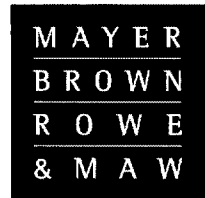


October 12, 2006

BY HAND-DELIVERY

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



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Re: Finance Docket No. 34890, PYCO Industries, Inc. – Feeder
Line Application – Lines of South Plains Switching, Ltd. Co.

Finance Docket No. 34922, Keokuk Junction Railway Co. –
Feeder Line Application – Lines of South Plains Switching,
Ltd. Co.

217805

ENTERED
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Part of
Public Record

Dear Secretary Williams:

Enclosed for filing in the above-captioned proceedings are the original and ten (10) copies of BNSF Railway Company's Reply to PYCO's Revised Valuation Evidence and to KJRY's ALL-SAW Application.

I would appreciate it if you would date-stamp the enclosed extra copy and return it to the messenger for our files. Please let me know if you have any questions. Thank you for your assistance.

Sincerely yours,

Adrian L. Steel, Jr.
Adrian L. Steel, Jr.

Enclosures

cc: Thomas F. McFarland, Esq.
Charles H. Montange, Esq.
Gary McLaren, Esq.
John D. Heffner, Esq.
William C. Sippel, Esq.
William A. Mullins, Esq.
Andrew Goldstein, Esq.
James L. Gorsuch, Esq.

BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 34890

PYCO INDUSTRIES, INC.
– FEEDER LINE APPLICATION –
LINES OF SOUTH PLAINS SWITCHING, LTD. CO.

Finance Docket No. 34922

KEOKUK JUNCTION RAILWAY CO.
– FEEDER LINE APPLICATION –
LINES OF SOUTH PLAINS SWITCHING, LTD. CO.

**REPLY OF BNSF RAILWAY COMPANY
TO PYCO'S REVISED VALUATION EVIDENCE
AND TO KJRY'S ALL-SAW APPLICATION**

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Dated: October 12, 2006

BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 34890

PYCO INDUSTRIES, INC.
– FEEDER LINE APPLICATION –
LINES OF SOUTH PLAINS SWITCHING, LTD. CO.

Finance Docket No. 34922

KEOKUK JUNCTION RAILWAY CO.
– FEEDER LINE APPLICATION –
LINES OF SOUTH PLAINS SWITCHING, LTD. CO.

**REPLY OF BNSF RAILWAY COMPANY
TO PYCO'S REVISED VALUATION EVIDENCE
AND TO KJRY'S ALL-SAW APPLICATION**

Pursuant to the Surface Transportation Board's procedural schedule in these feeder line application ("FLA") proceedings, BNSF Railway Company ("BNSF") submits this reply to the following pleadings:

- PYCO Industries, Inc.'s ("PYCO") September 28, 2006 Revised Valuation of SAW ("PYCO Revised Valuation")
- Keokuk Junction Railway Co.'s ("KJRY") September 27, 2006 Expanded Competing Feeder Line Application ("KJRY Competing FLA")

BNSF takes no position on the FLAs filed by PYCO and KJRY and neither supports nor objects to either such application. BNSF does, however, wish to address four issues concerning the applications raised by PYCO's and KJRY's pleadings. The first is whether it is proper to include revenues generated in connection with rail service to Jarvis Metals at Burris, TX in calculating

the going concern value ("GCV") of SAW's lines. The second is whether it is proper to include in the GCV surcharges on SAW traffic which SAW is authorized to impose. The third is whether BNSF's right of first refusal should be preserved in these proceedings. The fourth is whether BNSF's rate making authority under its agreement with SAW should be preserved.

BACKGROUND

As reflected in the Verified Statement of Weldon E. Hale submitted herewith ("V.S. Hale at ___"), BNSF's interest in the proceedings arises out of its May 3, 1999 "Agreement for Sale of Certain Assets, Rights and Obligations of The Burlington Northern and Santa Fe Railway Company to South Plains Switching, Ltd., Company" ("1999 Agreement")¹ pursuant to which BNSF sold certain rail lines and associated trackage at Lubbock to SAW. Under the 1999 Agreement, BNSF interchanged traffic with SAW at BNSF's Lubbock Yard, and SAW in turn served local Lubbock shippers. V.S. Hale at 2. Now, under the Board's interim alternative service order issued in *PYCO Industries, Inc.—Alternative Rail Service—South Plains Switching, Ltd. Co.*, F.D. No. 34802 (served June 21, 2006), BNSF interchanges traffic with SAW and West Texas & Lubbock Railway Company, Inc. ("WTL") at BNSF's Lubbock Yard. While BNSF has worked with SAW and WTL to seek to maintain efficient operations during the interim period of alternative rail service,² BNSF needs to ensure that it can operate at Lubbock efficiently and without undue interference.³ *Id.* at 3.

