers on the affected lines are no worse off from a competitive perspective than if UP had never leased its lines to M&NA. Indeed, they appear to be better off in several respects.

Kwoka/Warren-Boulton recognize that the lease and interchange commitment have not adversely affected Entergy’s competitive position vis-à-vis UP. Nevertheless, they criticize the transaction and argue that the Board should take steps to improve Entergy’s position from what it was before the lines were leased. In essence, Kwoka/Warren-Boulton urge the Surface Transportation Board to restructure the transaction, after the fact, to create additional competition, offering a proposal that is beneficial to Entergy, but which does not include an appropriate economic analysis of the competitive effects of interchange commitments.

To justify their proposal, Kwoka/Warren-Boulton rely on an analysis that is incomplete. Their analysis focuses entirely on the issue of “static efficiency” – whether there might be short-run gains from regulating UP’s pricing. However, economists have

long recognized that in setting policy it is essential to focus also on “dynamic efficiency” – the long-run benefits for society that are produced when firms have incentives to invest and innovate. Allowing firms to extract and retain static “surplus” is appropriate and even essential to promoting long-run dynamic efficiency, and the terms of the UP/M&NA lease are consistent with this fundamental economic principle.

Moreover, the Kwoka/Warren-Boulton solution – a “Shipper Right of Approval” – would be, if adopted, a clear example of “free-riding” – a situation in which one party obtains a benefit with little or no expenditure or investment to the detriment of one or more other parties that *have* made significant investments. The “Right of Approval” would amount to a “revenue grab” by Entergy and other similarly situated shippers, and would further diminish railroads’ incentives to invest and innovate to the ultimate benefit of their customers. For these reasons, such free-riding ultimately harms competition and social welfare.

In Section II, I set forth the factual background that underlies my conclusions. In Section III, I describe the economic framework on which I rely in responding to Kwoka/Warren-Boulton, and I conclude – based on that same economic framework – that the UP/M&NA lease is not economically harmful, and to the contrary, has plausible customer benefits, and that the interchange commitment is a reasonable means to prevent free-riding. In Section IV, I use the analysis set forth in Section III to address the points raised by Kwoka/Warren-Boulton, and to explain why the potential harm from Board intervention far outweighs the possible benefits.

II. BACKGROUND

The UP/M&NA lease is one part of a transaction in which UP leased and sold portions of its Carthage Subdivision lines to M&NA. In the overall transaction, UP

leased M&NA its lines at the eastern (Pleasant Hill, MS to Bergman, AR), and western (Guion, AR and Diaz Junction, AR) ends of the Carthage Subdivision and sold M&NA a 102-mile segment in the middle (from Bergman, AR to Guion, AR) UP also granted M&NA trackage rights over UP's line between Pleasant Hill and Kansas City, Missouri, to interchange traffic with UP

The lease portion of the transaction gives M&NA exclusive rights to operate trains over the leased lines for up to 80 years, except that UP retains the option to acquire trackage rights over the leased premises between Diaz Junction and Independence, Arkansas, in order to serve, on an exclusive basis, Entergy's generating plant located at Independence

Under the interchange commitment, M&NA pays no rent as long as it interchanges 95% or more of its through traffic – that is, traffic that M&NA originates or terminates on the leased lines and interchanges with another carrier –with UP When UP and M&NA interchange traffic, UP establishes the transportation rate, and it pays M&NA a fee, established in the lease, to move the traffic between the shipper facility on the leased lines and a connection with UP M&NA is required to pay rent only if it interchanges more than 5% of through traffic with UP's competitors. the rent is calculated on sliding scale, up to a maximum of \$90 million a year (subject to inflation) if M&NA interchanges 96% or more with carriers other than UP

The interchange commitment does not apply to traffic originating or terminating on the line M&NA acquired from UP Also, M&NA pays no rent when it uses the leased lines to handle local traffic – that is, traffic that originates and terminates on the lines it leases or owns

UP entered into the transaction because it was seeking a more efficient approach to serving the shippers located on the lines after rerouting rail traffic that had once traversed the lines to more efficient routes. If UP had not entered into the transaction, it would have continued to operate the leased segments and abandoned the segment it sold. M&NA has never paid any rent to UP, instead, it has always interchanged sufficient traffic with UP.¹

Prior to the lease/sale transaction, UP was the only carrier that could establish rates and provide rail service to shipper facilities located on the affected lines, including Entergy's Independence plant. After the lease/sale transaction, M&NA can provide service to those shipper facilities under rates established by UP, or it can move up to 5% of the traffic (or more if it is willing to pay rent) under rates established in conjunction with one of UP's competitors.

III. ECONOMIC ANALYSIS

Entergy alleges that the terms of the lease between UP and M&NA are anticompetitive because, among other things, UP has market power over transportation of Powder River Basin coal to the Independence plant, and the lease effectively prevents Entergy from obtaining such transportation from any carrier other than UP. In this Section, I explain why the UP/M&NA lease is neither economically harmful nor anticompetitive, and indeed has plausible pro-competitive benefits. I also discuss why the interchange commitment is an appropriate means to achieve those benefits.

