

PUBLIC VERSION

208
KCS-18A
TM-17A

BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -



THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
and
THE TEXAS MEXICAN RAILWAY COMPANY

RESPONSE TO COMMENTS, PROTESTS, AND REQUESTS FOR CONDITIONS,
AND REBUTTAL IN SUPPORT OF APPLICATION

VOLUME 1 OF 2: NARRATIVE

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**THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
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**RESPONSE TO COMMENTS, PROTESTS, AND REQUESTS FOR CONDITIONS,
AND REBUTTAL IN SUPPORT OF APPLICATION**

INTRODUCTION AND STATUS OF THE TRANSACTIONS

In accordance with the order of the Surface Transportation Board ("STB" or "Board") issued June 9, 2003 in this proceeding ("Decision No. 2"),¹ Kansas City Southern ("KCS" or "Applicant"), The Kansas City Southern Railway Company ("KCSR"), Gateway Eastern Railway Company ("Gateway Eastern"), and The Texas Mexican Railway Company ("Tex Mex" or "TM") hereby submit this Response to comments, protests, and request for conditions, and Rebuttal in support of the Application.

Before addressing the merits of the KCS/TM application, which KCS/TM believes should be approved without conditions, and given recent events regarding KCS's related

¹ *Kansas City Southern-Control-The Kansas City Southern Railway Company, Gateway Eastern Railway Company, and The Texas Mexican Railway Company*, STB Finance Docket No. 34342, Decision No. 2 (served June 9, 2003), published at 68 Fed. Reg. 35474 (June 13, 2003).

proposal to acquire control of TFM, S.A. de C.V. ("TFM"), KCS wishes to update the Board about the current status of both the KCS/TM transaction and the KCS/TFM transaction.

As the Board and the public are fully aware, on April 21, 2003, KCS and Grupo TMM S.A. ("TMM") reached a series of agreements that would result in KCS obtaining control of TFM and KCS changing its name to NAFTA Rail (the "KCS/TFM transaction"). The KCS/TFM transaction was subject to the approval of the Mexican Competition Commission ("MCC"), the Mexican Foreign Investment Commission ("FIC"), the U.S. Department of Justice ("DOJ"), and various other conditions. The MCC has approved the transaction. The DOJ thoroughly reviewed the competitive effects of the transaction, including effects here in the U.S. and allegations of anticompetitive vertical foreclosure, and determined not to further investigate the transaction or challenge its ability to be consummated. Kansas City Southern Press Releases, *Kansas City Southern and Grupo TMM Announce Expiration of Department of Justice Hart-Scott-Rodino Waiting Period Allowing NAFTA Rail Transaction to Proceed Without Further U.S. Antitrust Review* (Aug. 1, 2003), available at <http://www.kcsi.com>.

Surprisingly, however, on Monday, August 18, TMM, announced that its shareholders had voted unanimously against the sale of TMM's interests in TFM, represented by shares of Grupo Transportación Ferroviaria Mexicana, S.A. de C.V., to KCS. The vote did not include any aspect of the KCS/Tex Mex transaction. See Rebuttal Verified Statement of KCS's Chairman, CEO, and President, Michael R. Haverty attached hereto ("R.V.S. Haverty") at 4. See also Kansas City Southern Press Releases, *Kansas City Southern Issues Statement in Reaction to TMM Announcement* (August 18, 2003), available at <http://www.kcsi.com>.

In a letter from its counsel to TMM's counsel, KCS communicated its concerns over this sudden change and explicitly stated that it is committed to consummating the KCS/TFM

transaction and that KCS will continue to pursue all commercial and legal alternatives in order to complete the acquisition. *Letter from John F. Marvin to Kenneth A. Ostrow*, filed as Ex. 99.1 to Current Report (8-K) of Kansas City Southern (filed Aug. 21, 2003), *available at* <http://www.sec.gov>. As Mr. Haverty clearly explains, KCS believes the KCS/TFM agreements are legally still valid and binding, and KCS plans to obtain enforcement of those agreements and eventually consummate the KCS/TFM transaction.²

While the August 18 action had no immediate impact on the KCS/Tex Mex transaction, on August 27, Mr. Serrano, in his capacity as Chairman of TFM, informed KCS that TFM was exercising its option under the Mexrail Stock Purchase Agreement to reacquire the Mexrail shares. As the Board is aware, KCS purchased 51% of those shares from TFM and placed those shares into an independent voting trust pending authority to commonly control KCSR, Gateway Eastern, and Tex Mex. It is that transaction which is subject to the Board's prior approval and authorization. KCS had hoped that, given the fact that on August 18, when TMM shareholders did not approve the KCS/TFM transaction, TFM did not request the Mexrail shares back, that the KCS/Tex Mex transaction would not be adversely impacted by the events involving the KCS/TFM transaction. That appears now not to be the case

KCS is reviewing its options and, if it is legally required to do so, KCS will sell those shares back to TFM, returning TFM to the position of being 100% owner of Mexrail. KCS believes that contracts should be abided by and KCS will comply with the TFM notice in

² On August 27, KCS acknowledged receiving notice from the Mexican Foreign Investment Commission that it had deferred decision on KCS's proposal to acquire control of Grupo TFM until after such time as the dispute between KCS and TMM over the continued effectiveness of the KCS/TFM transaction agreement is resolved. *See* Kansas City Southern Press Releases, *Kansas City Southern Receives Notice of Mexican Foreign Investment Commission Decision on KCS Control of TFM* (August 27, 2003), available on <http://www.kcsi.com>.

accordance with the terms of the Mexrail Stock Purchase Agreement. Nonetheless, control of both TFM and Mexrail remains a strong possibility and KCS is currently taking all available legal avenues to ensure that such is the case. As noted and reemphasized in Mr. Haverty's rebuttal statement, KCS believes that the KCS/TFM agreement is still valid and that it is likely that KCS will eventually be successful in acquiring control of TFM, which would also mean control of Mexrail and Tex Mex.

Although the KCS/TFM transaction is technically not in front of the Board and never can be (as KCS's acquisition of control of TFM is not subject to the prior authorization and approval of the Board), numerous parties have addressed issues related to TFM in this proceeding. Because some of those issues are similar to issues raised in the context of the KCS/TM transaction, KCS and Tex Mex will address, in this filing, all issues surrounding the competitive effects of both the KCS/TM and KCS/TFM transactions. Doing so will give the Board a better understanding of why the MCC and DOJ both determined that KCS's plans to acquire control of TFM and Tex Mex do not raise any competitive issues. Indeed, as of this filing, the record with respect to all issues surrounding KCS's plans to acquire control of both Tex Mex and TFM will be substantially complete. In these circumstances and consistent with past precedent,³ KCS believes this proceeding should continue, consistent with the timeframes set forth in Decision No. 2. KCS is not withdrawing its application to obtain authority to control Tex Mex.

SUMMARY OF ARGUMENT

³ See *Illinois Central Corp. & Illinois Central R.R. Co.-Control-Midsouth Corp., Midsouth Rail Corp., MidLouisiana Rail Corp., and SouthRail Corp.*, Finance Docket No. 31801, slip op. at 3 (I.C.C. served Feb. 20, 1991) (stating that approval of control under Section 11343 transactions is permissive, not mandatory, and rejecting the contention that authorization is based on submission of an executed agreement). The Commission specifically stated that "[w]e have jurisdiction to grant approval of a proposed transaction, even if external factors might ultimately prevent consummation of the approved transaction." *Id.* at *3.

The issue before the Board in this proceeding is whether KCS's acquisition of control of Tex Mex -- not TFM -- is likely to result in a substantial reduction in competition in surface freight transportation in the U.S., the creation of a monopoly, or a restraint of trade. The answer to that question clearly is no. This conclusion is the same whether or not the effects within the U.S. of the TFM transaction are considered in conjunction with the KCS/Tex Mex transaction.

Indeed, the benefits of KCS's acquisition of control of Tex Mex and the related acquisition of control of TFM have been clearly recognized by the shipping public, as to date over ninety parties have expressed support for the two transactions. Supporters include two of the largest automotive manufacturers in the U.S., Daimler/Chrysler and Mazda; numerous grain interests, including the U.S. Department of Agriculture ("USDA"); large intermodal users such as J. B. Hunt Transport; two of the world's largest chemical companies, Dow Chemical and DuPont; and numerous shortline railroads, receivers, importers, ports, customs brokers, and other transportation providers. Perhaps of most importance, the nation's largest shipper trade association, the National Industrial Transportation League ("NITL"), which represents over 700 shippers and other transportation interests, supports the two transactions. Meanwhile, other parties who commonly oppose merger transactions, such as the American Chemistry Council, Society of the Plastics Industry, the National Grain and Feed Association, the Western Coal Traffic League, utility companies, the Railroad Commission of Texas, and most importantly, DOJ, expressed no opposition to the KCS/Tex Mex and KCS/TFM transactions.

With respect to the KCS/Tex Mex transaction, no party has challenged the pro-competitive benefits of bringing Tex Mex fully within the KCS corporate family. Evidence presented in the Application with respect to the new single-line efficiencies to be gained, the reduced costs, and the improved financial stability of Tex Mex has gone unchallenged.

Likewise, despite the pre-August 4, 2003 posturing of certain parties, no party has challenged the adequacy of the environmental report or the conclusion that the transaction is categorically exempt under those rules. Indeed, not one party in this entire transaction has requested that KCS's acquisition of control of Tex Mex be rejected or disapproved.

Two concerns have been expressed regarding the KCS/Tex Mex transaction. The first involves whether or not KCS, once it acquires control of Mexrail and Tex Mex and thus control of the U.S.-end of the Laredo Bridge, will continue to operate the Laredo Bridge in a neutral and efficient manner. The second involves whether or not Tex Mex will have incentives to interchange with The Burlington Northern and Santa Fe Railway Company ("BNSF") at Robstown. Neither of these concerns rises to the level of an anticompetitive effect that is both "likely" and "substantial" so as to warrant imposition of a condition. Furthermore, even if the concerns warrant a condition, which they do not, the remedies suggested by the Union Pacific Railroad Company ("UP") and BNSF are not narrowly tailored. Instead, existing contracts, private agreements, and market forces are more than adequate to address the concerns raised by UP and BNSF with respect to the Tex Mex transaction.

Almost universally, the comments submitted on August 4 were submitted not by shippers, but by other railroads. Indeed only one shipper (Pacer International) submitted actual comments and evidence in opposition. Of the comments submitted by all of these parties, with the exception of a small portion of BNSF's and UP's comments addressed to the Tex Mex transaction, the comments and argument focused not on the transaction that the Board has jurisdiction to approve, but on the alleged effects that "might" or "could" occur if and when KCS were to acquire control of TFM.

Although the TFM issues have been brought into this case and the parties have thoroughly briefed those issues, no party has shown that this Board has the legal authority to condition its approval of KCS's acquisition of control of Tex Mex on alleged anticompetitive effects which do not arise from the transaction subject to the Board's jurisdiction, but rather from KCS's potential acquisition of control of TFM. If a cross-border railroad merger or transaction is subject to the Board's review because both the domestic and foreign railroads operate property in the United States, the Board has full authority to condition that transaction. Such is not the case here. TFM does not operate property in the U.S. and has never been subject to the Board's authority. To impose conditions on the KCS/TM transaction that would have the effect of regulating the rates and practices of TFM, such as requiring TFM to enter into rate making agreements between other U.S. carriers and itself or requiring TFM to maintain certain rates at the Laredo gateway, would be an unprecedented action contrary to long standing Interstate Commerce Commission ("ICC") and U.S. Supreme Court precedent.

Even assuming that the Board has authority to condition the KCS/Tex Mex transaction based upon anticompetitive effects allegedly arising from the KCS/TFM transaction, no party has demonstrated that any such anticompetitive effects are either likely or substantial so as to warrant imposition of conditions by the Board. Indeed, as noted, all of the agencies with authority to review the KCS/TFM transaction and to require appropriate remedies to alleviate any anticompetitive concerns have approved the transaction without conditions. These agencies understood that, as with the KCS/Tex Mex transaction, the KCS/TFM transaction will not result in one shipper seeing its competitive options reduced from 3-to-2 or 2-to-1. Likewise, the MCC and DOJ also understood that concerns expressed about alleged vertical foreclosure of other carriers' routings into and out of Mexico were speculative, unproven, and unlikely to occur.

Having failed in those forums to stymie the transaction or achieve conditions, UP and others now request the Board, in effect, to overrule the MCC and DOJ and find that the KCS/TFM transaction will result in inefficient vertical foreclosure, raise prices to shippers, and thereby necessitate conditions. Notwithstanding the legal issues involved, such a finding is unwarranted and would be unprecedented. As the Board has found in every merger case since 1982, an end-to-end merger between an upstream competitor and a downstream “bottleneck” carrier is highly unlikely to result in the foreclosure of efficient interline routes or increased prices to shippers. There is nothing unique about the KCS/TFM transaction that would change that well-established conclusion and precedent. Likewise, if KCS, upon acquiring control of TFM, were to attempt to raise prices to shippers or to inefficiently foreclose other carriers, that action would result in a substantial loss of traffic and revenue to the entire NAFTA Rail system. Plainly, such actions would cause UP and BNSF to switch to alternative gateways, or would cause rail traffic to be diverted to other modes. Just as now, where KCS is a minority owner of TFM but has made huge investments to expand TFM’s traffic base, it will continue to be in KCS’s interest to grow traffic on the TFM, not reduce it. Likewise, even if KCS could divert UP/TFM or BNSF/Tex Mex/TFM interchange traffic over a KCS/Tex Mex routing, such diversions would be highly constrained due to the lack of capacity on UP’s line used by Tex Mex to connect with KCSR.

Finally, even if the Board agreed that the KCS/TFM transaction was likely to result in substantial anticompetitive effects, and further found that the Board has the authority to condition the KCS/Tex Mex transaction because of such KCS/TFM effects, the conditions suggested by UP and others are not narrowly tailored. KCS has discussed and remains willing to discuss private agreements with parties to resolve any concerns such parties may have with

respect to the KCS/TFM transaction. Indeed, KCS did precisely that with respect to its agreement with NITL. Such a willingness to negotiate, however, is not a result of a recognition that the KCS/TFM transaction has anticompetitive effects that need resolution or conditions, nor a concession that this Board has jurisdiction to review the KCS/TFM transaction as UP and BNSF contend, but is instead a means of establishing future commercial relationships that would benefit both KCS and other parties. Forcing KCS, under an STB mandate, to negotiate agreements regarding the KCS/TFM transaction when no anticompetitive effects were found by the MCC or DOJ and none have been shown here, not only would be legally invalid, but would require KCS to provide newfound commercial access to its properties without obtaining commercial access from the other carriers in exchange. This would represent bad policy, would prevent KCS from earning an adequate return on its investment, and would limit KCS's ability to cover its cost of capital.

In the end, the KCS/Tex Mex transaction will not result in a substantial lessening of competition, creation of a monopoly, or a restraint of trade in freight surface transportation in any region of the U.S. It should be approved without conditions. This conclusion is not altered in any way if one also considers the effects of the KCS/TFM transaction. Creation of the NAFTA Rail system will result in a stronger and healthier competitor in the marketplace, providing shippers with a strong and efficient alternative to the dominance of the mega-systems. KCS requests the STB to support those efforts and to approve the KCS/Tex Mex transaction.

I. THE KCS/TEX MEX TRANSACTION WILL NOT RESULT IN A SUBSTANTIAL LESSENING OF COMPETITION, CREATION OF A MONOPOLY, OR RESTRAINT OF TRADE IN FREIGHT SURFACE TRANSPORTATION IN ANY REGION OF THE UNITED STATES.

The transaction contemplated by this Application accepted for consideration in Decision No. 2 involves the common control of one Class I carrier, one Class II carrier, and one Class III

carrier, all of which already closely cooperate and today share some common ownership. Thus, this transaction is governed by the standards of 49 U.S.C. § 11324(d), which provides as follows:

(d) In a proceeding under this section which does not involve the merger or control of at least two Class I railroads, as defined by the Board, the Board shall approve such an application unless it finds that--

- (1) as a result of the transaction, there is likely to be substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States; and
- (2) the anticompetitive effects of the transaction outweigh the public interest in meeting significant transportation needs.

In determining whether to grant this application and whether to impose conditions, the Board must determine whether substantial competitive harms are likely to result from the transaction. If it concludes that such harm will not occur, the Board need not even consider whether the transaction benefits the public interest.⁴ Even if it concluded that such harms would occur, however, the Board would nevertheless be required to grant the application unless it found that the projected harm outweighed the benefit to the public interest of granting the application and could not be sufficiently ameliorated by conditions. *E.g., Illinois Central Corporation And Illinois Central Railroad Company-Control-CCP Holdings, Inc., Chicago, Central & Pacific Railroad Company And Cedar River Railroad Company*, 1996 STB LEXIS 157 at *7 (served May 14, 1996).

Parties opposing the application or seeking conditions bear the burden of proving competitive harm. “The burden of proof is on opposing parties to show an adverse competitive impact resulting from the transaction. See *Rio Grande Industries, Inc.-Purchase and Trackage*

⁴ The public interest standards of Section 11324(c) do not apply to minor transactions. *Illinois v. Interstate Commerce Commission*, 687 F.2d 1047, 1053 (7th Cir. 1982).

Rights- Chicago, Missouri & Western Ry. Co., 5 I.C.C.2d 952, 969 (1989).”⁵ Any such showing must be made by substantial evidence. Decision No. 2, slip op. at 15. “A showing of expected substantial harm to a particular competitor as a result of a transaction is not equivalent to a showing of harm to competition.” *Wisconsin Central Transportation Corporation-Continuance In Control-Fox Valley & Western Ltd.*, 1992 ICC LEXIS 279 (Dec. 4, 1992).

To meet the standard of Section 11324(d)(1), harms shown must truly be substantial. The ICC said in *Wisconsin Central Transportation Corporation-Continuance In Control-Fox Valley & Western Ltd.*, 9 I.C.C. 2d 729, 732-3 (1993) that to warrant conditions, harms shown must be more substantial than just “some harm,” and cannot be small or merely transitory.

As previously noted, the KCS/TM transaction has support from every sector of industry. Not one party has requested that the transaction be denied. Very few parties, principally UP, BNSF and Pacer, have raised any concerns or issues with respect to KCS’s acquisition of control of Tex Mex. Their concerns involve KCS’s control of the Laredo Bridge and KCS’s willingness to continue an interchange between BNSF and Tex Mex at Robstown.

No party has established that the alleged anticompetitive effects are both likely and substantial so as to warrant denial of the transaction or conditions to alleviate such alleged effects. Even if the Board agreed with the concerns with respect to the KCS/TM transaction, which it should not, the conditions suggested by UP, BNSF, CN and Pacer are not narrowly tailored and should not be imposed.

A. KCS’s Control Of Tex Mex Will Not Result In Any Shipper’s Independent Routing Options Being Reduced.

⁵ *Kansas City Southern Industries, Inc.-Control-Midsouth Corporation*, Finance Docket No. 32167, 1994 ICC LEXIS 75 at *5-*6 (served May 4, 1994).

This transaction involves an end-to-end connection whereby two carriers, who already share some common ownership and operating practices, will finally be controlled by a single company with a unified management team. Although KCS has no plans to merge the companies, it will exercise common control over KCSR, GWER, and Tex Mex and thus offer shippers more efficient and competitive single line service. The transaction will not have any anticompetitive effects. There will be no shippers or receivers who will see their competitive options reduced from three-to-two or two-to-one, and there will not be any loss in source competition. Rather, this transaction will be pro-competitive in nature. The benefits of this transaction are expected to be closer coordination of operations between the participating carriers, improved efficiency, greater financial stability and increased access by the smaller railroad to cars, marketing and other resources available only to larger railroads.

1. There Are No “2 to 1” or “3 to 2” Effects

KCS requested Professor Curtis Grimm to perform a competitive analysis of the transaction in order to determine whether or not any shipper would actually experience a reduction in rail-to-rail competition. Professor Grimm analyzed the competitive impacts of the transaction using DOJ’s and FTC’s horizontal merger guidelines for defining relevant markets. Professor Grimm defined rail-to-rail competition between any origin and destination pair as the relevant product market and did not consider the extent to which intermodal competition also played a role. By defining the relevant market as rail-to-rail competition between any two BEA’s and excluding the effects of intermodal competition, Dr. Grimm’s analysis, would if anything, overstate any anticompetitive effect of the proposed transaction.⁶

⁶ There are numerous shippers or receivers located at stations or points within a BEA that do not receive service from all of the rail carriers serving that BEA. For example, while there may be

An important issue that Dr. Grimm had to consider in defining rail markets is that the complexity of many long-haul movements requires coordination by more than one carrier. For example, it is common for connecting carriers to submit a single competitive bid for the entire length of a long-haul movement. Therefore, competition is greatly enhanced when alternative, fully-independent routings are available. On the other hand, if one carrier participates in all possible routings, competition can be greatly hampered. The importance of independent routing alternatives has been recognized by the ICC/STB in *Consolidated Papers, Inc. v. Chicago and North Western Transp. Co.*, 7 I.C.C. 2d 330, 338 (1991), where the ICC noted that:

Competition between railroads generally requires the presence of two or more independent routes, that is, routes having no carriers in common. When a single carrier is a necessary participant in all available routes, *i.e.*, a bottleneck carrier, it can usually control the overall rate sufficiently to preclude effective competition.

Accordingly, to deal with this issue, Dr. Grimm focused his analysis primarily on instances where the proposed common control will reduce the number of independent railroad routings between a particular origin and destination pair, which tests for the creation of a bottleneck carrier in any given market. Using this methodology, Dr. Grimm examined all markets (origin-destination BEA pairs) where KCSR and Tex Mex participate using the 2001 waybill sample and the KCSR traffic tapes. There were over 100 such BEA pairs. There were no BEA to BEA pairs where shippers shipping in those corridors would experience a reduction in the number of independent railroad routing options. The conclusion that no shipper would experience a reduction in their competitive rail routing options from three-to-two or two-to-one

three rail carriers originating or terminating traffic within a single BEA, many individual shippers or receivers within that BEA will not receive service from all three carriers. Many only have access to a single carrier. Accordingly, it has been argued that a BEA may constitute, in some instances, an overly broad geographic market when determining competitive impacts, and thus overstate the anticompetitive impacts of a transaction.

went unchallenged by any party in this proceeding. Indeed, UP's Dr. Hausman affirmed it. V.S. Hausman, UP-7B, at 20-21. Therefore, the common control of KCSR and Tex Mex is purely end-to-end and has no anticompetitive horizontal effects. *See* Rebuttal Verified Statement of Dr. Curtis Grimm ("R.V.S. Grimm").

2. There Is No Reduction In Source Competition

While it is clear that there are no horizontal impacts as a result of the transaction, Dr. Grimm also was concerned that there may be some shippers or receivers who might see a reduction of source or geographic competition. Dr. Grimm considered source competition as being an effective constraint on rail pricing when a shipper or a receiver at a particular location has the ability to receive a given commodity from either KCSR or Tex Mex and from different geographic originations. For such a potential to exist, however, there would have to be a point or location that KCSR and Tex Mex both serve, albeit to or from different geographic regions. The only common point served by both KCSR and Tex Mex is Beaumont, TX. This represents the only location where a shipper or receiver located at a given point might see a reduction in source or geographic competition. Upon examination, Dr. Grimm concluded that no such reduction in source or geographic competition would occur, because at Beaumont there are no shippers or receivers that have the independent option of choosing either Tex Mex or KCSR for movements to different sources or geographic locations. KCSR originates or terminates all local traffic at Beaumont and thus Tex Mex does not compete in the same corridors as KCSR.

Dr. Grimm's analysis of no reduction in source competition went unchallenged. CN, in its July 14, 2003 Petition To Reopen Decision No. 2, claimed that Dr. Grimm did not apply the correct source competition test. CN's Petition To Reopen did suggest another possible approach to analyzing source competition. KCS, in its Reply To The Petition To Reopen, suggested that

even if one applied the approach suggested by CN, the result would be the same: no reduction in source competition. KCS challenged CN to present their own analysis of source competition to rebut Dr. Grimm's analysis in CN's August 4th comments. For whatever reason, and despite bearing the burden to prove competitive harm, CN did not, in its August 4th comments, present a rebuttal to Dr. Grimm's source competition analysis or make a case that source competition would be reduced. Thus, the only study and conclusion in the record is Dr. Grimm's analysis. As such, no party has shown that source competition would be reduced while KCS has shown that it would not.

B. KCS's Control Of The International Bridge at Laredo Will Not Result In A Lessening of Competition, Creation Of A Monopoly, Or The Restraint Of Trade.

KCS, Tex Mex, TFM and their many customers have an unquestionable interest in preserving efficient and fair operations at the Laredo Bridge. That interest will continue following the Board's approval of the pending Application. Moreover, NAFTA Rail will have an equal incentive to ensure the efficient and fair movement of UP's trains over the Laredo Bridge. That incentive is, and will continue to be, driven by the efficient movement of cars over the bridge in order to enhance revenues and reduce costs. Indeed, any steps to disadvantage or disrupt the efficient flows of UP/TFM traffic would be counterproductive.

First, any disruption of UP's service would also disrupt the efficiency of TFM's service. Second, UP has benefited from the \$1 billion that KCS has invested in TFM and its infrastructure. Without that investment, the UP/TFM operations would not be as efficient as they are today. Third, and most importantly, UP's feigned concerns rest on the implausible suggestion that KCS, after common control is granted, would deliberately take steps that result in

inefficient operations over the bridge – which would harm all parties involved. *See* V.S. Barkley at 10; V.S. Gray at 24.

UP's comment ignores the fact that Tex Mex has only one way out of the Rio Grande Valley⁷ -- UP's line from Robstown to Beaumont. V.S. Barkley at Exhibit D Public. That line is already being operated at "over capacity."⁸ As such, there would be no place to put the traffic that UP claims would be diverted from it by KCS. Thus, even if KCS were so short sighted as to disrupt the current, efficient operations over the Laredo Bridge, KCS could not handle the increased traffic due to the lack of capacity over the UP's lines between Robstown and Victoria, Texas.

UP is well aware of the implausible nature of its opposition, yet it attempts to manipulate the Board's processes in order to ensure its already dominant position. KCS and Tex Mex submit that UP's suggestions are not for competitive concerns, but for institutionalizing its ability to bully the smaller railroads that own the Bridge, which are driven to conduct their own daily operations in an efficient manner, into a Board-regulated working relationship with UP.

The Board should view this matter in terms of cold reality and disregard the unsupportable conjecture that permeates UP's contrived concerns regarding the Laredo Bridge. As discussed below, the record is devoid of probative evidence that NAFTA Rail would have

⁷ UP's Delay Study covered the period from November 13, 2002 to November 16, 2002. As the UP Study demonstrates, each train that was operated experienced, on average, a delay of 255 minutes or 4.25 hours per train.

⁸ *See* Union Pacific Railroad Spring Dispatching Center Train Meet and Delay Study, KCS-P-0016, wherein UP states that the "Normal Operating Capacity" of the Bloomington to Kingsville segment of UP's Brownsville Division is "11 to 13 Trains Per 24 Hr Period." Moreover, the UP's own evidence reveals that the 75 trains that moved over the line by UP, BNSF and Tex Mex (during a four-day study of that line's traffic) incurred a total of 19,140 minutes or 319 hours of delay.

any incentive or ability to unravel the “extensive efforts to improve ... operating practices, so that movements across the Bridge are as fluid as possible.” Barkley V.S. at 5.

1. Because The Privately Negotiated Agreement Which Governs Operations Over The Laredo Bridge Has Worked, There Is No Demonstrated Need For The Board To Take Any Action

KCS and Tex Mex submit that the agreement governing operation of the Laredo Bridge has operated, and will continue to operate, in an efficient and competitive manner. This position has been supported by UP’s own evidence in statements from Messrs. Barkley and Gray, executive officers of UP. Mr. Barkley has noted several times that the Laredo Bridge is already operating in an efficient and cooperative manner:

- “In recent years, the three railroads that use the Laredo Bridge have made great strides in improving the efficiency of movements over the Bridge. . . [They] have made extensive infrastructure improvements to increase their ability to stage trains crossing the border in an efficient manner and to minimize interference between northbound and southbound trains in the Laredo area.” Barkley V.S. at 5.
- “[T]he railroads have worked hard to coordinate the timing of movements over the Bridge. The three railroads now exchange extensive information on their operating arrangements, so that each railroad can position its trains according to a predictable timeline.” *Id.* at 6.
- “[T]he railroads have pre-blocked cars for each other [which] helps keep train operations more fluid on both sides of the border, which makes the Bridge crossing process more efficient.” *Id.* at 6-7.
- The many operational improvements that have been made over the years and “that are now in place have essentially *tripled the capacity of the Bridge since 1994.*” *Id.* at 7 (emphasis added).

Importantly, Mr. Barkley’s noted improvements were independently agreed to -- they were not mandated by either the Board or its predecessor. Instead, they represent an acknowledged “strong spirit of cooperation among the parties.” V.S. Barkley at 8.

Mr. Barkley's observations are echoed by Mr. Gray, who is forced to concede that since privatization, TFM, though partially owned by KCS, "has cooperated extensively" with UP to develop efficient cross-border rail transportation offerings." V.S. Gray at 19. As Mr. Gray has admitted:

- TFM has provided UP with reasonable rates and rate factors to enable effective competition between UP-TFM routes and those involving KCS-Tex Mex and BNSF-Tex Mex. *Id.*
- TFM has worked with UP on a wide array of operational issues, including pre-blocking of rail cars, directional handling of empties,⁹ and cooperation at Laredo Bridge. *Id.*
- TFM has coordinated with UP on border crossing issues, such as data exchange for blocking and customs purposes and has helped UP support customer requirements through the supply of railcars and related services. *Id.*

Thus, based on UP's own evidence, it cannot claim in good faith that "[s]hifting control over TFM from its Mexico parent (Grupo TMM) to a U.S. carrier will extinguish TFM's cooperation with UP." V.S. Gray at 21. Indeed, UP is reduced to whining that "TFM personnel have become more distant and more formal in their relations with us" -- V.S. Barkley at 11 -- and that TFM's Border Superintendent, who has admittedly "administered Laredo Bridge operations in an even-handed manner"¹⁰ for years, "has been less accessible than previously." *Id.* at 11. This

⁹ It should be noted that the routing of empty cars through Brownsville/Matamoros, which Mr. Gray touts (Appendix A at 53) as helping "to keep the key gateway of Laredo less congested" simultaneously interferes with Tex Mex's ability to make full use of its trackage rights over UP's Brownsville Subdivision. Nevertheless, KCS has not seen fit to try to take any steps to influence TFM's decision to streamline operations over the Laredo Bridge.

¹⁰ *Id.* at 9. As Mr. Barkley has also admitted, the Border Superintendent "has generally made crossing decisions in a manner that has permitted UP to move cars across the Bridge in proportion to its overall percentage of Laredo traffic" and "has cleared UP trains to cross first more than half of the time, reflecting UP's higher percentage of the southbound traffic." Because the same has been true of TFM blocks intended for UP, "for loaded cars, the allocation

claim is wholly lacking in merit.¹¹ In any event, such imagined slights do not warrant any interference with the private agreement that has resulted in mutually beneficial, fluid movement of cars across the Bridge. Until UP produces verifiable evidence of actual anticompetitive activities, there is no reason to “fix what isn’t broken.”

2. UP’s “Concerns” Regarding Future Operations
Are Nothing More Than Baseless Conjecture

UP claims that when KCS controls both Tex Mex and TFM, it will realize “new incentives and opportunities” to manipulate operations at the Laredo Bridge -- UP Comments at 55 -- and use its control to discontinue cooperation with UP, which would degrade the service available to customers from UP-TFM routes and increase shipper costs. UP Comments at 48. There is no credible evidence to support UP’s assertions.

UP’s comments ignore the extreme, adverse impact that such actions would have on both TFM and Tex Mex operations over the Laredo Bridge, as well as Tex Mex’s operations over the trackage rights granted by the ICC in the *UP/SP*¹² merger to preserve competition at Laredo. As Mr. Riney has explained in his Rebuttal Verified Statement, UP’s professed concern that

of slots for Bridge crossings has approximately reflected the market demand for the UP and Tex Mex services.” *Id.*

¹¹ Although UP failed to mention it, the Border Superintendent, Erasmio “Mito” Santos, has his office in UP’s terminal, V.S. Santos at 1, which is located within sight of the Laredo Bridge. As a result, it is impossible for him to have been “less accessible than previously.” V.S. Santos at 4. As has been the case since 1994, Mr. Santos is there roughly twelve out of fourteen days and is on call twenty-four hours a day. In carrying out his functions, he is in constant contact with all three of the railroads that use the Bridge. This includes daily conference calls that occur at 9:00 a.m. and 6:30 p.m. at which the past operations are discussed and future operations are planned. V.S. Santos at 3-4.