¹ A copy of the 1999 Agreement is attached to BNSF's petition for leave to intervene in these proceedings filed on August 31, 2006.

² Under the parties' current arrangement, BNSF delivers incoming traffic destined to shippers on SAW's lines to WTL at BNSF's Lubbock Yard. WTL then moves the traffic to SAW's yard, where the traffic which SAW is to deliver is given to SAW. WTL then delivers PYCO's traffic to its facility. In contrast, outgoing traffic is delivered from the customers' facilities to the BNSF yard directly by both SAW and WTL. Both SAW and WTL must utilize portions of BNSF's

(cont'd)

The 1999 Agreement provides that BNSF has the authority to establish through routes and offer through freight rates via through routes involving SAW and BNSF with an interchange in Lubbock. *See* Section 16. Furthermore, the 1999 Agreement obligates SAW to automatically concur with the through rates and routes established by BNSF. *Ibid.* The Agreement additionally provides that SAW can not impose a surcharge on traffic interchanged without BNSF's consent, which consent is not to be unreasonably withheld. *Ibid.*

In addition, the 1999 Agreement provides in Section 7 (b) that "[a]ny subsequent agreement by Buyer [SAW] to sell all or any portion of the Rail Line (except to an affiliate of Buyer) must contain the effective right for Seller [BNSF] to purchase the Rail Line". The 1999 Agreement further provides BNSF with the right to review any sale of the trackage for sixty (60) days from the receipt of an executed sales agreement, and BNSF is vested during that period with the right to purchase the property "on the same, or substantially similar, basis" as set forth in the executed sales agreement for a "purchase price equal to the average of the highest three bids" received by SAW. *See* Section 7(b).

The right of first refusal was an important part of BNSF's agreement to sell its lines at Lubbock to SAW for several reasons. Initially, BNSF needed to ensure that, over the long run, it would be able to provide efficient and effective rail freight service to its customers at Lubbock. If it turned out (as has in fact been the case) that SAW was not able to provide the level of rail

(... cont'd)

mainline in making their deliveries of outgoing traffic, and the increased use of the mainline has at times interfered with BNSF's operations. V.S. Hale at 3.

³ No party has asserted objection to BNSF's request that the Board require that the successful FLA applicant be required to enter into an operating protocol with BNSF to ensure that BNSF can operate in such a manner, with the Board resolving any disputes that the parties cannot resolve.

transportation services at Lubbock that the customers require, then BNSF needed the right to step in and take over the lines in the event SAW sought to sell the lines to a new shortline operator. V.S. Hale at 3-4. Further, as reflected in the 1999 Agreement, SAW paid nowhere near the GCV of the lines, and, in fact, it paid only \$10 to BNSF for the lines. *See* Section 2(a)(2). As Mr. Hale has explained, the right of first refusal, together with the right to establish rates for through routes and restrictions on the surcharges SAW could impose, were needed to ensure that BNSF would realize the GCV of the lines over time. *Id.* at 6-8.

Jarvis Metals Haulage Fees

SAW asserted in its Statement in Response to PYCO's Feeder Line Application to Acquire "ALL-SAW" filed on September 18, 2006 ("SAW Statement") that the GCV should include revenues of \$75 per car on traffic for Jarvis Metals at Burris, TX that BNSF has agreed to pay pursuant to a haulage agreement. This agreement is, however, a temporary agreement, pending judicial appeal. V.S. Hale at 4. The agreement may or may not survive appeal. In addition, the agreement is cancelable by either party on 30 day's written notice. *Ibid.* The agreement therefore should not be relied upon as an on-going source of revenue to SAW.

Surcharges

SAW also asserted in its Statement that the GCV should include revenues which would be received through the imposition of a \$60 surcharge on shipments of less than 27 cars at a time and \$40 per car on shipments of 27 or more cars. To date, however, SAW has only imposed a surcharge of \$20 per car on PYCO's traffic, which moves in shipments of less than 27 cars at a time. V.S. Hale at 4. SAW has not assessed the full \$60 per car on the PYCO traffic or any surcharges at all on the traffic of the other shippers. *Ibid.* SAW asserts nevertheless that the full surcharge revenues should be taken into account in determining the GCV of All-SAW because those revenues are an asset of SAW that can be realized at SAW's discretion at any time.