¹ I understand that UP voluntarily reduced the interchange commitment to 90% in one year in which service difficulties were limiting its ability to interchange traffic with M&NA, and M&NA was concerned that it might inadvertently exceed the 5% threshold because of pre-existing commitments to interchange traffic with other carriers. I also understand that UP has waived the interchange commitment to allow M&NA to provide service in conjunction with other carriers when UP was not interested in providing the service itself.

I should note at the outset that Kwoka/Warren-Boulton do not suggest that the lease caused any harm to competition, instead, they focus on putative short-term efficiency improvements that they believe should be imposed on the lease by the Board. My discussion below describes why their approach is not consistent with fundamental principles of antitrust economics.

A. An Economic Analysis of the Lease Should Emphasize Dynamic Efficiencies

A proper economic analysis of the lease should focus on its long-term competitive effects (its “dynamic efficiencies”), and not on whether UP has market power with respect to the prices it charges for service to Entergy’s Independence plant. Economic theory is simply not concerned about the existence of market power in a given market, *per se*. The attainment of market power – even substantial market power – through the skill, foresight, and knowledge of a firm is seen as an appropriate reward for the successful innovative and other competitive activities of the firm.

With the attainment of market power comes the possibility of its misuse, and improper actions by a firm to maintain or extend its market power are deemed anticompetitive.² Although there is some debate as to exactly where to draw the line between permissible and impermissible behavior, it is generally accepted to distinguish between (a) conduct of a firm designed to benefit from what the firm has created, without consideration of the effect of that conduct on the firm’s rivals (and, by extension, its

² During my tenure as Deputy Assistant Attorney General, the Antitrust Division of the Department of Justice (successfully) brought several cases involving monopolization.

customers), and (b) conduct that increases a firm's profits by weakening or eliminating altogether competitive constraints provided by a particular rival³

Economists generally agree that firms should be allowed to engage in the first type of conduct, because permitting a firm, even one with substantial market power, to benefit from what it has created legitimately preserves incentives to invest and innovate. Antitrust laws in the United States are routinely applied in a way that permits firms to capture as much value that the firm – by its own initiative, foresight, and knowledge – has created. That is why transactions that do not affect the competitive status quo are not seen as anticompetitive, and why the lease cannot be seen as anticompetitive simply to the extent that it preserves any UP market power.

The economic reasoning behind this view rests on the concept of “dynamic efficiency” discussed previously. A dynamically efficient policy is one that generates appropriate incentives for firms to continue to invest in their business, to develop new products and new ways of delivering services, and to engage in efficiency-enhancing transactions.

Dynamic efficiencies are distinguished from “static efficiencies,” which are short-run gains that flow from regulation that causes a firm to lower its price to its customers. The static efficiency gain arises because lower prices allow certain customers of the firm

³ In evaluating the behavior of firms with monopoly power, I have advocated a “profit sacrifice” perspective, under which an anticompetitive action is one that would not be profitable except for the direct harm to a targeted competitor. See, for example, Franklin Fisher and Daniel L. Rubinfeld, “U.S. v. Microsoft: An Economic Analysis,” *Antitrust Bulletin*, Spring, 2001, pp. 1-69. See also, Douglas Melamed, “Exclusive Dealing Agreements and Other Exclusionary Conduct—Are there Unifying Principles?” *Antitrust Law Journal*, Vol. 73, 2006, pp. 375-412. Others might argue for a test that balances that the pro-competitive benefits of a firm's actions against the anticompetitive harm. See, for example, Steven C. Salop, “Exclusionary Conduct, Effect on Consumers and the Flawed Profit-Sacrifice Standard,” *Antitrust Law Journal*, Vol. 73, 2006, pp. 311-374.

to consume the product or service when they would not be able to do so at higher price levels

The danger of basing competition policy solely on concerns for static efficiency was described more than half a century ago by Joseph Schumpeter, who is often credited with developing the economics underlying evolutionary theories of innovation and investment in research and development⁴ Schumpeter, and other economists that followed him, explained that an analysis that focused entirely on static efficiency could often lead to harmful outcomes because it disregards the adverse effects on the incentive to invest and innovate, i.e., dynamic efficiency⁵

The Kwoka/Warren-Boulton analysis ignores Schumpeter's perspective, and in doing so is surprisingly incomplete As I mention above, they do not suggest that the lease harmed competition (by extending UP's market power or otherwise) Their analysis is limited to a discussion of principles of static efficiency,⁶ and fails to account for the adverse effects that Entergy's proposals would have on dynamic efficiency In particular, Kwoka/Warren-Boulton recognize that the lease they are analyzing – even with the challenged interchange commitment – would produce gains “in production efficiency” and represent “a socially desirable outcome,” yet they fail to acknowledge the disincentives to make investments and efficiency-enhancing initiatives in the railroad industry that would result if an *ex post* change in the lease terms were imposed by the

