RAILROAD MERGERS – A COAL SHIPPER'S PERSPECTIVE

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I. INTRODUCTION

Today's American railroad industry is in many respects a case study in industry concentration. According to statistics compiled by the Association of American Railroads ("AAR") (the industry's trade association), fully 95% of the "revenue ton-miles"[1] handled by the entire industry in 1999 were carried by just the four largest carriers.[2] Moreover, these nationwide market share figures actually understate the true level of concentration in the railroad industry today, as only two of the four industry giants conduct extensive operations in the eastern United States, and only two in the western United States. Rail-dependent shippers in either region, therefore, have at most only two carriers from which to choose for their long-haul rail transportation requirements. In a very real sense, therefore, the industry has now become effectively a system of two regional duopolies.[3]

The industry was not always this concentrated. In 1929 there were 162 "Class I" railroads[4] operating in the United States, of which the largest four handled just 23% of total

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[1] "Ton-miles" is a widely-used measure of railroad transportation services, as it reflects both the amount of traffic handled and the distance it is transported. (A five-ton cargo transported four miles would thus equate to 20 ton-miles, as would a single ton hauled 20 miles.) Ton-miles for which railroads are paid constitute revenue ton-miles.

[2] *See* Association of American Railroads, *Analysis of Class I Railroads* (1999). The four industry giants are CSX Transportation, Inc. ("CSXT") and the Norfolk Southern Railway Company ("NS") in the eastern United States (primarily operating east of the Mississippi River), while the Burlington Northern and Santa Fe Railroad Company ("BNSF") and Union Pacific Railroad Company ("UP") are in the west. Each of those carriers is the product of multiple previous acquisitions and mergers over the last several decades.

[3] Railroad representatives would presumably interject at this point that such a railroad-only market portrayal vastly overstates the rail giants' true market power, because for much of their traffic they face intense competition, if not from other railroads, then from other modes of transportation, especially motor carriers. However, whatever competitive constraints may limit a railroad's market power with respect to, for example, intermodal traffic (trucks and/or containers moving on railroad cars for part of their journey), those constraints have little bearing on most long-haul bulk traffic, of which the primary example is coal. For electric utilities in particular, railroad transportation is typically the only practicable method of delivering coal from distant mines to land-locked power plants.

[4] Railroads are grouped by annual revenues into three categories under Surface Transportation Board ("STB") regulations: Class I railroads (the largest carriers, whose annual revenues from railroad operations exceed $250 million in 1991 dollars); Class II carriers (with revenues between $20 million and $250 million in 1991 dollars); and Class III

revenue ton-miles.[5] As recently as 1980, there were still 36 Class I carriers, and the top four handled only 43% of total revenue ton-miles.[6] This paper seeks to address the reasons why this consolidation has been allowed to occur, without intervention from federal regulators, given the significant increase in market concentration that resulted.[7] The paper also discusses the ramifications of these changes for coal shippers and other customers whose businesses are dependent on rail transportation.

II. EIGHTY-FOUR YEARS OF RAIL MERGERS – A JAUNDICED VIEW

1. Pre-Staggers Era, 1920-1980

For almost a century, from passage of the Interstate Commerce Act[8] in 1887 until enactment of the Staggers Rail Act of 1980 ("Staggers Act"),[9] the nation's railroads were subject to a complex system of federal and state regulation of their rates and services. Rates on interstate traffic were required to be set forth in tariffs on file with the Interstate Commerce Commission ("ICC"), and were required to be "reasonable" and "non-discriminatory."[10] Intrastate rates and services were subject to comparable supervision by state agencies.

At first, federal regulation was largely confined to rates. However, in 1920, Congress responded to widespread concern that the railroad industry had become overbuilt and inefficient by expanding the ICC's jurisdiction to include the review and approval of railroad mergers. These mergers were to be judged on a "public interest" standard. Congress made it clear that mergers were to be encouraged where they would bring about improved efficiency, but that consolidations should preserve existing service – and competition – to the greatest extent possible. Mergers approved by the ICC could be implemented notwithstanding any other federal or state law, including the antitrust laws.[11]

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or "short line" railroads (those with revenues below $20 million in 1991 dollars). Class II and III railroads are subject to relaxed reporting and filing requirements, as befits their assumed lack of market power.

5 Interstate Commerce Commission, *Statistics of Railways of the United States* (1929).

6 AAR, *Analysis of Class I Railroads* (1980).

7 As discussed below, railroad mergers were subject to review and approval by the Interstate Commerce Commission ("ICC") from 1920 to 1995, and by the Surface Transportation Board ("STB") since 1995. Throughout that period, ICC/STB-approved mergers have been immune from challenge under the antitrust laws, *cf.* 49 U.S.C §11321(a).

8 Ch. 104, 24 Stat. 379 (1887).

9 Pub. L. No. 96-448, 94 Stat. 1895 (1980).

10 The framework for ICC regulation of rail rates differed in several respects from that typically associated with public utilities. In particular, railroads have always been responsible for setting their own rates in the first instance, and such carrier-initiated rates have never required regulatory pre-approval in order to become legally effective. Moreover, when the ICC did review a rail rate (usually in response to a complaint from an affected shipper or competitor), its analysis of the challenged rate's reasonableness was not a straightforward "rate-base/rate-of-return" exercise; rather, ICC rate review usually entailed a comparison of the challenged rate (a) with the rates that the carrier was charging for similar services to other shippers; and/or (b) with the costs the carrier incurred in handling the traffic at issue.