¹² *Union Pac.-Control and Merger-Southern Pac. Rail Corp.*, 1 S.T.B. 233 (1996) (“*UP/SP*”).

NAFTA Rail would take steps to disadvantage UP and cause its service to deteriorate is “unfounded and ludicrous.” R.V.S. Riney at 2.

First, UP has the greatest number of cars moving over the Bridge on a daily basis. Due to the physical layout of the staging tracks, UP also has a built-in advantage that is not going to change -- multiple, close-range staging tracks.¹³ Because of this advantage, UP can accept multiple northbound trains and, at the close of a northbound window, have a southbound train ready for immediate delivery to TFM.

Second, Tex Mex’s tracks cut through the heart of downtown Laredo. This prevents Tex Mex from staging trains at or near the Bridge because it would halt all vehicular traffic in the heart of the city. This behavior would impact local governmental and judicial systems, as well as the local college. It is rational to believe that such a tactic would be politically sensitive and would quickly turn the local citizens and government against Tex Mex. R.V.S. Riney at 7.

Third, Tex Mex lacks the personnel to stage trains at three different locations: at the Bridge; at Arkansas Street (which is 45 minutes from the Bridge); and at milepost 9 (which would still leave the back end of the train in Tex Mex’s Serrano Yard). As a result, Tex Mex is unlikely to use more than two openings during any six-hour window. Because UP’s multiple tracks are more favorably located, it does not suffer the same operational constraints. Once again, this is not going to change in the future.

¹³ Unlike Tex Mex, which must operate over a single track that feeds into the Bridge and then passes through the heart of Laredo, UP has three staging tracks within a few hundred feet of the Laredo Bridge. This means that if Tex Mex takes a northbound train from TFM at the Bridge, it must deliver that train to a point that is about 45 minutes away before it can stage a southbound train or return to the Bridge to retrieve another northbound train. R.V.S. Riney at 7. *See also* V.S. Santos at 4.

Plainly, these physical differences not only require the Bridge operations of all three railroads to be closely coordinated, they ultimately favor UP. As a result, there is no possibility or even likelihood that KCS could dictate a change in operations that would favor Tex Mex without disrupting TFM's operations following creation of the NAFTA System.

3. The Proposed Remedies Are Unnecessary

As noted above, UP's request that the Board establish new Bridge protocols has no basis in fact. Because UP will continue to be the source of an overwhelming majority of the southbound traffic for TFM, and the recipient of the same overwhelming majority of the northbound traffic generated by TFM, as well as because of the disparate nature of the physical facilities of UP and Tex Mex, there is no proven (or plausible) economic incentive for TFM and NAFTA Rail to reduce the level of communication and coordination that has evolved over the past few years. In fact, the continued growth of rail traffic over the Bridge demands coordination between all parties.

UP's request for a Board-approved dispatching protocol scheme or a joint operations center would be unnecessary (and intrusive) given the facts in this case. Under the existing bridge operating agreement, recent improvements have essentially tripled the capacity of the Bridge since 1994. V.S. Barkley at 7. Also, many of the past problems with congestion, caused by TFM and its predecessors on the Mexican side of the border, have disappeared because TFM has expanded its capacity to handle more and longer trains at its Sanchez Yard. R.V.S. Riney at 8. Finally, establishing a joint operations center would be a waste of resources because the Border Superintendent's office is currently located in UP's building, ensuring that UP has hourly contact with the Border Superintendent. For these reasons, UP's requested protection through Board-mandated remedies is unnecessary. Indeed, if any party needs protection with regard to

the traffic moving over the bridge, the Board should be concerned with Tex Mex's position as a minority carrier and the competitive concerns relating to this market disparity.

For example, if UP were to gain control of a joint operations center, KCS and Tex Mex submit that UP could be expected to exert pressure to ensure that the movement of traffic enhances UP's already dominant position. Because the most effective method of deterring a dominant carrier's anticompetitive tendencies is to put it in a position where it must cooperate with the much smaller railroads, the Board should not require any modification of the existing arrangement in the absence of convincing evidence that UP is being harmed.

Contrary to UP's request for Board-mandated behavior, KCS submits that the Bridge is currently managed in a non-discriminatory manner that is achieving the maximum efficiency in operations. V.S. Barkley at 16. Moreover, Applicants have no future intention of managing the Bridge in a way that would lessen efficiencies or discriminate against any railroad that is authorized to use the Bridge, which includes UP. *See* July 31, 2003 STB Hearing Transcript, Testimony of Gerald K. Davies at p. 167, Line 14 through p. 168, Line 3, and p. 173, Line 10 through p. 175, Line 6.

Based on its requests, UP is asking the Board to freeze the existing allocation of slots to prevent Tex Mex from increasing its use of the Bridge. This anticompetitive request should be denied for several reasons.

First, there is no "one-for-one protocol" governing operations. As explained by Mr. Santos, the current imbalance of traffic allows the carrier with staged trains to cross without waiting for the other carrier to send a matching number of trains over the Bridge. Thus, if UP has three trains staged and ready to cross, it will move all three unless Tex Mex is ready to move a train. Second, Tex Mex's physical constraints (regarding street crossings and the distant

location of its staging areas -- R.V.S. Riney at 5-8) will contain the balance of each railroad's share of traffic at the Laredo crossing. Last, the Bridge has more capacity than is currently used. Currently, there are several "dead" hours each day that are capable of being filled. R.V.S. Riney at 4.¹⁴ Thus, there is no reason to freeze the current slot allocations other than to guarantee a competitive advantage for UP.

Applicants would also note that UP has offered hypothetical situations that merit discussion, namely: UP's petition for a right to run 100% of its trains over the Bridge; and UP's claim that Tex Mex has demanded half of the available slots. First, UP's request to run 100% of its trains is based on an example in Mr. Barkley's Verified Statement that clearly shows the discrepancy of traffic between the two carriers. V.S. Barkley at 11. As the example shows, however, if the trains are rotated based on availability, then UP, which has eight trains to run, will have a run of several unanswered trains due to the fact that Tex Mex has only two trains to run. Therefore, after the fourth train, there will be an uninterrupted movement of UP trains. As Mr. Riney has observed, "in such instances, Tex Mex routinely cedes time to UP." R.V.S. Riney at 6. Second, Tex Mex takes issue with the unsubstantiated hearsay that "Tex Mex has argued that its southbound trains, or blocks of cars TFM is sending northbound to Tex Mex, should receive 50 percent of the available slots." V.S. Barkley at 9; UP Comments at 57. That claim is disputed by both Mr. Santos and Mr. Riney. V.S. Santos at 2; R.V.S. Riney at 6.

In conclusion, the Board should reject UP's arguments that the existing protocol is inadequate to a degree that necessitates agency involvement. Until there is tangible,

¹⁴ The number of cuts on the Bridge is reduced by the 5 mile an hour speed limit that is currently in place in order to assist U.S. and Mexico Customs and their Vehicle and Cargo Inspection Systems (a/k/a "gamma ray" systems). Today, the parties are looking to increase the speed to 15 mph. This would allow as many as 32 cuts per day, as compared with the current maximum of 24.

anticompetitive behavior put forth by UP, not mere conjecture, the Board should follow its precedent and refuse to extend its jurisdiction into the private contractual agreements between parties. The precedent of *Mexrail, Inc. v. Union Pacific Railroad Company and Missouri Pacific Railroad Company*, F.D. No. 32980, slip op. at 2-3 (STB served July 13, 2000) (“*Mexrail*”) supports this position. *Mexrail* evidences how, in two prior instances involving disagreements over terms of use of the Bridge, the parties were able to reach negotiated private solutions without the Board or the ICC imposing a solution. In the earlier instance, for example, the ICC promoted the private settlement of the dispute over use issues, explicitly stating that it wanted to “give [UP’s predecessor] and Tex Mex an opportunity to negotiate a **voluntary** joint use arrangement.” *Id.*, citing *International-G. N. R. Co. Trustee Trackage Rights*, 275 I.C.C. 27, 56-58 (1949) (emphasis added). The Board should take the same basic approach now and reject UP’s demands that the Board dictate replacement of the private agreements already in place.

D. KCS’s Control Of Tex Mex Will Not Result In Inefficient Foreclosure Of BNSF/TM Routings.

Most of the concerns expressed by other carriers regarding access to the Laredo gateway and whether or not routings to and from Mexico will be inefficiently foreclosed derive not from KCS’s acquisition of control of Tex Mex, but rather from KCS’s acquisition of control of TFM. BNSF, however, expressed concerns about whether or not KCS would use its control of Tex Mex to prevent an interchange with BNSF at Robstown.

Mere concerns about whether or not existing interchanges will be continued after an end-to-end transaction is consummated do not prove that the end-to-end transaction will result in an anticompetitive action, such as substantially increased prices or substantially reduced service to

shippers, which would warrant imposition of a condition.¹⁵ Nor do mere concerns establish that such actions are both “likely” and “substantial” as required by the statute. And for any party to establish that an end-to-end transaction will result in increased prices to shippers or reduced service, it must overcome over twenty years of ICC and STB precedent. *See Union Pac. Corp., Union Pac. R.R. Co. and Missouri Pac. R.R. Co.-Control-Chicago and North Western Transportation Co. and Chicago and North Western Ry. Co.*, Finance Docket No. 32133, Decision No. 25, slip op. at 70 (I.C.C. served Mar. 7, 1995) (“*UP/CNW*”) (“[C]onsolidations of end-to-end railroads rarely raise competitive concerns.”). They must also provide “substantial evidence that the end-to-end transaction will result in such an anticompetitive effect that a condition is warranted. Decision No. 2 at 15. As is thoroughly addressed latter in this pleading, no party has established that KCS’s acquisition of control of Tex Mex or TFM will result in increased prices to shippers or a reduction in service due to inefficient routing options or anticompetitive vertical foreclosure at the Laredo gateway.

E. KCS Control Of Tex Mex Improves Efficiencies and Reduces Costs.

Placing KCSR and Tex Mex under common control will allow KCSR and Tex Mex to integrate their marketing and financial departments, increase coordination, cut costs, and otherwise implement efficiencies that cannot be obtained when companies remain under separate ownership. These actions should improve the ability of KCSR and Tex Mex to provide a competitive alternative to UP and other modes. As in previously approved end-to-end transactions, the benefits of this transaction should be closer coordination of the marketing functions between the participating carriers, improved efficiency, greater financial stability and

¹⁵ *See Wisconsin Central Transportation Corporation-Continuance in Control-Fox Valley & Western, Ltd.*, 9 I.C.C.2d 729, 732 (1993).

increased access by Tex Mex to cars, locomotives, and other resources available to KCSR that are not currently available to Tex Mex. See *Illinois Central Corp. and Illinois Central R.R. Co.-Control-CCP Holdings, Inc., Chicago, Central & Pac. R.R. Co. and Cedar River R.R. Co.*, 1996 STB LEXIS 59 at *8-*9 (STB served March 1, 1996) (reciting Applicants' assertions that better car supply availability and increased financial soundness of acquired railroads cited as benefits which helped characterize the transaction as minor) 1996 STB LEXIS 162 at *10 (accepting Applicants' assertions); *CSX Corp. and CSX Trans. Inc.-Control-The Indiana R.R. Co.*, Finance Docket No. 32892, 1996 STB LEXIS 254 at *9 (STB served Aug. 2, 1996) (citing potential for improved marketing); and *Burlington Northern Santa Fe Corp.-Control- Washington Central R.R.*, STB Finance Docket No. 32974, 1996 STB LEXIS 201 at *5-6 (STB served July 17, 1996) (citing prospective increased operating efficiency). The Application clearly established that the KCS/TM transaction fits squarely within these precedents and would result in similar benefits. This evidence has gone unchallenged.

F. Any Concerns With Respect To Safety Are Being Addressed.

As the Board is aware, KCS and Tex Mex distributed an extensive safety integration plan ("SIP") on July 1. DOT's July 31 filing with the Board included comments on the SIP. Those comments requested additional information in several areas of the SIP, including specification of expenditures for certain projected operational or capital improvements; further specification about implementation of KCS's Management Control System ("MCS") on Tex Mex; financing of planned Tex Mex track improvements; and operational coordination with TFM. The comments acknowledged that KCS, Tex Mex and the Federal Railroad Administration ("FRA") had worked cooperatively on SIP issues, and that continuing cooperation was anticipated.

KCS and Tex Mex conducted an extended conference call with FRA in mid-August in which the heads of several major KCS operating departments participated. That call answered many of the questions posed by DOT's July 31 comments, as well as ancillary issues.¹⁶ There have been several follow-up consultations since that time. KCS and Tex Mex are hopeful that they will have a final revision of the SIP in FRA's hands within the next week, and expect that they will be able to discuss and settle with FRA any remaining issues well before the decisional deadline in this proceeding.

G. As Set Forth In The Environmental Appendix, The Transaction Is Categorically Exempt Under NEPA.

Prior to the August 4th deadline, UP and CN had questioned whether the Environmental Appendix was fully adequate because it did not contain an analysis of the KCS/TFM transaction. KCS responded that there would be no added environmental impacts from the KCS/TFM transaction because KCS did not anticipate any additional traffic would be added to the KCSR and Tex Mex lines as a result of the KCS/TFM transaction but, that if there were, the environmental impacts would be negligible as such diversions could be handled within existing trains. Accordingly, environmental thresholds contained at 49 C.F.R. § 1105 would not be exceeded so as to take the effects of this transaction - KCS/TM - out of the categorical exemption, even if the effects of the KCS/TFM transaction were considered. In addition, KCS challenged the legal basis for requiring an environmental analysis of a transaction outside the

¹⁶ In particular, the parties made clear that while Tex Mex has not yet filed a Railroad Rehabilitation and Improvement Financing ("RRIF") loan application seeking \$50 million in funds for track rehabilitation and improvement, Tex Mex did file a RRIF loan application with FRA in October 2000 (information from which was produced by KCS in discovery as KCS-C-0066 through KCS-C-0171), and had considerable discussion of that application with FRA since that time, leading to the plan to submit a revised, \$50 million application.

scope of the Board's jurisdiction. Finally, KCS challenged parties to present evidence and comment on the Environmental Appendix that would establish that the KCS projections regarding Tex Mex or TFM diversions were inadequate.

On July 31, the U.S. Department of Transportation ("DOT") filed comments with respect to the Environmental Appendix. DOT's comments took no position on the merits. DOT stated that to the extent that the only traffic changes brought about in the U.S. were the changes set forth in the Application as supplemented, then DOT would agree with KCS's assessment that the transaction was categorically exempt. DOT said that it would later address any further comments based upon any comments on the Environmental Appendix received on July 31. No other comments were filed on July 31, no party has challenged the conclusion that the KCS/TM transaction is categorically exempt and the Board should so find.

H. KCS Does Not Object To The Requests Of Rail Labor.

Two unions filed comments with respect to the KCS/TM transaction, the Transportation Communications International Union ("TCU") and The Brotherhood Of Maintenance Of Way Employees ("BMWE"). Neither TCU nor BMWE oppose the KCS/TM or the KCS/TFM transactions. Both agree with KCS's statement that the appropriate level of labor protection is *New York Dock Ry.-Control-Brooklyn Eastern Dist.*, 360 I.C.C. 60 (1979) ("*New York Dock*").

TCU wants the Board to clarify what *New York Dock* means with respect to work that may be transferred to Mexico. KCS has no objections to the Board adopting TCU's request that in the event work is transferred from the U.S. to Mexico, employees should not be required to relocate to Mexico in order to retain their *New York Dock* protection. Further, employees should not be required, as a condition of preserving their *New York Dock* benefits, to show that they were precluded from moving to Mexico by Mexican law.

**II. EVEN ASSUMING THE BOARD HAS LEGAL AUTHORITY TO
CONDITION THE KCS/TM TRANSACTION ON ALLEGED
EFFECTS ARISING FROM THE KCS/TFM TRANSACTION, IT
SHOULD NOT DO SO BECAUSE THE KCS/TFM TRANSACTION
WILL NOT RESULT IN ANY ADVERSE COMPETITIVE EFFECTS**

**A. The Transactions Will Not Result In Any Shipper's Options
Being Reduced From Three-To-Two Or Two-To-One And
There Will Be No Reduction In Source Competition.**

As with his conclusion with respect to the KCS/TM transaction, Dr. Curtis Grimm explained in his June 23 Supplemental Verified Statement that his conclusion would be the same even if the KCS/TFM transaction were also considered, that is: there would be no adverse competitive effects from either the KCS/TM or the KCS/TFM transaction. No markets will see a reduction in the railroad routing options available in that corridor from “two to one” or from “three to two.” Dr. Grimm’s conclusion that there are no horizontal effects does not depend upon the presence of intermodal competition, and was reached using rail-to-rail competition as the relevant product market.¹⁷ Importantly, Dr. Grimm’s conclusion that both transactions have no horizontal competitive effects has stood completely un rebutted. Indeed, Professor Hausman stated: “Based on a purely horizontal competitive analysis, I agree with Professor Grimm that no problems arise because no 2-to-1 (or other) reductions in the number of competing carriers will occur.” (V.S. Hausman at 20-21.)

**B. The Transactions Will Not Result In
Vertical Foreclosure At The Laredo Gateway.**

Having agreed with Dr. Grimm that there are no horizontal effects, Dr. Hausman admits that this case, and UP’s entire argument, is based upon a vertical foreclosure analysis. This same

¹⁷ Dr. Grimm, in the attached Rebuttal Verified Statement (“R.V.S. Grimm”), reiterates his conclusions, explaining why his analysis is fully consistent with prior ICC and STB precedent and why that initial analysis did not address vertical foreclosure issues.

admission was made by Dr. David Reishus for BNSF. *See* BNSF-4, V.S. Reishus at 2-3 and 21-22. Both admit that vertical mergers typically do not create the potential for anticompetitive effects, but claim that such vertical anticompetitive effects will occur in this instance. As academic support, Dr. Hausman points to the economic literature that says a motivation of vertical mergers may be done to help a firm evade or avoid government price controls, taxes, and regulations or to evade statutes and regulations that prohibit price discrimination. *See* UP-7B, V.S. Hausman at 21, n. 26. Dr. Reishus makes no attempt to apply the standards articulated in that literature to the facts of this case, but instead simply makes a standard railroad vertical foreclosure case, a position that has been rejected time and time again in the context of railroad end-to-end mergers and should be rejected again here. Dr. Hausman at least tries to concoct a rationale for an anticompetitive incentive for KCS to vertically integrate, based on alleged Mexican government regulation prohibiting price discrimination, but as is discussed in more detail below, this assumption is incorrect. By reviewing ICC and STB precedent with respect to vertical mergers in the rail industry, contrasting that precedent with the assumptions set forth in Dr. Hausman's and Dr. Reishus' analyses, and then establishing why the assumptions in their analysis are incorrect, one easily comes to the conclusion, as Dr. Andrew Kleit does in his attached verified statement, that the KCS/TM and KCS/TFM transactions fit squarely within that ICC/STB precedent and that there will be no anticompetitive effects from these purely end-to-end transactions.

1. Past Precedent Clearly Indicates That An End-To-End Transaction Cannot Increase Market Power

- a. The One Lump Theory

UP and BNSF argue that the intent of KCS and the result of the consolidation will be to vertically foreclose these rival railroads from participation in the U.S./Mexican market. Of

course, this argument is diametrically opposed to standard economic theory on vertical foreclosure, which has been consistently applied by the ICC and STB to evaluate end-to-end mergers for over 20 years.

Standard economic theory clearly states that any market power resulting from a bottleneck carrier (*i.e.*, TFM's lines in Mexico) can be fully exploited without vertical integration, and that there is no vertical foreclosure incentive to engage in an end-to-end merger because no additional market power will be gained through the merger. This is commonly referred to as the "one-lump" theory, because within any given rail rate, there is but one economic rent (*i.e.*, profit) to be gained.¹⁸ Under this theory, whatever economic incentives exist prior to the merger for the bottleneck carrier to fully exploit its monopoly power will be exploited, and the merger with a connecting end-to-end carrier will not change those incentives. Likewise, if for whatever reason the bottleneck carrier is not exploiting its monopoly power, *i.e.*, is not taking its full "lump," then there likely are market forces in play preventing such an action and the merger with an end-to-end carrier will not change those market forces. Those forces will continue to exist in a post merger environment and prevent the bottleneck carrier from taking anticompetitive actions.

One of the better illustrations of these principles was set forth by the ICC in the *UP/MP/WP* decision.¹⁹ In that case, a utility company was served at the destination by a bottleneck carrier. That carrier was proposing to merge with one of two upstream connecting

¹⁸ See Verified Statement of Dr. Andrew Kleit ("V.S. Kleit") attached hereto, for a further explanation of the theory and why it applies under the circumstances of this proceeding.

¹⁹ *Union Pac. Corp., Union Pac. Rail System, Inc., and Union Pac. R.R. Co.-Control-Missouri Pac. Corp. and Missouri Pac. R.R. Co.*, 366 I.C.C. 459, 538 (1982). ("UP/MP/WP").

carriers, who both served origins for coal used by the utility company. The utility company, along with the non-merging upstream connecting carrier, argued that the competition between the two upstream carriers would be diminished because the destination carrier was currently “neutral” between the two connecting carriers and this neutrality must be maintained or the shipper would lose the benefit of the upstream competition. The ICC rejected those claims:

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. That is, the through rate will be at the level maximizing net revenue for the traffic, subject to regulatory limits, and the destination carrier will establish favorable through service with the origin carrier willing to take the lowest division of the through rate for its segment of the movement. Although a destination carrier might not always be successful in executing this strategy, it will always have the incentive of profit-maximization to attempt to execute the strategy. Therefore, this rate strategy will be pursued and should succeed unless there are obstacles to its execution with respect to a specific movement.

[It has been asserted, however,] that a neutral destination carrier usually will not be able to execute this "vertical price squeeze" and, therefore, has an incentive to merge with an origin carrier in order to drive the through rate to the optimum profit-maximizing level. We are not convinced either that a carrier with a destination monopoly for steam coal traffic will generally be unable to execute the described rate strategy or, on the other hand, that a neutral destination carrier that is unable to execute the strategy would be significantly more capable of raising the through rate to the level that maximizes its profits after affiliation with an origin carrier.

UP/MP/WP, 366 I.C.C. at 538.

This same issue has been reviewed time and time again by the ICC and STB, and the conclusions have always been the same. No individual shipper has been able to establish that it is benefiting from the upstream competition, nor has a carrier been able to show that it will be inefficiently foreclosed. See *CSX Corp.-Control-Chessie System, Inc., and Seaboard Coast Line Industries, Inc.*, 363 I.C.C. 521, 538 (1980); *CSX Corp.-Control-American Commercial Lines, Inc.*, 2 I.C.C.2d 490, 520-27 (1984) (“*CSX/ACL*”); *Norfolk Southern Corp.-Control-NAVL*, 1

I.C.C.2d 842 (1985) (“NS/NAVL”); *Milwaukee-Reorganization-Acquisition by GTC*, 2 I.C.C.2d 427, 454-456 (1985) (“SOO/Milwaukee IP”); *Union Pac. Corp.-Cont.-MO-KS-TX Co.* 4 I.C.C.2d 409, 488-89 (1988) (“UP/MKT”); *UP/CNW*, slip op. at 87-89; *CSX Corp. and CSX Trans., Inc., Norfolk Southern Corp. and Norfolk Southern Ry. Co.-Control and Operating Leases/Agreements-Conrail Inc. and Consolidated Rail Corp.*, 3 S.T.B. 196, slip op. 94-95 (1998) (“CSX/NS/Conrail”). In all of these cases, the ICC or the Board found that the transaction would not enhance or extend the existing market power of the bottleneck carrier, and that not enough evidence had been presented to overcome the Board’s well-established and judicially-approved approach to vertical foreclosure arguments.

Notwithstanding that the issue has long been settled, the vertical foreclosure issue has re-emerged in this proceeding. UP and BNSF are arguing nothing new. UP is claiming that TFM is “neutral” with respect to either the KCS/Tex Mex or UP routings, and that the shippers benefit from the intense upstream competition between those two systems. According to UP, unless TFM remains neutral, the competition between the two upstream carriers will be diminished. BNSF is arguing that Tex Mex and TFM are neutral between BNSF and KCSR, and that Tex Mex and TFM must remain neutral after the transaction.²⁰

Of course, there are numerous problems with UP’s and BNSF’s arguments, two prominent ones are as follows: First, not one shipper has come forward to present evidence to prove UP’s or BNSF’s theories and to disprove over twenty years of economic analysis and Board precedent. Second, neither UP nor BNSF have presented one piece of evidence -- no contract, no rate factors, no rate study, no traffic study, nothing -- to show that Tex Mex and

²⁰ Notwithstanding BNSF’s assertion that the Board expected, in *UP/SP*, for Tex Mex to be neutral, one will search the *UP/SP* decision in vain to find any reference to the notion that Tex Mex was supposed to be a “neutral, independent bridge carrier for both BNSF and KCS.”

TFM are neutral today. Nor have they shown that the lump is being passed along to the shippers rather than being taken by one of the upstream carriers.²¹

For the theories expressed by UP and BNSF to be valid, one must assume that existing UP or BNSF rates to many shippers could be pushed higher without loss of that traffic. This is simply not true because existing rail rates, including UP's and BNSF's, are already as high as they can go without having that traffic switch to other modes or to other origins and destinations. R.V.S. Davies at 2, 14-19. To assume otherwise is to assume that UP and BNSF, as well as TFM, are not currently pricing their traffic to maximize profits. Furthermore, if for whatever reason TFM is not taking the full profit and is not extracting the last dollar, UP certainly is. Given that much of the traffic going through the Laredo gateway moves to or from points where UP is the only carrier with single-line access to Mexico -- R.V.S. Mutén at 7-8 and R.V.S. Davies at 11 -- UP clearly has both the incentive and ability to extract the last dollar from shippers. *See* V.S. Kleit at 17-21. Indeed, given the traffic data produced by Mr. Mutén to rebut UP's claims about the intense competition between KCSR and UP for Laredo traffic, it is more likely that UP is the bottleneck carrier taking the "lump," not TFM. In fact, this points directly to UP's motivations for its intense opposition to the transactions: UP is taking the "lump" and

²¹ UP and BNSF have thus failed to meet their burden of proof. According to the ICC, for a condition to be imposed in the context of a vertical transaction:

The record must clearly show, first, that prior to the merger the benefits of origin competition flowed through to the [shipper] and were not captured by the destination monopoly carrier, and second, the competitive flow through will be significantly curtailed by the merger.

Burlington Northern Inc. and Burlington Northern R.R. Co.-Control and Merger-Santa Fe Pac. Corp. and the Atchison, Top. & S.F. Ry. Co., Finance Docket No. 32549, 10 I.C.C.2d 661, slip op. at 70 (I.C.C. served Aug. 23, 1995) ("*BN/ATSF*"). Clearly even if UP's and BNSF's theories are plausible, they have not met this test, nor have they even attempted to comply with it.

they are afraid that after the transaction, TFM will be in the better position to take it, or at least part of it. Regardless, there is only “one lump” to be taken, and one of the carriers is taking it. The Board should reject UP’s and BNSF’s claims because, as the ICC and STB have consistently found, the common control of end-to-end carriers will not allow any party to extract additional market power.

b. Past Precedent Indicates That Market Forces That May
Prevent The Lump From Being Taken Will Continue
To Exist After Common Control Of Vertical Firms

Of course if it is true, as UP claims, that TFM is not extracting the “one lump” because of certain regulatory constraints in Mexico, it is also true that those same regulatory constraints will continue to exist in a post-control environment.²² As fully set forth in the Rebuttal Verified Statement of Mr. Davies, KCS submits that if for some reason TFM or Tex Mex are not extracting their “one lump,” it is because of regulatory constraints in Mexico not overwhelmingly intense, widespread, rail-to-rail competition that UP would like this Board to believe KCSR provides to UP,²³ but rather the result of certain inherent structures in the marketplace. KCS suggest that these market structures are as follows:

²² There is an inconsistency inherent within UP’s argument and its application to the economic literature cited by Dr. Hausman. The economic literature cited by Dr. Hausman claims that the one lump theory does not apply when there is strict rate regulation of the bottleneck carrier and little regulation of the downstream carriers. In that case, UP’s theory would be beneficial to help to evade that regulation. The problem with that application of the facts of this proceeding is that it presumes a high degree of government regulation and involvement with TFM’s rates. Yet, at the same time, UP vociferously argues that Mexican regulation is so weak, uncertain, and undeveloped that the STB is the only party capable of reviewing the competitive effects of the TFM transaction.

²³ Even without the benefit of the Mutén study, which confirms that there are very few locations where KCS and UP compete head-to-head, the notion that KCSR provides intense rail-to-rail competition with UP so as to force UP to lower its prices is almost ridiculous on its face, as a mere cursory review of the rail map would confirm. Perhaps the most effective rebuttal to this

First, the enormous market coverage of UP and BNSF, and the vast number of markets that are UP or BNSF sole-served points would make it not in KCSR's interest to eliminate TFM access to UP and BNSF routings. Indeed, notwithstanding UP's comment that KCSR "and its connections, including BNSF" can compete for 80% of the traffic going through Laredo, KCSR competes with UP at very few locations and only 2 of 15000 6-digit SPLC locations have KCS and BNSF as the only competitors. Second, if NAFTA Rail did attempt to foreclose efficient UP and BNSF routings in favor of inefficient alternative KCSR routings, as claimed by BNSF, affected traffic would simply switch to other gateways or other modes, depriving TFM of needed revenues that could not be made up by relying on KCSR routings. Third, because most of the traffic is locked up under long-term contracts between TFM and the other carriers, KCS could not utilize its control of TFM to eliminate UP or BNSF routings. In sum, both UP and BNSF have enormous leverage and bargaining power in establishing rate divisions with TFM; that leverage will remain present following the consolidation. Finally, there simply is not enough capacity on the UP line used by Tex Mex for KCS to use its control of TFM and Tex Mex to route significant amounts of traffic away from UP and BNSF.²⁴

The argument that a bottleneck carrier may not be taking its full lump because marketplace structures prevent it from doing so, and that such structures will not be changed by the transaction, is not a new notion. As the ICC stated:

Our experience has been that where a single rail carrier controls a destination segment, and no transportation alternatives are available, the shipper will be

argument was presented in BNSF's arguments, which paints the exact opposite picture of that offered by UP.

²⁴ These reasons are fully explained in the Rebuttal Verified Statement of Gerald Davies and in the section below on why the assumptions underlying the theory espoused by Dr. Hausman are not an accurate reflection of the marketplace.

captive and the single rail carrier will be able to capture the preponderance of the economic profits. Conversely, when certain factors are present that limit a carrier's ability to take full advantage of a bottleneck, those factors will remain in place as effective safeguards after the merger. We have consistently adhered to these principles in assessing harm in merger cases and in making market dominance determinations in rate cases. The fact that a bottleneck carrier might not have sufficient information to execute a perfect price squeeze or to extract the last penny of economic profits does not mean that substantial benefits to shippers will be lost when the bottleneck carrier merges with a connecting carrier.

BN/ATSF at *189-91 (emphasis supplied). If it is true that TFM is not extracting the preponderance of the economic profits, that is due to numerous factors and in particular the vertical leverage of UP and BNSF, and those factors will remain after the control is obtained by KCS. *Accord, UP/MP/WP*, 366 I.C.C. at 538 (a neutral destination carrier who is unable to execute a profit maximizing strategy is not significantly more capable of raising the through rates to the level that maximizes its profits after affiliation with an origin carrier.)

c. Precedents Establish That Efficient
 Joint Line Routings Will Continue

UP's and BNSF's basic theory also depends upon the companion argument that their shippers will be harmed by the KCS/TM and KCS/TFM transactions because the vertically integrated KCSR/TM/TFM will act to foreclose UP and BNSF from participating in efficient through routes and will favor KCSR routings. Both ICC/STB precedent and actual experience are to the contrary. "Simply put, there is no reason for a carrier to foreclose an efficient connecting carrier just to achieve a long haul. If a connecting carrier [UP or BNSF] can provide service at a lower cost than can BN/Santa Fe [KCSR], it is in the interest of all the carriers to reach an agreement for a joint service." *BN/ATSF*, Slip op. at 74. Dr. Kleit explains this theory in his verified statement and its continued applicability to these transactions. In another recent case, the STB noted that a merging railroad won't favor its long haul if it is less efficient than a

short-haul interline routing because competitive pressures will ensure the use of the most efficient routing. *Dakota, Minnesota & Eastern Railroad Corporation And Cedar American Rail Holdings, Inc.-Control-Iowa, Chicago & Eastern Railroad Corporation*, STB Finance Docket No. 34178, slip op. at 16 (served Feb. 3, 2003). In an earlier case, the ICC noted that competition compels movement of traffic over efficient routes, and that proposals to ensure the neutrality of the bottleneck carrier were unnecessary. Specifically, the ICC stated that “merged railroads -- regardless of whether they maintain bottleneck facilities or market dominance -- have the incentive to encourage full use of the most efficient route, even when it entails a joint-line alternative to a single system route.” *BN/SF*, citing *Seaboard Air Line Railroad Company-Merger-Atlantic Coast Line Railroad Company (Petition to Remove Traffic Protective Conditions)*, Finance Docket No. 21215 (Sub-No. 5) (I.C.C. served Mar. 27, 1995).