⁴ Joseph Schumpeter, *Capitalism, Socialism, and Democracy*, Harper & Row, 1942

⁵ According to Schumpeter, what is most important is “competition from the new commodity, the new technology, the new source of supply, the new organization – competition which commands a decisive cost or quality advantage and which strikes not at the margins of the profits and the outputs of the existing firms but at their foundations and their very lives ” (p. 84)

⁶ Indeed, Figures 1 and 2 of the Kwoka/Warren-Boulton submission could have been drawn from my discussion of the potential benefits of regulating a monopoly in my intermediate microeconomics textbook Robert S. Pindyck and Daniel L. Rubinfeld, *Microeconomics*, 7th Edition, 2008, Chapter 10, Section 10.4

Board See Kwoka/Warren-Boulton VS at 6 & 7 n.2 This is a serious omission, given that the significant social value created by dynamic efficiencies has been a primary driver of U.S. competition policy for years

B. Permitting Firms to Earn Returns from Their Investments Promotes Dynamic Efficiency and Is Consistent with Sound Competition Policy

Allowing firms that have acquired their market power legitimately to extract value (and, thereby, earn profits) provides critical incentives for firms to continue to invest and innovate, and ongoing investment and innovation are widely acknowledged as creating significant benefits for society as a whole. Consequently, while allowing a firm to capture economic “surplus” might appear to be inefficient in the short run, the costs of this inefficiency are offset by the long-run efficiencies that are created for the economy as a whole by preserving incentives to invest and innovate.⁷ These dynamic efficiencies include innovative business arrangements that create benefits such as a more appropriate sharing of risk, the provision of higher quality services, and the provision of goods and services at lower cost.

Forcing a firm to pass through to others legitimately acquired surplus, instead of permitting the firm to capture it, would – among other effects – discourage firms from investing or innovating, even if those activities would generate outcomes that would be desirable from society’s perspective. Despite the potential chilling effects on investment and innovation, however, regulators are routinely asked to focus on the short-term – which tends to treat levels of investment and innovation as a “given” – by taking actions

⁷ In an industry such as railroading, in which significant elements of investment have long economic lives and are effectively sunk, exclusive focus on enhancing static efficiency also makes it riskier for railroads to make the investments required to replenish existing assets that are needed merely to *maintain* existing services and service quality.

that would improve static efficiency at the expense of dynamic efficiency⁸ But fundamental principles of economics – and more broadly the “law and economics” that underlies our antitrust laws and the ways they are enforced – promote dynamic efficiency by permitting firms to engage in activities that allow the firms to capture surplus

It is an essential precept of market economics that firms that undertake investments and initiatives must be rewarded to the extent those investments and initiatives are successful, that reward needs to reflect the risks undertaken, and policy makers must recognize that potentially long-lived rewards in some cases appropriately compensate for losses that flow from other investments It is in society’s best interest for firms to benefit from the gains that flow from those investments

Given the social value created by permitting firms to capture static surpluses, it is natural to ask for a second time whether there ought to be any limitations from an economic perspective on the particular practices pursued by firms, including those with market power So long as the firm’s activities involve seeking to extract surplus from legitimately gained market power, those activities should not be seen as economically harmful However, it is appropriate to look closely at practices that are designed to extract surplus from rivals weakened by the targeted strategies of firms with substantial market power

I note that this perspective is widely supported within the antitrust economics field For example, this is the view advocated by the current Acting Deputy Assistant Attorney General for Economics, Ken Heyer, and the most recent Deputy Assistant

⁸ These chilling effects would not be restricted to future potential spin-offs of Class I Railroad assets to short-line/regional railroads A regulator’s willingness to take *ex post* action to deprive a railroad of earnings it has come by legitimately will potentially discourage all forms of investment and innovation

Attorney General for Economics, Dennis W. Carlton in distinguishing between
“extraction” and “extension” in assessing the conduct of firms

[W]e distinguish between two types of single-firm conduct. The first, which we call “extraction,” is conduct engaged in by the firm to capture surplus from what the firm has itself created independent of the conduct’s effect on rivals. A simple example would be pure price discrimination. The second, which we call “extension,” is single firm conduct that increases the firm’s profit by weakening or eliminating the competitive constraints provided by products of rivals. An example would be exclusive dealing where the effect is to eliminate smaller rivals from having access to distribution.

We subscribe strongly to the view that an essential element of appropriate antitrust policy is to allow a firm to capture as much of the surplus that, by its own investment, innovation, industry or foresight, the firm has itself brought into existence. We believe that alternative approaches to single-firm conduct, including in particular ones aiming to enhance static efficiency at the possible cost of dynamic efficiency, as well as ones seeking to maximize overall welfare through more targeted intervention on a case-by-case basis, threaten seriously to impede economic growth and welfare over time.⁹

I agree with the Heyer-Carlton conclusion that approaches that “aim[] to enhance static efficiency at the possible cost of dynamic efficiency” – such as the one taken by Kwoka/Warren-Boulton – “threaten seriously to impede economic growth and welfare over time.”