11 *Transportation Act of 1920*, 41 Stat. 456 (1920). Specifically, § 407 of that Act directed the ICC to develop a master plan for consolidation of all the railroads into a "limited number of systems," and specified that in such a plan "competition shall be preserved as fully as possible and wherever practicable the existing routes and channels of trade and commerce shall be maintained." The section went on to provide for carrier-initiated mergers, specifying that the

After World War II, as both passenger and freight traffic increasingly deserted the railroads in favor of the highways, excess rail capacity became a chronic problem. Time-consuming ICC scrutiny of railroad efforts to cut their losses through consolidations came to be seen as a hindrance, rather than an aid, to needed system rationalizations. This perception of regulation as the problem rather than the solution hardened into certainty in the minds of many when the ICC took eleven years to approve the Union Pacific-Rock Island merger in 1974, by which time the condition of the Rock Island had deteriorated to such an extent that Union Pacific called off the merger, and the Rock Island slowly slid into bankruptcy and eventual liquidation.[12]

Meanwhile, the financial condition of the railroads operating in the northeastern United States — and especially the condition of the Pennsylvania Railroad and the New York Central Railroad (which in 1968 merged into the Penn Central) — was becoming increasingly precarious. With the collapse of Penn Central into bankruptcy in 1970, Congress concluded that something drastic had to be done. The first step Congress took was to enact the Regional Rail Reorganization Act in 1973.[13] That statute established a special agency known as the United States Railway Association to study the situation and develop a plan for radically pruning the bankrupt carriers' systems, and for assembling the parts worth saving into one or more shrunken, sustainable carrier(s). The outcome of that pruning and consolidation process was a "Final System Plan" that called for the creation of a single carrier, Conrail, out of the remnants of Penn Central and the other bankrupt carriers in the Northeast. Congress responded with enabling legislation, which became part of the "Railroad Revitalization and Regulatory Reform Act of 1976 (the "4R Act")[14] and resulted in the creation of Conrail on April 1, 1976.

The 4R Act also included provisions that began the "deregulation" process for railroads throughout the country, although these were perhaps less publicized at the time. As a result, the ICC's jurisdiction to find a published railroad rate unreasonably high and to order the rate reduced (and refunds paid on past shipments) was confined to traffic that was found not subject to "effective competition." The ICC was also given the authority to exempt from regulation additional transactions, or classes of transactions, if it found that regulation was unnecessary. Additionally, a 31-month time limit was imposed on ICC disposition of merger applications. The statutory public interest standard for evaluating mergers, however, remained unchanged.

2. The Staggers Act Era, 1980-1995

Despite its fresh start, the newly-created Conrail continued to lose large amounts of money. By 1979 the pressure was again building in Congress for a "fix" in the form of a

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carriers must file an application with the Commission, which would approve mergers if it found them consistent with the public interest and with the master plan.

The government-sponsored master plan for railroad consolidation never went anywhere, but federal regulation of carrier-initiated mergers under the public interest standard, and the exemption of approved mergers from the antitrust laws, have survived to the present day.

[12] *See* the discussion of the Rock Island saga in H.R. Rep. No. 94-725, at 62 (1975) (the House Report on what became the *4R Act*, *infra*).

[13] Pub. L. No. 93-236, 87 Stat. 988 (1973).

[14] Pub. L. No. 94-210, 90 Stat. 31 (1976).

further relaxation of regulatory constraints on the railroads' ability to structure their services and to set their rates in a "businesslike" manner. By doing so, Congress hoped that Conrail and others would earn enough to survive. The ultimate result was enactment of the Staggers Act, which made numerous and far-reaching changes in the way railroads are regulated, dramatically advancing the deregulation process that had begun with the 4R Act. Of particular relevance to this paper, the Staggers Act: (a) shortened the deadlines for ICC decisions in railroad merger cases not involving Class I carriers; (b) added a new "rail transportation policy" statement to the statute (codified at 49 U.S.C. § 10101a), elevating the encouragement of "effective competition among rail carriers and with other modes" into a major objective of railroad regulation (previously competition had not been mentioned at all in the statute's transportation policy statement); and (c) added a requirement that in evaluating Class I railroad merger proposals, the ICC consider (in addition to the other statutory factors) the adverse effect, if any, of the proposed merger "on competition among rail carriers in the affected region."[15] Approved mergers, however, remained exempt from the antitrust laws, and thus enforcement of the new pro-competition policies remained up to the ICC rather than to the U.S. Department of Justice or the Federal Trade Commission.

The ICC's regulations governing rail mergers, promulgated soon after enactment of the Staggers Act, established rules to guide the processing of merger applications within the statutory time frames, and also included a detailed "General policy statement for merger or control of at least two Class I railroads" ("ICC Merger Policy").[16] In that policy statement the ICC indicated that it would:

> [E]ncourage[] private industry initiative that leads to the rationalization of the nation's rail facilities and reduction of its excess capacity. One means of accomplishing these ends is rail consolidation . . . .[17]

The policy statement added that:

> [T]he Commission does not favor consolidations that substantially reduce the transport alternatives available to shippers unless there are substantial and demonstrable benefits to the transaction that cannot be achieved in a less anticompetitive fashion.[18]

The policy statement went on to state that:

> If two carriers serving the same market consolidate, the result would be the elimination of the competition between the two. Even if the consolidating carriers do not serve the same market, there may be a lessening of potential competition in other

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[15] Additionally, the *Staggers Act* completely eliminated maximum rate regulation of rates found to be at or below a "jurisdictional threshold" level of 180% of "variable costs," regardless of whether there were any other indicia that effective competition was present, and divested the ICC of jurisdiction over rates on rail movements covered by "railroad transportation contracts" between carriers and shippers (previously, the enforceability, and indeed the legality, of contract rates had been subject to considerable uncertainty).

[16] 49 C.F.R. §1180.1 (1982).

[17] *Id.*

[18] *Id.*.