For those markets where KCSR does not compete with BNSF or UP, which is the vast majority of markets for Laredo gateway traffic, Dr. Kleit and Mr. Mutén explained in their statements that TFM would have no incentive to foreclose UP or BNSF routings because without them the traffic cannot move by rail. In those very few markets where KCSR/Tex Mex/TFM routings do actually compete against a UP/TFM routing or a BNSF/Tex Mex/TFM routing, TFM or Tex Mex have every incentive to continue to use those routings as long as they provide the same or more profit to NAFTA Rail as if the move originated and terminated solely on NAFTA Rail. This is possible wherever UP’s or BNSF’s route is more efficient than the KCS/TM route, something which both UP and BNSF stress is often the case. In other words, neither KCS nor TFM has any incentive in a post-control environment to foreclose efficient joint-line movements, even where the joint line movements might theoretically compete against a newly created single-line movement, as long as the profit to NAFTA Rail is the same or more via the interline route.

For example (and drawing heavily on the ICC's decision in Ex Parte No. 282 (Sub-No. 5), *Rulemaking Concerning Traffic Protective Conditions In Railroad Consolidation Proceedings*, 366 I.C.C. 112, 124-126 (1982)), assume that TFM's variable cost to ship from Laredo to Mexico City is \$50, that UP's variable cost from Laredo to Chicago is \$50, and that KCSR's variable cost is \$100 (because KCSR's route to Chicago is much more circuitous and depends upon haulage rates and other interchanges). Also assume that there are two possible rates set by market forces, such as intramodal or intermodal competition -- \$150 and \$200. As the chart below shows, in each case NAFTA Rail as a whole would gain more by using UP/TFM routings rather than KCSR/Tex Mex/TFM routings.

Rate	Profit To NAFTA Rail Using Only NAFTA Rail	Combined Profit Using UP and TFM	Portion Of Combined Profit Going To NAFTA Rail Via Joint Line Route
150	Profit = Rate (150) minus Costs (100+50) = 0	Profit = Rate (150) minus Costs (50+50) = 50	25 (50/50 split of profits)
200	Profit = Rate (200) minus Costs (100 + 50) = 50	Profit = Rate (200) minus Costs (50 + 50) = 100	75 (75/25 split of profits)

As a result, in both cases it is to NAFTA Rail's benefit to route via UP/TFM rather than KCSR/Tex Mex/TFM. In this example, the fight between the interline carriers is over how to divide the profit, *i.e.*, the division, not whether or not the efficient interline carrier is foreclosed from the market. There are powerful economic incentives for both carriers to use the more efficient routing.

This simple example confirms what both UP and BNSF are truly concerned about, *i.e.*, their split of the profits, not whether or not rail rates to shippers will increase. In fact, if UP is correct that its cost structure is lower than KCSR's and that KCSR's routings are less efficient than UP's routings, then pure economics, as set forth in the above example, dictates that NAFTA Rail would be better off using the UP/TFM routing rather than the inefficient KCSR/Tex

Mex/TFM routing. In such situations, NAFTA Rail is better off using UP, and the only way NAFTA Rail will be able to efficiently gain its long-haul is by lowering its costs. As KCS has consistently said all along, the only way for KCSR and Tex Mex to be able to compete against UP is to lower our costs, not raise them.

Despite BNSF's claims to the contrary, the diversion study presented by KCS and Tex Mex confirms the view that NAFTA Rail would not foreclose efficient interline routings. BNSF said in its August 4 filing with the Board that "KCS' diversion analysis confirms KCS' intent to divert traffic from BNSF, even if that diversion results in inefficient routings of rail traffic." BNSF Comments at 12. This is simply wrong. As set forth in the Rebuttal Verified Statement of Mr. Bengt Mutén, Executive Officer-Products of Reebie Associates, BNSF's argument on this point is a distortion of the meaning and intent of a diversion study.

A diversion study is, in essence, a best estimate of the amount of existing traffic that will be attracted to rail routings that become more efficient and more competitive due to the merger or common control of two rail carriers. It is not, as BNSF construes it, a statement of intent by the merging carriers to force traffic over new, albeit inefficient single-line routings. As the diversion study showed, it is expected that there will be diversions to the KCSR/Tex Mex system. However, the traffic that KCS will divert to its system as a result of the KCSR/Tex Mex transaction is not a result of inefficient diversions, but efficient diversions brought about by new single-line efficiencies and improvements to the Tex Mex infrastructure. R.V.S. Mutén at 2. These diversions to the KCSR/Tex Mex system will only come about if it is efficient for the routings to shift. If the Tex Mex infrastructure is not improved, if there is a lack of capacity on the trackage rights lines used by Tex Mex, or if this traffic is locked up in long term (more than a year) contracts, then the model will overstate the amount of diversions. Since neither BNSF nor

any other party took issue with Mr. Mutén's assumptions or the results of his study, they remain as the most accurate and unchallenged evidence in the record.

It is true that almost half of the diversions come from the BNSF system (\$6.5 million), but not because there will be inefficient diversions, but rather because it is either more efficient, or just as efficient, to route this traffic KCSR/Tex Mex rather than BNSF/Tex Mex. As Mr. Mutén states, most of this shift is for traffic that BNSF currently interchanges with other carriers at Kansas City and then interchanges with Tex Mex at Robstown. As BNSF's witness Rickerhauser points out in BNSF-4, V.S. Rickerhauser, Exhibit 2, the KCS/Tex Mex routing from Kansas City is just as efficient as a BNSF/Tex Mex routing. Thus, whatever shifts away from BNSF to KCSR/Tex Mex is due to efficiencies, not due to an exercise of economic leverage. There will be no diversions from BNSF to KCSR/Tex Mex as a result of "forced" inefficient routings or anticompetitive actions taken by KCS. There will be no increased rates to shippers or reductions in service and BNSF has not established that there will be.

2. The Theories Expressed By Dr. Hausman and Mr. Gray

BNSF's witness, Dr. Reishus, makes no attempt to explain why the economic principals (as consistently applied by the ICC and the Board for over twenty years) establishing that efficient joint line interchanges would not be foreclosed in an end-to-end transaction are not applicable to the KCS/TM transaction or the KCS/TFM transaction. Dr. Reishus' arguments are simply contrary to the realities of the marketplace and the standard theories involving vertical foreclosure. Without evidence as to why his theory is both likely to occur and will have substantial anticompetitive effects, evidence which is lacking, his arguments can be rejected. (Further discussion of the implausibility of his theory is set forth fully below.)

UP witnesses John Gray and Dr. Hausman at least attempt to explain why the standard theories governing vertical foreclosure might not apply in the KCS/TFM transaction, though they make no similar claim with respect to the KCS/TM transaction. UP contends that the KCS/TFM transaction is motivated by anticompetitive vertical foreclosure on the part of KCS, and that UP's interline routes will be vertically foreclosed following the consolidation. Mr. Gray and Dr. Hausman's model yields results opposite from the standard theory.

Mr. Gray, UP-7A, Table 1 at 51, assumes that that TFM could raise its rate factors from \$100 to \$106 or from \$100 to \$120 and KCS could reduce its rate factor from \$105 to \$99 or even to \$95. Under either the "post-control" scenario, because of the increase of the TFM rate factor, the UP/TFM routing will always be more expensive than the KCSR/TFM routing, and notwithstanding the fact that the shipper's rates would have gone up, KCSR/TFM would obtain the traffic, gaining new profits of \$5 or \$15. Mr. Gray's theory applies to all shippers' traffic. According to UP-7A, Table 2 at 55, Dr. Hausman's theory is similar in that TFM raises its rate factors and KCSR lowers its factors, but his theory posits that only inelastic shippers would suffer a rate increase, as KCSR would lower its factors to keep the rate the same for elastic shippers.

The Gray and Hausman theory is remarkable for the number of faulty assumptions and conclusions that it makes. First, it assumes that it is common control that will give these railroads the incentives to undertake the posited scenarios, yet it ignores the current common equity ownership between TFM, Tex Mex and KCS and the fact that if such scenarios were profitable to both TFM and KCS, as UP claims, TFM and KCS could be undertaking these scenarios today. Second, it assumes that Mexican rate regulation is so strict and pervasive that TFM is not free to differentially price between connecting carriers, different origins and

destinations, or between shippers based upon each individual circumstance. Third, and perhaps most importantly, both Table 1 and 2 assume that KCSR is free to raise or lower its division requirements, but that somehow UP's divisions must remain frozen and inflexible and cannot respond to the actions taken by KCSR. Fourth, it assumes that UP could not retaliate by switching to other gateways, using Ferromex, or using its control of the Tex Mex trackage rights to disfavor KCSR/TFM routings. Fifth, it assumes that such a scenario is profitable to NAFTA Rail even though such a scenario would result in a complete loss of TFM interline traffic from UP and BNSF solely-served points, which are far more numerous than KCS-served points. *See R.V.S. Mutén at 7.* Sixth, it assumes that most of the U.S./Mexico traffic is inelastic in that shippers would simply absorb a rate increase without switching to other modes or to other origins and destinations. Finally, it assumes that traffic can be easily diverted, regardless of the existence of long-term contracts and the lack of capacity over the UP Brownsville Subdivision.

As set forth below and fully discussed in the attached Rebuttal Verified Statement of Mr. Gerald Davies and the Verified Statement of Dr. Andrew Kleit, Professor of Energy and Environmental Economics at Pennsylvania State University and UP's own witness in the *UP/CNW* control transaction, the assumptions underlying the Gray and Hausman theories are implausible and have no relationship to the realities of the marketplace. When confronted with the utter implausibility of the numerous assumptions underlying UP's Table 1 and Table 2, one can only conclude that the ICC/STB's long standing precedents are correct, and that UP/TFM and BNSF/TFM routings will not be inefficiently foreclosed.

3. The Assumptions Underlying Dr. Hausman's And Mr. Gray's Theories Have No Relationship To Actual Market Conditions
 - a. Whatever Incentives There Are To Foreclose UP and BNSF Routings Exist Today, And Common Control Will Not Change Those Incentives

A basic premise of the arguments raised against the two transactions is that KCS's control will create new incentives for Tex Mex and TFM to take certain actions to either raise prices to shippers or force shippers to divert from efficient UP or BNSF routings to inefficient NAFTA Rail routings. The underlying assumption of that premise is simply wrong. Given the high degree of common ownership and coordination between KCSR, Tex Mex, and TFM today, the incentives to take the actions described by UP and BNSF will be the same after the NAFTA Rail transaction as they are today. The fact that the alleged anticompetitive actions that could occur have not, in reality, occurred is strong evidence that existing market forces prevent these actions from occurring and is fully consistent with the Board precedent on this point. As the ICC and STB have consistently found, the merger between a bottleneck carrier and one of its two upstream connecting carriers will not change or eliminate those market forces.

The fact is that KCS is a major owner of Tex Mex and TFM, and has been for several years. As this Board is fully aware, up until about a year and a half ago, KCS directly owned 49% of Tex Mex through its ownership share of Tex Mex's parent, Mexrail, while at the same time owning 46.5% of Grupo TFM, TFM's parent. While Mexrail was sold to TFM, KCS still remains the 46.5% owner of TFM. KCS, Tex Mex, and TFM share some common officers and/or common board members. There are numerous provisions in the corporate bylaws, shareholder agreements, and operating agreements that give KCS a substantial voice in how the companies are run.²⁵

²⁵ When UP decided to take 100% control of CNW, another purely end-to-end transaction, many parties raised the same issues in that proceeding, *i.e.*, CNW would no longer have an incentive to interline traffic, would foreclose existing routing options, and that shippers' rates would increase. UP, of course, opposed all of these arguments on the bases that efficiency and shipper preferences should govern such matters, and given the high degree of existing cooperation

As soon as TFM was acquired jointly by Grupo TMM and KCS, KCS urged, supported and was directly involved in (1) upgrading TFM's physical plant to U.S. mainline standards; (2) upgrading and expanding the rolling stock fleet; (3) replacing the core of the locomotive fleet with new AC locomotives; and (4) upgrading the skill of the workforce and expanding effective computer support. *See* R.V.S. Davies at 5. During this time, KCS has not taken any capital out of Mexico, but has been focused on re-investment in Mexico. It was KCS's expertise that framed TFM's operating practices today. It was KCS that urged, and helped to complete, quick and massive investment in TFM. It was KCS that worked with TFM to raise TFM's service capability to provide highly efficient service, to develop new markets for TFM, and to improve what UP itself recognizes as a high degree of cooperation and investment by KCS into TFM. *See* V.S. Gray at 9, 10, 22, and 38.

KCS's high degree of investment into and involvement with TFM was being done at the same time TFM and UP were coordinating their operations and developing their arrangements. Given UP's large market share of TFM interline traffic, approximately 80-85%, KCS knew that the vast majority of its investment would benefit UP/TFM routings. R.V.S. Davies at 5. KCS understood that the vast majority of the growth on TFM was being fueled by UP/TFM routings, but most of the UP/TFM traffic was traffic for which KCS/Tex Mex routings could not compete, often moving to or from origins and destinations not even capable of being served by a KCSR routing. R.V.S. Mutén at 7, Attachment A. KCS never considered trying to stop these UP/TFM routings. R.V.S. Davies at 6.

between UP and CNW, CNW would have no more incentive to foreclose other corners after the transaction than before it. The ICC agreed with UP's position. The STB should likewise follow its *UP/CNW* precedent, as well as its numerous precedents regarding end-to-end consolidations, and reject the now inconsistent claims raised by UP.

In light of the fact that a vast majority of KCS's investment in TFM benefits UP directly, one must ask why KCS has made those investments. Why haven't KCS and TFM today taken any of the alleged anticompetitive actions hypothesized by UP's witness, John Gray? The reason is simple: KCS invested in TFM to grow the market, thereby increasing the value of TFM, and this requires working with both UP and BNSF to increase traffic over the Laredo gateway. UP states that this philosophy will change as soon as KCS control TFM. However, UP's position not only blatantly contradicts decades of claims that UP has made before the ICC and STB, it also ignores the reality of the past and of the marketplace as it exists today and will exist in the future. R.V.S. Davies at 5 n.1 and 6.

TFM will continue to be heavily dependent on UP's traffic to continue TFM's growth and to increase TFM's value. The fact that KCS has not already prevented UP/TFM cooperation and routings proves that the marketplace, and its reliance on private agreements and private sector solutions, is more than adequate to "check" any alleged market power that KCS will gain due to the transactions.

UP's witness, John Gray, when responding to KCSR's arguments that it will have to lower rates to capture market share away from UP, correctly recognized that if NAFTA Rail's true desire was to lower rates, then "it could take this step today." UP-7B, V.S. Gray at 34. Just as NAFTA Rail could lower rates today, it could also raise them and undertake the various strategies outlined in Mr. Gray's statement. In fact, he even claims today that Mexican regulatory structures are so weak and ineffective that TFM could raise its rates at will, just as KCSR could lower its at will.

Thus, the two assumptions underlying Mr. Gray's argument, *i.e.*, that TFM could raise its rates and that KCSR could lower its rates exist today, and change of control will not alter those

facts. For example, in Table 1 set forth by Mr. Gray, he claims that after control, TFM could increase its rate factors from \$100 to \$106 or from \$100 to \$120 and KCS could reduce its rate factor from \$105 to \$99 or even to \$95. Under either “post-control” scenario, the shipper’s rates would go up and “KCSR” supposedly would win by gaining new profits of \$5 or \$15.

Setting aside for the moment the fact that this analysis is based on numerous unrealistic and inaccurate assumptions,²⁶ Mr. Gray has already admitted that TFM could raise its rates today and KCSR could currently lower its rates. If TFM could increase its rate factors and KCSR reduce its rates so that the combined KCSR/TFM could gain an extra \$5 or an extra \$15, they would do so today because both would split that extra revenue in accordance with their respective equity ownership interests in TFM. If TFM could raise its factors from \$100 to \$106 or to even \$120 and still have the traffic move via the KCSR routing (with KCSR lowering its rates), it would presumably be in the interests of both TFM and KCSR to do so today because in doing so both would increase their revenues, not just KCSR.

Mr. Gray assumes that it is “control” of TFM by KCS that gives KCSR this incentive because KCS would “get those dollars back through its ownership of TFM.” V.S. Gray at 27. Yet, that ignores the fact that KCS today has effective equity ownership of 46.5% of TFM and would thus get at least 46.5 cents of every “extra” dollar earned back today. If KCSR and TFM would have an incentive to undertake these actions to gain an extra \$5 or \$15, they each have the same incentive to do so today, although each would have to divide the extra \$5 or \$15 between

²⁶ Of course, amongst the biggest shortcomings in Mr. Gray’s and Dr. Hausman’s analyses is that there are no references to costs, so the Board does not know what is the “profit” of each of the carriers involved. Each of the scenarios could occur without any rate increases to shippers through the simple fact that one carrier could change or lower its profit margins to retain the traffic.

the two of them, but both would be better off. Nothing about going from 46.5% ownership to 100% ownership changes these incentives.

Dr. Hausman's theory, as set forth in Table 2 of UP-7A at 55, suffers from the same faulty assumption, along with many others. His theory starts with the premise that Mexican law constrains TFM's ability to differentially price between KCSR and UP, forcing TFM to price all traffic at the rate that a shipper with elastic demand for rail service (*i.e.*, available transportation alternatives) is willing to pay. UP claims that common control would change the environment by giving the commonly-controlled company the ability to price discriminate freely, with TFM raising its overall rate factor from \$100 to \$120 and KCS "manipulating the KCSR/Tex Mex rate factor north of the border" UP-7A at 55, so as to hold rates constant for elastic traffic (through KCSR's reduction of its rate factor from \$100 to \$80) but raising rates for inelastic traffic.

The fallacy is that such a scenario could happen today, and common control does not change the incentives to do so. Indeed, his model depends upon KCSR's ability, not TFM's ability, to differentially price rail traffic, yet KCSR has that ability today. There is nothing about control or lack of control that prevents TFM from raising its rate factors from \$100 to \$120 and KCSR from reducing its rate factor for elastic traffic from \$100 to \$80 and holding constant its rate factor for inelastic traffic.

If it were in NAFTA Rail's self-interest to take the steps hypothesized by Mr. Gray and Dr. Hausman, it would be in both KCSR's and TFM's self-interest to take those steps today. It is not a satisfactory explanation to say that Mexican law requires TFM to charge the same "neutral" rates to both UP and KCSR/Tex Mex and that it is this constraint which somehow keeps TFM from undertaking the various scenarios today. If that is truly a constraint, then the same constraint will exist in a post-control environment as in a pre-control environment. If Mexican

law is not the constraint, and TFM is free to differentially price between different origins and destinations (which is in fact the case), then TFM is free to so price today.²⁷

The bottom line is that despite UP's argument that KCS control of TFM will create "new" incentives or opportunities to exploit TFM market power, there are no "new" incentives being created. Each of the proposed scenarios could happen today, with TFM raising its rate factors south of the border and KCSR reducing its factors north of the border. The fact that KCSR and TFM have not taken those steps shows that such steps are not in NAFTA Rail's self-interest because they cannot be taken in light of existing competitive pressures. Common control will not change these factors.

b. TFM Can Differentially Price And Need Not Be
Neutral With Respect To KCSR, Tex Mex, and UP

Another assumption of the UP and BNSF theories is that Tex Mex and TFM are currently "neutral" vis-à-vis KCSR with respect to divisions and rate factors.²⁸ With respect to BNSF, this is simply not accurate. R.V.S. Davies at 32. Given the close coordination and cooperation between Tex Mex and KCSR and common ownership, one would expect this result. As such, BNSF's premise that KCS's control of Tex Mex will cause Tex Mex to no longer be "neutral" with respect to BNSF and KCSR is simply wrong.

²⁷ See V.S. Gray at 31, where he claims that "if KCS's argument is correct that TFM could discriminate by charging lower rates to favor KCSR routings" (which is in fact true), then it is also true that KCSR "could discriminate by charging higher rates to shift traffic away from efficient UP-TFM routings." Again, the fact that NAFTA Rail could discriminate in favor of KCSR today but has not foreclosed UP-TFM routings by charging higher rates to UP-TFM routings clearly indicates that market forces are in place preventing such UP foreclosure from occurring.

²⁸ Dr. Hausman's and Mr. Gray's theories depend, in part, on the notion that TFM or Tex Mex treat UP and BNSF the same as they treat KCSR. Mr. Davies disputes that theory. R.V.S. Davies at 32 n.22.

With respect to TFM, UP claims TFM is likewise neutral with respect to BNSF/Tex Mex routings or KCSR/Tex Mex routings. UP-7B, V.S. Gray at 20-22. UP provides no evidence for its claim that TFM is neutral with respect UP, BNSF, and KCSR routings. UP's only claim for such a broad statement is that TFM cooperates extensively with UP. This proves nothing and as Mr. Davies states, such cooperation is a result of market forces not regulatory constraints. R.V.S. Davies at 33.

Although Mexican law does require TFM to charge the same rate for identical traffic moving to/from the same origins or destinations and in the same volumes, that same law allows Mexican carriers to differentially price between connecting carriers and similarly situated shippers if such differential pricing is a result of different services provided by rail carriers. Thus, in many respects, Mexican law regarding rail pricing is not that much different than the U.S. law contained at 49 U.S.C. Section 10741. Furthermore, while TFM is required to register the maximum rate with the SCT, such a rate is the maximum rate that can be charged. TFM is free to discount from that maximum rate based upon differences between the transportation services provided by connecting carriers or based upon individual circumstances between shippers. R.V.S. Davies at 33.

As a result, almost all Mexican traffic moves under contract, and each contract provides for a "promotion" or discount from the registered rate. The extent to which this promotion is offered is based upon different services. For both Ferromex and TFM, rates and service terms provided to connecting U.S. carriers or to shippers are based upon differences between car types, lading weights, origins and destinations, train size, car hire amounts, switching services, length of the contract, volume differences, and other differences between shipments. It simply is not correct to say that TFM must be "neutral" with respect to UP routings versus Tex Mex routings.

UP's own testimony supports the ability of TFM to differentially price, and undermines a critical assumption of Professor Hausman's model. In particular, the submission of Mr. Fuentes makes it clear that differential pricing of rail traffic is clearly permitted under Mexican regulation. According to Mr. Fuentes, UP-7B, V.S. Fuentes at 4, Mexican railroads are allowed to offer discounts to shippers "in accordance with the specific characteristics of each service." In the railroad sector, "specific characteristics" include the goods being shipped, the volume of goods being shipped, and the quality of service of the relevant shipment. These are indeed the standard bases for rail differential pricing. Given the range of rail shippers, each with a unique rail price based on commodities, volumes and origin/destinations, a strict price discrimination law could not prevent effective rail differential pricing without the presence of a proactive regulatory agency which gathered detailed information on prices charged for various shipments along with estimated costs. Clearly such a regulatory structure does not exist in Mexico.

As Mr. Davies and Mr. Fuentes both confirm, TFM can offer discounts to different shippers and charge different rate factors to its connecting railroads. In fact, such differential pricing happens today, and common control of TFM (or Tex Mex) by KCS will not change the incentives or ability that either of these carriers has to alter TFM prices with regard to its interline partner. Market forces dictate those incentives, not government regulation.

- c. Shipper Rates Will Not Increase, Because As UP and BNSF Can Lower Divisions To Respond To Actions Taken By NAFTA Rail

Another problem with the theory expressed by Mr. Gray, and somewhat by Dr. Reishus and Dr. Hausman, is that Mr. Gray simply assumes that UP's rate factors are frozen while TFM and KCSR rate factors can go up or down. Of course, if TFM or Tex Mex request a larger portion of the profit, *i.e.* the lump, prices to shippers do not automatically increase; nor could

they, given the pervasive intermodal competition for U.S. Mexican traffic and the ability of UP and BNSF to switch gateways.

As noted, Mr. Gray's table assumes that the only option is for shipper rates to increase, but his analysis assumes that current rail rates could be pushed higher without shippers changing modes, ignores costs and profits, and ignores the ability of UP and BNSF to adjust their divisions. Hausman uses a Mr. Gray's and Dr. Hausman's models yield a result that the efficient interline route of UP is foreclosed. As we can see clearly with reference to Gray Table 1, when TFM raises its rate factor or division on all traffic, the TFM-UP interline option is priced out of the market because UP's division is assumed to be held constant. Of course, in reality, UP's divisions are fully flexible. The standard theory that efficient interline options will not be foreclosed, as enunciated by the ICC in 1982 and re-stated by the ICC and STB countless times, clearly assumes that the unintegrated carrier can and will alter its division. Indeed, the assumption by Gray and Hausman that UP will just passively hold its division constant in the face of the TFM increase and endure the loss of substantial traffic runs counter to the standard theory and ascribes clearly irrational behavior to UP. If the interline routing is efficient, as UP claims it is, there is a division that UP can take which will be profitable for both UP and TFM to maintain the interline routing. The powerful findings of the standard theory that efficient interline routings will not be foreclosed must take precedence over the highly questionable assumption of Gray and Hausman.

We can illustrate this point by revising Gray Table 1 to reflect the more realistic assumption that UP's divisions are flexible, not fixed. With the assumption of flexible divisions, it is clear that the UP-TFM interline route need not be foreclosed and rail rates need not go up in the event TFM were to increase its revenue requirements in a post-control environment.

BEFORE KCS/TFM CONTROL			AFTER KCS/TFM CONTROL	
			Example 1	Example 2
	Rate/Factor	Costs	Rate/Factor	Rate/ Factor
UP Factor	100	45	94	80
KCS Factor	105	50	99	95
TFM Factor	100	60	106	120
UP-TFM Rate	200		200	200
KCS-TFM Rate	205		205	215
Outcome	UP wins; Rate at 200		UP wins; Rate Stays at 200	UP wins; Rate Stays at 200

Here, TFM increases its rate factors after control, just as in the original Gray model, but for both Examples 1 and 2, UP *lowers* its rate factor correspondingly. In this instance the traffic continues to flow over the UP-TFM interline route and at the same rate. The point of this simple example is to show that TFM and KCS can take the precise actions contemplated in Gray's table, *i.e.*, TFM raises its rate factors while KCS lowers its, and yet the rate to the shipper still stays at \$200 and the traffic is still routed over the UP/TFM routing, rather than the KCS/TFM routing. We can also add a column reflecting costs for each routing, with UP's assumed to be lower, to illustrate that it will clearly be in UP's interests to lower their divisions and continue to handle the traffic. The scenario presented above is much more likely to occur given UP's self-acknowledgement that it has lower costs than KCSR, a larger network, and more efficient routings. It is also much more consistent with past ICC and STB analysis regarding vertical foreclosure issues and simply confirms long-standing precedent that efficient interline options will not be foreclosed.

- d. Due To KCSR's Limited Market Scope, It Has
No Incentive To Foreclose Either UP or BNSF

According to UP, there is intense rail-to-rail competition between KCSR and UP and it is that competition that is driving prices to an extremely competitive level. UP stated that KCS

“and its connections in the United States, including BNSF,” UP-7B, V.S. Gray at 25, could compete with UP for approximately 80% of the traffic moving over the Laredo Gateway and that, as a result, KCS stood to gain a great deal of divertible traffic by discriminating against UP. Of course, if that is true, KCSR, and BNSF for that matter, must not be doing a very good job of competing, given UP’s near monopoly market share for Laredo gateway traffic. However, if one closely examines UP’s premises with the traffic data, it is clear that UP has its dominant role not because it is competing, but rather because the vast majority of U.S./Mexico rail traffic is coming from UP solely-served locations where shippers have no choice but to use UP. In other words, it is UP who has the bottleneck, not TFM. The data shows that UP has greatly exaggerated the potential benefit to KCS of such discrimination.

It must be noted that in UP’s statement, V.S. Gray, data has been so aggregated that effectively UP is comparing the routes of KCS, Tex Mex, and every other carrier in the country against UP’s own lines. *See* V.S. Gray Exhibit J. Even with that basis of comparison, UP by its own admission still has no competition at 20% of the points involved. To look more directly at points where KCS and UP compete head-to-head, Mr. Mutén used the 2001 Carload Waybill Sample and identified all 1,099 six-digit Standard Point Location Codes²⁹ (“SPLCs”) that served as origins for movements to Laredo. Results of this analysis, and the same for the 388 markets served from Laredo, are shown in R.V.S. Reebie, Attachment A.

Most telling, UP and KCS compete head-to-head with each other exclusively at only 7 of the 1,099 origins for traffic moving to Mexico in 2001. That is a mere 0.6% of the origins for

²⁹ “ ‘SPLC’ ” refers to the Standard Point Location Code, a code used on all interline freight accounting forms to identify all U.S. points served by rail or motor carriers. It may have up to six position numbers, identifying a geographic area in the first position, the state in the second position, the county in the third and fourth positions, and the station in the city or town in the fifth and sixth positions.” *UP/SP* Decision No. 44, 1 S.T.B. 233 at 373, n. 102.

traffic moving over Laredo, accounting for 1.9% of the carloads. Indeed, points that are “UP-served only” are fully 17.4% of all origins combined and account for 36.5% of all carloads moved to Laredo. This is a far cry from the notion that there is intense rail-to-rail competition between UP and KCSR. Even based on a broader market definition of four digit SPLCs, UP and KCS compete in less than 2% of markets.

Of course, in the *UP/SP* merger case, UP treated UP and SP as competing only at 2-to-1 points, with a point being defined as no larger than a SPLC. UP cannot now claim there is no intense head-to-head competition between UP and KCSR by adding all other railroads to the KCSR side of the ledger, and thus expanding the number of “points” to include BEA’s, SPLC 4’s, gateways, and any other place where KCSR and UP simply have a presence, regardless of how many other railroads are present. Yet, that is precisely the definition used by Mr. Gray in his Exhibit J. The STB rejected such a broad definition of rail-to-rail competition in *UP/SP* and it should likewise do so here. Using “points” as defined in *UP/SP* as “points” in this proceeding, *i.e.*, comparing apples to apples, completely exposes the hypocrisy of the UP argument and shows that there are very few points where UP and KCSR compete head-to-head.

In fact, BNSF’s comments about the scope of KCS’s routings and route structure and the ability for NAFTA Rail to compete against UP are precisely the opposite of UP’s view. In BNSF’s view, it, and only it, has the ability to compete against UP. BNSF claims that KCSR cannot “provide the competitive presence that BNSF can and does provide to and from major gateways and throughout the western United States.” BNSF-4 at 4. In its view, BNSF’s ability to compete for grain traffic is because of its “broad geographic reach” and its “reasonably efficient” routings to Laredo, routings that KCSR does not have. BNSF-4 at 10. BNSF’s views

are simple: KCSR has neither the geographic reach nor the efficient routings that permit it to compete for U.S./Mexico traffic vis-à-vis UP.

UP's views and BNSF's view with respect to the existing competition provided between KCSR and UP are clearly irreconcilable. BNSF actually makes the case for why the Gray and Hausman assumptions are incorrect. According to BNSF, if KCS took actions to divert traffic away from the BNSF/Tex Mex routing "a very real and ironic possibility. . . could be the diversion of only a small incremental amount of traffic KCS predicts in its control application to KCS long term, but the surrender of more traffic and future growth to UP, water/barge or truck, and not to KCS/NAFTA Rail." BNSF-4. V.S. Rickerhauser at 19. Likewise, they state that "[t]he delays imposed by forced diversions to KCS' lines would likely make KCS' service uncompetitive for much traffic going to Mexico, particularly grain, motor vehicle and auto parts." BNSF-4 at 14. That is, of course, precisely the point that KCS is making about why it would have no incentive to eliminate efficient BNSF/Tex Mex routings. Curiously, UP does not seem to share BNSF's views that KCS will use its control of Tex Mex and TFM to make BNSF routings inefficient so as to shift traffic to UP routings. If it did, UP should be supporting the two transactions rather than leading the opposition. BNSF's views also undercut UP's notion that KCSR could simply raise rail rates to shippers and raise UP's costs and thus those shippers would have no alternative but to use a NAFTA Rail routing but at a higher costs. The irreconcilability of BNSF's and UP's arguments demonstrates the danger of conditioning this transaction on speculative theories, when at least one (though KCS believes both) must be wrong.

As Mr. Davies explains, the enormous market coverage held by UP and BNSF provides TFM's customers with access to many geographic locations and sources of product or markets

for products that KCSR simply could not provide to those customers. KCSR does not remotely possess the market scope that UP and BNSF have, so it is not in KCSR's interest to eliminate TFM access to UP and BNSF routings. R.V.S. Davies at 10. Given the vast amount of TFM interchange traffic that comes or goes to UP and BNSF points that KCSR does not serve, NAFTA Rail will have no ability to foreclose this traffic in the future. Attempting to do so would result in a dramatic loss of revenue to TFM.