To recap, the means by which a firm with market power chooses to extract its economic surplus should not be a concern from a competition standpoint, unless those practices involve the extension of that market power made possible by weakening the competitive constraints imposed by rivals.

⁹ See Dennis W. Carlton and Ken Heyer, “Appropriate Antitrust Policy Towards Single-Firm Conduct,” Economic Analysis Group, Antitrust Division, Department of Justice, Working Paper EAG 08-2, March 2008.

C. There Is No Economic Basis For Amending the UP/M&NA Lease

Reliance on the principles that I have just laid out leads me directly to the conclusion that the Board should leave the terms of the UP/M&NA lease in place. To whatever extent UP had market power vis-à-vis the shippers now served by the M&NA before the lease was negotiated, that market power remains unchanged. The lease simply alters the form by which UP extracts the economic surplus that it has legitimately earned.

Of course, if Entergy could demonstrate that the terms of the lease amounted to conduct by UP that extended market power by weakening or eliminating altogether certain competitive constraints (provided by rivals) that existed before the lease was negotiated, then the Board would have reason to delve more deeply. But nothing in the facts surrounding the UP/M&NA lease, as they are set forth in Section II, suggests that the Board needs to be concerned about economically harmful conduct on the part of UP. To the contrary, the lease agreement has left shippers such as Entergy in no worse a competitive posture as they were when UP owned and operated the lines that now comprise the M&NA, while simultaneously providing an opportunity for additional benefits that would not have been available had UP continued to operate these lines.

To assess the competitive effects of UP's entering into the lease it is appropriate to compare the competitive positions of the parties before the lease transaction with their competitive positions today. When UP operated these lines, it clearly was the only carrier capable of setting rates for transportation of coal from the PRB to Entergy's Independence plant. This did not mean, however, that Entergy was completely devoid of bargaining leverage in its rate and service negotiations with UP. For example, I understand that Entergy had the option to create *intramodal* competition for this traffic by

building out to the BNSF. Moreover, because railroad transportation services are subject to rate regulation, Entergy had the ability to petition this agency (and its predecessor, the Interstate Commerce Commission) to evaluate the reasonableness of any tariff rate provided by UP.

The UP/M&NA lease has changed none of this. UP has no increased power to set rates for coal transportation from the PRB to Entergy's Independence Plant. Entergy still has the same ability to create intramodal competition by building out to BNSF (I understand it has instituted Board proceedings to construct such a build-out), and rail transportation rates from the PRB to Entergy's plants remain subject to the Board's rate regulation to the same extent. In short, Entergy remains in *at least* the same competitive position as it was historically, when the lines were operated by UP. As a result, there is ample evidence that UP's entering into the lease with M&NA has had no deleterious effect on competition. (I should note again that Kwoka/Warren-Boulton offer no disagreement on that key point.)

In fact, as I explain below, the UP/M&NA lease offers plausible pro-competitive benefits, which makes Entergy's effort to further *improve* its competitive position beyond what it was before the lease was negotiated (and what it is now) even less appropriate. Indeed, accepting Entergy's request would run counter to widely accepted economic principles. The Board should not ignore UP's *ex ante* expectations when it negotiated the M&NA lease, and the chilling effect that changing the lease terms after the fact would have on long-haul carriers' willingness to pursue socially beneficial investment and initiatives. Taking such a step would sacrifice significant dynamic efficiencies to create potential static efficiencies – which is harmful from a social point of view.

To sum up, my economic analysis shows that Entergy has experienced no harm arising from the lease and that society in general is better off. Under these circumstances, there is no economic reason for the Board to be concerned about the terms of this lease – or to take any action, *ex post*, to alter them.

D. Entergy's "Going Concern Value" Arguments Are Not Valid

In its *Argument of Counsel*, Entergy argues that “the Board’s Ex Parte No. 575 decision supports allowing Class I carriers to utilize paper barriers to protect the pre-transaction Going Concern Value of their lines. Restrictions that go beyond that level (such as the UP/M&NA lease restriction), preclude the interchange of traffic without justification in situations that would benefit the public interest.” *Argument of Counsel at 37*. This argument is somewhat difficult to decipher, but Entergy seems to believe either that UP should not be allowed to earn more than the pre-transaction going concern value of the lines (i.e., what UP would have earned absent the transaction) or that UP should not be allowed to earn more than it expected from the lease transaction. Neither argument has a valid economic foundation.

The view that UP is limited to earning the pre-transaction going concern value is inconsistent with the dynamic efficiency principles I describe above; a firm should be able to profit from undertaking successful initiatives. If that profitability increases over time, or as the result of additional initiatives undertaken by UP to reduce cost or improve quality, that is entirely appropriate.