> markets. While the reduction in the number of competitors serving a market is not in itself harmful, a lessening of competition resulting from the elimination of a competitor may be contrary to the public interest. ... In some markets the Commission's focus will be on the preservation of effective intermodal competition, while in other markets (such as longhaul movements of bulk commodities) effective intramodal competition may also be important.[19]

On its face, the ICC's merger policy statement seemed to reflect the balancing approach called for under the new statute, acknowledging the twin statutory goals of facilitating improvements in efficiency and preserving effective competition. However, the merger policy remained unchanged over the next 27 years, despite fundamental changes in the rail industry during that period. Moreover, the policy was applied in a way that seemed to move increasingly out of touch with reality. Indeed, in 2001 the Surface Transportation Board ("STB"), as successor to the ICC, acknowledged that its merger guidelines were no longer suitable as the basis for evaluating Class I merger proposals, and revised them to raise the bar applicants would have to overcome in the future.[20] Unfortunately, however, by then most of the damage had already been done.

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The fifteen years following the Staggers Act's enactment saw a major transformation of the railroad industry. Aided in part by the ICC's liberal use of its exemption authority to facilitate abandonments of little-used and unprofitable branch lines, along with the spin-off of more marginal lines to new, low-cost (and predominantly non-union) short line railroads, the Class I railroads as a group became significantly leaner, enjoyed substantial productivity gains, and became considerably more profitable than they had been in the 1970's. Indeed, even Conrail – thought by many in the late 1970's to be financially unviable – became profitable in 1981.[21] By the mid-1990's, Conrail had become financially strong enough to be an attractive merger target for neighboring Class I railroads.

Another watershed development in the 1980's that transformed much of the railroad industry, especially in the western United States, was the inauguration of competitive two-carrier access to the huge and readily-accessible reserves of low-sulfur coal in the Powder River Basin ("PRB") of Wyoming. Until 1984, only the Burlington Northern Railroad Company ("BN") had tracks serving the mines in the PRB, and thus the numerous electric utilities in the West that burned PRB coal had no choice but to deal with BN for their coal transportation needs. Beginning in the mid-1970's, BN sought to take advantage of its strong market position by posting substantial increases in its effective or proposed unit train coal

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[19] *Id.*

[20] *See* Ex Parte No. 582 (Sub-No. 1), *Major Rail Consolidation Procedures* (unprinted decision served June 11, 2001). The rulemaking that culminated in the June 11 decision began more than a year earlier in Ex Parte No. 582, *Public Views on Major Rail Consolidations*, 4 S.T.B. 546 (2000), in which the STB imposed a 15-month moratorium on further mergers of Class I carriers with one another while it considered needed modifications of its merger rules. (*See* the discussion *infra*, beginning at page ##.)

[21] *See* "A Brief History of Conrail," at http://www.conrail.com/history.htm.

rates. BN's customers objected strenuously to the increases, resulting in a spate of maximum rate litigation before the ICC.[22]

Things changed dramatically in 1984, when the Chicago & North Western Transportation Company ("CNW"), in cooperation with UP (with which CNW later merged), gained the ability to serve most of the PRB coal mines in direct competition with BN. This development effectively precipitated a price war between the two competitors, as CNW/UP sought to build market share while BN fought to keep what it had. The resulting rate reductions were quite dramatic, and were well received by coal shippers.

Coal shippers whose plants were served (or could be served) by two or more carriers, and who therefore enjoyed the luxury of carrier competition from origin to destination, were of course the most favorably situated of all. Such shippers could simply solicit bids from the carriers competing for their traffic, and then lock in the resulting savings in long-term rail transportation contracts. But even many utilities whose plants could be served by only one carrier saw their coal transportation costs go down significantly, provided the delivery carrier was "neutral" (that is, not aligned with either BN or CNW/UP). Such shippers were still able to solicit bids from both BN and CNW/UP for the right to originate their traffic (such bids were in most cases submitted as part of alternative joint rates with the neutral delivery carrier). The resultant through bids were typically much lower than the joint rates such shippers had paid before CNW/UP's entry into the PRB.[23]

Meanwhile, in 1982 the ICC had decided its first major merger case since the Staggers Act had elevated the importance of preserving competition in such transactions. The ICC conditionally approved the consolidation of UP with the Missouri Pacific Railroad Company ("MP") and the Western Pacific Railroad Company ("WP").[24] In that case, BN was fearful that if UP acquired MP, and then CNW (which was allied with UP) gained access to the PRB, UP would be able to divert to its own lines all of the PRB coal traffic that BN had been handling for customers on MP's lines. Accordingly, BN asked the ICC to condition any approval of the transaction on a grant to BN of trackage rights and/or "independent

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[22] *See, e.g., San Antonio, Texas Acting By and Through Its City Pub. Serv. Bd. v. Burlington N., Inc.*, 355 I.C.C. 405 (1976); *Incentive Rate on Coal – Cordero, Wyoming to Smithers Lake Texas*, 358 I.C.C. 537 (1977); *Arkansas Power & Light Co. v. Burlington N., Inc.*, 361 I.C.C. 504 (1979).