SAW also argues that there is no legal or factual basis for contending that SAW's authorized surcharges would divert rail traffic from SAW. SAW claims that the fact that there will be no traffic diversions is supported implicitly by a Texas state court jury finding (upheld on appeal) that BNSF cannot unreasonably withhold its consent to SAW's imposition of the surcharge. SAW also asserts that the surcharges would not cause traffic diversions because the traffic is captive to BNSF and is not susceptible to truck transportation diversion. SAW further asserts that the surcharges would not divert traffic because the surcharge amounts represent a very small portion of the total freight charges and because much greater increases by BNSF in total freight charges have not resulted in traffic diversions.

SAW's inclusion of surcharges is, however, unjustified on several grounds. First, SAW's position rests on the assumption that all of its shippers are captive. SAW, however, provides no data to support its position. Indeed, notwithstanding that certain of the shippers may be rail-dependent, the imposition of surcharges could cause shippers to reduce their use of SAW, cause them to go out of business, or result in a shift production to other locations. V.S. Hale at 4. As Mr. Hale describes, SAW's arguments reflect a simplistic view of how rail transportation rates are established, and, if taken to their logical extreme, would allow a carrier to increase rates to whatever level it sees fit without a threat of losing traffic. Certainly, carriers periodically seek rate increases in those circumstances where costs or market conditions will support an increase. The possibility for traffic diversions, or customers substituting a locally available alternative to the commodity hauled by the carrier, are factors that must be considered in deciding whether to increase rates. In order for a rate increase to be sustainable, the entire rail transportation product must meet the needs of the customer, or the customer will rightly seek an alternative. Service is an extremely important component of the equation, and no amount of rate increase is supportable

if service does not meet the needs of the customer. *Id.* at 5. Here, for example, Hanson Aggregates has decided to no longer use SAW to serve particular markets due to poor service.⁴ In addition, shippers could readily shift their freight to trucks, thereby depriving the rail carrier of not only the surcharge but the underlying revenue as well. *Ibid.*

With respect to SAW's claim that the issue of traffic diversion has been judicially determined, the fact is, as reflected in the appeals court decision,⁵ that the traffic diversion question was not specifically presented to the jury, but was only a factor among many in determining whether or not BNSF's disapproval of the surcharge was unreasonable.

As Mr. Hale notes, if SAW's arguments are correct that the imposition of a \$60 surcharge on shipments of less than 27 cars at a time and \$40 per car on shipments of 27 or more cars would have absolutely no effect on traffic levels, then the question arises as to why has SAW not taken advantage of its ability to impose the surcharges and reap the revenue increase. V.S. Hale at 5. The magnitude of the revenue increase that SAW would realize from the imposition of the surcharges is such that it is counterintuitive that SAW, or any other business for that matter, would not immediately put the surcharges in place. Using the data shown in SAW's witness Plaistow's Exhibit 51 for 2006, SAW's total haulage revenue, excluding the effect of the surcharges, would be \$1,504,472. Full imposition of the surcharges yields an additional \$735,000, an increase in revenue of 48%. *Ibid.* If SAW could increase revenues by 48%, without risk of losing any carloads, what explains the fact that SAW has not already imposed the

⁴ Hanson's decision is reflected in its August 1, 2006 letter to the Board which was submitted by PYCO in F.D. No. 34890 on August 2, 2006.

⁵ A copy of the Texas state court of appeals decision is attached to Delilah Wisener's Verified Statement submitted with SAW's Statement at Appendix DW-5.

surcharge? The very plausible answer suggested by Mr. Hale is that customers served by SAW would object strenuously to the additional cost and would look to divert shipments to truck or move their businesses to a location that would allow rail service to continue, but without a surcharge. *Ibid.*

SAW's current arguments regarding the surcharge issue are even more counterintuitive when viewed in light of the arguments that SAW made at trial as to why the surcharge was necessary in the first place. At trial, SAW testified it needed the surcharge revenue to make up for a revenue shortfall resulting from BNSF purportedly reneging on a deal to outsource additional switching to SAW.⁶ If SAW's arguments were correct that it needed the surcharge to be revenue adequate, then again, why hasn't the surcharge been implemented? Again, a very plausible answer suggested by Mr. Hale has to be that SAW recognizes it cannot impose a surcharge without risking the loss of traffic. V.S. Hale at 6. Accordingly, SAW's inclusion of the surcharge revenues in the GCV should be rejected by the Board.