Similarly, there is no reason to limit UP’s returns to its projected *earnings* at the time the lease terms were negotiated. Under that view, UP would retain the downside risk in the event of unexpected traffic losses, but would be prevented from realizing the

benefit if revenues are higher-than-anticipated (recall that these benefits are necessary to compensate for past investments that might have incurred losses). Following Entergy's formulation would create, *ex post*, a different (and less desirable) risk profile for UP from the one that existed before the lease transaction took place, and is another example of the dynamic inefficiencies that Entergy's proposals would create

In my view, the Board's discussion in Ex Parte No 575 about how interchange commitments work is consistent with my analysis of the competitive effects of the lease, *i.e.*, that the *revenue stream* resulting from the agreement "should be no more than what the carrier would have received had it not divested or leased the rail facilities in question"¹⁰ That formulation – which is fundamentally different from Entergy's focus on *earnings* – leaves UP with the same symmetry of risk it experienced before the lease was negotiated UP assumes the downside risk that traffic volumes will drop, but it also enjoys the upside benefit in the event traffic volumes, revenues and/or profitability increase As the Board noted, such an interchange commitment "would not overcompensate the carrier and may shift the risk of unexpected traffic loss to the selling or leasing (Class I) carrier – the party that was more able to assume the risk"¹¹ Of course, had M&NA paid UP the going concern value in 1992, then M&NA would have accepted both the downside risk and upside opportunity

Setting aside the accuracy of Entergy's going concern value calculations, by arguing that the interchange commitment should be voided now, because the contribution UP has actually earned exceeds what UP projected it would earn from the arrangement

¹⁰ *Review of Rail Access and Competition Issues – Renewed Petition of the Western Coal Traffic League*, Ex Parte No 575 (STB served Oct 30, 2007) ("October 2007 Decision")

¹¹ *October 2007 Decision*, slip op at 11

before it was negotiated, Entergy is asking the Board to alter *ex post* the risk profile that UP rightfully assumed at the time it entered into the lease. This would not permit UP to enjoy the “revenue stream [it] would have received had it not divested or leased the rail facilities in question,” and depriving UP of those revenues would create dynamic inefficiencies by forcing Class I carriers engaged in line divestiture discussions – and all other forms of investment and innovation – to assume more downside risk in the future.

No one would argue that a tenant that negotiates a fixed-price, 20-year lease for new office space is later entitled to free rent for the last 5 years of the life of the lease because the landlord has made more money than anticipated from other tenants in the first 15 years of the building’s life (due to rapid increases in lease rates, for example). Instead, most people recognize that the landlord is entitled to earn more than anticipated, if that is the way things unfold, because at the time the building was constructed the landlord also accepted downside risks such as a decline in rents over time, or that vacancies would be higher than anticipated at the time the building was constructed. What Entergy proposes here would simply provide Entergy with a potential windfall – at UP’s expense – without its having taken any risk or made any investment to earn that windfall.

Finally, I should emphasize that Entergy’s assertion that UP has earned more than the pre-transaction going concern value (*i.e.*, the amount it would have earned if it had not leased the lines) is not an assertion that M&NA has compensated UP for the going concern value that UP would recoup if it sold the lines. That value would have to be calculated at the time of a sale. To continue with the landlord/tenant analogy, no one would argue that a tenant that has leased a house for 30 years is entitled to own the

property, even if the total rent payments exceeded the lessor's total mortgage payments. If the tenant wanted to buy the house after 30 years, it would have to pay the market value of the house as of that date (with no adjustment for prior lease payments), reflecting the *future* stream of income the owner would lose at the time of sale.

In short, my economic analysis shows that Entergy's effort to alter the risk profile of the underlying transaction is inappropriate.

E. The M&NA Lease Provides Plausible Procompetitive Benefits

As demonstrated above, UP's lease with M&NA left Entergy in an unchanged competitive posture vis-à-vis the railroads and, therefore, resulted in no change in the level of market power that previously resided with the railroad. In fact, as the Board suggested was likely in its October 2007 decision in Ex Parte No. 575, the lease between UP and M&NA exhibits a number of pro-competitive characteristics.

In the *October 2007 Decision*, the Board stated that "[g]enerally, interchange commitments have facilitated the creation and growth of short-line railroads, which in turn has benefited the public by lowering transportation costs, improving service, and in some cases preserving rail transportation to localities and communities that might otherwise have seen service over their lighter-density line deteriorate or be lost altogether."¹² Kwoka/Warren-Boulton support this sound statement, explaining that these transactions produce gains "in production efficiency," represent "a socially desirable outcome," and may allow railroads to free up "scarce management and capital resources." See Kwoka/Warren-Boulton VS at 6 & 7 n. 2.

¹² *October 2007 Decision*, slip op. at 7.