[23] How and why such shippers seemed to benefit from the new origin competition, despite remaining captive at destination, has been the subject of much debate. A widely-accepted economic model (often referred to as the "one lump," or "single monopoly profit," theory) suggests that the destination monopolist should be able to extract the entire profit from the through movement, just as if it had a monopoly over the entire route from origin to destination, in the process "soaking up" any rate cuts offered by the origin competitors, and producing identical through rates via either route. Notwithstanding the one lump theory, however, many representatives of destination-captive coal shippers have testified to the savings they achieved when they began to play the origin carriers off against one another in competitive bidding. Seeking to explain this phenomenon, some experts have suggested that the answer may lie in the nuances of inter-carrier relationships (for example, the destination carrier might wish to remain on good terms with both origin competitors, and therefore not wish to be seen as too greedy or as favoring one over the other, leading it to give each origin carrier the same "revenue requirement" for its delivery services, which in turn would allow the competing carriers' price cuts to pass through to the shipper). Whatever the explanation, many such shippers have objected to "end to end" mergers between their destination carrier and one of the origin competitors, fearing that the combined carrier would exclude competition from the other origin carrier and thereby regain the ability to dictate pricing for the entire movement, just as BN had done before it faced competition from CNW/UP.

[24] *Union Pac. Corp., Pac. Rail Sys., Inc., and Union Pac. R.R. Co. – Control – Missouri Pac. Corp. and Missouri Pac. R.R. Co.*, 366 I.C.C. 459 (1982), *aff'd sub nom. Southern Pac. Trans. Co. et al. v. Interstate Commerce Comm'n*, 736 F.2d 708 (DC Cir. 1984), *cert. denied*, 469 U.S. 1208 (1985) ("*UP/MP*").

ratemaking authority" to such destinations over the former MP lines. This was necessary, BN argued, to protect such customers from vertical foreclosure of the competition between BN and UP/CNW that they would soon enjoy absent the merger.

The ICC rejected BN's argument and requested relief, explaining:

> BN . . . contend[s] that a utility will receive the benefit of competition between carriers serving the origin point of a coal movement, even if only one carrier serves the destination, so long as the destination carrier is unaffiliated with, and thus neutral toward, the carriers serving the origin (neutrality theory). We conclude that the neutrality theory has not been shown to support BN's arguments with respect to the coal transportation markets involved in these proceedings.
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> A carrier with a destination monopoly will likely push the through rate as high as possible and keep the monopoly profits to itself by playing off competing connecting carriers against one another in setting divisions . . . .
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> *   *   *
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> [T]the market power faced by an existing utility is not created, or increased by, consolidation of a monopoly destination carrier with an origin carrier . . . . In such circumstances, the benefits of competition at the destination would usually inure to the benefit of the destination carrier, unless the utility served has a sufficiently strong bargaining position to enable it to exert leverage over the destination carrier.
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> We do not reject the possibility that the benefits of origin competition might flow through to a utility despite a destination monopoly. We do not, however, presume that these benefits will, in fact, always flow through. Rather, we require a showing that a specific utility is able to obtain the benefits of origin competition even though it is served exclusively by one carrier at the destination. In making this showing, the most persuasive evidence is testimony on behalf of the utility explaining how it has effectively obtained, or could obtain, the benefits of origin competition at the plant with monopoly service.[25]

Thus emerged what became the ICC's lodestar "one lump" theory (see footnote 23).

In subsequent merger cases, coal shippers took up the vertical foreclosure issue, proffering evidence they thought proved a passthrough of competitive benefits by the neutral delivery carriers serving them. However, in every case, the ICC found such evidence insufficient to overcome the supposedly rebuttable presumption it had articulated in UP/MP.

Thirteen years later, BN itself sought approval of a proposed merger with the Atchison, Topeka & Santa Fe Railway Company ("ATSF").[26] In that case, several coal shippers whose plants were served by ATSF submitted detailed testimony and documents reflecting

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[25] 366 I.C.C. at 538-39.

[26] *Burlington Northern, et al.– Merger–Santa Fe Pacific, et al.*, 10 I.C.C.2d 661 (1995), *aff'd sub nom. Western Resources, Inc., et al. v. Surface Transportation Board*, 109 F.3d 782 (DC Cir. 1997) ("*BN/SF*").

the substantial reductions that BN and ATSF had offered them on their through movements of PRB coal when BN learned that UP/CNW was interested in handling such traffic between the PRB and an ATSF interchange. The evidence also showed that in at least one instance BN had forthrightly acknowledged that it was responding to UP/CNW competition. Although such testimony seemed to be exactly what the ICC in UP/MP had said was needed to rebut the no-passthrough presumption, the ICC in BN/SF brushed it aside and again denied relief.[27] In the minds of many observers, it was clear that the agency had made up its mind and no longer would give serious consideration to evidence proffered to rebut the one-lump presumption.[28]

3. The STB Era, 1995-Today

a. The ICC Termination Act

Despite the substantial relaxation of railroad regulation under the Staggers Act, and the ICC's own efforts thereafter to reduce unnecessary regulation still further,[29] the ICC continued to be viewed in many quarters as a government agency that had long since outlived its usefulness. The common view was that the agency had become a drag on economic growth and efficiency, rather than a vital protector of the public interest. Thus, when outside political developments induced President Clinton in his 1995 State of the Union address to declare that "the era of Big Government is over," and to propose "sunsetting" the ICC, his message fell on receptive ears. Proposals to do just that were soon introduced in Congress.

Of course, it seldom turns out to be as simple to eliminate a government agency as proponents of such action might hope, and the ICC proved no exception. Shippers and carriers alike promptly made known to Congress their views on which portions of the ICC's railroad (and other) jurisdiction and functions remained important and should be preserved in some fashion. The end result was the somewhat mis-named ICC Termination Act of 1995 ("ICCTA").[30] While the ICCTA eliminated the ICC effective January 1, 1996, it then proceeded to create the STB in its stead. The STB had the same membership and substantially the same personnel and responsibilities as the ICC had had for railroad matters.

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27 *See* BN/SF, 10 I.C.C. 2d at 693-96, 749-57.

28 When some shippers nonetheless tried to meet the pass-through test in the *UP/SP* merger case (*infra*, at page), their claims were rejected in a brief footnote. *See* 1 S.T.B. 233, 398 n.140.