Right of First Refusal

Both SAW and KJRY contend that BNSF's right of first refusal to purchase All-SAW does not apply to a purchase resulting from these feeder line proceedings. In particular, Delilah Wisener, SAW's president, contends that the right of first refusal applies only to a voluntary sale by SAW and that a sale pursuant to a feeder line application is a forced sale.⁷ Verified Statement

⁶ That argument, however, was not sustained. V.S. Hale at 6.

⁷ SAW seeks to buttress Mrs. Wisener's contention in its reply to BNSF's petition for leave to intervene in these proceedings by asserting that a sale under the feeder line statute does not constitute a "subsequent agreement . . . to sell . . . the Rail Line" (emphasis original) within the meaning of the Section 7(b) right of first refusal. While BNSF disagrees with that assertion, it is immaterial to these proceedings. Any dispute between SAW and BNSF as to whether the right

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of Delilah Wisener at 2.⁸ KJRY argues that the right of first refusal should not apply because it would be inconsistent with Section 10907. KJRY Competing FLA at 29. It further argues that the application of BNSF's right of first refusal would be bad economic policy and that it would cause potential feeder line applicants not to proceed. *Id.* at 30.

As established below, however, the application of BNSF's right of first refusal is consistent with Section 10907. Initially, the Board's order approving a feeder line application does not, in and of itself, constitute a conveyance of the subject lines. Instead, the Board's approval decision orders the line owner to sell the lines to one of the applicants found to be qualified at the acquisition cost as determined by the Board. *See* 49 U.S.C. § 10907(b)(1) ("the Board shall require the rail carrier owning the railroad line to sell such line to such financially responsible person" (emphasis added)). The transaction is between the incumbent and the chosen applicant. It is undertaken pursuant to a sale agreement negotiated by those two parties. For example, in *Indiana Hi-Rail Corporation – Feeder Line Acquisition – Conrail Line Between Beesons and Connersville, IN*, 366 ICC 42 (1981), the Interstate Commerce Commission ("ICC" or "Commission") found that both of the competing feeder line applicants (Indiana Hi-Rail Corporation and Indiana and Ohio Railroad Company) demonstrated that they qualified as financially responsible parties. As established precedent provides, the Commission did not, however, select between the two applicants but instead ordered that Conrail "negotiate with

(... cont'd)

of first refusal is contractually triggered by a FLA sale must be resolved in state court, not by the STB.

⁸ Mrs. Wisener's Verified Statement was submitted as Tab 3 to the SAW Statement.

either one of [the] parties for the sale of the line” and that “[t]he buyer should inform us if a formal contract for sale is entered.” *Id.* at 50.

Further, the incumbent (here SAW) is bound in its sale of the lines by whatever terms and conditions apply to its ownership of the lines as may arise under the contractual documents by which it originally acquired ownership. There is no need for the Board (and, in fact, it lacks jurisdiction) to override BNSF’s contractually bargained-for right of first refusal. This principle is confirmed by the ICC’s decision in *Milford-Bennington Railroad Company, Inc. – Feeder Line Acquisition – Boston and Maine Corporation Hillsborough Branch*, F.D. No. 31701 (1991 ICC LEXIS 250) at *9-*10, where the Commission held that encumbrances on a line involved in a feeder line application (in that case a lease between the line owner and one of its affiliates) do not constitute a bar to the application, that the encumbrances remain in effect pursuant to the parties’ contractual agreements, and that the granting of an application only authorizes the applicant to acquire the owner’s interest in a line, whatever that interest may be. The feeder line applicant is required to deal with the encumbrances itself as it may be permitted to do under the relevant contract(s).⁹

Further, the preservation of BNSF’s right of first refusal will not interfere with or detract from the purpose of the feeder line provisions under Section 10907 to enable shippers who are receiving inadequate service to receive alternative service from a different carrier. *See Caddo Antoine & Little Missouri R. Co. v. United States*, 95 F. 3d 740, 745-46 (8th Cir. 1996).

⁹ SAW’s assertion in its reply to BNSF’s petition for leave to intervene that the Interstate Commerce Commission found in *Milford-Bennington* that it had “statutory authority to remove encumbrances to sale of a line under the feeder statute” (emphasis original) is without merit. The ICC instead found just the opposite, and there is nothing in the decision that holds that encumbrances such as BNSF’s contractual right of first refusal can or should be held inapplicable in a feeder line application.