It is this potential dramatic loss of traffic that also undermines another assumption set forth by Dr. Hausman. As Dr. Kleit explains, Dr. Hausman's theory is that TFM will raise its rate factors to both UP and KCSR but must charge them the same rate factor due to Mexican regulatory requirements requiring TFM to treat all of its connecting carriers the same. He then assumes that UP cannot lower its rate requirements but KCSR could (Dr. Hausman does not explain why UP could not match KCSR's rate reduction). The problem with this analysis is that if UP cannot lower its rate factor and TFM has increased its rate factors, then all of the TFM-UP traffic that is solely served by UP in the U.S. would be lost to TFM as rail prices to the shippers at these UP solely-served points would increase and this traffic would either dry up, switch to other modes, be shipped through another gateway or to another UP served origin or destination. The same outcome would occur if NAFTA Rail attempted the same sort of foreclosure strategy against BNSF. Given that the fact that the vast majority of Laredo gateway traffic is from either UP or BNSF solely served points, or depends upon the routing choices of CSX, NS, CP, or CN, such a foreclosure strategy would be extremely costly to the NAFTA Rail system.

- d. Most Of The Traffic Is Elastic Traffic Subject To
Diversion To Other Modes If Rates To Shippers Increase

Another faulty assumption of the scenario put forth by Mr. Gray is that KCS could simply raise existing rail prices from \$200 to \$205 or even to \$215 and the traffic would

continue to move and not switch to other modes or move to other origins or destinations. The Hausman theory, a variant of the Gray theory, rests on a similar assumption that the foreclosure strategy would be profitable because KCS could raise rates to shippers and such shippers would have no choice but to accept the rate increase. Both theories assume that rail rates could increase without losing this traffic.

Besides the problem that this theory assumes that UP is not already raising rates as high as it could and is leaving money on the table, which is not grounded in reality, *see* R.V.S. Davies at 25-27, this theory also assumes that the traffic to/from Mexico is rail dependent, not subject to diversion to other modes or, in economic terms, is “inelastic” traffic. In the rail industry, inelastic traffic generally means such rail dependent commodities as coal, some chemicals, and some grain movements without access to water carriers. In this case, however, the types of commodities shipped through the Laredo gateway are precisely not the types of commodities generally considered inelastic. All parties seem to agree that the major commodities shipped through the Laredo gateway are export grain, automotive, and intermodal. Yet these are precisely the commodities that are most susceptible to diversion to other modes, *i.e.*, these are the most “elastic” commodities. V.S. Kleit at 21-22.

A review of past ICC and STB precedent, the traffic data, and of the UP and BNSF documents produced in discovery³⁰ clearly shows that neither UP nor BNSF view KCSR or any

³⁰ While UP and BNSF generally cooperated with KCS’s discovery requests, CN refused to produce any documents, even documents relevant to the arguments it raised. Given the short time frames between the filing of the August 4 comments and the September 2 comments and CN’s uncooperative posture, KCS did not have time to file a motion to compel, have it ruled upon, and have those documents used in this filing. The Board should caution all parties of the need to cooperate in discovery requests and not to use the relatively short time frames involved in a minor transaction to entirely foreclose legitimate discovery. Likewise, by redacting certain information from even “Highly Confidential” documents, UP has in effect created a category of

other railroad as their main competitor for U.S./Mexico traffic.³¹ Instead, UP and BNSF view their main competition as transportation by other modes and past precedents confirm that view.

It is the strength of this cross-border competition by other modes that restrains all rail carriers from driving up prices or degrading service and completely contradicts the theories espoused by Gray and Hausman. This view was expressed in the *UP/SP* merger by UP itself in the context of arguing against Tex Mex's request to obtain trackage rights to connect with KCSR. In UP's view, the Tex Mex condition was not needed because the pervasive existence of such modal competition was so strong that it was more than sufficient to constrain UP's rail rates at Laredo even when UP would have a monopoly on rail traffic at Laredo.³² *UP/SP*, Decision No. 44 at 130-31 and 131 n. 145.

confidential information that cannot even be produced under a HC designation. *See, e.g.*, UP-H-5210 through UP-H-5218. UP has done precisely what this Board has been cautioning against with respect to the abuse of the confidentiality designation. This practice of creating an even higher level of confidentiality than what is produced under the HC designation began with the CSX and NS in the *CSX/NS/Conrail* proceeding and its continued use should be cautioned against. The Highly Confidential designation and the existence of the Protective Order provide more than sufficient protection against unwarranted disclosure.

³¹ This provides yet additional proof that the theory expressed by Gray and Hausman that rail-to-rail competition between UP and KCSR is setting prices and driving the market so as to give an incentive for KCSR to raise prices is simply not borne out by the facts. Accord BNSF's comment that "a very real and ironic possibility. . . could be the diversion of only a small incremental amount of traffic KCS . . . but the surrender of more traffic and future growth to UP, water/barge or truck." BNSF-4, V.S. Rickerhauser at 19.

³² Contrary to UP's assertions at UP-7A at 72-73, Tex Mex itself did not argue that there was no competition from trucks or water; it did argue that truck and water competition would not be sufficient to constrain rail rates at Laredo if UP were granted a monopoly at the Laredo gateway. *See* UP-7A at 73, n. 112, quoting Tex Mex witness Ellebracht that truck and water competition were not sufficient to constrain rail prices "in the absence of effective rail-to-rail competition."

As the Board itself recognized in *UP/SP*, competition from trucks and water did provide a competitive constraint on rail rates.

The more efficient Mexican routings for both *UP/SP* and BNSF will help improve the rail share of traffic to and from Mexico. Today, trucks dominate this traffic. Even at Laredo, the most efficient Mexican rail gateway, trucks handle approximately 86% of the cross-border traffic. Upgrading the Southern Corridor lines, instituting new Laredo-California intermodal service, and greatly improving the efficiency of operations in the Laredo-Memphis-St. Louis-Chicago corridor will give rail a much better ability to capture a larger share of this market.

UP/SP at 566. Moreover, in rejecting the Department of Justice's concerns about 3-to-2 points, the Board relied on intermodal competition, stating in part that "[m]ore than 70% of the 3-to-2 traffic is made up of commodities that are clearly much more truck-competitive than grain," while pointing out that "[b]arges, where they are available, are a particularly important factor in grain transport." *UP/SP* at 389. "Further, applicants explain that most chemical traffic, other than plastics, moves predominately by truck and barge, [footnote omitted] in addition to moving by rail," the Board noted. *Id.* at 396.

In the *BN/SF* merger case, the ICC likewise stressed that the proposed merger would make railroads more competitive against strong truck and water competition for transportation to Mexico:

The fourth major route enhancement would be the creation of a direct single-line route between Central and Western Canada and the major Mexican gateway at El Paso. . . . Via these routes, the United States would participate economically in the movement of goods such as forest products, minerals, chemicals, and metals that might otherwise move entirely outside the U.S. transportation network via Canadian ports on the Great Lakes or in British Columbia.

Because Santa Fe accesses the El Paso gateway, a commonly controlled BN/Santa Fe will have single-line access to Mexico. Moreover, a significant

Here, *UP*, BNSF, and KCS/Tex Mex all serve the Laredo gateway and will continue to do so after common control.

amount of trade in grain is now carried out by rail and barge movement to Gulf Coast ports, with subsequent waterborne shipment to the Veracruz region of central Mexico. The introduction of new single-line service in grain transportation to the Gulf by BN/Santa Fe will enable it to compete more effectively (primarily with KCS). This will enhance the grain trade with Mexico, and with other international markets as well.

BN/ATSF at *155-57.

UP, BNSF and KCS all recognize that to gain market share for U.S./Mexico rail traffic, they must improve service to attract traffic from trucks. UP's summary dated January 31, 2003, says that UP's objective is to

UP-H-1309. UP's strategy includes:

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UP-H-1311.

-

UP-H-1315.

-

UP-H-1413.

Leading the way in UP's Mexico Business Development Scorecard is conversion of truckloads to rail in 2002, yielding in UP revenue, more than of UP's revenue growth for Mexico for the year. UP-H-1312. Similarly, in summarizing its Mexico market strategy, BNSF states that it intends to

BNSF-HC-00531.

Rail growth opportunities target

UP-H-2293, a page of

Other presentations from this major UP marketing initiative for cross-border traffic state, and

UP-H-1895 and UP-H-1896. Service levels must meet

UP-H-1896.

UP-H-4700. Rail pricing is also dictated to a large degree by *See, e.g., UP-H-4630 – UP-H-4640, especially UP-H-4638 and 4640 (*
).

Water-borne transport is also a significant competitive constraint on railroads. As a recent internal UP memorandum stated:

Future growth in rail traffic and revenues will likewise come through new, competitive offerings by rail carriers. “Over the next few years, Pacer projects that at least 500,000 carloads can be converted from truck to intermodal rail *assuming performance and pricing levels can continue to be improved at the rate they have in recent years.*” Comments of Pacer International, Inc., at 8.

Despite the *UP/SP* merger and despite the tremendous progress made within Mexico as a result of privatization of that nation's railways,³³ statistics clearly demonstrate that trucks remain the dominant means of cross-border transportation today. Bureau of Transportation Statistics data show that for Laredo alone in 2002, the combined value of exports to and imports from Mexico by truck was approximately \$55.8 billion,³⁴ while rail crossings at Laredo accounted for approximately \$6.4 billion of exports and \$16.9 billion of imports.³⁵ Figures for other top U.S./Mexico border crossings showed the following values for trade carried by truck: El Paso, TX: \$35,093,583,193; Otay Mesa Station, CA: \$20,367,624,663; Hidalgo, TX: \$12,184,735,176; Brownsville/Cameron, TX: \$9,455,249,911; Nogales, AZ: \$8,750,090,264; and Calexico-East, CA: \$8,278,428,327. Altogether, the value of all U.S./Mexico shipments transported by truck was \$161,518,340,301 in 2002.³⁶ By contrast, the value of all exports to and imports from Mexico by rail in 2002 was less than one-fifth as much, only \$30,933,693,502.³⁷

UP and BNSF documents clearly recognize

A January 2003 UP report stated,

UP-H-4451. Similarly, BNSF's documents show

³³ As Mr. Davies testified at the Board's July 31 hearing, the rail share of Mexican intercity transportation has grown since privatization in 1996 from approximately 10 percent to approximately 17 percent today. July 31, 2003 Hearing Transcript at 171.

³⁴ http://www.bts.gov/ntda/tbscd/reports/annual02/port/pt_2002_trk.html.

³⁵ http://www.bts.gov/ntda/tbscd/reports/annual02/port/pt_2002_ral.html.

³⁶ http://www.bts.gov/ntda/tbscd/reports/us_mex_2002_Truck.html.

³⁷ http://www.bts.gov/ntda/tbscd/reports/us_mex_2002_Rail.html.

BNSF-HC-00144.³⁸

said the UP

UP-H-4651.

The prospect of opening of the U.S. border to Mexican trucks carrying international traffic beyond the border economic zone would further intensify this already vigorous competition. As UP wrote

UP-H-

4423.

Anticompetitive behavior of the type suggested by Gray, Hausman, or Reishus, which would increase prices or reduce the value of services offered, would simply undo the gains made by the rail industry in the past half-dozen years, and drive freight back to trucks. As stated in Pacer's comments, "[M]ost, if not all, of Pacer Stacktrain's U.S./Mexico intermodal traffic [would be lost] to truck," if the Laredo gateway did not remain open to competition.

, UP and BNSF understand that the market is not driven by rail-to-rail competition for inelastic traffic so that a hypothetical increase in price would be profitable, but rather trucks remain by far the dominant mode of transportation for U.S./Mexico traffic, and will become an even stronger competitor when the border opens to international trucking beyond the border commercial zone. Water transport is also an important

³⁸ By volume of movements as well, truck shipment clearly predominates. Texas A&M International University reports 5.56 million truck crossings at the Texas border in 2002, <http://texascenter.tamui.edu/bbi/bridge/truck/dataTruck.asp>, but only about 565,000 rail car crossings that year. <http://texascenter.tamui.edu/bbi/bridge/rail/dataRail.asp>. (This data is somewhat skewed because southbound rail crossings at El Paso were not included.) While rail has made some incursions into the truck market, the vast majority of shippers still truck their goods across the border.

competitive factor for some commodities, including grain.³⁹ Increasing rail market share requires cooperation by all railroads to provide improved, more competitive service offerings. Anti-competitive actions by any carrier will simply divert traffic back to truck, a lose-lose situation for all railroads.

- e. UP and BNSF Can Retaliate Against Anticompetitive Actions Taken By NAFTA Rail By Using Ferromex Or Switching To Other Gateways

Another underlying assumption of the theories expressed by Dr. Hausman, Dr. Reishus, and Mr. Gray is that UP and BNSF have no choice but to use the Laredo gateway or, if they did switch to the other gateways, efficiency would suffer. The problem with this assumption is that both BNSF and UP have the option of switching their routings away from Laredo and TFM to other gateways and for most of the UP and BNSF traffic these gateways are just as efficient as the Laredo gateway. Mr. Michael H. Rogers, CEO of Cogent, Inc., discusses the extent to which these other gateways are used today and as the data shows, the Laredo gateway only serves half of the U.S./Mexico rail traffic.

The simple fact is that Laredo must remain efficient and open. If it does not, UP and BNSF will use these other gateways. UP has access to six gateways. BNSF has access to four. KCS has access to one. It may be that for some traffic Laredo is the most efficient gateway and that shippers prefer the Laredo gateway, but those efficiencies were created as a result of both TFM and KCS investments in TFM's and Tex Mex's infrastructure. KCS and TFM fully understood that to attract UP and BNSF traffic to the Laredo gateway, they had to make that gateway the gateway of choice. To assume that KCS would now want to use its control of Tex

³⁹ See, e.g., Verified Statement of Gerald K. Davies, Applicant's Supplemental Evidence (KCS-10, TM-10) filed June 9, 2003, at 9-10.

Mex and TFM to downgrade service and cause inefficiencies in UP and BNSF routings and risk losing a substantial amount of traffic to other modes or other gateways is illogical, and runs contrary to KCS's actions over the past six years in investing in TFM and Laredo, even though it fully knew that UP would be the primary beneficiary of those investments. R.V.S. Davies at 4-7.

(i) BNSF Can And Does Use Other Gateways

With respect to BNSF's arguments regarding their ability to use other gateways, KCS does not disagree that the Laredo and Brownsville gateways are important gateways, but they are not the only gateways used by BNSF, or capable of being used by BNSF. Despite BNSF's and UP's claims of being dependent on the Laredo gateway, the carriers' own internal documents show that they have both the ability and the incentives to use a variety of gateways. In fact BNSF moves more traffic via interchange with Ferromex than it does via interchange with TFM

If KCS were to use its control of Tex Mex to make the BNSF/Tex Mex routing inefficient, BNSF would simply shift this traffic to its Eagle Pass or El Paso gateways and an interchange with Ferromex.

BNSF historically has made significant use of gateways other than Laredo.⁴⁰ To a large extent, BNSF's own route structure causes this.

BNSF-HC-00165 and BNSF-HC-00169.

BNSF-HC-00162.

⁴⁰ For example, in late 2000, in response to perceived service problems on Tex Mex, BNSF-HC-00043.

BNSF-

HC-00047. Simply as a result of BNSF's own route structure, BNSF is often already at a competitive disadvantage vis-à-vis UP at Laredo. Given that BNSF is the prime competitor to UP, and not KCS, if KCS wants to provide a competitive choice to UP, which it does, it does not make any sense for KCS and Tex Mex to add further inefficiencies to BNSF routings. Precisely the opposite is true, KCS and Tex Mex need to work with BNSF even more closely in order to encourage them to use Laredo more.

BNSF-HC-0176.

BNSF-HC-00056; BNSF-HC-00176.

BNSF-HC-00206. In fact, even this result may be somewhat skewed from the result of normal market forces

. BNSF-HC-00166. If BNSF were as dependent upon Laredo as it portrays in its August 4 filing, surely these facts would be significantly different.⁴¹ It is precisely because of BNSF's extensive use of

⁴¹ While BNSF confined many of its answers to KCS's discovery to traffic moving only over Laredo and Brownsville, that BNSF in the past has handled traffic moving over various Mexican gateways

BNSF-HC-00250.

Ferromex and its other gateways that KCS would have no incentive to encourage them to use Ferromex and other gateways even more.

The truth is that as a strategic matter, BNSF hopes to exploit its advantages at El Paso to avoid colliding with the more firmly entrenched competition from UP at Laredo.

BNSF-HC-00529.

BNSF-HC-00531.

BNSF-HC-0167.

BNSF-HC-00168.

Likewise, BNSF has and will continue to make extensive use of its Brownsville gateway. According to BNSF, it has increased its Brownsville traffic 250% over the 1996-2002 time period. BNSF-4 at 8. Of course KCS and Tex Mex wish that they could encourage BNSF to use the Laredo gateway for this traffic instead of the Brownsville gateway as doing so would provide added revenues to the Tex Mex, a carrier that has suffered financially over the past few years and that is in desperate need of revenue to continue improvements in its infrastructure and to continue to compete against UP. BNSF discloses part of the reason why that traffic does not go over the Laredo gateway. According to BNSF, 60-70% of this traffic at Brownsville serves a single receiver – Regasa. *Id.* BNSF then claims that if the Brownsville gateway were no longer open on commercially reasonable terms, “Regasa could only receive its soybean shipments

through UP, or via barge or truck.” BNSF-4 at 9. Of importance is that BNSF did not claim that this traffic would switch to a KCS routing, creating an incentive for KCS to inefficiently foreclose BNSF, but rather that this traffic would switch to UP or other modes. BNSF’s comments make precisely the point emphasized by KCS throughout this proceeding: KCS has absolutely no incentives to raise prices or reduce service for BNSF traffic. If it did so, traffic that is routed BNSF/TM/TFM or KCS/TM/TFM would simply switch to UP or other modes. Accordingly, KCS has every incentive to continue to work with BNSF to increase BNSF’s share of the market.

As a result of BNSF’s ability and its desires to use other gateways, KCS in a post-control environment will likely have to offer incentives to BNSF in order to encourage BNSF to route its traffic over the Tex Mex rather than Eagle Pass or El Paso. This is especially true for BNSF originated or terminated traffic from the Northwest, West Coast, and Southwest, points that KCS cannot even serve. KCS thus has no possible incentives to reduce the effectiveness of the BNSF/Tex Mex routing.

Indeed, in the *UP/SP* decision, the Board fully expected that BNSF would actually prefer their other gateways over the Laredo gateway and thus felt it necessary to grant KCS access to the Laredo gateway via the Tex Mex trackage rights to effectively preserve two carrier competition at Laredo. In that proceeding, BNSF argued that its trackage rights to Brownsville and its connection with the Tex Mex at Robstown would preserve competition at Brownsville and Laredo. KCS and Tex Mex argued that BNSF would be “uninterested in, or will be incapable of, providing competitive interline service for movements into Mexico over the Laredo gateway.” *UP/SP* Decision No. 44 at 137. The Board agreed with KCS’s and Tex Mex’s assessment and specifically found that it has “some reservations about BNSF’s willingness and

ability to attract sufficient traffic over the Laredo gateway,” a problem remedied by the Board “by giving Tex Mex trackage rights” to connect with KCSR to “permit it to gain additional traffic.” *Id.* at 138.

The STB’s reasons for granting Tex Mex the trackage rights to connect with KCSR at Beaumont were further explained not ten pages later. There, the STB made it crystal clear that the BNSF Settlement Agreement would preserve shippers’ competitive alternatives at Brownsville and Eagle Pass, but there were “legitimate concerns” that unless Tex Mex was allowed to connect with KCSR at Beaumont, “the merger could result in a reduction in competition at Laredo.” *UP/SP Decision No. 44* at 147. Over the next three pages, the STB explained that because BNSF would have access to Brownsville and Eagle Pass, Tex Mex needed the connection with KCSR to preserve competition at Laredo and to ensure the essential services provided by Tex Mex. Indeed, both UP and BNSF argued against a grant of the Tex Mex trackage rights on the basis that the BNSF Settlement Agreement, with its connection with Tex Mex at Robstown, was more than sufficient to preserve competition at Laredo. The STB specifically rejected UP’s and BNSF’s claims and found that “a partial grant of Tex Mex’s responsive application [*i.e.*, the trackage rights connection with KCSR] is required to ensure the continuation of an effective competitive alternative to UP’s routing into the border crossing at Laredo.” *Id.* at 149.

(ii) UP Likewise Uses Other Gateways

Like BNSF, UP also is able and willing to use other gateways as alternatives to Laredo.⁴²

⁴² Like BNSF, UP is a predominantly western carrier,

UP-H-4533 (

).⁴³ In fact,

. UP-H-1292. Moreover, UP

has

. UP-H-1387.

UP-H-1514.

UP also has favorable connections at non-TFM crossings. All of UP's connections to alternative Mexican gateways – Calexico, Nogales, El Paso, Eagle Pass and Brownsville – are via UP's own lines, not via trackage rights controlled by another carrier. Together, these gateways have greater capacity (*i.e.*,

UP-H-1316

UP-H-2494.

In short, UP is fully capable of using alternative gateways to Mexico. Because some difficulties involved with using other gateways arise in part from a shortage of railroad yards on

UP-H-4531.

UP-H-3386 through UP-H-3389.

the U.S. side of the border, where UP owns the track,⁴⁴ UP is in a superior position to immediately improve the accessibility of Mexico via these other gateways. Such investments, were UP to make them, could improve alternative services available to shippers throughout the U.S.

The idea that NAFTA Rail would use its facilities at Laredo and Tex Mex to foreclose efficient UP and BNSF routings is simply a theory, not grounded in reality. If NAFTA Rail attempted to do so, it would lose a significant amount of traffic to other modes and whatever traffic remained on rail would be switched to the other gateways. The fact that the presence of other gateways constrains anticompetitive behavior at a gateway is not only consistent with economic principles, but also with Board precedent. Indeed, the *Canada Southern*⁴⁵ case, relied upon by UP and CN for their views with respect to the Board's authority to review the cross-border effects of a transaction, actually is illuminating with respect to the fact that the existence of alternative gateways with connections to other independent railroads provides a competitive constraint on the ability to raise rates to shippers or to foreclose efficient routings. *See Canada Southern* at *26.

In that case, U.S. domestic rail carriers argued that control of the main tunnel and main bridge between the U.S. and Canada by two Canadian carriers would foreclose efficient rail routings between the Canadian carriers and carriers unaffiliated with the Canadian carriers.

⁴⁴ UP-H-1244 (citing shortage of yard space north of the border at Eagle Pass, Nogales and El Paso as inhibiting efficient connections with Ferromex). Moreover, in *UP/SP* Decision No. 44, the Board cited UP's stated intent to develop the Calxico border crossing. *UP/SP* Decision No. 44, 1 S.T.B. 233, 483 (1996).

⁴⁵ *Canadian National Ry. Co. and Canadian Pac. Ltd.-Acquisition-Interests of Consolidated Rail Corp. in Canada Southern Ry. Co. and Detroit River Tunnel Co.*, Finance Docket No. 30387, 1984 ICC LEXIS 332 at *26-27 (1984).

(This is, of course, the same argument being advanced in this proceeding by UP and BNSF).

The ICC rejected those claims, as the Board should do here.

Detroit and Niagara Falls/Buffalo are important gateways for traffic moving between points in the United States and southeastern Canada. However, they are not the exclusive means of access to Canada, either by rail or other modes of transportation, and there is no evidence that control of these facilities by CN and CP will adversely affect competition at these gateways.

* * * *

Although this transaction will result in CN and CP control of the rail crossings between the United States and Southern Ontario, we see no real incentive for these carriers to restrict access to Canada. . . . It would generally appear to be in their interests to preserve and increase their interchange options at the gateways on both the Canadian and U.S. side.

This is not to say the temptation to discriminate against U.S. carriers is totally lacking. With respect to Detroit, CN's plans include the diversion to CSR and to the tunnel of a very large volume of CN-GTW traffic now handled via the Port-Huron-Sarnia gateway, and there is the possibility that it might be tempted to favor its subsidiary in the scheduling of such traffic through the facility.

However, such a move would likely invite other U.S. carriers serving the gateway to initiate retaliatory measures against CN.

Canada Southern at 26-29.

Certainly UP, BNSF, NS, and CSX, CP, and CN have many more ways to retaliate against KCS than a NAFTA Rail would have available against any of them. As KCS has established, both UP and BNSF have many alternatives and if they decided to exercise those alternatives, NAFTA Rail would lose much more traffic than it could gain by attempting to foreclose UP or BNSF routings.

- f. There Is Not Enough Capacity On The UP Line
Used By Tex Mex To Handle Substantial Diversion
To KCSR/Tex Mex Routings

Even if NAFTA Rail had the ability and the incentive to foreclose UP and BNSF routings over Laredo so as to divert all of the Laredo traffic over the NAFTA Rail system, this presumes

that all of the UP/TFM and BNSF/TM/TFM traffic lost could be made up. Besides the issues noted above, another problem with this theory is that it presumes that there is adequate capacity and infrastructure over the NAFTA Rail system to handle this presumed vast amount of diverted traffic. The theory thus ignores the fact that the Tex Mex, in order to connect with KCSR, must traverse the lines of UP and there is a key section of UP's Brownsville Subdivision where all three carriers, UP, BNSF, and Tex Mex, must operate. It is this piece of track that is severely congested due to the lack of adequate infrastructure.

Not only is that key section of UP track used by KCS/Tex Mex for NAFTA traffic, but BNSF also uses that portion of UP's line for both the Laredo traffic that it interchanges with Tex Mex at Robstown, and local and through traffic from Houston to Corpus Christi and Brownsville, including NAFTA traffic interchanged with TFM at Brownsville. In addition, UP traverses that segment for its local and through traffic from Houston to Corpus Christi and Brownsville, including any NAFTA traffic interchanged through Brownsville. As a result, this segment is heavily utilized by UP, BNSF, and Tex Mex. Indeed, UP's study indicates that the Bloomington to Kingsville Segment (Kingsville is slightly south of Robstown) has a capacity of 11 to 13 trains per 24 hour period. KCS-P 0006. In UP's study period, which included a 15-day period in October of 2002, the traffic on the line equaled or exceeded capacity for 9 of those 15 days. In his Verified Statement in the Application ("V.S. Riney"), James L. Riney, General Manager of the Tex Mex, testified that the traffic levels today are twice what UP believes the capacity of the Brownsville Subdivision to be. Application, V.S. Riney at 134-135. As he noted, that line has the capacity of anywhere from 11 to 13 trains per day but is currently averaging 19 to 22 trains per day. This fundamental fact has gone unchallenged by UP. It would simply be

impossible for NAFTA Rail to divert additional traffic over this line in an effort to foreclose UP and BNSF routings.

UP claims that it has suggested several remedies that supposedly would protect Tex Mex from delays caused by UP. First, UP claims that Tex Mex is free to participate in its Spring Dispatching Center in order to head off delays. V.S. Barkley at 22. Tex Mex cannot afford the \$100,000 annual cost of placing an individual in the Spring facility simply in order to watch the UP dispatchers.⁴⁶ In addition, the Board should be aware that Tex Mex pays UP over \$700,000 per month to handle dispatching. Therefore, there should be no need for Tex Mex to incur additional costs. Furthermore, even when Tex Mex originally assigned an Assistant Trainmaster to work with UP, that did not translate into fair, non-discriminatory treatment over the trackage rights. In any event, participation in the Spring Dispatching Center would not alleviate the congestion on the Brownsville Subdivision. R.V.S. Riney at 11-12.

Second, UP claims that although Tex Mex has the right to “identify and fund construction of sidings and other capital improvements on the trackage rights lines” under the 1996 trackage rights agreement that Tex Mex has never done so. That statement is false. In fact, to help alleviate the capacity problems on UP’s lines, Tex Mex spent \$2.25 million of its own funds in 1999 to construct an additional siding on UP’s line between Placedo and Flatonia at Adel. While UP professes to lack knowledge of it, UP’s dispatchers routinely use the Adel siding as a “parking spot for [Tex Mex] trains to allow their traffic to keep moving rather than equally

⁴⁶ In addition, Tex Mex would incur expenses associated with office furniture, computers and the like.

dispatching all trains on a first come/first served basis.”⁴⁷ R.V.S. Riney at 12. In short, UP has prevented Tex Mex from making full use of its investment.

Last, UP notes that it has sold the old SP Wharton line to Tex Mex. That line runs between Victoria and Rosenberg. To date, Tex Mex has not been able to begin the rehabilitation of that line due to ongoing litigation. While rehabilitation will alleviate some problems, it will not cure the problems associated with the lack of adequate infrastructure on UP’s Brownsville Subdivision. After rehabilitation is completed, Tex Mex still must operate over the Brownsville Subdivision between Bloomington and Robstown, the portion that lacks the capacity.

Furthermore, even if the capacity could be improved, that does not change the fundamental fact that UP will control the dispatching and could use this control to retaliate against NAFTA Rail if KCS took any actions to foreclose UP’s and BNSF’s use of the Laredo gateway. In fact, UP has often used this control to discriminate against Tex Mex trains in favor of its own trains. Tex Mex trains suffer extensive delays due to the congestion caused by the lack of capacity. UP claims (UP Comments at 79) that the delays suffered by Tex Mex are a result of Tex Mex not having enough crews; however, the many delays that Tex Mex encounters have little to do with the length of its crew districts. In fact, with proper dispatching and adequate capacity, Tex Mex’s existing crew districts are not too long. R.V.S. Riney at 10. In addition, UP’s claim that it does not discriminate against Tex Mex is refutable by the evidence: UP does discriminate against Tex Mex trains by giving priority treatment to its ‘Z’ and ‘A’ trains, which involve high speed trains; and by routinely moving its slow trains past Tex Mex trains, which are being held up by UP dispatchers on the UP-controlled lines. *Id.*

⁴⁷ E-mail, Ronney O. Nichols, 6/21/00, attached as Exhibit C.

UP seeks to avoid the charge of discrimination by claiming that its own studies show that “UP trains suffered the most minutes of delay per train,” -- UP Comments at 80 -- and that “the impact of the delays on these lines falls much more heavily on UP than Tex Mex, in part because UP operates many more trains than Tex Mex over these lines.” UP Comments at 79. The facts behind these claims, however, tell a different story.

UP’s evaluation that it suffers the largest number of delay minutes per train is but one way to view the statistics. If viewed on a train-mile basis, which takes the number of trains, as well as the mileage traveled, into consideration, Tex Mex trains, on average, were delayed 1.45 minutes per mile operated. By comparison, UP’s trains were only delayed .84 minutes per train-mile.⁴⁸ In addition, during the study period, Tex Mex trains were not put into sidings. As a result, the study does not reflect standard operating procedures. R.V.S. Riney at 10-11. In short, UP’s claim that “Tex Mex trains suffered the fewest minutes of delay per train” -- V.S. Barkley at 21 -- is highly misleading. R.V.S. Riney at 11. Tex Mex suffered fewer total minutes of delay because it operated fewer trains over fewer miles, not because its trains were delayed less than UP’s. In fact, Tex Mex’s trains were delayed more.

This conclusion was supported when Tex Mex completed its own congestion study in December of 2002. KCS-P 0020-36. In the September-November 2002 period covered by the study, Tex Mex had 72 trains delayed due to hours of service limits that were caused by UP congestion or UP’s refusal to take Tex Mex’s trains.

⁴⁸ These averages assume that Tex Mex trains traveled approximately 85 miles per train (the distance between Robstown and Placedo on the subdivisions covered by UP’s report, and that UP trains traveled approximately 343 miles (the combined length of the Brownsville and Angleton Subdivisions covered by the report) per train.

Accordingly, the diagnosis by both UP and Tex Mex is the same: there is simply not enough capacity on the Brownsville subdivision, which creates substantial congestion there that is causing delays in service and increased crew costs. *Id.* Given this high degree of existing congestion and capacity constraint, it would be nearly impossible for NAFTA Rail to undertake actions as suggested by UP and BNSF that would effectively route more traffic over this line.

g. Most Traffic Is Locked Up Under Contract

Dr. Hausman's and Mr. Gray's theories also depend upon the actual ability to divert traffic at will. This theory does not consider the fact that almost all U.S./Mexico traffic is governed by contract and pursuant to those contracts, NAFTA Rail could not simply raise prices or divert traffic from UP or BNSF routings. UP has locked up major portions of U.S./Mexico traffic under intermediate and long-term contracts, making such traffic unavailable for diversion to the NAFTA Rail system. UP has not attempted to refute the statement in the June 23 Supplement to Application that on April 24, 2003, UP's President Richard Davidson said the following when describing to financial analysts UP's lack of concern that NAFTA Rail would divert significant traffic from UP:

Furthermore, the majority of the traffic is locked up under contract, so you take into account the service capabilities, the fact that much of the traffic is locked up under long-term contract or intermediate term contract. And, plus, TFM has got to have a strong traffic flow to and from Union Pacific to make money. We are the 80% percent market share participant there."