29 As noted above, the *4R Act* authorized the ICC to exempt railroad transactions or classes of transactions from regulation, if it concluded that continued regulation of them was unnecessary. *See 4R Act* §207 (now codified as amended at 49 U.S.C. §10502). The ICC could exercise this authority on its own motion or pursuant to a request from an interested party.

Over the years, the ICC has issued numerous "class" exemptions covering a wide variety of typically non-controversial transactions, such as the creation of new Class III carriers to acquire and operate light density branch lines shed by Class I carriers (*see* 49 C.F.R. §§1150.31 *et seq.*). Several classes of traffic, such as most agricultural products, have also been exempted (*see* 49 C.F.R. §1039.10). Moreover, as the railroad industry has gotten used to the exemption process, petitions for individual exemptions have become the preferred means of obtaining relatively speedy authorization for non-controversial transactions that do not fall within any of the pre-established class exemptions.

30 Pub. L. No. 104-88, 109 Stat. 803 (1995).

The ICCTA did, however, make further deregulate the railroad industry, and the manner in which the STB was to exercise that jurisdiction. In particular, the statute further shortened the time limits on review of Class I merger applications, from 31 months to just 16.[31]

b. The UP/SP Merger

(1) The Proposal

On August 12, 1996, the STB issued its first decision in a Class I merger case, approving the consolidation of UP with the Southern Pacific Transportation Company ("SP") and its affiliates, which had operated an extensive rail network in the southwestern and western United States.[32] Because UP's and SP's systems overlapped in several areas, a simple combination of the two networks into one would have substantially reduced rail service options, and intramodal competition, in many areas. Accordingly, UP and SP agreed at the outset to grant extensive trackage (that is, operating) rights over their merged systems to other carriers – primarily BNSF – in order to ameliorate such anticompetitive effects.

Numerous shippers and shipper groups, including coal shippers, nevertheless protested the merger, challenging the trackage rights UP/SP had offered as inadequate to provide or preserve meaningful intramodal competition. Additionally, the United States Department of Justice ("DOJ") challenged the proposed merger as incurably anticompetitive, in large measure because: (a) BNSF could not be an effective competitor via the proposed trackage rights; and (b) even if it could, the western United States would still be left with only two huge rail carriers where before the merger there were three. DOJ urged that the application be denied altogether, or at a minimum, that extensive divestitures – to an entity other than BNSF – be required.[33] However, since DOJ lacked the power to formally block or challenge the merger, the actual decision remained in the hands of the STB.

(2) The Decision

In its decision, the STB expanded the trackage rights to be granted to BNSF in certain respects to deal with issues such as loss of build-out rights (potential competition) that

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31 Additionally, the *ICCTA* abolished the requirement that railroad common carrier rates be published and filed with the agency in tariff form (though railroads remained subject to their common carrier service obligations and were still required to quote rates for such services on request, and such rates remained subject to challenge before the STB if market dominance were shown).

32 *Union Pac. Corp., et al.–Control and Merger–Southern Pac. Rail Corp., et al.*, 1 S.T.B. 233 (1996), *aff'd sub nom. Western Coal Traffic League v. Surface Trans. Bd.*, 169 F.3d 775 (DC Cir. 1999) ("*UP/SP*").

33 The United States Department of Transportation ("DOT") also challenged the adequacy of the trackage rights proposed for BNSF, arguing that while trackage rights could be a vehicle for providing effective competition in certain circumstances (lower volumes, shorter distances), they were inadequate in the *UP/SP* context because BNSF could not "conduct a completely independent operation on an equal footing." *See* the synopsis of the DOJ and DOT positions set forth at 1 S.T.B. at 350-51.

The US Department of Agriculture ("DOA") echoed DOJ's concern about the reduction in major carriers in the region to just UP/SP and BNSF, contending that the BN/SF merger had already reduced competition in the affected region, and that this merger would reduce competition still further. *See* 1 S.T.B. at 353. The major coal shippers represented by the Western Coal Traffic League ("WCTL") made a similar point with respect to the proposed merger's impact on competition for their traffic, contending that as a duopoly BNSF and UP/SP would be able to engage in tacit price stabilization at a non-competitive level, secure in the knowledge that there were no other carriers around who could undercut them. *See* 1 S.T.B. at 286-88.

shippers had raised.[34] However the STB categorically rejected all arguments for divestiture or for outright rejection of the merger, strongly criticizing the analyses proffered by DOJ as fraught with methodological errors and misunderstandings regarding the special characteristics of the railroad industry.[35] The STB rejected the fears expressed by DOJ, DOT, DOA and others that the rail services market in the western United States would be at great risk of tacit price collusion with just two firms as potential sellers. It opined that such concerns were unfounded because the secrecy of contract pricing and the heterogenous nature of rail services would make it extremely difficult for either railroad to monitor the pricing initiatives of its competitor, which in turn would make effective collusion or coordination virtually impossible. Accordingly, the STB confidently predicted that BNSF and UP/SP would continue to compete aggressively on both price and service, just as BNSF and UP had done in the past with respect to PRB coal shipments.[36]

(3) The Aftermath

It has now been more than eight years since the STB approved the UP/SP merger. The STB's predictions of service improvements, efficiency gains and continued vigorous price competition have not been borne out by experience.