The opinion expressed by KJRY's expert, William J. Brennan, that potential FLA applicants in future situations involving inadequate rail service might choose not to proceed is speculative, and, in any event, the purpose of the feeder line statute would be fulfilled since the lines will be returned to the rail carrier exercising the right of first refusal (which will almost always be a Class I railroad). Moreover, the potential FLA applicant would, as PYCO and KJRY here, be fully aware of the existence of the right of first refusal and could not therefore justifiably claim to be prejudiced by the right.

As Mr. Hale relates, KJRY, being part of shortline holding company, is well aware of the typical structure of shortline sales, especially of the type employed when BNSF sold the lines in Lubbock to SAW in 1999. V.S. Hale at 6. It is not at all unusual for a Class I railroad to sell rail lines to a shortline operator for what might appear to be a very low price. In the case of the 1999 sale to SAW, BNSF sold the lines for \$10. The valuations submitted by SAW, KJRY, and PYCO demonstrate that, even if the valuations are adjusted for traffic levels as they existed in 1999, SAW purchased the lines for a price that was not remotely close to GCV. The reason that a Class I railroad would make such a deal is simple. It is that most shortline operators are not financially able to purchase lines at full GCV. Over the long term, the Class I railroad realizes the GCV by several means: 1) retaining the right to establish through routes and to set the rates for those routes; 2) requiring the shortline operator to automatically concur with through rates and routes established by the Class I railroad, ensuring that the Class I railroad will retain the customers going forward; 3) restricting the ability of the shortline operator to impose surcharges on the customers, thereby reducing the threat of a reduction in traffic; and 4) including a right of first refusal in the sale agreement so that the Class I can ensure that in the event of a sale the new

operator will provide the level of service required by the customers. V.S. Hale at 6-7. With this structure, the shortline industry has been allowed to grow and flourish since the Staggers Act.

Preservation of BNSF's Rate Making Authority

The preservation of BNSF's rate making authority under its agreement with SAW is critical to BNSF's ability to realize the economic benefits of the 1999 sale and to preserve the traffic base on the lines. V.S. Hale at 7. Preservation of this right benefits all three parties: the Class I railroad, the shortline, and the customers. From the standpoint of the Class I railroad, the preservation of rate making authority has the effect of assuring a revenue flow from the new shortline. This revenue flow has value, and the value should not be put at risk by providing the shortline with the ability to set rates independent of those quoted by the Class I railroad. From the standpoint of SAW, BNSF's ability to establish through rates and routes was accepted after arm's-length negotiations. SAW could have determined that this arrangement was not beneficial and bought out this right from BNSF. In fact, this is not uncommon in the industry. Finally, from the customer's perspective, the arrangement continues the commercial opportunities available to the customer before the sale to the shortline. *Ibid.* After the 1999 sale to SAW, customers have continued to see the same routing opportunities they had prior to the sale. Shipments to and from a given customer on SAW have, since 1999, been considered as BNSF-direct movements from the standpoint of the customer. *Ibid.*

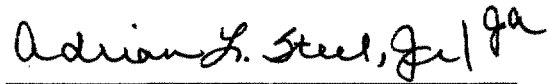
To summarize this point, SAW agreed to BNSF retaining the authority to establish through rates and routes for shipments moving to customers served by SAW. Both parties saw this arrangement as having value, or presumably neither party would have signed the agreement. Elimination of the right to set through rates and routes for shipments moving to customers served by SAW would impede BNSF's ability to realize the GCV of the lines sold to SAW in 1999 and would put the traffic at risk, which adversely effects both the Class I railroad and the shortline.

V.S. Hale at 7-8. Accordingly, the Board should confirm that BNSF's rate making authority with respect to the SAW lines is to be preserved. This can be accomplished either by confirming the applicability of BNSF's right of first refusal under the 1999 Agreement (in which case, BNSF could negotiate the preservation of its rate making authority with the successful FLA applicant), or the Board could directly require the successful FLA applicant to negotiate a contract with BNSF which preserves BNSF's rate making authority.

The structure described above was put in place to ensure that, over time, BNSF would realize the GCV of the lines sold to SAW in 1999. The FLA process should not be allowed to devalue BNSF's original deal nor should SAW be allowed to benefit by being a bad actor. SAW argues that the right of first refusal does not apply to a "forced sale". In this instance, SAW has demonstrated the inability to provide the service required by PYCO and other Lubbock shippers. SAW nonetheless argues that by this behavior, not only should it be relieved of the terms and conditions of the 1999 Agreement, specifically that it not be bound by the right of first refusal clause, but that it should benefit monetarily by the sale of the lines.