Furthermore, in its evaluation of the challenged interchange restrictions in the *Ex Parte 575* decision, the Board appropriately focused on an *ex ante* view of the transactions at issue

in arguing that these agreements are always anticompetitive, WCTL takes an entirely *ex post* view of the restrictions. But viewed *ex ante* (i.e., before the sale or lease of the facilities), the agreements may have been beneficial and furthered the public interest in a number of ways, including better service and/or better rates, and the creation or strengthening of short line railroads that have the potential to expand into other markets, and thereby ultimately add to competition.¹³

Especially from that *ex ante* view, the lease between the UP and the M&NA is pro-competitive in several respects

First, I understand that the UP/M&NA lease provides a rent-free lease as long as M&NA meets the interchange commitment. This “rent-free” aspect of the lease agreement is pro-competitive because it eliminates any need for M&NA to make an upfront investment. In that way, the lease preserves UP’s contribution on the traffic originating or terminating on the line, while making the transaction more likely to occur, it does so by effectively leaving a significant portion of the risk that business would deteriorate with UP, rather than shifting this risk to M&NA by requiring it to invest in fixed track and right-of-way assets up front. This, in turn, made pro-competitive benefits – such as preservation of service over the entire line, reduced operating costs associated with M&NA operation of the line, and more focused customer service to all customers on the line – more readily available. Coupled with the complete control that the lease grants

¹³ *Id.* at 9

M&NA with respect to local traffic, these reduced barriers to entry also enhanced M&NA's incentives to expand service to such shippers

Second, because the interchange commitment is for 95% of the traffic, not 100%, the UP/M&NA lease instantaneously created potential competition for existing or new traffic that – had UP continued to operate the lines – would have been captive traffic. Moreover, providing M&NA with the option of ignoring the interchange commitment *for a fee* creates the potential for additional intramodal competition. From an economist's perspective, this type of tangible increase in potential competition is an important pro-competitive benefit.¹⁴

Third, it is my understanding that one effect of the UP/M&NA lease was to provide a mechanism for keeping the entire line in service – had UP instead continued to operate the line, I understand that it planned to abandon the segment between Bergman, Arkansas and Guion, Arkansas. Obviously, keeping this portion of the line in service provided increased options both to shippers located on that line and others who might efficiently use that line. Indeed, it is my understanding that Entergy's empty coal trains are now being routed over that segment on their return to the Powder River Basin, and that Entergy will benefit from a more efficient route via the M&NA line should it elect to obtain coal originated at mines in western Missouri than would have existed if UP had retained ownership and abandoned the line. As a result, Entergy is today in an *enhanced* position to develop geographic competition for UP-originated PRB coal as a result of the UP/M&NA lease.

¹⁴ It is important to recognize that the lease agreement would have been pro-competitive even if it had required M&NA to ship 100% of its non-local traffic via UP – shippers would be in the same intramodal competitive posture as they would have been had UP continued to operate the lines without any of the other benefits that I describe here.

Had UP instead considered selling the lines to M&NA, or entering into a lease without the interchange commitment, it would have risked losing profitable traffic – a risk that it would avoid by continuing to own and operate the line itself. For a lease or sales transaction to have moved forward under these circumstances, UP would have needed compensation up-front for the present value of the at-risk contribution – which would have created a significant barrier to entry, and a barrier to achieving the pro-competitive benefits of M&NA operation identified above

F. The Interchange Commitment And Rent Provision Are Appropriate Means To Prevent Free Riding

The interchange commitment and rent provision are appropriate means to protect the parties' interests and permit the transaction to proceed and generate pro-competitive benefits. From an economic perspective, contract provisions – such as the interchange commitment entered into by M&NA as part of the lease agreement – serve to protect UP by preventing “free riding” by Entergy and the other shippers on the line.

In this case, eliminating the interchange commitment would eliminate UP's incentives to lease the line to M&NA, which in turn would eliminate the benefits associated with low barriers to entry by shortline and regional railroads: *i.e.*, reduced operating costs, improved customer service, and the provision of rail service where it might have been lost altogether.¹⁵ Without an interchange commitment, free-riding could be prevented by charging an annual rental or one-time sales price high enough to offset *both* the potentially lost contribution *and* any additional costs that would be associated with losing the traffic (diseconomies of scale, for example, in maintaining the track and

¹⁵ See *October 2007 Decision*, slip op. at n 19.

dispatching traffic along the connecting route), this would, at a minimum, create significant barriers to entry by shortline/regional railroads

Similarly, the lease's rent provision appropriately prevents free-riding. Although Entergy argues that the maximum lease rental of \$90 million (as adjusted) is inappropriate because it exceeds UP's potential lost contribution from traffic on the line, the potential rental payments do not enhance UP's ability to raise rates. To the contrary, the through rates for service via UP-M&NA remain subject to the same competitive forces and/or the same level of Board rate regulation as existed when UP operated the line. While a lower rental payment would put Entergy and the other shippers in a *potentially* more favorable intramodal competitive posture than does the current agreement, all other things being equal (and assuming that M&NA could be induced to share some of this benefit with its shippers, which is by no means certain), the current agreement is at least as favorable to shippers as the alternative of continued operation by UP. Thus, the rental to be paid in the event M&NA disregards the interchange commitment cannot put shippers in a less favorable intramodal competitive posture than they would have been under continued UP operation – and, therefore, cannot be deemed anticompetitive – regardless of its level.¹⁶