On the service side, problems arose almost as soon as UP and SP started consolidating their operations. Congestion began to increase on the merged UP system in and around Houston. These problems quickly grew to such an extent that traffic on UP's system in central and south Texas, and in many traffic corridors leading thereto, ground to a near standstill. The STB responded to the resulting public outcry by instituting a special oversight proceeding to consider the imposition of emergency remedies to get the traffic flowing again.[37]

UP/SP ultimately was able to overcome these congestion problems, and by 1999 was assuring its customers and the public that its operations were now running smoothly. The underlying problems were apparently never completely resolved, however, and in 2003-04 the congestion problems reappeared. Today, all the Class I carriers are now warning that overall rail system capacity in many areas is simply inadequate to handle current and expected traffic volumes.

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[34] UP/SP had previously agreed to some of that expansion during the pendency of the case, as part of a settlement with a large shipper group. The STB, however, went further by extending the future connection/buildout right to all shippers, rather than just to members of the settling shipper group, and by making the right permanent. *See* 1 S.T.B. at 419-21.

[35] *See*, *e.g.*, 1 S.T.B. at 368-69, 376-80

[36] *See* 1 S.T.B. at 374, 570-75.

[37] Finance Docket No. 37260 (Sub-No. 26), *Union Pac. et al.–Control and Merger–Southern Pac. et al. [Houston-Gulf Coast Oversight]* (Decision No. 1, served March 31, 1998, *published at* 63 Fed. Reg. 16,628, April 3, 1998). Among the remedies ultimately applied (by UP voluntarily, by agreement among the carriers, or pursuant to STB orders) were grants of additional trackage rights to BNSF and other, smaller carriers over portions of UP/SP in order to permit them to divert some of the traffic on the most congested parts of UP's system onto their own lines, and increased institution of directional flows over parallel routes wherever possible. As the "meltdown" of UP service in the Houston/Gulf Coast area caused equipment and manpower shortages that rippled through other parts of UP's system, shippers including coal shippers found themselves unable to transport sufficient volumes to avoid impairment of their own operations, causing some to seek termination of their contracts with UP in order to divert their traffic to BNSF.

In the minds of many, UP's recurring service problems following its merger with SP have substantially corroborated the conclusions of DOJ's expert witnesses in UP/SP regarding the overstated nature of the merger applicants' promised efficiency gains, and cast doubt on the credibility and competence of the STB's own analyses and conclusions in that regard. Moreover, it is now manifest that UP's congestion problems can adversely affect not only its own operations, but also those of its trackage rights tenants[38] – lending further credence to DOJ's concerns (along with DOT and others) that trackage rights over such extensive portions of UP/SP's merged systems would be inadequate as a substitute for competitive rail service over the competing carriers' separate systems.

As for the vigorous price competition that the STB predicted, coal shippers have perceived that both UP and BNSF seem intent on improving returns on their existing coal traffic, competitive or not, and on avoiding any aggressive pricing moves that could rekindle another price war.[39] In addition to the significant increases in rate levels that both carriers are reportedly demanding when transportation contracts come up for renegotiation, there are the much-publicized efforts by each carrier to standardize its coal rate structure through such public-pricing mechanisms as UP's recent "Circular 111."

In a duopolistic market characterized by firms with marginal costs well below average costs,[40] each participant soon understands that its competitor can and will react by matching any price reduction it may offer, and that the end result of such a price war will be reduced profits for both firms. To avoid such an unpleasant result, each firm, acting in its own self-interest, needs to refrain from aggressive price cuts; no further collusion or coordination between the competitors is necessary. To increase revenue levels may be a bit more complex; in industries such as the airline industry (which may be characterized as a functional duopoly in many markets, albeit a far more contestable one than the railroad industry), implementing price increases seems to require "price signaling" in the form of one firm's posting of an increase, which it will then withdraw if its competitors fail to match it. UP's Circular 111 coal pricing document is seen by many western coal shippers as such a signaling effort adapted to the circumstances of the railroad industry; and thus far, such shippers report, BNSF seems to be happily following UP's lead.[41]

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[38] Letter from Michael R. Haverty, Chairman, President and Chief Executive Officer, Kansas City Southern, to Chairman Roger Nober, Surface Transportation Board (June 28, 2004) (available at www.stb.dot.gov/stb/docs/kcsfallpeakletter.pdf).

[39] Both carriers' reduced interest in gaining market share at the other's expense may also be dictated in part by the heavy traffic volumes and resulting capacity constraints that each is experiencing at present, as discussed above.

[40] A significant portion of the overall costs borne by the railroad industry is fixed, *i.e.* such costs do not vary directly with traffic volumes because railroads own and maintain their own rights-of-way. Accordingly, the marginal costs to a railroad of handling additional traffic (so long as its physical plant does not require expansion to accommodate it) will generally be well below its average costs, which by definition include a share of fixed costs.

[41] The STB's reliance in *UP/SP* on the secrecy of rail contract pricing, and the heterogenous nature of rail traffic, as obstacles to price coordination between UP and BNSF seems in retrospect to have been singularly misguided. To say that UP and BNSF cannot monitor one another's pricing activities on all of their traffic is not to say that they are unable to do so in the critical unit train coal transportation market, where UP's circular seems if nothing else to have provided the necessary framework for such monitoring and coordination.

c. The CSXT/NS Acquisition of Conrail

Even as the problematic aftermath of the UP/SP merger was unfolding at the STB and in the western United States, another major rail consolidation case was pending – this time in the eastern United States. Two of the three remaining large Class I carriers, CSXT and NS, first engaged in a bidding war to acquire the third major Class I in the region, Conrail, and then settled their dispute by agreeing to acquire Conrail jointly and divide up its traffic and rail lines between themselves.[42] The STB approved the entire transaction.[43]