The FLA process should not, however, allow SAW to ultimately benefit while BNSF forfeits the benefits it bargained for when it sold the lines to SAW for \$10 in 1999.

Respectfully submitted,



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Attorneys for BNSF Railway Company

Dated: October 12, 2006

**VERIFIED STATEMENT OF
WELDON E. HALE**

My name is Weldon E. Hale. I am Director of Short Line Development for BNSF Railway Company ("BNSF"). My business address is 2500 Lou Menk Drive, Fort Worth, Texas 76131.

As Director of Shortline Development, I am responsible for managing all aspects of the relationship between BNSF and 45 of its connecting shortline railroads. I am responsible for communicating with market managers responsible for marketing traffic over these lines; evaluating the shortlines' request for the waiver of contract provisions; assisting the shortlines in their efforts to increase the amount of local traffic moving over their lines; working to amend the purchase and sale agreements of the shortlines as necessary; and negotiating new line sales and lease agreements. In addition, I am responsible for ensuring that BNSF and its shortline connections comply with the terms and conditions of the purchase and sale agreements. I have also managed the successful cutover of operations when BNSF has outsourced rail lines to a new shortline operator.

Prior to my current position, I spent eight years in BNSF's Coal Marketing Business Unit managing coal transportation to a number of electric utility customers in the upper Midwest and Canada. In this position, I negotiated transportation rates, established operating parameters, negotiated contracts, and managed the on-going relationship with the utilities.

The purpose of my testimony is to provide information concerning and issues relating to the May 3, 1999 "Agreement for Sale of Certain Assets, Rights and Obligations of The Burlington Northern and Santa Fe Railway Company to South Plains Switching, Ltd., Company" ("1999 Agreement"). In so doing, I will describe the principal terms of the Agreement as they are relevant to the pending feeder line applications ("FLA") filed by PYCO Industries, Inc. ("PYCO") and Keokuk Junction Railway Co. ("KJRY"). In particular, I will address four issues raised by KJRY's September 27, 2006 Expanded Competing Feeder Line Application and PYCO's September 28, 2006 Revised Valuation of SAW. These issues are (i) rail service to Jarvis Metals at Burris, TX; (ii) surcharges on traffic which SAW is authorized to impose; (iii) BNSF's right of first refusal; and (iv) BNSF's rate making authority under its agreement with SAW.

1999 Agreement

Under the 1999 Agreement, SAW acquired, for the actual sum of \$10.00, approximately fifteen miles of rail line consisting almost entirely of industry tracks in the vicinity of BNSF's Lower Yard in Lubbock, Texas. Under the 1999 Agreement, SAW agreed to maintain the properties and provide switching services to BNSF and its customers. For the switching services it provided, SAW would receive a "division of revenue" – *i.e.*, a portion of the freight revenue billed to and collected from the customer by BNSF – according to a formula established in the 1999 Agreement.

Under the 1999 Agreement, BNSF retained authority to establish what are referred to in the Agreement as "through routes." Under a through route, a shipper arranges for the transportation with the originating carrier and is billed for the freight by the originating carrier despite the fact that a portion of the transportation occurs on another carrier's rail line. In the case of BNSF and SAW, the through route consisted of SAW merely interchanging cars with

BNSF in the Lubbock Lower Yard and switching the cars to and from the industry track destinations on SAW's rail line. Furthermore, the 1999 Agreement obligates SAW to automatically concur with the through rates and routes established by BNSF. The Agreement further provides that SAW can not impose a surcharge on traffic interchanged without BNSF's consent, which consent is not to be unreasonably withheld.

In addition, the 1999 Agreement provides BNSF with a right of first refusal in the event SAW were to decide to sell the lines. In Section 7 (b), it states that "[a]ny subsequent agreement by Buyer [SAW] to sell all or any portion of the Rail Line (except to an affiliate of Buyer) must contain the effective right for Seller [BNSF] to purchase the Rail Line". The 1999 Agreement further provides BNSF in Section 7(b) with the right to review any sale of the trackage for sixty (60) days from the receipt of an executed sales agreement, and BNSF is vested during that period with the right to purchase the property "on the same, or substantially similar, basis" as set forth in the executed sales agreement for a "purchase price equal to the average of the highest three bids" received by SAW.