UP-H-1292. With these types of commitments from major shippers, UP clearly will not be susceptible to any exercise of market power by KCS/NAFTA Rail such as it now claims to fear, because KCS/NAFTA Rail would not be able to divert traffic that is committed to UP under

contract. Furthermore, to the extent that TFM is also party to those contracts, KCS has said that contracts of Tex Mex and TFM would be honored. Contractual commitments by TFM would further protect UP against the supposedly “likely” anticompetitive manipulations of KCS/NAFTA Rail.

C. UP’s And BNSF’s Theories Are Based Upon Speculation
And Not Supported By The Shipping Community.

UP and BNSF both assert that KCS is going to use its control of Tex Mex and TFM to raise prices to shippers and degrade service. In particular, they claim that grain, automotive, and intermodal shippers will be harmed the most. For grain, UP Witness Gray claims that “[f]or grain moving from most of the U.S. Midwest to large portions of eastern and central Mexico, rail is the only viable option.” UP-7B, V.S. Gray at 36. Yet, as explained further in Mr. Davies statement, almost all of the “grain” going to Mexico is corn and the majority is now shipped via barge for export and rail needs to lower prices to compete, not raise them. In fact, if UP and BNSF were correct about the lack of intermodal competition and the ability of NAFTA Rail to raise rates, one would expect that grain interests would be kicking and screaming about the NAFTA Rail transaction. Instead, as reflected by the numerous grain shippers who filed comments in support of NAFTA Rail and testified at the July hearing, grain interests support the NAFTA Rail transaction. Indeed, for the first time in recent memory, the USDA actually testified in support of a rail merger transaction.

The story is similar with respect to automobile traffic. UP’s witness claims that automotive traffic is rail dependent and would suffer as a result of the proposed NAFTA Rail system. He even goes so far as to cite DaimlerChrysler as the type of shipper who depends upon rail and points out that for DaimlerChrysler’s Toluca plant in Mexico, TFM is the only rail option. With this in mind and given UP’s arguments that KCS is going to make U.S./Mexico

shipments inefficient and raise prices to shippers, one would expect DaimlerChrysler to oppose the transaction. In contrast to UP's theory, DaimlerChrysler and Mazda filed support statements with the Board and fully support the NAFTA Rail concept, without conditions. No automobile manufacturer or auto parts supplier has submitted comments backing UP's hypothetical concerns.

All that has been presented by UP and BNSF are theories and various scenarios of what may or could happen. One merely needs to review their comments to understand that they have presented no evidence. According to BNSF (emphasis supplied):

- Shippers "may be forced to use less efficient and more costly routes" - BNSF-4 at 3;
- The transaction "may lessen the competitive options" - BNSF-4 at 13;
- After the transaction, "NAFTA Rail could impose competitive restraints" - BNSF-4 at 11;
- If KCS obtains control of both Tex Mex and TFM, it will be in a position "potentially to interfere with BNSF" - BNSF-4 at 27;
- KCS and Tex Mex "could jeopardize BNSF's progress" - BNSF-4, V.S. Rickerhauser at 9;
- Tex Mex and TFM "may restrict BNSF's access to Mexico, and thereby may prevent BNSF from providing an effective competitive alternative" - BNSF-4, V.S. Rickerhauser at 9;
- With control of TFM, NAFTA Rail "could engage in economically inefficient foreclosure or discrimination" - BNSF-4, V.S. Reishus at 9.

UP argues:

- When KCS controls both Tex Mex and TFM, "[i]t could use its control to discontinue cooperation with UP" - UP-7A at 48;
- KCS "could" stop cooperating with UP - *Id.*;
- KCS "could" cause TFM to stop working with UP to improve UP-TFM service offerings - UP-7B, V.S. Gray at 31;
- KCS "could" use a similar strategy to increase its profits to shippers' detriment - UP-7A at 51;
- KCS "could" cause TFM to become less cooperative in pursuing commercial and marketing opportunities" - UP-7B, V.S. Gray at 32;
- The transaction "may produce higher prices to certain U.S. shippers" - UP-7B, V.S. Hausman at 3.

CSX claims:

- NAFTA Rail “could discourage and substantially reduce competition for rail transportation services.” CSX Comments at 5.

NS focuses on the KCS Meridian to Dallas line and claims:

- NAFTA Rail “may unduly divert attention and resources away from its Dallas-Meridian service, which in turn could reduce the effectiveness and competitiveness of east-west rail service over the Meridian Speedway.” NS Comments at 4.

Pacer claims:

- “KCS’s interest in maximizing KCS traffic over Tex Mex and the bridge . . . could wreak havoc for much of the cross-border NAFTA traffic” - PI-4 at 12.
- “TFM could favor shipments that it picks up from the KCS/Tex Mex over those traveling on UPRR or other railroads” - PI-4 at 14.
- The implementation of MCS “could” threaten Laredo gateway traffic and “could cause severe train delays and congestion throughout the new NAFTA Rail network” - PI-4 at 16.
- KCS’s capital improvement plans “could cause further delays and congestion throughout the NAFTA Rail network and over the Laredo Bridge” - PI-4 at 17.

CP makes no claim that the transactions would or could result in anticompetitive actions, but instead merely expresses concern over the level of evidence and the need to keep the Laredo gateway open on commercially reasonable terms. CN infers, but does not establish, that the KCS/TFM transaction may not be procompetitive because KCS will need to raise revenues to pay for the TFM transaction by taking some undefined anticompetitive action. In fact, the conclusion of CN’s witness is not that he has found evidence that the transaction will be anticompetitive, but rather that he has found no evidence on the record to conclude that the transaction “will be neutral or procompetitive.” CN-6, V.S. Vellturo at 4. The burden, however, is on all of these parties to show by substantial evidence the existence of harms that are truly substantial, not small or transitory. And, “[a] showing of expected substantial harm to a particular competitor as a result of a transaction is not equivalent to a showing of harm to competition.” Furthermore, precedent indicates that for end-to-end transactions, a condition

should not be imposed unless the parties can actually show that shippers benefited from the upstream competition.⁴⁹

Not one of these carriers has presented substantial evidence to establish that either the KCS/Tex Mex transaction or the KCS/TFM transaction will result in increased prices to shippers, decreased service, or inefficient routings. In fact, not one of these parties has provided this agency with any substantial proof, but only theory and speculation.

1. Pacer's Concerns Do Not Warrant A Condition.

The only shipper to provide substantive evidence and comment against the transaction was Pacer International, Inc. ("Pacer"). Pacer requests that the Board impose conditions relating to the operation of the International Bridge at Laredo, the installation of KCS's Management Control System ("MCS") on Tex Mex and TFM, and capital improvements on Tex Mex. However, Pacer fails to establish the necessary prerequisite for its requested conditions by failing to show any actual anticompetitive effect of the transaction before the Board.⁵⁰ Its requests also ask the Board to exceed its jurisdiction by reaching across the border to regulate activities of a Mexican railroad. All of Pacer's concerns either are dealt with by the NITL Agreement, by dealings between KCS, Tex Mex and the FRA regarding the SIP, or are beyond the bounds of this proceeding.

As an initial matter, Pacer's asserted concerns about anticompetitive activities by KCS, Tex Mex and/or TFM ring hollow because Pacer's traffic is handled under long term contracts

⁴⁹ "The record must clearly show, first, that prior to the merger the benefits of origin competition flowed through to the [shipper] and were not captured by the destination monopoly carrier, and second, the competitive flow through will be significantly curtailed by the merger." *BN/ATSF*, slip op. at 70.

⁵⁰ With respect to Pacer's argument that NAFTA Rail's financial structure would virtually compel it to discriminate, *see* Section II.E.2 hereof and Verified Statement of Ronald G. Russ.

with UP and TFM. Pacer states that its traffic between the U.S. and Mexico travels “primarily under contracts with the UPRR in the United States and the TFM in Mexico.” Pacer Comments at 8.

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It is reasonable to expect that Pacer’s contract with TFM protects Pacer against the type of anti-competitive conduct that it allegedly fears. Pacer says that it places great importance on timely, coordinated service. Clearly, therefore, it would be reasonable for Pacer to have written such requirements into its contract with TFM, including perhaps rate penalties if TFM failed to abide by the contractual standards.⁵¹ If Pacer had not incorporated those standards into its contracts, one would have to question the importance of those standards to Pacer, but from Pacer’s pleading it appears likely to KCS and Tex Mex that Pacer’s service standards, and some teeth to enforce them, are incorporated into its “recently-negotiated [] long-term partnership with TFM.”

Assuming the Pacer service standards are supported by contractual commitments from TFM, then Pacer should have no concerns about anticompetitive manipulation of operations of TFM or the bridge. KCS personnel have repeatedly stated that if they acquire control of Tex Mex (and/or TFM), KCS will honor the contractual commitments of those carriers. *See, e.g.*, Statement of Gerald K. Davies, July 31 Hearing Transcript, at 161. Even if KCS did not honor those commitments, legal remedies exist to enforce any legal contract. Accordingly, KCS and Tex Mex believe that Pacer’s interests are fully protected by its existing long-term contracts with UP and TFM.

⁵¹ *See, e.g.*, Pacer comments, page 8 (“Stringent performance measures have been established with UPRR and TFM to ensure the accomplishment of ‘just in time’ delivery.”)

Furthermore, much of the traffic that Pacer handles to and from Mexico is automotive traffic. Major auto manufacturers such as Mazda and DaimlerChrysler support this transaction because they understand the benefits of the improved competition that KCS and Tex Mex expect to offer. Other major auto manufacturers -- General Motors and Volkswagen -- are members of NITL, which entered into an agreement with KCS protecting the interests of shippers throughout the country. Thus, while Pacer allegedly fears the potential effects of the Tex Mex and TFM transactions on its automotive traffic, auto manufacturers themselves apparently have no such fear.

Pacer's concerns about operation of the International Bridge are likewise misplaced. Pacer contends that NAFTA Rail would have an incentive to discriminate against traffic handled by UP. As stated above, it seems likely that Pacer traffic handled by UP is protected by contracts with TFM which would prevent any such discrimination. Also, Pacer's argument presumes that it would somehow be in the interest of Tex Mex or TFM to discriminate against UP traffic, risking the bridge-crossing revenue from that traffic, even though for the vast majority of UP's traffic, KCS would not be able to serve the origin or destination served by UP and the traffic would be lost to truck rather than being diverted to KCS/Tex Mex.⁵² *See* R.V.S. Mutén at 5.

More importantly, however, KCS has said repeatedly that it will continue to operate the bridge as the bridge has been operated under longstanding agreements, and has offered to negotiate new agreements that are more satisfactory to all involved parties. *See, e.g.,* Testimony of Gerald K. Davies at July 31 STB Hearing, Transcript at 173-175. Indeed, KCS has had such

⁵² Indeed, in UP's April 24 conference call with financial analysts, Mr. Davidson pooh-poohed the idea of KCS being able to attract traffic away from UP considering UP's route structure and other factors. Similarly, the traffic diversion analysis presented in the KCS/Tex Mex application in this proceeding projects diversion of only about 4,000 carloads of UP's over 250,000 carloads moving over the Laredo gateway.

discussions with UP during the course of this proceeding. *Id.* While KCS and Tex Mex are not amenable to allowing non-owners of the bridge to take over and control its operation, because the possibility of discrimination by those non-owners is at least as obvious⁵³ as the possibility that historically-proven operations (which have facilitated Pacer's development of substantial cross-border traffic) will cause discrimination, KCS and Tex Mex expect the bridge to be operated as effectively in the future, or more so, as occurs now.⁵⁴

For several reasons, Pacer's requests to impose conditions on implementation of MCS on Tex Mex and TFM should be denied.⁵⁵ First, as UP recognizes, installation of MCS on Tex Mex is not directly connected with this proceeding, but is an independent initiative that was planned without regard to how the parties proceed on the control issue.⁵⁶ Second, the MCS implementation on Tex Mex is an issue covered by the SIP and in which the FRA has expressed interest. Consequently, FRA will oversee that implementation. Finally, the NITL Agreement, paragraph 4, provides that KCS and Tex Mex will monitor service levels between Beaumont and Laredo and will submit to the STB a corrective action plan if service levels fall below those in

⁵³ Pacer's concerns about prospective discrimination stem from NAFTA Rail's economic incentives to maximize its length of haul. Pacer Comments at 2.

UP-H-1292. Applying Pacer's criteria, it would appear that UP also could not be trusted not to discriminate.

⁵⁴ Inasmuch as TFM actually manages day-to-day operations on the bridge, wresting control of the bridge away from current owners also would raise issues of the Board's jurisdiction over a Mexican railroad, as discussed elsewhere in this filing.

⁵⁵ KCS does not plan to install MCS "immediately after its acquisition of control;" rather, MCS implementation is based on a separate contract and schedule.

⁵⁶ See UP-7A at 61-62 and n. 94.

effect at the time of the agreement. In combination with FRA monitoring under the SIP, any concerns that Pacer has about the implementation of MCS on Tex Mex are fully addressed.⁵⁷

Pacer's interest in the management of track improvements on Tex Mex is difficult to fathom inasmuch as Pacer traffic does not move over Tex Mex's line. Nevertheless, the proposed track work is planned to be conducted to cause as little disruption as possible in Tex Mex operations. Due to the nature and level of Tex Mex's traffic, windows of opportunity exist for performing work in between trains and for scheduling trains to foster completion of the work. Again, the track work is a matter addressed in the SIP. As such, it is a matter in which FRA has taken and will continue to take an interest, particularly if the track work is funded under the Railroad Rehabilitation and Improvement Financing program. Also, the effects of the track work would be reflected in service levels, monitoring of which will be conducted under the NITL Agreement. Finally, most of the work to be done is not in an area that would even indirectly affect Pacer's traffic, as significant work between Serrano Yard and the bridge has previously been done.

In short, Pacer's professed concerns for its own traffic are most likely adequately addressed and protected under its existing long-term contracts with UP and TFM. Those contracts will remain in force according to their terms regardless of this transaction. Implementation of MCS on Tex Mex and the conduct of track rehabilitation on Tex Mex will be monitored by FRA and will also be subject to operational monitoring under the NITL Agreement. KCS has repeatedly expressed its expectations that the operation of the International Bridge at Laredo will continue consistent with historic patterns and agreements, absent

⁵⁷ Because the TFM transaction is not before the Board and because operational monitoring in Mexico raises substantial jurisdictional issues, KCS and Tex Mex submit that any condition related to MCS implementation on TFM would be highly inappropriate.

agreement of affected parties to more suitable arrangements. Accordingly, and particularly in light of Pacer's failure to demonstrate anything other than hypothetical potential anticompetitive effects, mostly arising from the TFM transaction which is not before the Board, Pacer's request for conditions should be denied.

2. Other Shipper Letters Do Not Warrant A Condition.

As posited by UP, U.S./Mexico rail shippers using the Laredo gateway have no choice but to use rail because other modes are not feasible, must use the Laredo gateway because other gateways don't work, and because there is intense rail-to-rail competition between UP and KCSR, KCS has an incentive to foreclose UP routings. KCS has already explained why all of these assumptions are incorrect and why this transaction is consistent with over twenty years of ICC/STB precedent regarding end-to-end transactions and should be approved without conditions. Nonetheless, while no shipper, other than Pacer, submitted substantive comments seeking conditions on or disapproval of the transaction, a small number of shippers did provide letters to the STB expressing concerns about the transaction. Importantly, however, not one of those letters directly supports UP's theory that the shipper benefits from competition between UP and KCS or BNSF and KCS could be lost, or that their rail rates will increase because of the transactions, or their service will decline. A review of these letters confirms that fact.

IMC Chemicals ships "all" its Mexico shipments via UP through Laredo from its facility in Trona, California. Apparently this is a UP solely-served facility as IMC makes no reference to being able to use BNSF. Of course, KCSR does not serve this facility and thus IMC does not benefit from UP and KCSR competition. IMC Chemical does not oppose the transaction but wants a condition for the protection of UP's routing option. It has not shown why such a condition is necessary. Indeed, why KCS would use its control of TFM to purposely make the

UP/TFM routing for 20,000 tons of chemicals “inefficient” for traffic that KCSR could not even serve is not explained. The UP/TFM routing for IMC provides TFM with revenue, revenue that KCS could not replace and upon which TFM depends to provide an earnings stream. KCS has no incentive to stop this traffic.

Both BNSF and UP quote from AK Steel Corporation’s (“AK Steel”) letter. AK Steel makes steel products used in automotives, appliances, and manufacturing. AK Steel ships 120,000 tons of steel per year to Mexico. AK Steel does not oppose the transaction but wants a condition to protect its UP routing option. CSX originates this traffic and interchanges it to UP in Illinois, which takes it to Laredo for interchange with TFM. AK Steel does not claim that it benefits from competition between KCSR and UP. Instead, it says it has “several alternative routings that are available to move its product to the Mexican gateway.” Which gateway goes unsaid.

AK Steel is afraid that TFM will “favor” traffic that originates on KCSR over interchange traffic with UP or BNSF. AK Steel makes no attempt to prove that TFM isn’t already favoring steel originations on the KCSR, in which case the control transactions would have no impact on AK Steel’s traffic. In fact, AK Steel admits that TFM can exercise bottleneck control. TFM can and is likely doing that today. If TFM is not already favoring steel originations on KCSR, then there are likely other competitive pressures that are preventing it from exercising such control and there is nothing in the TFM control transaction that will eliminate those existing competitive pressures. Likewise, AK Steel does not show that its current rail options aren’t already locked up under contract. UP itself has admitted that most of the UP traffic is already locked up under contract, and KCS’s acquisition of control cannot terminate those contracts. AK Steel also fails to show that there are originations on the KCSR that compete with AK Steel origins so that these

origins could serve as an adequate substitute and that such substitutions, if they occurred, wouldn't be at a lower price for the ultimate end user. AK Steel's comments prove nothing other than an unsubstantiated fear about why might happen. Furthermore, providing lower prices for supplies of product on your own line, which is what KCS would have to do to "favor" its steel shippers, is not an anticompetitive action.

International Paper ("IP") provided an interesting comment. IP does not oppose the transactions. It claims that Mexico, broadly defined, is an emerging market and that IP shipped 213,000 tons in 2002 and that volume is expected to grow significantly. While Laredo is the gateway of choice for IP, it also has other gateway options, which IP uses. These options provide a check on KCS's ability to inefficiently foreclose IP's Laredo option. Furthermore, as Mr. Gerald Davies confirms, most of IP's shipments to Mexico via Laredo are already locked up in UP/TFM contracts that KCS must and will abide by when it gains control of TFM. R.V.S. Davies at 22.

IP in fact praises KCS as a valuable service provider. IP does have concerns about "possible" and "potential" discrimination, but doesn't claim it will happen. In fact, its strongest statements are not about anticompetitive actions that KCS could take, but rather that UP would take anticompetitive actions by "not providing neutral treatment to Tex Mex trains that necessarily move over trackage rights on the Union Pacific." This again confirms what KCS has consistently stated: UP has many more ways to retaliate against KCS and it is UP who has the chokehold over KCS, not the other way around.

Given that KCS is already a service provider to IP, whatever incentives KCS and TFM would have to favor a KCS/TFM routing already exist and the control transaction would not change those incentives. While requesting KCS to abide by its commitments, IP also challenges

UP and BNSF to live up to their merger commitments, which IP infers UP and BNSF are not doing. IP also asks that any commitments imposed on KCS should be imposed on BNSF and UP in both future and past actions, even if that includes reopening prior mergers. KCS understands IP's concerns with respect to all rail mergers, past and present, but it does not believe IP's concerns warrant imposition of a condition as IP has not shown that it would suffer competitive harm that is both likely and substantial.

One of the letters most often quoted by both UP and BNSF is the letter written by Mr. Mastandrea, Vice President/Distribution, for Unimin Corporation ("Unimin"). Unimin is one of the nation's largest distributors of industrial materials, such as sand, ball clay, bentonite, and kaolin. Curiously, there are four ball clay producers in Tennessee, all solely served by CSX. One of those facilities is a Unimin facility and the other three are Unimin competitors. Unimin has a Texas plant that is currently solely-served by UP. It supplies products to Mexican receivers or users. It is this Texas plant that currently has an advantage over the Tennessee plants and Unimin's competitors.

Upon examination, it is clear that Unimin makes no claim that it currently benefits from competition between a KCSR/TM/TFM routing and a UP/TFM routing or that competition will be reduced in a post-control environment, which is the basis of UP's economic arguments. Likewise, Unimin does not claim that its rail rates will increase or that UP isn't already charging the highest rate possible. Rather Unimin is concerned that the common control of Tex Mex and TFM by KCS will allow KCS to offer "preferential traffic packages to Tennessee customers to enable KCS to carry Gleason, Tennessee ball clay from New Orleans to Laredo."⁵⁸ In other

⁵⁸ Unimin also expresses concern that its Mexican customers will shift their sources of supply for fractured sand to "Unimin's major competitor that utilizes KCS." Again, Unimin is

words, Unimin's concerns are not that the transactions will reduce competition between railroads, but rather the transactions will actually expand the sources of product for both U.S. and Mexican receivers. From the perspective of Unimin's competitors in Tennessee, they look forward to the efficiencies of new NAFTA Rail service so as to be better able to compete against Unimin's Texas plant. From the Mexican receiver's standpoint, it will now have efficient access to five sources of ball clay for its manufacturing process.⁵⁹ STB precedent makes clear that it "will not impose a condition just because one group of shippers obtains pro-competitive merger benefits that other shippers do not enjoy." *UP/SP* Decision No. 44, slip op. at 130. *See also BNSF*, slip op. at 99 (The fact that a transaction results in some shippers being better off may work to the disadvantage of other shippers does not justify the use of ICC/STB conditioning power).

Most of the concerns expressed by the letters quoted by UP and BNSF are not that these shippers benefit from competition between KCSR and BNSF or between KCSR and UP so that the transactions would eliminate that competition, but rather that these shippers are afraid that KCS will use its control of Tex Mex and TFM, not to raise the rates charged by UP or BNSF (which of course assumes that UP and BNSF are not already charging the highest rate

expressing concern not about a reduction in competition between rail routings, but rather about Mexican customers who will now have additional sources of supply -- a procompetitive benefit of the two NAFTA Rail transactions.

⁵⁹ Unimin also admits that it has the option of routing its Troup, Texas shipments originating on UP to another gateway, Eagle Pass. Eagle Pass is a competitive gateway to Laredo. If KCS and TFM take actions against UP or BNSF routings to hamper the efficiencies of their Laredo shipments, UP and BNSF will shift traffic to those other gateways and begin investing in those other gateways.

possible),⁶⁰ but that KCS will lower rates on its own system in order to open up new origins of supply and expand the options of those who use NAFTA Rail routings. That is precisely what KCS must do to succeed with NAFTA Rail, and such an action is not anticompetitive but procompetitive. That is why the vast majority of the shippers and the shipping community support these transactions.

C. UP and BNSF Are Motivated By A Desire To Protect Their Profitability And Divisions, Not By Concerns For Shippers.

1. Protection of Competitors, Not Protection of Shippers, Underlies UP and BNSF's Arguments

As has been clearly established, all major types of U.S./Mexican rail traffic (grain, automotive, and intermodal) are subject to diversion to other modes, and in order for NAFTA Rail to compete and to grow its traffic base, it will need to lower prices and improve efficiencies. UP witness John Gray, in his Table 1 example, makes no distinction between the type of traffic that is subject to competition from these other modes and the type of traffic that is truly rail dependent. His table simply assumes that rail rates could increase from the existing rate of \$200 to \$205 to \$215 and so on, and the shippers would just be "forced" to pay it. Likewise, the assumption is the same with respect to UP's Table 2.

As has been explained, the assumptions underlying these tables are simply incorrect. Rail rates could not be pushed higher without significant competitive consequences. Therefore, boiled down to their essence, the arguments advanced by UP and echoed somewhat by BNSF,

⁶⁰ As the verified statements of Mr. Davies and Dr. Kleit establish, existing UP and BNSF rail rates are already as high as they can go without having that traffic switch to other modes or to other origins and destinations, and if, for whatever reason, TFM is not taking the full profit, *i.e.* the "one lump," UP or BNSF is taking that lump. R.V.S. Davies at 2. To assume otherwise is to assume that UP and BNSF are leaving money on the table and not taking the full profit maximizing rate, which assumes a significant act of generosity on behalf of UP and BNSF.

while disguised as concerns for rates to shippers, are in reality simply concerns about the revenue divisions that UP or BNSF will receive in a post-control environment.

Protecting its share of the rate is why BNSF wants a rate and service freeze. BNSF wants to lock in the benefits of its contracts with Tex Mex for far longer than the contracts themselves provide.⁶¹ BNSF is not seriously concerned that the KCS/Tex Mex transaction will result in increased prices or reduced service for shippers, but rather that it will result in lower divisions for BNSF via BNSF/Tex Mex routings. BNSF has effectively admitted as much, stating that traffic diversions from BNSF projected in the Application would not raise prices to shippers but instead would “squeeze BNSF’s margins.”⁶² This obviously is BNSF’s motive, for KCS has committed to maintaining all existing contracts through their current term, preventing KCS from eliminating BNSF/Tex Mex routings even if it wanted to do so, and, of course, given that Tex Mex handles a substantial amount of BNSF traffic for which KCS cannot compete or provide a replacement, driving BNSF traffic away would cost Tex Mex substantial revenue.

Protecting and improving its divisions/rate factors is likewise why UP wants to set a rate matrix for movements throughout the TFM system. UP claims that TFM is a bottleneck carrier

⁶¹ KCS has informed BNSF that KCS expects renegotiation of the BNSF/Tex Mex divisions agreement upon its expiration because KCS believes the current divisions do not provide Tex Mex with sufficient revenues to cover its costs and rehabilitate its track structure to the level needed to handle current and future traffic with acceptable efficiency. However, such negotiations will take place within the context of the marketplace, as they should. Given BNSF’s ability to switch to other gateways and other competitive factors, that renegotiation of divisions may not change the carriers’ rate factors, but regardless, the STB should not interfere with discussions among carriers regarding divisions. To do so would be unprecedented in the context of the post-Staggers Act regulatory scheme. *See, e.g., Removal of Divisions of Revenue Regulations*, STB Ex Parte No. 637 (Sub-No. 1), slip op. at 2 (served Aug. 29, 2003) (eliminating regulations governing division of revenue cases because “agency records indicated that there had not been a divisions of revenue complaint in over 20 years”)

⁶² BNSF-4, n. 8.

but is prevented by regulation from capturing the “one lump” ordinarily available to a bottleneck carrier. If UP believes that it is correct, and if UP can convince the Board to constrain TFM’s ratemaking authority, then UP, which is the sole carrier serving the origins and destinations of most of the cross-border traffic (*see* R.V.S. Mutén at 7-8 and V.S. Kleit at 16), can maximize for *itself* the profit potential of all traffic. In other words, UP wants to wrest profits away from TFM using Board-imposed regulation or negotiation as the means to accomplish that goal. *See* V.S. Rogers at 12, and V.S. Kleit at 35-38.

In short, the theories of anticompetitive manipulation offered by parties seeking conditions are simply the classic arguments between rival railroads about divisions. UP and BNSF know that market forces would prevent NAFTA Rail from raising rates to shippers so they want to gain as much of the division (*i.e.*, the profit) as possible. BNSF and UP (and Pacer,

-- *see* UP-H-3484) stand to profit handsomely if they can limit the profit potential of their connections, TFM and/or Tex Mex, by government intervention.

As the Board has stated in many cases,⁶³ protection of competition (and essential services), not competitors, is the Board’s regulatory responsibility. “Conditions are not warranted to indemnify competitors for revenue losses absent a showing that essential service would be impaired.”⁶⁴ *Burlington Northern, Inc.-Control and Merger-St. Louis-San Francisco*

⁶³ *See, e.g., Conrail*, 3 S.T.B. 764; 1998 STB LEXIS 800 at *38; *UP/CNW*, 1995 ICC LEXIS 37 at *268; *St. Louis Southwestern Railway Company-Trackage Rights Over Missouri Pacific Railroad Company-Kansas City To St. Louis*, 8 I.C.C. 2d 80, 86 (1991); *Consolidated Rail Corp.-Control-Monongahela Ry. Co.*, 1990 ICC LEXIS 253 at *9; and *Rio Grande Industries, Inc., SPTC Holding, Inc., And The Denver And Rio Grande Western Railroad Company-Control-Southern Pacific Transportation Company*, 4 I.C.C. 2d 834; 1988 ICC LEXIS 267 at *180 n. 66.

⁶⁴ *Canadian National Ry. Co.-Control-Illinois Central Corp.*, Oversight Decision No. 4, served Dec. 27, 2001, slip op. at 22, n. 72 (“*CN/IC Oversight*”).

Ry. Co., 36 I.C.C. 788, 951 (1980). Indeed, the Board supports diversions between carriers that result from competition. “The Board has always held that traffic diversions that occur through natural rivalry between competitors leading to lower rates or improved service are not anticompetitive.” *Canadian National Ry. Co.-Control-Wisconsin Central Trans. Corp.*, Finance Docket No. 34000, Decision No. 10, slip op. at 74, (STB served Sept. 7, 2001) (“*CN/WC*”). That is precisely what must occur here if NAFTA Rail is to succeed.

Ultimately, market conditions will dictate that KCS/NAFTA Rail must grow revenues by adding more traffic to TFM through pro-competitive actions, not anticompetitive actions that will drive UP and BNSF to no longer use TFM. The Board should allow that marketplace to work in conjunction with the NITL Agreement and KCS’s stated willingness to continue to work with all parties. The proposals set forth by UP and BNSF would simply interfere with the marketplace, create inefficiencies, and impose unnecessary government oversight. Even setting aside for the moment the issue of the Board’s jurisdiction to regulate rail rates and services in Mexico, the Board should not make NAFTA Rail compete with one hand tied behind its back simply to protect the earnings of UP, BNSF and Pacer.

2. Requested Rate and Service Conditions Seek to
Turn KCS’s Investments in Mexico Against KCS
by Obligating Them to UP and BNSF

Requests that the Board mandate TFM’s rate and service levels, in addition to being an attempt to protect UP’s and BNSF’s divisions, also attempt to divert the benefits of KCS’s huge investments in Mexico to UP and BNSF and away from KCS. The Board should not succumb to this extension of UP’s stated business strategy to

UP-H-1310.⁶⁶ (Emphasis added.) TFM has made huge investments in rail infrastructure in Mexico since its privatization in 1997.⁶⁷ Those investments have greatly reduced TFM's operating costs, and have significantly upgraded service capacity.

KCS's competitors recognize the value of these investments. *See* UP-H-4231 (

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the Board's July 31 hearing, "It's that route [created by TFM's investment] that makes competition

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UP-H-3429.

see UP-H-3484,

. *See* UP-H-3493.

⁶⁶ *See also* UP-H-1293 (

⁶⁷ "It is TFM that invested more than \$1 billion since 1997 in upgrading the route from Laredo down to Mexico City, a route that has 136 pound welded rail, concrete ties, solid ballast." Testimony of Gerald K. Davies, July 31 Public Hearing Transcript, page 164. *See also* UP-H-4231 (

).

BNSF-HC-00194.

⁶⁸ While UP and BNSF clearly recognize the value of these investments, they are not making similar investments of their own to increase overall capacity.

UP-H-4475.

UP-H-1244. This lack of capacity is within UP's direct control, yet UP apparently is unwilling to remedy it.

possible for Pacer in Mexico.” July 31 Hearing Transcript at 164. Proposals to regulate TFM rate and service levels through rate freezes or rate matrices that apply in connection with cross-border shipments with BNSF and UP are an attempt to lock up the benefits of KCS’s investments in Mexico to reduce competition. By obligating Tex Mex and/or TFM to maintain certain services, corporate capital and operating funds are kept from other uses. Because UP and BNSF are the dominant carriers in Mexico rail trade, this freezing of assets helps to perpetuate their dominance.

In addition, by obligating TFM and Tex Mex resources to BNSF and UP, those carriers can avoid making similar investments themselves at other gateways or on UP’s affiliate Ferromex.⁶⁹ These requests, which seek to freeze the status quo and to handicap KCS would help perpetuate UP’s dominance and BNSF’s position, while acting as disincentive to them to invest in facilities that would make other gateways and services more available to shippers on both sides of the border. Even if the Board had authority to control rates and services of a railroad in Mexico, the Board should not give in to UP’s and BNSF’s inducements to obligate the benefits of KCS’s investments in Mexico to UP and BNSF.