Just as the merger applicants had in UP/SP, CSXT and NS touted the substantial efficiency gains that their proposed transaction would produce, along with the service improvements that it would facilitate. Here, as in UP/SP, protestants contended that the applicants' predictions of efficiency gains and resulting costs savings were wildly unrealistic, and that the inflated purchase price paid by NS and CSXT for Conrail as a result of their bidding war likely would force them to press for substantial rate increases on their pre-existing traffic in order to finance their acquisitions. STB again rejected the protestants' concerns and accepted the carriers' assurances that their predictions of efficiency and service improvements were accurate, and that the entire transaction would pay for itself. Once again, subsequent events bore out the concerns expressed by the protestants; the two acquiring carriers almost immediately began experiencing major congestion and related service problems in their operations over parts of Conrail, and failed to achieve the cost savings from increased efficiencies that they had indicated would finance the transaction. The resulting drag on NS and CSXT profits appears to have been a major factor motivating them to impose large increases in their rates on coal shipments to captive plants once the shippers' contracts came up for renewal; this effort in turn led to the initiation of major coal rate litigation by two large coal shippers in the Southeast.[44]

d. The STB Finally Seems to See the Light: BNSF-CN and the Merger Moratorium

On December 20, 1999, BNSF and the Canadian National Railroad Company ("CN") jointly filed a notice of intent to file a merger application.[45] Under STB regulations the promised application was due 3 to 6 months later, at which point the statutory 16-month clock would start ticking on its consideration by the STB.

Shippers, politicians, and – with uncommon unanimity, all three of the other major U.S. Class I carriers – voiced immediate objections to the new merger proposal. The other Class

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[42] The division of Conrail between CSXT and NS seemingly was encouraged by then-STB Chairman Morgan, who speculated about such a "solution" to the bidding war in published interviews.

[43] *CSX Corp. et al.–Control–Conrail Inc. et al.*, 3 S.T.B. 196 (1998) ("*Conrail*").

[44] *See* Docket No. 42069, *Duke Energy Corp. v. Norfolk S. Rwy. Co.* (unprinted decision served November 6, 2003); Docket No. 42070, *Duke Energy Corp. v. CSX Trans., Inc.* (unprinted decision served February 4, 2004); and Docket No. 42072, *Carolina Power & Light Co. v. Norfolk S. Rwy. Co.* (unprinted decision served December 23, 2003). As of the date of this writing (September 2004), administrative appeals and related proceedings remain pending in all three dockets.

[45] The notice was docketed at the STB as Finance Docket No. 33842, *Canadian National Railway Company, Grand Trunk Western Railroad Incorporated, Illinois Central Railroad Company, Burlington Northern Santa Fe Corporation, and The Burlington Northern and Santa Fe Railway Company–Common Control.*

I's warned that the proposed merger, if allowed to proceed, would force them to rush into defensive consolidations of their own, which would require the dedication of resources and time that none of them, still working to overcome the operational problems they had experienced following the last round of mergers, could easily afford. For their part, shippers and government representatives expressed alarm that this was the opening salvo in the next, and final, round of consolidations that would inevitably lead to a transcontinental rail duopoly.

The STB responded with uncharacteristic rapidity to this display of massed opposition. On January 24, 2000, the Board issued a "Notice of Public Hearing and Request for Comments" in a new rulemaking docket, Ex Parte No. 582, in which the Board acknowledged the serious concerns that had been raised, both about the inevitable downstream impacts of the proposed transaction and about the continued relevance and applicability of the decades-old ICC Merger Policy to the radically transformed rail industry of the 21st Century.

Following public hearings on March 8 and 9, 2000, the Board on issued a further order in which it directed all Class I railroads (translation: BNSF and CN) to:

> [S]uspend activity relating to any railroad transaction that would be categorized as a major transaction under 49 CFR 1180.2, pending development of new rules by the Board . . . . [46]

The STB added that "[n]o filings relating to such a transaction will be accepted for 15 months."[47]

The Board acknowledged that its moratorium on major mergers was "unprecedented," but explained that:

> [O]ur hearing was triggered by the announcement that BNSF and CN seek to merge. This announcement came as the rail sector and the shipping public have been struggling to recover from the disruptions associated with the most recent round of mergers. Those consolidations regrettably have been accompanied by a number of serious service problems, and, while service levels have shown improvement in certain areas, overall, service is clearly not where it should be. Promised customer benefits have not yet been fully realized . . . .
>
> [I]f the BNSF/CN proceeding goes forward . . . , the Class I railroads have clearly stated that they would find it necessary to respond in kind, and there is a substantial possibility that, absent decisive action on our part, in the very near future, we will likely be left with the prospect of only two large railroads serving North America. We . . . are seriously concerned about the competitive consequences of this level of industry restructuring, and, in any event, about whether it would be in the public interest at this time, while the industry is still recovering from service difficulties and other disruptions associated with the last round of major rail consolidations.

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[46] Ex Parte No. 582, *Public Views on Major Rail Consolidations*, *supra* footnote 18, 4 S.T.B.at 559.

[47] *Id*.

> [W]e cannot close our eyes to the fact that the mere consideration of any major merger now would likely generate responsive proposals that, if approved, could result in a North American duopoly.[48]

The Board went on to explain why it no longer viewed the old ICC Merger Policy as suitable for judging the next and last round of mergers:

> Our existing merger policy guidelines were adopted by the Interstate Commerce Commission soon after passage of the Staggers Act of 1980. At that time, good government required a merger policy that, while recognizing the importance of competition, would encourage railroads to formulate proposals that would help rationalize excess capacity in the industry.
>
> The goals of that merger policy have largely been achieved. It does not appear that there are significant public interest benefits to be realized from further downsizing or rationalizing of rail route systems, as there is little of that activity left to do . . . .
>
> Given the current transportation environment, and with the prospect of a transportation system composed of as few as two transcontinental railroads, we may wish to revisit our approach to competitive issues such as the "one-lump theory" and the "three-to-two" question . . . .[49]

The foregoing passages were truly remarkable, not only for the unprecedented action they were written to justify (the moratorium), but perhaps more fundamentally, for the seeming ease with which the agency savaged the operational results of the very rail mergers that until then it had approved and so vigorously defended.[50] Equally remarkable was the STB's sudden revelation that facilitating the development of ever-larger railroad duopolies indeed might pose a risk to intramodal price and service competition after all.