In short, Entergy's demand that the Board amend the lease and require UP to permit *uncompensated* interchanges on the M&NA line is no different from a free-riding perspective than if Entergy were to complete a build-out to the BNSF tracks and then be

¹⁶ I should add that the rental provision allows M&NA the flexibility to interchange traffic with other carriers whenever its contribution from that traffic would exceed the resulting rent payment. Contrary to Entergy's suggestion, UP would not receive a "windfall" in such situations, because the rent payment would be less than the contribution that M&NA was deriving – and thus that UP could have been deriving – from the use of the leased lines.

required to provide *uncompensated* trackage rights over that line to a competing power generation company. In both cases, dynamic efficiencies would be eliminated by the significant free-rider problem caused by the regulation in question.

IV. KWOKA/WARREN-BOULTON HAVE NOT DEMONSTRATED ANY COMPETITIVE HARM, AND THEIR PROPOSED “SOLUTION” IS UNTENABLE

In the context of the economic principles set forth and illustrated in the Sections above, the Kwoka/Warren-Boulton analysis of the “competitive effects” of the UP/M&NA lease fails in several important respects. I describe much of my analysis and conclusions above, but it is worth highlighting a few points here.

The Kwoka/Warren-Boulton analysis inappropriately ignores the fact that under the lease Entergy is in, at worst, an identical competitive position, with respect to its rail transportation providers, as it was when UP provided single line service on the rail lines at issue. Indeed, Kwoka/Warren-Boulton do not even suggest that the lease harmed competition. As a result, Kwoka/Warren-Boulton focus entirely on arguing that Entergy could be made even better off by changing, *ex post*, the interchange commitment terms of the lease, and ignore the dynamic inefficiencies that this sort of *ex post* change would create.

These dynamic inefficiencies take several forms. First, the future willingness of Class I railroads to spin off certain portions of their operations to shortline and regional carriers – or to undertake other investments or innovations that create societal benefits and have the potential to improve profitability – will be adversely affected to a significant extent if they have to worry that the Board will later change the terms of the arrangements they freely negotiate – essentially changing the calculus on which the costs

and benefits of undertaking the initiatives are initially evaluated. In the context of line rationalizations, this would deprive society of the benefits associated with a healthy and growing shortline/regional railroad industry, with the enhanced opportunities for competition this engenders, the lower costs of production that characterize these alternative operations, and the higher level of customer satisfaction that can be associated with shortline and regional railroad operations. In the larger context, the willingness of a regulator to take *ex post* action to reduce the financial upside of initiatives can be expected to have a substantial chilling effect on the willingness of railroad investors to embark upon all sorts of potentially risky initiatives in the future.

Second, the form of future shortline transactions – if they occur at all – and the terms under which they will occur, would likely change to protect the earnings associated with a given operation from *ex post* regulation. This means that sales prices (and, likely, lease rentals) will be structured to require payment for all or a large portion of these earnings up front, raising the barriers to entry by shortlines and regional railroads, which has the same adverse effect on dynamic efficiency as is discussed above.

Third, *ex post* changes in the interchange commitments would obviously be designed to transfer contributions historically earned from these facilities by UP to either the M&NA itself, or to the shippers served over the leased facilities – without either party having paid for this benefit. Such a promotion of free riding would create dynamic inefficiencies because it decreases the incentives of UP and its shareholders to make investments, decreases the likelihood that new entrants would be attracted to the industry, and decreases the incentives for Class I railroad investors to continue to invest in the industry.

Finally, the “Shipper Right of Approval” proposed by Kwoka/Warren-Boulton – which would effectively require Class I railroads to provide shippers on a proposed spin-off line the right to veto the deal – would distort and weaken the market by encouraging free riding and providing shippers with the opportunity to extort significant “hold up” value from the railroads. I should stress that nothing in the Shipper Right of Approval would lead to increased dynamic efficiencies, to the contrary, the form of free-riding reflected in the proposal has an adverse effect on dynamic efficiencies, and rewards shippers who might otherwise have pursued socially desirable innovations and investments of their own.

Moreover, the Shipper Right of Approval does not directly address the alleged problem that it is apparently intended to solve – the concern that Entergy does not benefit from any reduction in operating costs, including reduced operating costs made possible by the lease itself. Even if it were appropriate for the Board to put the interests of Entergy ahead of the broader interests of society (and I have already described why it is not), the Shipper Right of Approval is crafted far too broadly to provide an appropriate remedy, *particularly* when as here it would be applied after the fact, thereby creating the significant dynamic inefficiencies discussed above. Instead, it would create a major shift in bargaining leverage, thus creating precisely the type of “hold up” concerns and inappropriate revenue transfers that I describe above.