E. CN’s Assertion That KCS Must Be Acquiring TFM For Anticompetitive Reasons Is Baseless And Inaccurate.

1. KCS Seeks an Increased Stake in TFM to Maintain a Strategic Investment.

CN has attempted to cloud the otherwise clear picture of the competitive benefits of NAFTA Rail by manufacturing a false dilemma designed to lead the Board to conclude that KCS

⁶⁹ As Mr. Davies said at the July 31 hearing, and as UP’s document cited in the preceding footnote confirm, “They made a comment about FXE not being developed intermodally as TFM. The reason is simple. FXE hasn’t put the money in the plant that TFM has put in. They haven’t replicated that billion dollars.” July 31 Hearing Transcript at 165, Lines 10-13.

intends anticompetitive manipulations as the only means to recover its planned investment. CN's assertions in this regard are completely off base. KCS, CN says, must have agreed to increase its stake in TFM for one of two reasons. Either, CN says, KCS agreed to increase its stake in TFM to exploit efficiencies to gain traffic and revenue, or KCS must intend to increase its stake in TFM to generate added revenues through anti-competitive actions against other carriers.⁷⁰ Asserting that no added efficiencies from the TFM transaction have been shown, CN says that the Board is left with no alternative but to conclude that KCS intends to harm competition by exploiting TFM's "bottleneck" position.

Leaving aside the fact that the TFM transaction is not before the Board for approval and was found by the U.S. Department of Justice and the Mexican Competition Commission not to present competitive problems, and further ignoring for the moment CN's flawed assumptions about the transaction's ability to pay for itself, CN's position is baseless. The problem with CN's argument is that it ignores KCS's real motivation for the transaction, which stems from KCS's existing stake in TFM, the importance to KCS of TFM's profitability, and the damage to KCS threatened by the potential harm to TFM from the precarious financial condition of KCS's Mexican partner, Grupo TMM. *See* R.V.S. Haverty at 4.

⁷⁰ As stated by CN's counsel at the Board's July 31 hearing:

The Board has long recognized that there are two basic reasons why a railroad would pay the market value of a bottleneck railroad.

The first is that the purchaser believes it can reduce the cost of its service in conjunction with the bottleneck railroad, and thereby earn its cost of capital on its investment. Second, the purchaser believes it can better exploit the market power of the bottleneck railroad without any new efficiencies.

July 31 STB Hearing Transcript, Page 45, Line 19 through Page 46, Line 6.

As stated by KCS's President Mike Haverty at the Board's July 31 hearing just a few minutes before CN's counsel spoke,

[T]he reason we're doing what we're doing, if you look at this company's [KCS's] earnings over the last year or two, half or more than half of our earnings come from Mexico. I don't think it's any secret that our partner was having financial difficulties, TMM, and we felt that we could not allow this investment to get away from us, when over half of our earnings are created from this investment. For us to let that get away, it was more important for us to get control of the company than it was to start trying to figure diversion studies and so on. Since we already were invested in it, we knew about the company, we knew about the traffic it handled and so on, and we just felt it was absolutely critical that we needed control of it, and that's why we negotiated a deal with our partner, and that's why we're here today.

July 31 STB Hearing Transcript, Page 24, Line 15 through Page 25, Line 8. At several other points in the hearing as well, Mr. Haverty emphasized to the Board the importance to KCS of maintaining control of its investment in TFM, so that investment would not be impaired as a result of financial problems afflicting Grupo TMM. *See* July 31 STB Hearing Transcript, Page 24, Lines 4-10 and Page 26, Lines 6-7.

KCS's investment in TFM has led to tremendous improvements in TFM's efficiency and profitability. Those improvements have made TFM a substantial contributor to KCS's own profitability in recent years. Thus, when it appeared that Grupo TMM's financial problems had the potential to adversely affect TFM, KCS needed to protect itself and its shareholders by moving to secure its stake in TFM. That was, from KCS's view, the motivation for agreeing to acquire an additional interest in TFM. R.V.S. Haverty at 5.

So, the dilemma posed by CN – that KCS agreed to acquire TFM in order to increase revenues through additional efficiencies or through anticompetitive behavior – is simply wrong. A third possible reason, which in this case is the real reason, was KCS's desire to protect the value of its existing investment in TFM against uncertainties arising from Grupo TMM's financial difficulties. Whether controlled by Grupo TMM or by KCS, there is no need for TFM

to act anticompetitively in order to achieve growth or to generate sufficient revenues to support the costs of KCS's agreed-upon acquisition. Instead, as Mr. Davies stated, "We'll perform the way we performed when we acquired the TFM franchise at the outset. . . . Growth is the way you pay for it." July 31 Hearing Transcript, page 171, Lines 14-16; page 172, Line 2.

2. KCS Did Not Pay A Burdensome Premium
Under Its Agreement with Grupo TMM

An additional false impression created by CN to impugn KCS's intentions is that KCS agreed to an inordinate acquisition premium which it can only finance through anticompetitive behavior. In fact, however, KCS did not agree to an inordinate premium for TFM. Even if it had, the Board in the past has shown little concern for alleged acquisition premiums.

Although it is sometimes used in a pejorative sense, an acquisition premium is nothing more than recognition of a reality. That reality is that a controlling ownership in a company allows the owner a greater ability to protect its investment. It also brings with it a commensurately increased stake in the corporation's financial progress.

Whatever their cause, acquisition premiums are nothing out of the ordinary, as even CN's witness Dr. Vellturo admits. Vellturo Verified Statement (hereinafter "V.S. Vellturo") at 2. They are so common that the publication *Mergerstat Review* is dedicated to measuring the acquisition premium paid for significant (\$1 million plus) merger transactions. In short, there is nothing inherently suspicious or wrong about an acquisition premium.

From the basic premise that acquisition premiums are common, CN's Dr. Vellturo leaps to the conclusion that TMM has negotiated an inordinate acquisition premium from KCS for control of Grupo TFM. V.S. Vellturo at 2. This assumption ignores several facts. First is the much-publicized financial distress that TMM is currently experiencing. In mid-May 2003, Grupo TMM became in technical default on \$177 million in bonds, and suffered a subsequent

technical default on \$200 million additional bonds. A company facing such a severe cash crunch obviously may not have the luxury of biding its time to maximize the acquisition premium in selling portions of its corporate holdings. V.S. Russ at 4. Additionally, KCS's right of first refusal to acquire TMM's interest in TFM potentially could dampen a third party's willingness to bid up the price of TFM shares, knowing that KCS could win any bidding contest by simply matching the third party's bid. These facts were not even considered by Dr. Vellturo.

Moreover, as a factual matter, the multiple of earnings that KCS is paying for TFM is not out of line with that paid in other railroad control transactions. For example, Mr. Russ was the Chief Financial Officer for Wisconsin Central Transportation Company ("WCTC") when it was acquired from private ownership by CN. He recollects that the price per earnings that KCS agreed to pay for TMM's controlling interest in Grupo TFM is very close to that paid by CN for control of WCTC. V.S. Russ at 4-5. He also confirms that KCS can pay for its acquisition through the existing earnings stream of TFM and need not raise rates to do so. The transaction is accretive from day one. V.S. Russ at 5-7. Thus, contrary to Dr. Vellturo's supposition, the price that KCS has agreed to pay TMM is nothing out of the ordinary.

The Board has been called upon a number of times to resolve issues related to acquisition premiums. In the *Conrail* proceeding, a number of parties vigorously challenged the transaction, alleging that prices paid by shippers must rise to repay the allegedly high acquisition premium paid by CSXT and NS. (CN's argument is a similar to these arguments, asserting that prices to shippers will rise due to anticompetitive manipulations resulting from the supposed acquisition premium for TFM.) After careful consideration in the *Conrail* case, *see Conrail*, slip op. at 62-67, the Board determined that imposition of conditions was not warranted based on the acquisition premium. That conclusion was upheld by the Second Circuit. *Erie Niagara Rail*

Steering Committee v. Surface Transportation Board, 247 F.3d 437 (2d Cir. 2001). More recently, the Board held in *Major Rail Consolidation Procedures*, 2001 WL 648944, *18 (2001) that an acquisition premium would be relevant to the Board's analysis in the required review of whether the resulting entity's ability to pay fixed charges would be impaired under 49 U.S.C. Section 11324(b)(3). No party has presented any evidence in this proceeding questioning KCS's future ability to pay its debts. Indeed, Mr. Russ fully refutes any such contention. V.S. Russ at 4.

Accordingly, nothing in the records or in the Board's precedent calls for any action by the Board related to an acquisition premium by KCS to TMM, as KCS's COO Gerald Davies testified at the Board's July 31 hearing:

We'll perform the way we performed when we acquired the TFM franchise at the outset. In 1997, when the two partners acquired that franchise from the Mexican government, the annual revenues were just over \$300 million U.S. for the TFM franchise. I've told you we put \$1 billion in it to upgrade the line, develop its service capability, to install a state-of-the-art customer service capability. And last year, the revenues at TFM were just over \$700 million.

Growth is the way you pay for it. Where does the growth come from? Well, when we started the transaction in Mexico, the rail share of the Mexican Intercity Transportation market was about 10 percent. Today, it's between 16 and 17 percent, a huge increase, and frankly, a larger market, because the pie is bigger than it was in 1996 also.

When you look at a country where you've only got 16 percent of the intercity freight on the rail, you still have a huge amount of freight that can be converted to rail for transportation to and from the two countries, and frankly, inside of Mexico also. That's the focus of this operation.

Thus, KCS/NAFTA Rail will not engage in the anticompetitive manipulations posited by UP, BNSF and those aligned with them to gain traffic and revenues. Instead, KCS/NAFTA Rail will invest in improved service and will compete to gain revenue.

**III. REQUESTED CONDITIONS ARE NEITHER NECESSARY
NOR APPROPRIATE.**

Of the commenting parties, only a relative few – principally KCS’s competitor railroads and those closely aligned with them – have requested that the Board condition its approval of this transaction. None of those parties, however, has met the standards set out by the Board for imposition of conditions – a proposal, narrowly-tailored to address substantial harms to competition which probative evidence shows will arise from the transaction before the Board. Rather, the conditions requested are overly broad, inefficient, anticompetitive, and call for the Board to reach well beyond its jurisdiction by regulating the rates and services of a railroad that is not a party to nor controlled by a party to this proceeding,⁷¹ and which operates wholly within Mexico. The Board should deny these overreaching requests for conditions, and instead rely on existing remedies, such as the NITL Agreement, backed up by the Board’s continuing ability to intervene in the future should actual unresolved competitive problems arise.

A. The Standards For Imposing Conditions Have Not Been Met.

1. Parties Requesting Imposition of Conditions
Must Cross a High Threshold

Board precedent sets a high standard that anyone requesting conditions on approval of a merger or control transaction must meet. First, because the Board must approve a transaction “unless there is likely to be a substantial lessening of competition, creation of a monopoly, or restraint of trade in freight surface transportation in any region of the United States,” 49 U.S.C. § 11324(d)(1), the party requesting conditions must prove that such effects are likely. In addition,

⁷¹ See also *Major Rail Consolidation Procedures*, Ex Parte No. 582 (Sub-No. 1), slip op. at 30 (STB served June 11, 2001). (“Moreover, imposing such conditions on carriers that are not applicants or controlled by applicants is not within our merger conditioning authority, which gives us only the power to ‘impose conditions governing the transaction.’”)

to meet the standard of § 11324(d)(1),⁷² harms shown must truly be substantial. As the ICC said in *Wisconsin Central Transportation Corporation-Continuance In Control-Fox Valley & Western Ltd.*, 9 I.C.C. 2d 729, 732-3 (1993):

[T]he adverse competitive impact must be both "likely" and "substantial" and must outweigh the public benefits. . . . [A]dverse impacts might be the likelihood of substantially higher rail rates charged to shippers or substantially poorer rail service levels, or a combination of the two. DOJ's focus on situations where a hypothetical monopolist can impose at least a "small but significant and nontransitory" price increase on a particular product (Merger Guidelines, April 2, 1992, sec. 1.11) is inconsistent with the "likely" and "substantial" competitive harm standard of § 11344(d). DOJ appears to equate some harm with substantial harm, whereas the statute makes it clear that we are to differentiate between the two and disapprove applications involving only the latter. By definition, it would seem that a small nontransitory rate increase would not be a substantial one. We find in this proceeding that, although DOJ's merger guidelines for defining a market may be useful as an intermediate step in measuring competitive harm in rail merger cases, they do not directly reflect the statutory standards for competitive harm. *Compare Union Pacific-Control-Missouri Pacific; Western Pacific*, 366 I.C.C. 459, 503 (1982).

The fact that DOJ guidelines might find a competitive harm but under STB precedent such a harm would not qualify as both likely and substantial so as to warrant a condition or denial of the transaction explicitly means that if DOJ has found no harm, then certainly there can be no harm under STB precedent. Here, DOJ has analyzed and studied the KCS/TM/TFM transactions and determined not to issue a second request and further investigate the competitive effects. In fact, DOJ granted early termination.

⁷² Precedent under former section 11344(d) applies in this instance, inasmuch as "the standards and procedures of former sections 11343-45 and current sections 11323-25 are substantially similar insofar as minor transactions are concerned." *Illinois Central Corporation And Illinois Central Railroad Company-Control-CCP Holdings, Inc., Chicago, Central & Pacific Railroad Company And Cedar River Railroad Company*, STB Finance Docket No. 32858, 1996 STB LEXIS 157at *2, n.2 (May 14, 1996).

UP would like the Board to believe that DOJ simply didn't have time to carefully review the TFM transaction, that DOJ lacked sufficient resources, and simply just didn't want to be bothered with investigating the transaction. Of course this same DOJ, which somehow lacks resources, has always been quite active in prior merger cases where it believed the potential for anticompetitive action existed. DOJ did study the transactions. V.S. Grimm at 5. The fact that DOJ didn't participate here indicates something more than a lack of resources.

Indeed, the issues of alleged vertical foreclosure of UP and BNSF routings, especially the notion that KCS would use its control of TFM to raise rates to shippers and decrease service, were extensively analyzed and reviewed by DOJ. DOJ assigned an attorney and an economist to review the potential competitive effects, including the international competitive effects, of KCS's plans to acquire control of Tex Mex and TFM. There were numerous meetings and discussions between KCS representatives and DOJ staff. R.V.S Davies at 28; R.V.S. Grimm at 5. The very same issues here, vertical foreclosure, impacts on grain, automotive, and intermodal shippers, and KCS's ability to favor its shippers over UP or BNSF shippers, were fully discussed and analyzed in those meetings. In the end, DOJ decided that issuing a second request was not needed (which it would do if it believed the competitive concerns warranted it) but instead granted early termination. As DOJ had full statutory and legal authority to review the international competitive effects and the domestic effects of the KCS/TFM transaction and in fact conducted an extensive review, including input from UP and perhaps others, the notion that the STB needs to review these effects because the DOJ did not is simply wrong. The fact that DOJ granted early termination in its review of the TFM transaction and that DOJ's standards are

more stringent than those under Section 11324(d) is an especially telling blow to arguments of anticompetitive effect based on the TFM transaction.⁷³

2. No Party Has Shown a Likelihood of Substantial Harm to Competition

No party has shown the first prerequisite to the imposition of a condition – the likelihood of a substantial harm to competition that must be remedied. In contrast to cases such as *UP/SP*, involving substantial horizontal competitive effects, including the loss of direct, head-to-head rail competition at a multitude of 2-to-1 points, the most “evidence” that anyone has offered in this case is hypothetical harms to competition that “might” or “could” happen under certain strained theoretical circumstances.

As explained in Section II of this Reply, accepting that such harms are likely and substantial requires disregarding years of Board and ICC economic principles and the realities of the marketplace. For example, accepting UP’s arguments would require accepting that TFM is a bottleneck carrier but discarding the ‘one lump’ theory. UP’s theory on this issue has several flaws, including its unspoken assumption that UP’s rate factors are always driven to the lowest possible levels by intense rail-to-rail competition in the U.S. UP’s own data show that

⁷⁴ , see UP-H-3424, UP-H-3425 and UP-H-4337.

And, from the Rebuttal Verified Statement of Bengt

⁷³ Likewise, and contrary to UP’s position, DOJ does have the ability to place conditions on merger transactions. DOJ frequently uses consent decrees or divestiture orders as a means of accomplishing such conditions. Like an STB decision, a consent decree often tells parties what type of conduct parties can and cannot do in a post-merger environment.

⁷⁴

Mutén, it is clear that UP is the only railroad serving well over 20% of the points that originate or terminate traffic moving over Laredo, R.V.S. Mutén at 5-8, and that those points where UP is the only serving carrier with direct access to Mexico account for approximately half of the traffic moving over Laredo. *Id. See also* V.S. Kleit at 18-19. Thus, rail-to rail competition for UP is not as intense as claimed by Mr. Gray and Dr. Hausman, nor is UP's rate factor consistently driven to a minimal level by rail-to-rail competition, as UP claims.

As pointed out by Mr. Davies, the theoretical competitive harms posited by parties seeking conditions also ignore marketplace realities. Although UP and BNSF, and their allies such as Pacer, downplay the ability of intermodal competition to constrain rail pricing and service offerings, UP marketing documents make clear that UP bases its pricing and marketing decisions on competing with and taking traffic away from trucks.

See also UP-H-2772. Accordingly, NAFTA Rail must compete against trucks to gain and retain market share, and cannot raise prices or reduce service as UP, BNSF and Pacer claim without losing revenue to truck competition. *See* R.V.S. Davies at 14 and Section II. B, *supra*. These fundamental facts, along with the strength of KCS's railroad rivals by virtue of their extensive networks, the number of gateways they serve, UP's control of Tex Mex's trackage rights operations, and traffic being committed to UP under long-term contracts, would doom any of the anticompetitive schemes posited by UP, BNSF or Pacer. R.V.S. Davies at 14-19. In short, no party has proven that harms to competition are likely. By virtue of that failure alone, no conditions should be imposed.

B. Private Sector Agreements Further Allay the Possibility of Anticompetitive Behavior.

As KCS has said throughout this proceeding, putting together NAFTA Rail is a pro-competitive venture. Through its proposals to control Tex Mex and TFM, KCS seeks to create a more vital and capable competitive alternative to UP's domination of U.S./Mexico rail traffic. No party has demonstrated any competitive harm that is likely to result from either of these transactions. In fact, the competitive opportunities are so clear that over 90 shippers have tendered statements to the Board supporting KCS's proposal to control Tex Mex.

Despite the fact that no party has shown a competitive harm that is likely to result from the KCS-Tex Mex transaction, KCS has said that it is willing to discuss with any party concerns that they had about the Tex Mex and TFM transactions and, if appropriate, to enter agreements to allay those concerns. KCS has done this, not out of concern for a need to remedy anticompetitive effects of its transactions, but rather out of confidence that the transaction is pro-competitive, and that reasonable assurances can be given to concerned parties to reaffirm that fact. Among those with whom KCS has had discussions have been UP, BNSF, CN, DuPont, ACC, and other shippers and shipper organizations, along with NITL.

As a result of its discussions with NITL, KCS entered an historic private agreement that provides pricing obligations and service monitoring responsibilities sufficient to allow the League to support KCS's application in this matter. This agreement was not entered into to resolve an anticompetitive problem of the transactions and should not be imposed as a condition because there is no link between a competitive problem and the need for imposition of the NITL agreement to resolve that problem. Instead, this agreement was done in the spirit of the new merger guidelines and as a means of working with shippers. The agreement is beneficial to both parties. In the end, the endorsement by the country's largest shipper organization is a testament to the pro-competitive nature of the transaction before the Board. KCS's willingness to enter a

binding agreement with NITL further confirms that KCS had no plans or the ability to take anticompetitive actions.

The Board's new merger guidelines, as well as other Board precedent, strongly favors resolution of issues by private sector agreement rather than government imposition. Private sector initiatives are presumed superior to government manipulation of the market because private sector initiatives are expected to be workable and to resolve issues satisfactorily to those most affected. Otherwise, the parties would not have agreed to them. Thus, the KCS/Tex Mex agreement with NITL is, consistent with Board precedent, presumed to be superior to Board-imposed solutions in meeting the needs of shippers, which NITL represents.

The NITL Agreement is also superior to Board-imposed regulation because it was developed for this specific situation. UP and BNSF basically propose transplanting agreements from other cases, either *UP/SP* or *CN/WC*, into this situation. Neither shows, however, that this situation is sufficiently similar to those to warrant such treatment.

It has been clear since the ICC rejected routine imposition of *DT&I* conditions (including their freezing of rates) and removed those conditions from past proceedings that the agency no longer favors strict rules or formulas being imposed across the board in all transactions, like the *UP/SP* and *CN/WC* private agreements which UP and BNSF suggest should be imposed here against the Applicants. Rather, the Board prefers specifically tailored and, if possible, private sector remedies. These remedies are supported by the Board's continuing oversight authority, should the private agreements fail. Granting the BNSF or UP request for rate freezes or to set rate formulae would be a step backward toward *DT&I*-type conditions which would be imposed without a showing that there is a competitive harm that is both likely and substantial. The STB was very clear when it issued the provision that gateways should be kept open in future major

mergers that it was not looking to return to the types of conditions requested here by BN and UP. In fact, the Board explicitly rejected formulaic and rigid gateway preservation proposals received during the proceeding to develop the new merger guidelines. Nor was there any indication by the Board that it was overturning its long-held view that it is highly unlikely that end-to-end mergers are motivated by or will result in anticompetitive vertical foreclosure.

In fact, imposing the remedies requested by BNSF and UP also would conflict with the NITL agreement. Shippers have not asked for rate or service freezes. They realize the tremendous service improvements for cross-border transportation that have occurred over the past decade, and do not want to see that trend frozen. Rather, they appreciate the flexibility accorded by the provisions for KCS and Tex Mex to provide commercially reasonable, common or contract carrier rates to shippers when requested. Neither do they ask that UP or BNSF be put in control of rates and services for the cross-border trade, as the solutions proposed by UP and BNSF would do. Nor do they ask the Board to override contract provisions agreed to by BNSF, as BNSF requests.

In order to grant BNSF's and UP's requests for conditions, the Board would have to choose remedies proposed by railroads, allegedly for the benefit of shippers, over what shippers themselves believe best serves their interests. The NITL Agreement is best way to comply with the spirit of the new gateway rules, and should not be supplanted with BNSF and UP-proposed "solutions."

The NITL Agreement need not be made a condition of this transaction to have its intended effect. Section 1 of the agreement acknowledges that the agreement may or may not be imposed by the Board as a condition. As NITL's comments make clear, the League was aware that, consistent with *CN/WC*, the Board might not impose the agreement as a condition.

Nevertheless, the parties executed the agreement and provided that it would be effective if the transaction or transactions contemplated by KCS were consummated. *See* Section 5 of the Agreement. While NITL requested that its agreement with KCS be imposed as a condition on the transaction, NITL did not show or attempt to show that the transaction, without the proposed condition, would harm competition. Instead, NITL merely stated that “there may well be issues raised about the competitive effects of the broader transaction.” NITL Comments at 5-6. Particularly inasmuch as NITL has not shown any anticompetitive effect, and because its suggestion that there “may” be “competitive issues” rests entirely on the TFM transaction, there clearly is no basis on which to grant NITL’s request to make the agreement a condition of this transaction. Nevertheless, the NITL Agreement remains a valid and enforceable obligation of KCS and Tex Mex, assuming that the preconditions for its application, stated in Section 5 of the agreement, are met. Should KCS or its affiliates fail to satisfy their duties under that agreement, those duties can be enforced through arbitration, as provided in the agreement.

Although this transaction is classified as “minor,” KCS’s commercial agreement with NITL nevertheless fulfills the goals of the Board’s *Major Rail Consolidation Procedures* (“*Procedures*”) that applicants “explain how they would preserve the use of major existing gateways,” *Procedures, slip op.* at 56, and “provide service benchmarks, . . . and establish contingency plans.” *Id.* The NITL Agreement provides in Section 2 that KCS and Tex Mex will establish and maintain commercially reasonable rates over existing interchanges with other railroads. It provides for arbitration to enforce those provisions. It also provides, in Section 4, for operational measurements and reporting, and that if operational monitoring shows service deterioration, KCS and NAFTA Rail will provide the Board with a corrective action plan. Even though *Procedures* does not apply to this transaction, KCS has, through the NITL Agreement,

provided the shipping public, and even its rival railroads, with reassurances against even the potential of harm from the transaction, as suggested by *Procedures*.

Because the KCS-Tex Mex transaction has not been shown likely to cause competitive harm, no conditions on the Board's approval are warranted. Rather, the Board should allow private agreements such as the NITL Agreement and the agreements governing operation of the International Bridge to function as the parties to them intended. This was the approach taken by the Board in the *CN/WC* merger,⁷⁵ and is equally appropriate here.

Should those agreements somehow fail and some competitive harm actually occur from the transaction, the Board would be within its residual powers over the proceeding to address such issues (*see* Subsection D below), but not until there is a known competitive problem could the Board develop a reasonably-tailored solution. Until then, conditions such as those proposed by UP, BNSF and Pacer remain poorly-focused, inefficient, anti-competitive and overly broad. As the Board said in its decision on the Houston/Gulf Coast Oversight phase of *UP/SP*,

Narrowly tailored merger conditions imposed to address merger-related harm are not considered a taking, but overreaching, disproportionate conditions could become confiscatory, particularly where it is not clear that carriers will be fully compensated for the traffic and revenues they would lose.

Union Pac.-Control and Merger-Southern Pac. [Houston/Gulf Coast Oversight], 3 S.T.B. 1030; 1998 STB LEXIS 999 at *5-*6 (served Dec. 28, 1998).

C. Proposed Conditions Are Not Narrowly-Tailored, and Would Impair Efficiency and Competition of NAFTA Rail and Its Carrier Subsidiaries.

Finally, as the Board said in Decision No. 2 in this case, "Protesting parties are advised that, if they seek . . . the imposition of conditions upon any approval, on the theory that approval

⁷⁵ "There is no evidence indicating that the terms of the NITL/CN Agreement must be imposed to remedy adverse consequences of the control transaction. Consequently, we will not impose the terms as a condition."

(or approval without imposition of conditions) will harm competition and/or their ability to provide essential services, they must present substantial evidence in support of their positions.” Decision No. 2, slip op. at 15. None of the parties requesting conditions has met these high standards. *See also Burlington Northern Inc.-Control and Merger-Santa Fe Pac. Corp. and the Atchison, T. & S.F. Ry. Co.*, 101 I.C.C.2d 661; 1995 ICC LEXIS 214, *143 (1995)(“While showing that a condition addresses adverse effects of the transaction is necessary to gain our approval, it is by no means sufficient. The condition must also be narrowly tailored to remedy those effects”); *UP/SP*, Decision No. 44, slip op. at 144-145.

Proposals by various parties to condition approval of KCS’s control of Tex Mex are, due to the absence of an identified substantial harm to competition caused by the transaction, requests for overly-broad, unfocused and competition-stifling government intervention. The requests derive principally from hypothetical effects of the TFM transaction, not from the transaction before the Board, and ask the Board to regulate operations of a railroad in Mexico, an exercise that is beyond the Board’s jurisdiction. Moreover, the requested conditions would improve the competitive position of KCS’s rival railroads to remedy matters that are not a result of either the Tex Mex or the TFM transaction.⁷⁶ For these reasons, the requested conditions do not meet the Board’s criteria for imposing a condition on a consolidation, and should be denied.

1. The I-5 Rate Proposal Is Overly Broad, Inefficient and Anti-Competitive.

⁷⁶ *See also Major Rail Consolidation Procedures*, slip op. at 30 (“Our primary focus in imposing conditions — including competitive conditions — should and will continue to be remedial. Contrary to arguments raised by numerous shippers and shipper groups, conditions should not be sought to fix competitive and other longstanding problems that have no nexus to the merger at hand.”); and *BN-Santa Fe*, 1995 ICC LEXIS 214 at *143 (“We will not impose a condition that would put its proponent in a better position than it occupied before the consolidation.”).

UP has suggested that to ameliorate alleged anticompetitive effects of the TFM transaction, the Board impose a condition requiring KCS to negotiate a rate agreement that would establish rate factors which UP could employ in quoting rates between points on TFM and points on UP, without having to consult TFM. UP suggests a proposal that is modeled after a proportional rate agreement voluntarily entered by BNSF and UP with respect to traffic moving to and from points north of Portland, Oregon. That agreement, voluntarily entered by UP and BNSF to ameliorate anticompetitive effects of the *UP/SP* merger,⁷⁷ establishes rate factors for BNSF service to specified SPLCs in Washington, Idaho and eastern Montana. UP can use these rate factors to quote interline rates from points on its lines in 7 western and southwestern states to the specified points on BNSF. V.S. Gray, Exhibit M, page 2 and Exhibit A. The agreement contains complicated billing and rating provisions, including maintenance of the rate matrix by a third party, along with provisions for auditing and for arbitration of disputes. V.S. Gray, Exhibit M, pages 6-15, 18-21. Nevertheless, as Mike Rogers testifies, BNSF and UP have squabbled about the agreement before the Board. V.S. Rogers at 10. In connection with this agreement, UP transferred one of its lines in northern California to BNSF, giving BNSF a new single-line route between Washington, Idaho and eastern Montana and points south. V.S. Gray at 42.

Again, there has been no identification of any competitive harm that would require a condition requiring KCS and UP to negotiate over new rates and rate proposals involving TFM and such a forced negotiation should not be imposed. Furthermore, the agreement as requested

⁷⁷ Interestingly, BNSF does not advocate imposing a rate arrangement like the I-5 Agreement in this transaction, perhaps in recognition of the unsatisfactory nature of such an agreement, even when entered voluntarily.

by UP⁷⁸ is not narrowly tailored, would put UP in a better position than it was in before the transactions, and would create a number of problems, including:

- It would exceed the Board's jurisdiction by putting the Board in the position of establishing rate factors applying wholly in Mexico. *See* Section IV hereof.
- It would impose a complex system on NAFTA Rail ratemaking. V.S. Rogers at 11-12.
- The agreement would reach too far, effectively regulating rates throughout the entire TFM system, as opposed to the limited geographic scope of the UP/BNSF I-5 Agreement. *Id.* at 10-12.
- It would be a government-imposed structure, not a privately-agreed solution like the UP/BNSF I-5 Agreement. *Id.* at 9.
- It would be imposed in the absence of a showing of any competitive harm.
- UP does not propose any exchange with NAFTA Rail akin to transfer of its northern California line to BNSF.
- An I-5-type arrangement would stymie NAFTA Rail's ability to compete, effectively limiting competition between UP and NAFTA Rail to points north of the border, where UP already has substantial market domination and substantial route advantages to many points. *Id.* at 10-12.

In short, the present circumstances are vastly different than those which led to the I-5 Agreement. UP's overly-broad suggestion for imposition of the I-5 Agreement on NAFTA Rail should be denied.

2. BNSF's Rate Freeze Suggestion Is Also Over-Broad, and Seeks to Improve BNSF's Competitive Position, Rather Than Merely Preserving It.

BNSF's proposed "simple" solution of a five-year rate and service freeze is again not directed at a particular competitive problem and is certainly not narrowly tailored to resolve that

⁷⁸ While UP actually requests that the Board set a deadline for UP and NAFTA Rail to negotiate an agreement, and then intervene and establish terms if the parties do not agree, the net effect of this structure would be to allow UP to insist upon an I-5-type agreement and, if NAFTA Rail was not willing to agree, to again advocate adoption of that approach for imposition by the Board. This sort of artificial supplementation of UP's bargaining leverage is unnecessary and inappropriate in light of UP's tremendous existing leverage. *See generally* R.V.S. Davies at 34.

problem. Its effect would be to better BNSF's competitive position by avoiding expiration dates in its agreements with Tex Mex. The proposal would exceed the Board's jurisdiction, would be financially damaging to NAFTA Rail, and would violate the Board's basic precept that conditions are designed to remedy competitive problems, not to better competitors' positions.

BNSF calls its proposal modest and simple. It is neither. Rather, it is a far-reaching effort to freeze rail rates and services on Tex Mex and TFM for five full years. Five years ago, TFM was a much different railroad -- less efficient, still in need of vast investment. Five years from now, TFM could be even better than it is today, but not if its allocation of resources is frozen by being required to maintain specific services, or to get BNSF's approval before changing them. Indeed, in light of the fact that BNSF has not invested a dime in TFM or Tex Mex, its request to be able to approve or disapprove resource allocation on those railroads is quite extraordinary.