The right of first refusal was an important part of BNSF's agreement to sell its lines at Lubbock to SAW for several reasons. Initially, BNSF needed to ensure that, over the long run, it would be able to provide efficient and effective rail freight service to its customers at Lubbock.¹ If it turned out (as has in fact been the case) that SAW was not able to provide the level of rail transportation services at Lubbock that the customers require, then BNSF needed the right to step

¹ Under the parties' current arrangement, BNSF delivers incoming traffic destined to shippers on SAW's lines to WTL at BNSF's Lubbock Yard. WTL then moves the traffic to SAW's yard, where the traffic which SAW is to deliver is given to SAW. WTL then delivers PYCO's traffic to its facility. In contrast, outgoing traffic is delivered from the customers' facilities to the BNSF yard directly by both SAW and WTL. Both SAW and WTL must utilize portions of BNSF's mainline in making their deliveries of outgoing traffic, and the increased use of the mainline has at times interfered with BNSF's operations.

in and take over the lines in the event SAW sought to sell the lines to a new shortline operator. Further, as reflected in the 1999 Agreement, SAW paid nowhere near the GCV of the lines, and, in fact, it paid only \$10 to BNSF for the lines. *See* Section 2(a)(2) of the 1999 Agreement.

Jarvis Metals Haulage Fees

In its Statement in Response to PYCO's Feeder Line Application to Acquire "ALL-SAW" filed on September 18, 2006 ("SAW Statement"), SAW stated that the GCV should include revenues of \$75 per car on traffic for Jarvis Metals at Burris, TX that BNSF has agreed to pay pursuant to a haulage agreement. This agreement is, however, only a temporary agreement, pending judicial appeal. In addition, the agreement is cancelable by either party on 30 days' written notice.

Surcharges

SAW has to date only imposed a surcharge of \$20 per car on PYCO's traffic, which moves in shipments of less than 27 cars at a time. SAW has not assessed the full \$60 per car on the PYCO traffic or any surcharges at all on the traffic of the other shippers.

As to SAW's argument that the surcharges would not divert rail traffic from SAW, SAW is wrong on several grounds. First, SAW's position rests on the assumption that all of its shippers are captive. However, notwithstanding that certain of the shippers may be rail-dependent, the imposition of surcharges could cause shippers to reduce their use of SAW, cause them to go out of business, or result in a shift production to other locations. SAW's arguments reflect a simplistic view of how rail transportation rates are established, and, if taken to their logical extreme, would allow a carrier to raise rates to whatever level it sees fit without a threat of losing traffic. Certainly, carriers periodically seek rate increases in those circumstances where costs or market conditions will support an increase. The possibility for traffic diversions, or customers substituting a locally available alternative to the commodity hauled by the carrier, are

factors that must be considered in deciding whether increase rates. In order for a rate increase to be sustainable, the entire rail transportation product must meet the needs of the customer, or the customer will rightly seek an alternative. Service is an extremely important component of the equation, and no amount of rate increase is supportable if service does not meet the needs of the customer. For example, Hanson Aggregates has decided to no longer use SAW to serve particular markets due to poor service. In addition, shippers could readily shift their freight to trucks, thereby depriving the rail carrier of not only the surcharge but the underlying revenue as well.

One has to ask, if SAW's arguments are correct [they are not] that the imposition of a \$60 surcharge on shipments of less than 27 cars at a time and \$40 per car on shipments of 27 or more cars would have absolutely no effect on traffic levels, then why has SAW not taken advantage of its ability to impose the surcharges and reap the revenue increase? The magnitude of the revenue increase that SAW would realize from the imposition of the surcharges is such that it is counterintuitive that the SAW, or any other business for that matter, would not immediately put the surcharges in place. Using the data shown in SAW's witness Plaistow's Exhibit 51 for 2006, SAW's total haulage revenue, excluding the effect of the surcharges, would be \$1,504,472. Full imposition of the surcharges yields an additional \$735,000, an increase in revenue of 48%. If SAW could increase revenues by 48%, without risk of losing any carloads, then what explains the fact that SAW has not already imposed the surcharge? A very plausible answer is that customers served by the SAW would object strenuously to the additional cost and would look to divert shipments to truck or move their businesses to a location that would allow rail service to continue, but without a surcharge.

SAW's current arguments regarding the surcharge issue do not agree with the arguments

SAW made at trial as to why the surcharge was necessary in the first place. At trial, SAW testified it needed the surcharge revenue to make up for a revenue shortfall resulting from BNSF reneging on a deal to outsource additional switching to SAW. That argument, however, was not sustained. If SAW's arguments were correct [they were not] that it needed the surcharge to be revenue adequate, then again, why hasn't the surcharge been implemented? Again, a very plausible answer has to be that SAW recognizes it cannot impose a surcharge without risking the loss of traffic.