Unfortunately (from the shippers' perspective) the Board's conversion proved short-lived. Following the promised rulemaking (conducted in a sub-docket, Ex Parte No. 582 (Sub-No. 1), Major Rail Consolidation Procedures), the STB on June 11, 2001 issued its final decision[51] adopting a reformulated merger policy in 49 C.F.R. §1180.1 (the "STB Merger Policy") and making minor modifications to the balance of the merger rules. The final rules were, on balance, a disappointment for coal shippers.

The wording of the new STB Merger Policy did represent an improvement in tone compared to the old ICC Merger Policy it replaced, in that the new version gave less emphasis to achieving improved efficiency and more emphasis to preserving or enhancing

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48 *Id.*, at 548-49, 552-53.

49 *Id.*, at 552.

50 Before issuing the March 17 decision, the Board had never acknowledged that the 1998 "meltdown" on UP/SP might in any way have resulted from the *UP/SP* merger; rather, the agency claimed that the service crisis would have happened anyway, and would have been much worse and long-lasting if SP had remained independent.

51 *See* footnote ##, *supra*.

competition.[52] Gone, however, was any indication that the "one lump" theory might be reconsidered in the next merger case, or that the Board would be any less committed to its "two is enough" assumption in evaluating reductions in the number of carriers serving a particular customer. Many suspect, it will be "business as usual" the next time a major consolidation is proposed.

III. CONCLUDING THOUGHTS – WHERE DO SHIPPERS GO FROM HERE?

Customers of unregulated industries who are threatened with a loss of competitive supply options usually can look to the antitrust laws, 15 U.S.C. §§1 et seq., for protection. This is so, regardless of whether the threat takes the form of a proposed merger among suppliers, or a straightforward price-fixing conspiracy. To be sure, the burden of proof applicable to a particular private antitrust action may be difficult to meet, but at least the cause of action usually is clear enough.[53]

Unfortunately, the same cannot be said for customers hurt by anticompetitive conduct on the part of railroads. As already discussed, rail mergers are subject to review only by the STB, and such transactions are completely immune from scrutiny under the antitrust laws once approved by that agency. Railroads do not enjoy comparable immunity for price-fixing, and thus the government remains free to prosecute railroads that engage in such behavior. However, private antitrust actions by shippers against railroads, seeking treble damages for such conduct, remain problematic under the *Keogh* Doctrine.[54]

In all probability there is no way to unscramble the BN/SF, UP/SP, and Conrail decisions. As a practical matter, shippers will have to live with the regional duopolies that resulted from those transactions. However, the ICC's and STB's rejection of requests for more localized relief, such as trackage rights to preserve origin competition, is not cast in stone. The STB still has the authority under 49 U.S.C. §11102(a) to order joint use (i.e., trackage rights) over railroad "terminal facilities, including main line tracks for a reasonable distance outside of a terminal," as well as the right under §11102(c) to order the implementation of "reciprocal switching" in such areas.

Thus far, trackage rights under subsection (a) have been routinely prescribed at the behest of merging carriers to fill in gaps between their systems over other railroads' lines, but have never been imposed at the behest of shippers seeking access to a second, nearby rail carrier – though nothing in the statute would preclude such application. Similarly,

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52 The STB's discussion of the final rules also stressed the importance of preserving competition and promised that the Board would henceforth take a more skeptical look at merger applicants' promises of efficiency improvements, as well as their assurances that they would not experience any "transitional" service problems.

53 Moreover, such a plaintiff can sometimes persuade the federal antitrust enforcement agencies (the Justice Department and/or the Federal Trade Commission) to get involved, and benefit from the Government's significant supporting resources.

54 In *Keogh v. Chicago & N.W. R.R.*, 260 U.S. 156 (1922), the Supreme Court held that shippers cannot recover under the antitrust laws for the allegedly excessive rate levels they paid as a result of an unlawful railroad price-fixing conspiracy, because such an award would compel an unlawful deviation from the carriers' filed tariff rates. That doctrine was upheld on *stare decisis* grounds in *Square D Co. v. Niagara Frontier Tariff Bureau*, 476 U.S. 409 (1986), despite intervening changes in the law that weakened some of the underpinnings of *Keogh*. Whether the Supreme Court would rule the same way today with respect to railroad rates that are neither filed nor subject to a "no deviation" rule (since the statute explicitly authorizes contract rates) is uncertain.

subsection (c), though added by Congress in the Staggers Act for the express purpose of facilitating competitive access, has for all practical purposes become a dead letter in the hands of an agency seemingly hostile to such relief. This hostility, however, is a result of the regulatory (or more accurately, deregulatory) philosophies of the ICC and STB members over the past 24 years; it is not compelled by any statutory limitations on their authority.[55] In time, perhaps, a different balance between the sometimes conflicting objectives of deregulation and promotion of competition will hold sway at the STB, at which point shipper attempts to obtain relief under §11102 may receive a more favorable reception. Until then, coal shippers will have to batten down the hatches.

[55] Legislative proposals are pending in Congress to strengthen shippers' remedies for overcoming segment monopolies and obtaining the benefits of, *e.g.*, competition between potential origin carriers, and similar proposals have been introduced in previous Congressional sessions. This paper does not address such proposals, however, but rather focuses on the current state of the law.