The freeze proposal is also an attempt by BNSF to better its competitive position by extending for as much as nearly 5 years past their current expiration dates contracts that BNSF has entered. In particular, BNSF seeks to freeze in place a rate arrangement with Tex Mex that expires at the end of this year. KCS has indicated to BNSF that if KCS gains control of Tex Mex, Tex Mex's revenue/expense ratio under that agreement needs to be improved for, as KCS sees it, Tex Mex is losing money under that agreement at present.⁷⁹ As a railroad which must seek loans supported by its owners in order to perform needed track work, and which has lost

⁷⁹ The fact that BNSF wants to apply the commercial reasonableness test only after five years is an indirect acknowledgement by BNSF that current arrangements are below a commercially reasonable level, making a freeze preferable to immediate application of a commercial reasonableness standard. Furthermore, given market conditions and the need to increase revenues on Tex Mex and TFM, it may not even be possible for KCS to negotiate additional divisions for the BNSF interline movements.

money in recent years, Tex Mex cannot afford to be locked into a money-losing arrangement for another five years, as BNSF requests. Because BNSF's proposed rate freeze would prevent expiration of various contracts to which BNSF had previously agreed, the proposal violates the Board's basic precept that conditions should not be granted to improve a party's position in matters that do not result directly from the transaction under review.

The rate/service-freeze proposal also is inappropriate because it requires that the Board extend its regulatory authority into Mexico. BNSF states clearly that it wants the Board to freeze TFM's rates and services for five years.⁸⁰ Doing so would be improper for at least two reasons. First, the Board has no jurisdiction in Mexico. *See* Section IV, *infra*. Any rates or service conditions that the Board would mandate to be carried out by TFM would be a clear invasion of Mexico's sovereignty.

Second, BNSF requests that TFM's rates be tied to RCAF-U for five years. RCAF-U is an index of U.S. rail costs, compiled by the Association of American Railroads. It does not include costs of Mexican carriers. In light of the differing inflation rates between the U.S. and Mexico, and in light of currency fluctuation issues, tying TFM's rates to a U.S. rail cost index would be highly inappropriate.

Finally, repeatedly since repeal of its standard imposition of *DT&I* conditions,⁸¹ the Board has held that freezing rates to preserve gateways is anticompetitive and inefficient. *See, e.g., Conrail*, 3 S.T.B. 196, 1998 STB LEXIS 243 at *169 (served July 23, 1998) ("Freezing

⁸⁰ "[T]he Applicants [should] be required to maintain the existing Tex Mex and TFM rates and services . . . for a temporary five-year period, subject to RCAF-U increases, and to provide commercially reasonable rates and services thereafter subject to the jurisdiction of the Board." BNSF Comments at 6.

⁸¹ *Detroit, T&I R. Co.-Control*, 275 I.C.C. 455, 492-3 (1950) ("*DT&I*").

agreements, rates, and routes would prevent efficiency enhancing changes that benefit shippers.”). The same applies to this case.

D. The Board’s Post-Transaction Authority Is Sufficient to Respond to Any Anticompetitive Behavior, Should Any Actually Occur.

Because no party has demonstrated a likely and substantial harm to competition that would result from KCS’s control of Tex Mex, the Board is not able at this time to develop a narrowly-tailored remedy for such a harm. Therefore, and in light of the Board’s continuing jurisdiction over the transaction, the Board need not condition its approval of the transaction.

The Board has consistently said that its conditions will be narrowly tailored to remedy competitive harms arising from a transaction. The Board cannot do that in this proceeding because no one has demonstrated such harms. At most, parties have shown hypothetical or potential harms that could occur. Because those harms are not occurring now, and because it is doubtful that they will ever occur, as explained in Section II hereof, the Board cannot fashion conditions that are targeted to remedy harms arising from the transaction.

The Board’s continuing remedial powers are sufficient to deal with competitive harm, should any actually arise. As the Board has often said, its authority over approved control applications continues without the need for formal oversight. “[W]e have continuing authority to enter supplemental orders and to modify decisions entered in merger and control proceedings under 49 U.S.C. § 11323, and the conclusion of the formal oversight process does not preclude any party from invoking our jurisdiction to address any merger-related concerns arising out of our conditions.” *CN/IC Oversight*, slip op. at 3. “Also, our Office of Compliance and Enforcement continues to monitor the rail industry generally and to make its Rail Consumer Assistance Program available to consider informal complaints involving railroads.” *Id.*

The Board's continuing remedial mechanisms are fully adequate to deal with any issues that may arise from KCS's control of Tex Mex. To date, no party has shown a competitive harm that would result from that transaction. Moreover, there are private agreements in place, including the NITL Agreement and the agreements governing operations of the International Bridge, which protect interested parties against anticompetitive behavior should any be attempted. On top of that are the Board's continuing remedial powers and informal assistance through its Office of Compliance and Enforcement. These remedies are more than adequate to deal with anticompetitive behavior, should any be attempted. KCS fully expects, however, that none will occur.

**IV. CONDITIONING THE KCS/TM TRANSACTION TO CONTROL
TFM RATES OR SERVICES, DIRECTLY OR INDIRECTLY,
WOULD EXCEED THE BOARD'S JURISDICTION**

**A. Requests That the Board Regulate TFM Exceed the
Board's Jurisdiction.**

Consistent with the fact that our opponents' theories about anticompetitive manipulations by KCS hinge on KCS acquiring control of TFM, several parties, led by UP and BNSF, directly request that the Board condition this transaction by regulating the rates and services of TFM. In support of their requests, they cite a few prior Board decisions. However, examination of those precedents make clear that they do not apply to this case, and that the conditions requested would exceed the Board's jurisdiction.

Several parties specifically request that the Board impose conditions on this transaction that would regulate the rates and services of TFM. *See, e.g.*, BNSF-4 at 6 ("A workable approach would be for the Applicants to be required to maintain the existing Tex Mex and TFM rates and services presently available for service in conjunction with BNSF at Laredo, Robstown/Corpus Christi and Brownsville for a temporary five-year period."), and UP-7A at 92

(“UP believes that there are only two basic requirements of any implementing agreement: First and foremost, the agreement would have to include some mechanism that provided UP (and other carriers) with the ability to offer shippers competitively-viable services in conjunction with TFM, including TFM commercial terms (e.g, rates, rate factors, etc.)”). UP goes on to suggest a rate matrix which would allow it to quote rates to and from points on TFM without consulting TFM. *See, e.g.*, UP-7A at 96. In fact, while BNSF alleges that the KCS/Tex Mex transaction has anticompetitive potential, “[a]rguably, how KCS uses its control of TFM is even more important than how it uses its control of Tex Mex.” BNSF-4 at 25-26.

For the Board to attempt, directly or indirectly, to regulate TFM’s activities would exceed the Board’s jurisdiction. TFM is a railroad that operates wholly within Mexico. Therefore, TFM is excluded from the Board’s jurisdiction by 49 U.S.C. § 10501(a)(2), which states that the Board’s jurisdiction “applies only to transportation in the United States.”

TFM does not operate in the United States. TFM is not a party to this application proceeding, and it is not asking any relief or approval from the Board in this matter. TFM is not an applicant or an applicant carrier under the Board’s definitions in 49 C.F.R. § 1180.3. Neither is it part of KCS’s “full system” as that term is used in the Board’s *Major Rail Consolidation Procedures*, inasmuch as TFM is run from Mexico City. Supplement to Application at 7. In short, TFM is a Mexican company, operated and operating in Mexico, and beyond the Board’s statutory authority.

Opponents of this transaction argue that the Board “should” regulate TFM, but struggle to find any authority for their position. Only UP makes a serious effort in this regard, citing the *Canada Southern*, *CN/WC* and *CN/IC* cases. These efforts fall short, however, for all these cases indicate is that the Board can consider the effects in the U.S. of a transaction that occurs in the

U.S. involving multiple carriers subject to the Board's jurisdiction when that transaction has been submitted to the Board for its review. That proposition is far different from the contention that the Board can reach across the border and control the rates and services of a railroad operating only in a foreign country.⁸²

Canada Southern, for example, involved the transfer of rail property, including rail property in the United States, from one U.S.-regulated, U.S.-domiciled carrier to two U.S.-regulated, Canadian-domiciled carriers. In the case, brought before the Board by the involved carriers, the Board specifically found that its jurisdiction was based on the fact that a small portion of the property being sold was a rail bridge and tunnel within the U.S. By contrast, TFM is not a party to this Board proceeding and does not operate or own rail properties (as opposed to stock in a rail carrier subsidiary) in the U.S.

The *CN/IC* and *CN/WC* cases are clearly distinguishable as well. In each, a major foreign-domiciled carrier, which already itself operated in the U.S., and was subject to the STB's

⁸² UP references the fact that from March of 2002 to April of 2003, TFM indirectly (through Mexrail) controlled Tex Mex. However, UP makes no showing that TFM, as opposed to a subsidiary of its subsidiary, ever operated in the United States, and presents no justification for its unspoken disregard of the Tex Mex or Mexrail corporate entities. UP also mentions TFM's participation in a Board-approved pooling agreement for cars used to transport auto parts. *Transportacion Ferroviaria Mexicana-Pooling of Car Service Regarding Multilevel Cars*, STB Finance Docket No. 29653 (Sub-No. 7) (STB served Sept. 28, 1999). KCS would point out that Ferromex also is a party to that same equipment pool. *Ferrocarril Mexicano, S.A. de C.V.--Pooling Of Car Service Regarding Multilevel Cars*, Finance Docket No. 29653 (Sub-No. 8) (STB served Jan. 19, 2001). If these carriers' limited participation in this railcar pool (both are limited to international traffic moving between Mexico, Canada and the U.S.) is sufficient to confer on the Board the power to regulate the rates and services of these carriers, then the Board effectively already has the power to regulate most of the Mexican rail industry. Clearly, however, the Board does not have such power. See, e.g., "Canadian or Mexican carriers file with us, if they so desire, the tariffs establishing joint rates with our domestic carriers, and we do not thereby obtain jurisdiction over those foreign carriers." *Canadian Pac. Ltd. v. United States*, 379 F. Supp. 128 (D.D.C. 1974), quoting *International Joint and Through Rates*, 337 I.C.C. 625, 635 n. 11 (1970).

jurisdiction, and which controlled multiple subsidiary railroads in the U.S., applied to the Board for authority to acquire still another U.S. railroad. Clearly in that situation the Board could review the cross-border effects. But this case is not that situation. This case is identical to a U.S. carrier acquiring British Columbia Rail (“BCR”). BCR operates solely in Canada but connects with U.S. carriers near the U.S./Canada Border. It is an important player in international trade and interlines cross-border traffic with U.S. carriers. BCR is currently for sale. If UP, CN, CP, or BNSF acquires BCR are any of them going to submit that transaction for Board review or accept conditions that would control BCR’s rates? Of course not, nor should they.

Yet, if the Board conditions this transaction based upon effects arising not from the KCS/Tex Mex transaction but rather from the KCS/TFM transaction, the Board would be establishing a precedent that it can review the competitive effects of a transaction that everyone admits is outside the jurisdiction of the Board. If such a precedent is established, we would expect that if UP acquires control of Ferromex or BCR, it will submit such transactions to the Board.

Moreover, even in transactions clearly subject to the Board’s jurisdiction, the Board has still refrained from imposing conditions involving the foreign carriers and operations, even if those carriers were subsidiaries of STB regulated carriers. For example, in *CN/IC*, the Board chose not to require divestiture of the Detroit River Tunnel, which lies partially within the United States, saying, “We have often said that divestiture is an extreme remedy not to be imposed lightly, and requiring divestiture of Canadian railroad assets would additionally involve us in difficult issues of sovereignty.” *CN/IC Oversight*, slip op. at 36. *Accord, Canada Southern*, 1984 LEXIS 332 at *21 (“[T]he interchange practices of Canadian carriers in Canada are beyond our jurisdiction.”); *George C. Anspach Company, Ltd., et al. v. Atchison, Topeka & Santa Fe*

Railway Company, et al., 311 I.C.C. 296, 298 (1960) (holding that the Commission could only prescribe new rates for rail lines with domestic destinations even if the railroad was charging unlawful rates abroad); *H.K. Porter Co. v. Central Vermont Ry.*, 366 U.S. 272, 274-275 (1961); and *Anglo-Canadian Pulp and Paper Mills, Ltd., et al. v. Aberdeen and Rockfish R.R. Co., et al.*, 351 I.C.C. 325, 1975 ICC LEXIS 5 (1965) (“to the extent complainants seek an order directed against carriers transporting newsprint solely in Canada under the involved joint international rate, their request is too broad”); and *Canadian Pac. Ltd. v. United States*, 379 F. Supp. 128 (D.D.C. 1974) (holding that the Commission did not have jurisdiction over proposed tariff rates when “direct action against a foreign carrier is the logical next step to the Commission’s assertion of jurisdiction.”)

The transactions in *CN/IC* and *CN/WC* bear no resemblance to the KCS-TFM transaction. *CN/IC* and *CN/WC* involved foreign-domiciled carriers that were already subject to the Board’s jurisdiction, whereas KCS/TFM does not. *CN/IC* and *CN/WC* involved acquisition of a U.S. carrier. KCS/TFM does not. And *CN/IC* and *CN/WC* involved transactions that were subject to the Board’s jurisdiction, whereas KCS/TFM does not.

The extraordinary conditions requested by BNSF and UP -- Board control of the rates and services of a foreign carrier for at least five years, if not perpetually -- are at least as extraordinary as the divestiture that the Board declined in *CN/IC*. ICC and judicial precedent clearly holds them to be beyond the Board’s jurisdiction. To start with, requests to control a foreign carrier’s services are fundamentally no different than ordering sale of its property as rejected in *CN/IC*; that is, both control the use of the carrier’s assets. BNSF and UP try to avoid this issue by suggesting that the Board, like the Great Oz, may manipulate from behind a curtain, ordering KCS to order TFM to behave in certain ways. UP suggests that the Board merely direct

KCS and UP to agree on a scheme to control TFM, though it also suggests that if they don't reach an agreement, the Board impose such a scheme as a condition. The purpose of making it a condition, of course, is to allow someone to come back to the Board and have that condition enforced. Thus, whether directly or from behind the curtain, whether immediately or after a delay, UP and BNSF are asking the Board to control the use of TFM's assets, rates, and practices. That is substantively no different from, and raises the same sovereignty concerns as, ordering sale of CN's Canadian property, controlling interchange practices, or ordering foreign carriers to enter into international through rates or adopt joint rates.⁸³

While the Board does have authority to regulate the U.S. portion of international through rates, it does not have the power to regulate the foreign portion of that rate. The Board's power cannot be stretched to cover the massive rate control that BNSF and UP seek for TFM. Precedent holds that the ICC (and, by succession, the Board) can determine the reasonableness of an international through rate and, if finding it unreasonable, can order reparations, but it cannot control the foreign portion of the international through rate. *Canada Packers, Ltd. v. Atchison, T. & S.F. Ry. Co.*, 385 U.S. 182 (1966) ["*Canada Packers*"]; *Canadian Pac. Ltd. v. United States*, 379 F.Supp. 128 (D. D.C. 1974) ["*Canadian Pacific*"]; *National Insulation Transportation Committee v. Aberdeen and Rockfish R.R. Co.*, 365 I.C.C. 624 (1982) ["*National Insulation*"]. In *Canadian Pacific*, the court noted that:

⁸³ There is a long line of cases holding that the ICC cannot require rail carriers to enter into joint rates for international transportation. See, e.g., *Central Vermont Ry., Inc. v. United States* 182 F. Supp. 516, 519 (1960); *Lewis-Simas-Jones Co. v. Southern Pac. R.R. Co.*, 283 U.S. 654, 660 (1931); *Fruit Importers v. Atlantic Coast Line R. Co.*, 188 ICC 520, 523 (1932); *International Nickel Co. v. Director General*, 66 I.C.C. 627 (1922). Yet, directing KCS to use its power over TFM to require TFM to establish certain rates or practices involving UP and BNSF U.S./Mexico traffic would be doing exactly what these cases say the Board cannot do.

Nor has the Commission cited to the Court one instance where it had ever taken any direct action against a foreign carrier for actions in a foreign country, regardless of whether or not such actions affected U.S. commerce or involved joint through international rates.

Canadian Pacific at 133. Furthermore, the court, citing *H.K. Porter*, said, “[A]s in Canada Packers, the Court implied that the Commission’s remedial powers cannot extend to direct control of the Canadian part of the transportation.” *Id.* at 134. Importantly, the court pointed out, “[I]t is well established that the Commission does not have the power to prescribe joint international rates, as it does domestic rates.” *Id.* at 133 n. 11.⁸⁴

These authorities make crystal clear that the Board does not have authority to prescribe rates and services on a wholly-foreign railroad as requested by BNSF and UP. As the court said in *Canadian Pacific*, “Congress has not attempted to confer jurisdiction on the Commission as to all matters ‘affecting’ commerce, but has expressly limited its jurisdictional grant.” *Id.* at 132 n. 9. “It is a longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.” *Sandra Jean Smith v. United States*, 507 U.S. 197, 204 (1993). In the absence of such an express grant, the Board cannot reach into other nations to control behavior within their borders. As stated by the Supreme Court in *McCulloch. Sociedad Nacional de Marineros*, 372 U.S. 10, 21-22 (1963), “the affirmative intention of the Congress” is required before domestic laws (in that case,

⁸⁴ See also *Changes in Routing Provisions-Conrail-Western Ry. Co.-Petition to Impose Surcharge for Conrail*, 365 I.C.C. 753, 766 (1982) where the Commission refused to address anticompetitive conduct by a foreign carrier in a foreign jurisdiction:

It is well established that we lack jurisdiction to compel Canadian carriers to participate in joint rates to the extent that they perform the transportation outside the United States. Indeed, we may not lawfully take any punitive actions against Canadian carriers for acts that take place outside United States territory. (Internal citations omitted.)

U.S. labor laws) should be applied in international situations (such as to foreign crews on foreign -- flag ships of the foreign subsidiary of U.S. company). The Board's statute is not such an affirmative grant. All of these cases support the proposition that the Board cannot impose rate and service requirements, directly or indirectly, on TFM as UP and BNSF request.

Finally, despite UP's disdain for Mexican regulation of rail rates, even UP admits that Mexico has such a regulatory scheme. Moreover, the MCC reviewed the TFM transaction and, citing the importance of TFM as an international transportation corridor approved the transaction. For the Board to even consider UP's invitation to regulate TFM because UP is dissatisfied with the development and processes of Mexico's regulatory scheme would set dangerous precedents.

CONCLUSION

The competitive issues surrounding KCS's plans to acquire of control of Tex Mex and its related acquisition of control of TFM have been fully briefed and addressed by all of the parties. KCS's plans to acquire control of TFM have been thoroughly analyzed by the MCC and DOJ. Both of those agencies have concluded that KCS's acquisition of control of TFM would not result in any anticompetitive effects, either in Mexico or in the United States. Notwithstanding those findings, UP, BNSF, and others have argued that the Tex Mex and TFM transactions could result in anticompetitive effects in the U.S.

With respect to the KCS/TM transaction, UP claims that KCS control of the northern half of the International Bridge at Laredo could lead to discrimination against UP's trains. UP has therefore requested that the Board to order the parties to negotiate a new dispatching protocol. If the parties cannot agree on such a new protocol, the Board should impose one, according to UP. This request should be rejected. UP has not established that KCS's control of the bridge would

“likely” have anticompetitive effects and that such effects are “substantial.” Indeed, other than speculation about what might happen, UP has failed to show that the existing agreements and arrangements, which have been in place for fifty years and have been bilaterally amended when necessary to improve efficiencies, are inadequate and should be renegotiated.

If UP has problems with the way the bridge is operated under KCS control, it can invoke its remedies under those agreements. KCS has indicated that it is willing to sit down with UP and discuss any concerns it may have about the way the existing arrangements could be changed or improved to the benefit of both parties. However, such a willingness to discuss this issue in good faith should not be imposed as a condition, nor has UP established that a condition is warranted. Likewise, the STB should not involve itself in these private discussions nor should it impose a new agreement when UP has not established that KCS control of the bridge would likely result in substantial anticompetitive behavior.

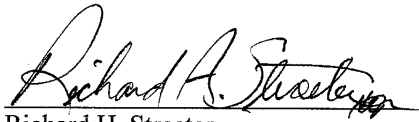
In addition to issues involving the bridge, UP, BNSF, and others have claimed that KCS control of Tex Mex and TFM will result in UP and BNSF routings being inefficiently foreclosed. Importantly, all parties agree that there are no horizontal competitive effects, and no party has challenged Dr. Grimm’s findings that there will not be a reduction in source competition. With respect to the vertical foreclosure issues, as the Board has found in every merger case since 1982, an end-to-end merger between an upstream competitor and a downstream “bottleneck” carrier is highly unlikely to result in the foreclosure of efficient interline routes or increased prices to shippers. There is nothing unique about the KCS/TFM transaction that would change that well-established conclusion and precedent.

UP witnesses do attempt to argue that the standard theories would not apply in this case. However, the Gray and Hausman theory is based upon a number of faulty assumptions and

conclusions. It ignores the current common equity ownership between TFM, Tex Mex and KCS. It assumes that Mexican rate regulation is so strict and pervasive that TFM is not free to differentially price today; that KCSR is free to raise or lower its division requirements, but other railroads must keep their divisions frozen and inflexible; that neither UP nor BNSF could retaliate by switching to other gateways; that shippers would just absorb rate increases without switching to other modes; and that there is unlimited capacity on Tex Mex so as to increase traffic over 500%. All of these assumptions are wrong. If NAFTA Rail attempted such a strategy, the only party that would be hurt would be NAFTA Rail as such a scenario would be extremely unprofitable. When confronted with the utter implausibility of the numerous assumptions underlying the UP and BNSF theories, one can only conclude that the ICC/STB's long standing precedents are correct, and that UP/TFM and BNSF/TFM routings will not be inefficiently foreclosed.

In the end, the KCS/Tex Mex transaction will not result in a substantial lessening of competition, creation of a monopoly, or a restraint of trade in freight surface transportation in any region of the U.S. It should be approved without conditions. This conclusion is not altered in any way if one also considers the effects of the KCS/TFM transaction. Creation of the NAFTA Rail system will result in a stronger and healthier competitor in the marketplace, providing shippers with a strong and efficient alternative to the dominance of the mega-systems.

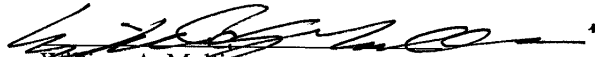
KCS requests the STB to support those efforts and to approve the KCS/Tex Mex transaction without conditions.



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Respectfully submitted,



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Company, and Gateway Eastern
Railway Company

September 2, 2003

PUBLIC VERSION

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, AND REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

EXHIBIT A PUBLIC

**INDEX OF UP
DISCOVERY DOCUMENTS CITED
IN REBUTTAL AND ATTACHED HEREIN**

**UP HAS DESIGNATED ALL OF ITS DOCUMENTS CITED IN
THE REBUTTAL AS HIGHLY CONFIDENTIAL
AND ARE THEREBY REDACTED FROM THE PUBLIC VERSION**

PUBLIC VERSION

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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AND REBUTTAL IN SUPPORT OF APPLICATION**

**EXHIBIT D
PUBLIC**

**INDEX OF KCS DOCUMENTS
CITED IN REBUTTAL AND ATTACHED HEREIN**

PRESS RELEASES

08/01/03	Kansas City Southern and Grupo TMM Announce Expiration of Department of Justice Hart-Scott-Rodino Waiting Period Allowing NAFTA Rail Transaction to Proceed Without Further U.S. Antitrust Review
08/18/03	Kansas City Southern Issues Statement in Reaction to TMM Announcement
08/21/03	Kansas City Southern Receives Notice of Mexican Foreign Investment Commission Decision on KCS Control of TFM

DOCUMENTS

KCS-P 0006-19
KCS-P 0020-36



For Immediate release:
August 1, 2003

For additional information contact:
William Galligan - 816-983-1551

Kansas City Southern and Grupo TMM Announce Expiration of Department Of Justice Hart-Scott-Rodino Waiting Period Allowing NAFTA Rail Transaction to Proceed Without Further U.S. Antitrust Review

[Previous Release](#) / [Next Release](#) / [Press Release Menu](#)

Today, Kansas City Southern ("KCS") (NYSE: KSU) and Grupo TMM, S.A. (NYSE: TMM and BMV: TMM A; "TMM") announced that the waiting period under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 ("HSR") for their proposed NAFTA Rail transaction has expired without a formal request from the U.S. Department of Justice ("DOJ") for additional information of documentary material, allowing KCS and TMM to consummate their transaction without any further delays that could have resulted from requests for additional information by the Justice Department under U.S. antitrust laws. Under the HSR process, the DOJ had thirty (30) days after notice is filed to issue a "second request" asking for various documents and information from the HSR parties. The waiting period officially expired yesterday, July 31, 2003, without action by the DOJ. While the transaction has cleared the regulatory waiting period under HSR for antitrust review in the United States, the transaction placing TFM, S.A., de C.V. ("TFM") under common control of NAFTA Rail must still be approved by the Foreign Investment Commission in Mexico, the shareholders of both companies, and TMM bondholders. The transaction has already received approval from the Mexican Competition Commission, which looks at antitrust issues in proposed transactions in Mexico.

"We are very gratified that the U.S. Department of Justice has determined to allow the transaction to proceed without a request for additional information under the antitrust laws," stated Michael R. Haverty, Chairman, President, and Chief Executive Officer of KCS. "We believe that NAFTA Rail will enhance rail competition in Mexico and the United States and improve rail service for shippers in the vitally important North American rail corridor. This is one more step in our effort to make NAFTA Rail a strong competitor in the NAFTA trade corridor."

Jose Serrano, Chairman of Grupo TMM, said "The expiration of the waiting period removes another hurdle to our ability to complete the transaction."

In a separate, but related proceeding, Haverty and KCS Executive Vice President and Chief Operating Officer, Gerald Davies, testified yesterday before the U.S. Surface Transportation Board ("STB") at a public hearing held to discuss and take evidence on KCS's plans to place The Kansas City Southern Railway Company ("KCSR"), Gateway Eastern Railway Company ("Gateway"), and The Texas Mexican Railway Company ("Tex Mex") under the common control of KCS (the "Applicant"). This public hearing was scheduled by the STB to allow the Applicant and the public to comment on this transaction, which is separate from the TFM transaction. KCS had earlier purchased 51 percent of Tex Mex's parent company, Mexrail Inc., for \$32.7 million but placed those shares in an independent voting trust pending STB authority to commonly control KCSR, Gateway, and Tex Mex. The STB has published a procedural schedule that would result in a final decision in this matter by October 17, 2003.

"We were very pleased that Chairman Nober and the STB staff scheduled this hearing to allow us and many of the affected parties to comment on the importance of our transaction to future competitive rail service between the U.S. and Mexico," said Haverty.

Joining KCS in testifying in support of the transaction at the STB hearing were The U.S. Department of Agriculture, Watco Companies, Inc., Triangle Marine Industrial Park, Bartlett Company, Beachner Grain, Inc., E. I. du Pont de Nemours and Company, Martin Product Sales LLC, and MeadWestvaco Corporation. Over 90 parties to date have filed written comments in support of the NAFTA Rail transaction.

KCS is a transportation holding company that has railroad investments in the United States, Mexico, and Panama. Its primary holding is The Kansas City Southern Railway Company. Headquartered in Kansas City, Missouri, KCS serves customers in the central and south central regions of the U.S. KCS's rail holdings and investments are primary components of a NAFTA Railway system that links the commercial and industrial centers of the United States, Canada and Mexico.

Headquartered in Mexico City, Grupo TMM is the premier Mexican multimodal transportation company and logistics provider. Through its branch offices and network of subsidiary companies, Grupo TMM provides a dynamic combination of ocean and land transportation services within Mexico. Grupo TMM also has the controlling interest in TFM, which operates Mexico's Northeast Rail Lines and carries over 40 percent of the country's rail cargo.

This press release includes statements concerning potential future events involving the Company, which could materially differ from the events that actually occur. The differences could be caused by a number of factors, including those factors identified in a Current Report on Form 8-K dated December 11, 2001 filed by the Company with the Securities and Exchange Commission ("SEC")) Commission file no. 1-4717). The Company will not update any forward-looking statements in this press release to reflect future events or developments.

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For Immediate release:

August 18, 2003

For additional information contact:

William Galligan - 816-983-1551

Kansas City Southern Issues Statement in Reaction to TMM Announcement

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In reaction to today's announcement by Grupo TMM, S.A. ("TMM") regarding its shareholders' decision not to approve the sale of TMM's interests in Grupo Transportacion Ferroviaria Mexicana, S.A., de C.V. to Kansas City Southern ("KCS"), KCS issued the following statement:

KCS is concerned by today's announcement about the TMM shareholder action and is exploring its rights under the agreements between the parties, and its legal options under U.S. and Mexican law. Jose Serrano, chairman of Grupo TMM, who signed and obligated TMM to the transaction agreements with KCS and who, in his capacity as a director of TMM, recommended approval of the transaction to TMM shareholders, is the controlling stockholder of Grupo TMM. KCS intends to pursue all appropriate legal or administrative action against any persons or entities involved in interfering with KCS and its agreements with TMM. KCS remains committed to completing the transaction.

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<TEXT>

[SONNENSCHN NATH & ROSENTHAL LLP LETTERHEAD]

August 21, 2003

VIA FACSIMILE - 213-629-5063
AND FEDERAL EXPRESS

Kenneth A. Ostrow, Esq.
Milbank, Tweed, Hadley & McCloy LLP
601 S. Figueroa Street, 30th Floor
Los Angeles, CA 90017-5735

Dear Mr. Ostrow:

Our client, Kansas City Southern (KCS) was shocked by the announcement on Monday, August 18, 2003, by Grupo TMM, S.A., (TMM) that TMM's shareholders voted down the Acquisition Agreement covering KCS's proposed purchase of TMM's ownership of the Mexican railroad, TFM.

KCS was also surprised that TMM's press release failed to disclose that the Serrano and Segovia families effectively controlled that result through their control of the voting rights of the vast majority of TMM stock. KCS was further dismayed by the press release's failure to explain why the individuals who signed the Acquisition Agreement on behalf of TMM - TMM's Chairman, Jose Serrano, and Chairman Serrano's nephew, Javier Segovia, TMM's CEO - and who as TMM directors recommended approval of the Agreement to TMM shareholders, turned around as the controlling TMM shareholders, rejecting their own recommendation, and voted against that approval.

KCS believes it was misled by previous statements from TMM representatives, including as recently as last Friday, August 15, 2003, when, in a telephone conversation between TMM CEO Javier Segovia and KCS Assistant to the CEO, Larry Lawrence, Mr. Segovia advised that the TMM shareholder vote was assured to be in favor of the Acquisition Agreement. KCS is perplexed at what could have happened over the week-end to change that prediction.

You should nevertheless understand that KCS does not consider the action taken by Mr. Serrano at the TMM shareholders' meeting to preclude completion of this acquisition. TMM shareholder approval, while contemplated in the Agreement and referred to publicly (KCS having been assured it was a "mere formality") was, as you must know, not included as one of the conditions precedent to TMM's obligation to close the transaction.