Right of First Refusal

Both SAW and KJRY contend that BNSF's right of first refusal to purchase All-SAW should not apply to a purchase resulting from these feeder line proceedings. The application of BNSF's right of first refusal here is, however, entirely consistent with the parties' intent and the purpose of that right.

KJRY, being part of shortline holding company, is well aware of the typical structure of shortline sales, especially of the type employed when BNSF sold the lines in Lubbock to the SAW in 1999. It is not at all unusual for a Class I carrier to sell rail lines to a shortline operator for what might appear to be a very low price. In the case of the 1999 sale to SAW, BNSF sold the lines for \$10. The valuations submitted by SAW, KJRY, and PYCO demonstrate that, even if the valuations are adjusted for traffic levels as they existed in 1999, the SAW purchased the lines for a price that was not remotely close to GCV. Why would a Class I make such a deal? The reason is simply that most shortline operators are not financially able to purchase lines at full GCV. Over the long term, the Class I realizes the GCV by several means: 1) retaining the right to establish through routes and to set the rates for those routes, 2) requiring the shortline operator to automatically concur with through rates and routes established by the Class I, ensuring that the

Class I will retain the customers going forward; 3) restricting the ability of the shortline operator to impose surcharges on the customers, thereby reducing the threat of a reduction in traffic; and 4) including a right of first refusal in the sale agreement so that the Class I railroad can ensure that in the event of a sale the new operator will provide the level of service required by the customers. With this structure, the shortline industry has been allowed to grow and flourish since the Staggers Act.

Preservation of BNSF's Rate Making Authority

The preservation of BNSF's rate making authority under its agreement with SAW is critical to BNSF's ability to realize the economic benefits of the 1999 sale and to preserve the traffic base on the lines. Preservation of this right benefits all three parties: the Class I railroad, the shortline, and the customers. From the standpoint of the Class I railroad, the preservation of rate making authority has the effect of assuring a revenue flow from the new shortline. This revenue flow has value, and the value should not be put at risk by allowing the shortline the ability to set rates independent of those quoted by the Class I railroad. From the standpoint of the SAW, BNSF's ability to establish through rates and routes was accepted after arm's-length negotiations. SAW could have determined that this arrangement was not beneficial and bought out this right from BNSF. In fact, this is not uncommon in the industry. Finally, from the customer's perspective, the arrangement continues the commercial opportunities available to the customer before the sale to the shortline. After the 1999 sale to SAW, customers have continued to see the same routing opportunities they had prior to the sale. Shipments to and from a given customer on SAW have, since 1999, been considered as BNSF-direct movements from the standpoint of the customer.

To summarize this point, SAW agreed to BNSF retaining the authority to establish through rates and routes for shipments moving to customers served by the SAW. Both parties

saw this arrangement as having value, or presumably neither party would have signed the agreement. Elimination of the right to set through rates and routes for shipments moving to customers served by the SAW would impede BNSF's ability to realize the GCV of the lines sold to the SAW in 1999 and would put the traffic at risk, which adversely effects both the Class I railroad and the shortline.

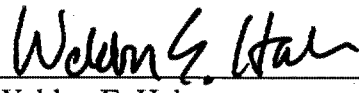
The structure described above was put in place to ensure that, over time, BNSF would realize the GCV of the lines sold to the SAW in 1999. The FLA process should not be allowed to devalue BNSF's original deal nor should SAW be allowed to benefit by being a bad actor. SAW argues that the right of first refusal does not apply to a "forced sale". In this instance, the SAW has demonstrated the inability to provide the service required by PYCO and other Lubbock shippers. SAW nonetheless argues that by this behavior, not only should it be relieved of the terms and conditions of the 1999 sale agreement, specifically that it not be bound by the right of first refusal clause, but that it should benefit monetarily by the sale of the railroad.

The FLA process should not allow the SAW to ultimately benefit while BNSF forfeits the benefits it expected to receive when it sold the lines to the SAW for \$10 in 1999.

VERIFICATION

I, Weldon E. Hale, verify under penalty of perjury under the laws of the United States that the foregoing is true and correct. Further, I certify that I am qualified and authorized to file this Verified Statement.

Executed on October ~~11/11~~ 2006.



Weldon E. Hale

CERTIFICATE OF SERVICE

I hereby certify that on this 12th day of October 2006, a true and correct copy of the foregoing Reply of BNSF Railway Company to PYCO's Revised Valuation Evidence and to KJRY's ALL-SAW Application was served by overnight delivery on the following:

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