The limitations of Kwoka/Warren-Boulton’s proposed remedy are apparent from their significant reliance on the “Coase Theorem,” which does not address dynamic efficiencies. As Kwoka/Warren-Boulton undoubtedly are aware, Ronald Coase’s seminal article focuses on static efficiency, and emphasizes the distortions to static efficiency

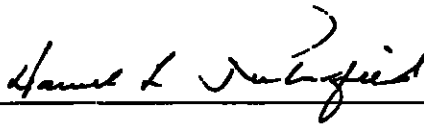
caused by the presence of transaction (especially bargaining) costs, including the bargaining costs associated with transferring property rights from existing owners to others that might value them more highly. But while there might be static efficiency gains from eliminating such costs (i.e. by regulating transfers of ownership rights), there are harms to dynamic efficiency that can flow from such regulation, and the “Coase Theorem” does not address such effects. In my view, the Coase Theorem is not appropriately applied here to the question of whether the Board should restructure, *ex post*, the terms of the UP/M&NA lease, and cannot be used to support a proposed Board remedy.

At the end of the day, permitting UP to continue to benefit from the same ability to charge Entergy prices under the terms of the lease that it had before it leased the lines is consistent with promoting dynamic efficiencies in the railroad industry. Sacrificing these benefits so that Entergy can obtain a windfall increase in its own profits is bad economics and bad public policy.

VERIFICATION

I, Daniel L. Rubinfeld, declare under penalty of perjury that the foregoing Statement is true and correct to the best of my knowledge. I further certify that I am qualified and authorized to file this Statement.

Executed on August 8, 2008

A handwritten signature in black ink, reading "Daniel L. Rubinfeld", is written over a horizontal line.

Daniel L. Rubinfeld

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Research Associate, Institute of Public Policy Studies, 1972-82
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Visiting Professor of Law, Spring 1989
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OTHER POSITIONS HELD

Research Assistant, William G. Bowen, 1966-67
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 Consultant, M I T - Harvard, Joint Center for Urban Studies, Spring and Summer, 1972
 Member, Ann Arbor Rent Control Study Commission, 1973
 Consultant, Urban Institute, 1973
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 Chair, Program in Law, Economics, & Institutions, UC Berkeley, 1986-97
 Member, National Academy of Sciences, Working Panel on Field Experimentation in Criminal Justice, 1986-87
 Consultant, U S Consumer Product Safety Commission, The Safety of All-Terrain Vehicles, 1987-88
 Chair, Program in Jurisprudence and Social Policy, U C Berkeley, 1987-1990, 1998-1999
 Member, Board of Directors, American Law and Economics Association, 1994-1996, 2001-2003
 Secretary-Treasurer, American Law and Economics Association, 2003-2004
 Vice President, American Law and Economics Association, 2004-2005
 President, American Law and Economics Association, 2005-2006
 Consultant and Lecturer, Federal Judicial Center, 1993-97, The Use of Regression Analysis by the Courts
 Lecturer, Swiss National Bank, Gerzensee, Switzerland, 1995-1997 (Economic Analysis of Law), 1999 (Antitrust), 2002 (Political Economy of Federalism), 2004 (Antitrust), 2006 (Antitrust)
 Consultant, World Bank (South Africa Mission), 1995-1997
 Vice Chair, ABA Section on Antitrust, Committee on Economics, 1997-1999
 Deputy Asst Attorney General, Antitrust Division, U S Department of Justice, June 1997-Dec 1998
 Consultant, Antitrust Division, 1999 (U S v Microsoft)
 Lecturer, U of Hamburg, May 1999, May 2002 (Law and Statistics), June 2008 (Antitrust)
 Lecturer, Federal Trade Commission, June-July, 2003 (Antitrust Economics)

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 National Science Foundation Fellowship, 1968-69
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 Research Fellow, National Bureau of Economic Research, Cambridge, Massachusetts, 1975-76
 Editorial Board, Public Finance Quarterly, 1980-2003
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 Advisory Panel, NSF, Program in Law and Social Science, 1982-84
 Editorial Board, Evaluation Review, 1985-1987
 Faculty Advisory Board, U C Berkeley, Center for Real Estate and Urban Economics, 1983-97, 2000-
 Co-Editor, International Review of Law and Economics, 1987-2003
 Lecturer, California Continuing Judicial Studies Program, 1988-1989
 Oversight Panel, NSF Program in Law & Social Science, 1988
 Board of Directors, I.ECG, 1995-1997
 Board of Directors, Atlas Assets, Inc., 1989-1997, 1999-
 Member, Correspondent Comm., Interuniversity Consortium for Political & Social Research, 1991-
 Editorial Board, Law and Social Inquiry, 1992-1999, 2002-2004
 Fellow, Center for Advanced Study in the Behavioral Sciences, 1992-93

Ida Beam Distinguished Lecturer in Law and Economics, University of Iowa, Spring 1995
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 Faculty Advisory Board, UC Berkeley, Burch Ctr for Tax Policy & Public Finance, 1994-97, 1999-
 Member, American Academy of Arts and Sciences, 2001-
 Advisory Council, Master Program on Law & Economics, Universidad de Buenos Aires, 2003-
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 Editorial Board, Journal of Australian Economic Education, 2003-
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