Therefore, we want to advise you, so that you may inform the Board of TMM, that KCS considers the Acquisition Agreement to remain valid and in effect. In particular, KCS calls your attention to Article 7 of that agreement, which places many restrictions upon the conduct of the business of Grupo TFM and its subsidiaries, including TFM, pending completion of this transaction. Those

<http://www.sec.gov/Archives/edgar/data/54480/000101381603000205/exhibit-8k.txt>



Union Pacific Railroad Spring Dispatching Center Train Meet and Delay Study

**For the Angleton and Brownsville Subdivisions
For the Period From November 13, 2002 to November 16, 2002**

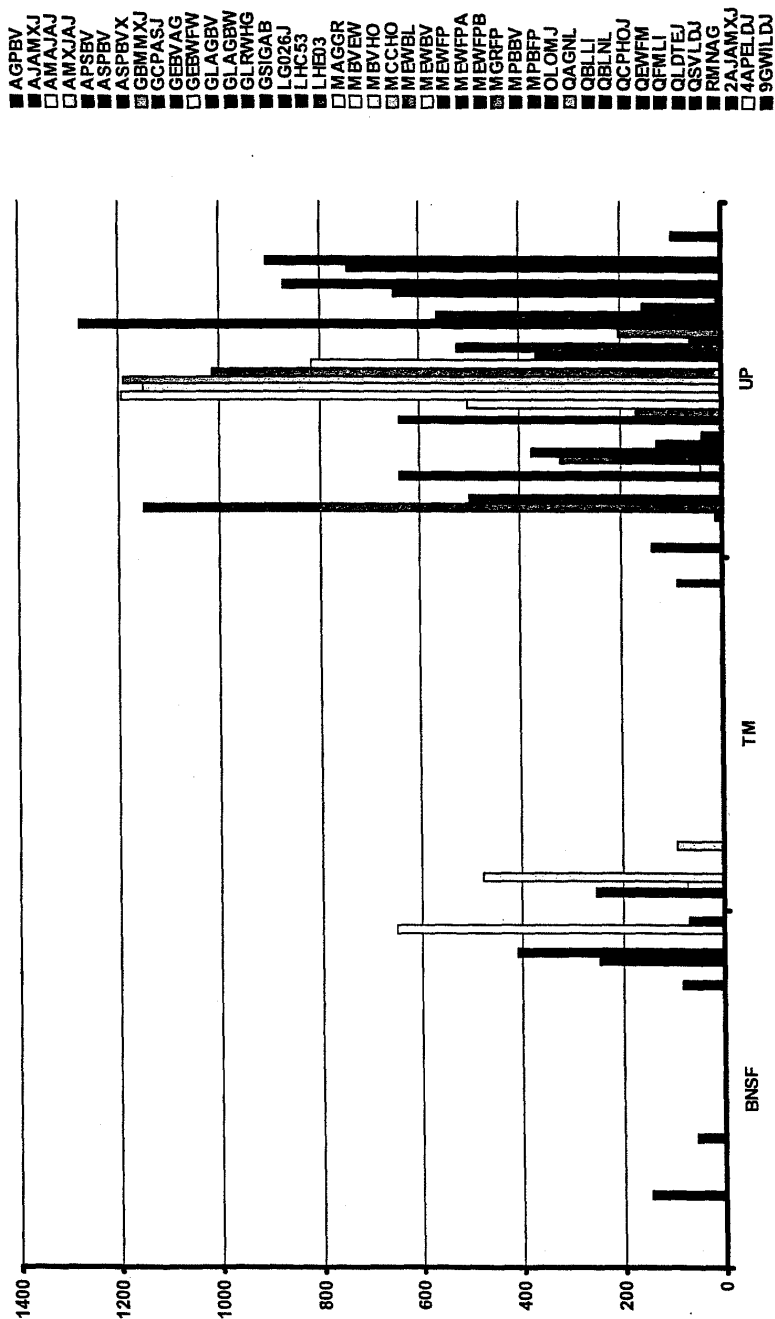


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KCS - P 0006

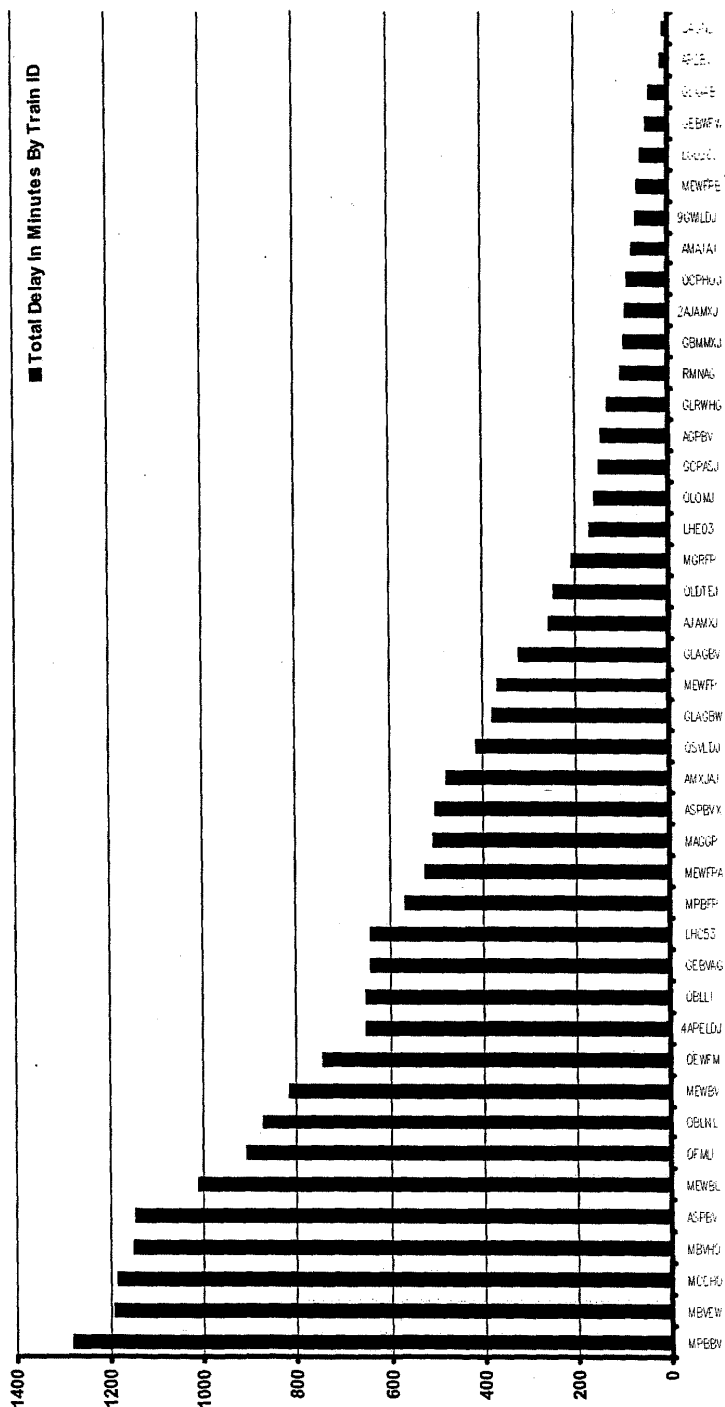


Union Pacific Railroad
Spring Dispatching Center
Angleton - Brownsville
Train Meet / Delay Study
November 13, 2002 to November 16, 2002





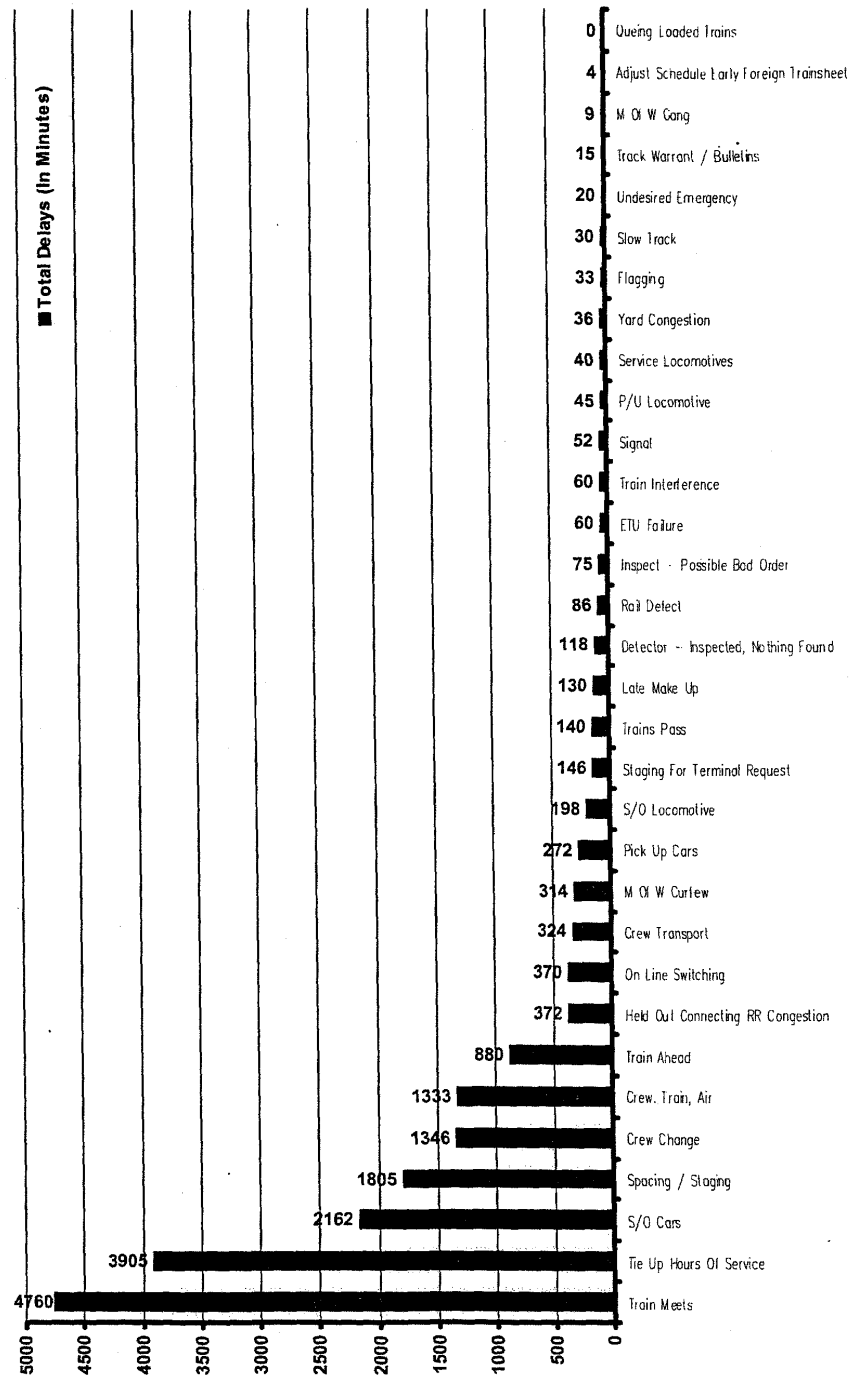
Union Pacific Railroad
Spring Dispatching Center
Angleton - Brownsville
Train Meet / Delay Study
November 13, 2002 to November 16, 2002





Angleton - Brownsville
Train Meet / Delay Study
November 13, 2002 to November 16, 2002

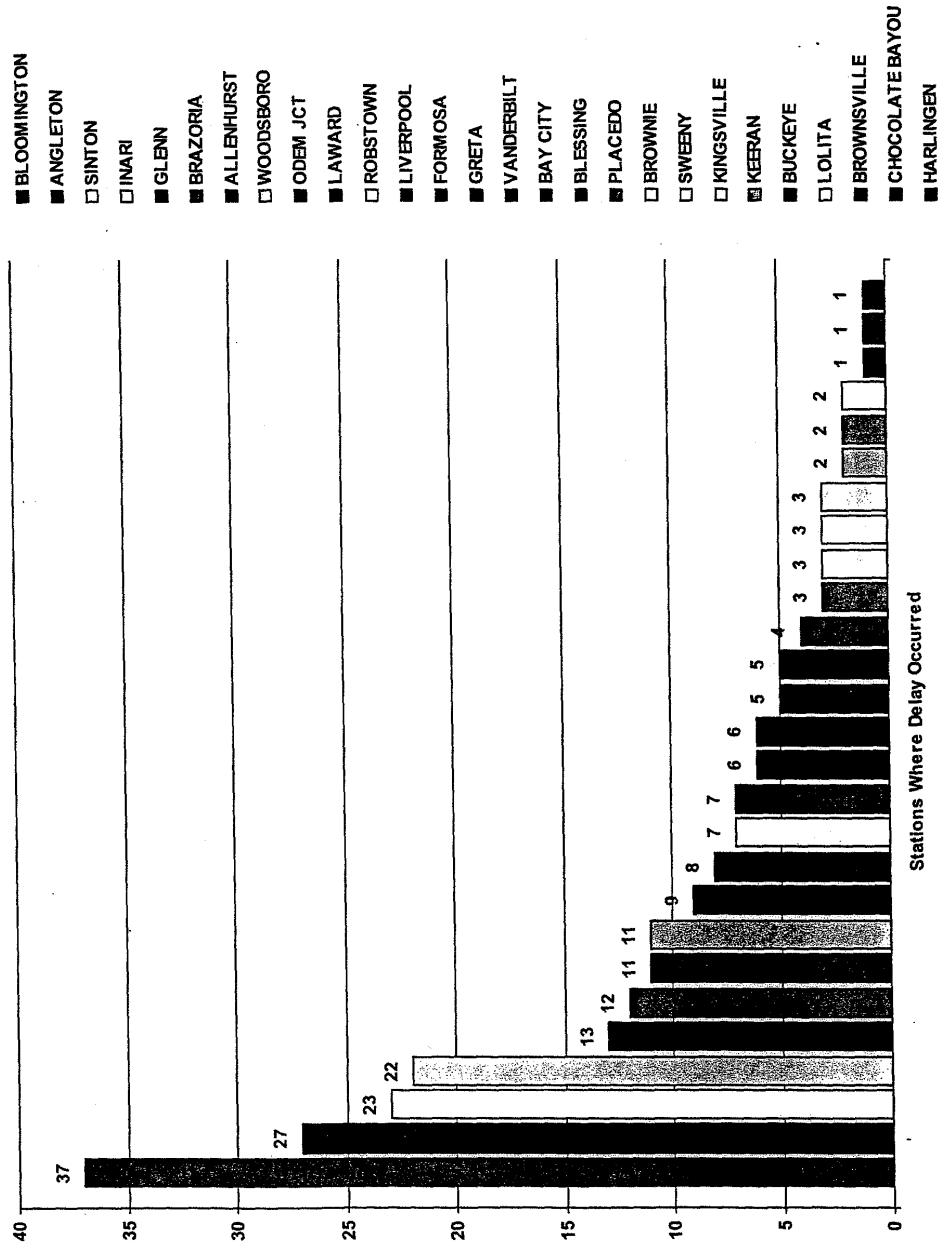
Union Pacific Railroad
Spring Dispatching Center





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Union Pacific Railroad Angleton - Brownsville
Spring Dispatching Center Train Meet / Delay Study
November 13, 2002 to November 16, 2002



KCS - P 0010



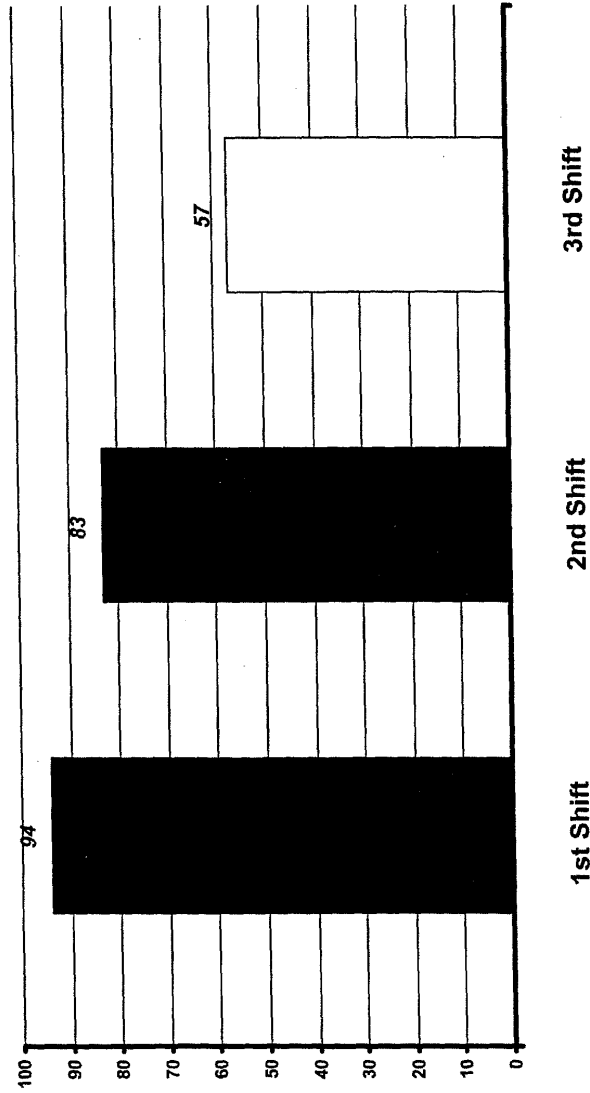
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Union Pacific Railroad
Spring Dispatching Center

Angleton - Brownsville
Train Meet / Delay Study
November 13, 2002 to November 16, 2002



Number Of Delays Incurred By Dispatcher Shift





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Union Pacific Railroad Spring Dispatching Center

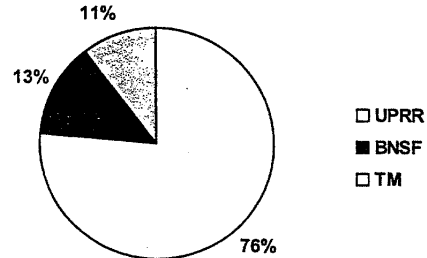
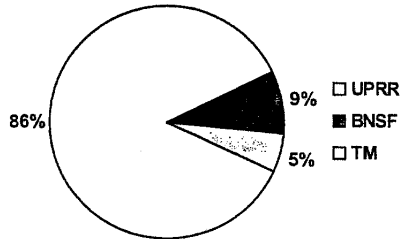
Delay and Train Meet Study
For the Angleton and Brownsville Subs
November 13, 2002 to November 16, 2002

Delays Incurred By Each Railroad

Total Number Of Trains On The Subdivisions

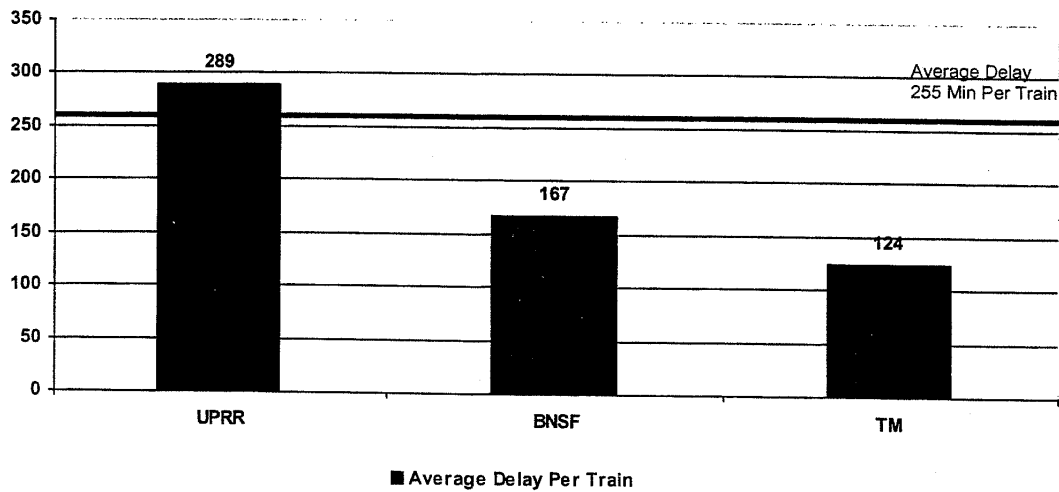
Magnitude Of Delays = UPRR - 16482 Min
BNSF - 1669 Min
TM - 989 Min

Trains Per Railroad = UPRR - 57
BNSF - 10
TM - 8



Average Train Delay Incurred By Each Train

Total Average Delays - Expressed in Minutes





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**Union Pacific Railroad
Angleton and Brownsville Subdivisions
Maximum Speeds Table**

Maximum Speeds - Algoa to Angleton

Permanent Speed Restrictions

MAXIMUM SPEED BETWEEN MILE POSTS	MPH
343.10 AND 321.00 (EXCEPT AS BELOW)	50
343.30 AND 342.90	25
320.30 AND 319.90	20

Siding and Turnout Speeds

Brownie (Algoa)	20
Liverpool	30
Glenn	30

Temporary Speed Restrictions: None

Maximum Speeds - Angleton to Bloomington

Permanent Speed Restrictions

Maximum Speed Between Mile Posts	MPH
321.0 AND 221.0 (EXCEPT AS BELOW)	50
319.90 AND 318.00	30
309.80 AND 308.20	25
305.60 AND 305.50	25
285.50 AND 283.40	30+
277.00 AND 276.50	25
234.30 AND 234.00	25
+ Head End Restriction Only	

Siding And Turnout Speeds

Brazoria	25
Allenhurst	30
Bay City	20
Buckeye	30
Blessing	30
LaWard	30
Vanderbilt	20
Keeran	20

Temporary Speed Restrictions

318.00 AND 317.00	40
313.00 AND 311.00	40
308.00 AND 307.00	40
305.00 AND 304.00	40
291.00 AND 289.00	40
286.00 AND 285.00	40
264.25 AND 263.75	40
236.75 AND 235.75	40
224.30 AND 224.25	25

Maximum Speeds Bloomington To Kingsville

Permanent Speed Restrictions

MAXIMUM SPEED BETWEEN MILE POSTS	MPH
221.00 AND 204.30 CTC (EXCEPT AS BELOW)	50
219.00 AND 219.30	25
216.00 AND 215.30	35
BETWEEN MILE POSTS 204.30 AND 141.4 TWC (EXCEPT AS BELOW)	49
204.30 AND 202.00	40
202.00 AND 190.00	25
190.00 AND 186.80	40
186.80 AND 184.90	25
184.90 AND 162.20	40
162.20 AND 161.60	20
161.60 AND 155.10	40
155.10 AND 154.50	20
141.50 AND 141.40	25

Siding and Turnout Speeds

Inari - Hand Throw Switches	10
Greta - Hand Throw Switches	10
Woodsboro- Hand Throw Switches	10
Sinton - CTC	20
Robstown - One Hand Throw Switch	20

Temporary Speed Restrictions

207.25 AND 206.50	25
140.50 AND 140.25	25

BROWNSVILLE SUBDIVISION (0542)

Mile Post	Rule 6.3	CP #s	Radio Display: Bloomington to Brownsville - 2020		Sta. #s	Siding Feet
			SOUTH ▼ STATIONS	NORTH ▲		
221.0	CTC	H221	BLOOMINGTON	BT	B 219	Yard
219.1		H219	(3.1)			
216.0			BARGE CANAL	(MD)		
			(10.0)			
206.0	TWC	H206	INARI	I	B 205	7667
204.4		H205	(12.6)			
193.4			GRETA		B 193	7252
			(12.6)			
180.8	CTC		WOODSBORO		B 180	6392
			(18.8)			
162.0		J162	SINTON JCT.		B 163	
			(0.8)	(X)UP(A)		
161.2		J161	SINTON		B 162	11004
159.0		J159	(4.5)			
156.4		J156	CP J156 (HO)			
154.6	TWC	J155	ODEM	TY	B 155	Yard
			(0.1)			
154.5			(X)UP(S)			
			(13.1)			
141.4			ROBSTOWN JCT.		B 141	7116
			(23.0)	(X)TM(A)		
118.4			KINGSVILLE	BY	B 119	Yard
			(20.8)			
97.6			SARITA		B 098	5168
			(20.6)			
77.0			ARMSTRONG		B 077	7456
			(9.4)			
67.6			NORIAS		B 068	4496
			(22.7)			
48.1			RAYMONDVILLE		B 046	5730
			(22.5)			
25.6	YL		HARLINGEN	BTY	B 025	Yard
			(6.6)			
19.0			SAN BENITO		B 019	
			(18.3)			
0.7			BROWNSVILLE	BY	B 000	Yard
(220.3)						
SI-01 MAIN TRACK AUTHORITY CTC Between MP 221.0 and MP 204.4; MP 162.0 and MP 154.6. TWC Between MP 204.4 and MP 162.0; MP 153.0 and MP 6.0. Yard Limits Between MP 154.6 and MP 153.0; MP 120.0 and MP 114.9; MP 28.2 and MP 22.2; MP 6.0 and End of track .						

SI-02 MAXIMUM SPEED TABLE

Maximum Speed	MPH
Between Mileposts 221.0 and 204.3	
(Except as Below)	50
216.0 and 215.3	35
Between Mileposts 204.3 and 0.7	
(Except as Below)	49
204.3 and 186.8	40
186.8 and 184.9	25
184.9 and 170.3	40
170.0 and 162.2	40
162.2 and 161.6	20
161.6 and 155.1	40
155.1 and 154.5	20
141.5 and 141.4	25
132.1 and 131.5	20+
125.6 and 124.8	15+
48.0 and 45.4	35
42.2 and 41.4	40
22.1 and 18.0	35+

SI-03 OTHER SPEED RESTRICTIONS

Maximum Speed	MPH
1. Thru Sidings & Turnouts	
Inari Siding.....	10
2. Dual Control Switch Turnouts.	
CP J155.....	10
3. Misc. Speed Restrictions (No Exceptions.)	

SI-04 MAIN TRACK DESIGNATIONS - None.

SI-05 MILEPOST EQUATIONS - None.

SI-06 DTC BLOCK LIMITS - None.

SI-07 ITEM 13 TRAIN DEFECT DETECTORS

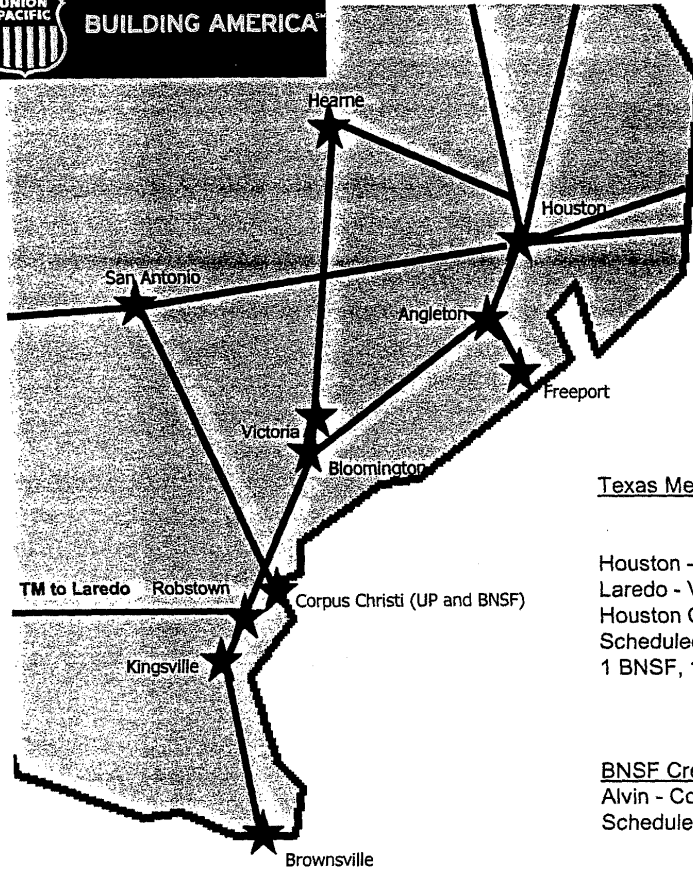
(#) 209.9
(#) 189.7
(#) 178.9
(#) 167.5
(#) 148.5
(#) 134.2

SI-08 RULES ITEMS - None.

SI-09 FRA EXCEPTED TRACKS - None.

SI-10 BUSINESS TRACKS

Track Name	MP	STA. #S
McFaddin S.....	209.4	B 209
Refugio S.....	186.0	B 186
Cranell S.....	173.6	B 174
Corpus Christi Filtration S.....	147.3	. . .
Lon Hill N.....	146.7	. . .
Nueces N.....	138.7	B 139
Driscoll	132.1	B 132
Bishop	124.9	B 125
Chemcel	122.8	B 123
Ricardo	112.0	B 112
Lyford S.....	41.4	B 041
Sebastian N.....	36.9	. . .
Russelltown	14.1	B 014



Crew District Mileage

Houston To Freeport	75
Houston To Angleton	52
Houston To Bloomington	157
Bloomington To Kingsville	100
Bloomington To Corpus Christi	83
Bloomington To Hearne	211
Kingsville To Brownsville	120
Houston To Victoria (TM)	216
Laredo To Victoria (TM)	242
Alvin to Corpus Christi (BNSF)	202
Alvin to Robstown (BNSF)	223

Texas Mexican Railway Crew Base

	Regular Eng/Cond	Extra Board Eng/Cond
Houston - Victoria	8 / 8	1 / 2
Laredo - Victoria	9 / 9	8 / 8
Houston Crews Protect Houston to Beaumont		
Scheduled Density 2.3 North / 2.3 South Daily		
1 BNSF, 1 KCS Each Way Daily. 1 TM Every 3rd Day		

BNSF Crew Base

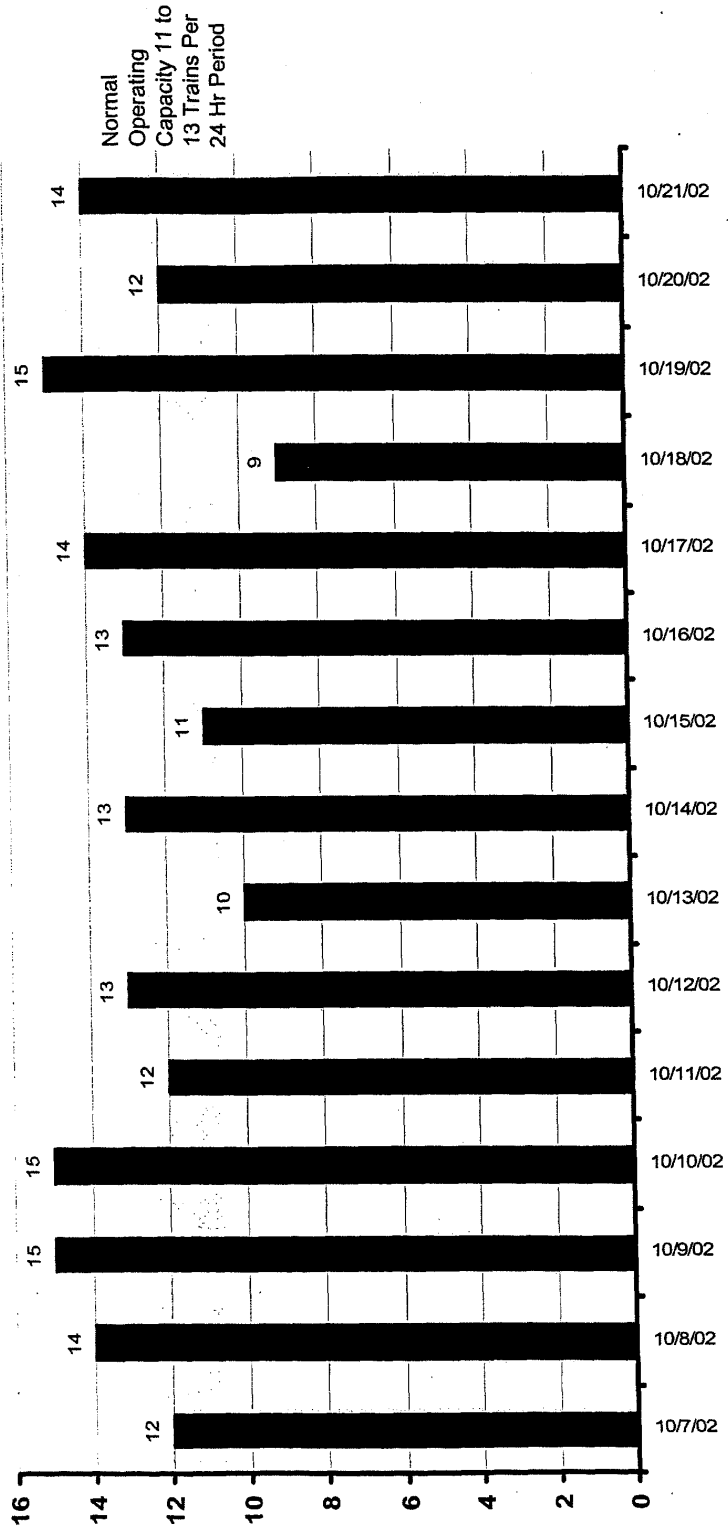
Alvin - Corpus Christi / Robstown	6 / 6	3 / 3
Scheduled Density 2 North / 1 South - Daily		

UPRR Crew Districts

	Regular Eng/Cond	Extra Board Eng/Cond
Houston to Freeport RE07/RT06 (XE02/XT02)	6 / 6	19 / 19
Houston to Bloomington RE15/RT15 (XE02/XT02)	17 / 17	19 / 13
Bloomington to Kingsville/Corpus Christi/Hearne RE07/RT06 (XE02/XT02)	17 / 17	9 / 9
Kingsville to Brownsville RE04/RT04 (XE02/XT02)	8 / 8	5 / 7

<u>UPRR Crew Starts Available Per Crew District</u>	<u>Avg.</u>	<u>Last 10 Days Operated</u>	
Houston - Freeport or Angleton	5	Min 2	Max 7
Houston - Bloomington	15	Min 12	Max 19
Bloomington - Kingsville / Corpus Christi / Hearne	15	Min 13	Max 17
Kingsville / Brownsville	7	Min 5	Max 9

Train Capacities Bloomington To Kingsville





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UPRR Delays By Type

Number Of Trains	Total Delay Minutes	Delay Code	Delay Description
77	3614	TM	Train Meets
22	2162	TS	S/O Cars
16	1346	CC	Crew Change
11	535	TT	Train Ahead
10	1333	LV	Crew. Train, Air
9	1805	TX	Spacing / Staging
8	3278	TU	Tie Up Hours Of Service
6	324	CT	Crew Transport
5	272	TP	Pick Up Cars
3	198	LS	S/O Locomotive
2	60	EF	ETU Failure
2	118	SI	Detector - Inspected, Nothing Found
2	52	SX	Signal
2	140	TB	Trains Pass
2	370	TL	On Line Switching
2	14	TW	Flagging
2	146	XI	Staging For Terminal Request
1	0	AQ	Queing Loaded Trains
1	75	BI	Inspect - Possible Bad Order
1	45	LA	P/U Locomotive
1	40	LT	Service Locomotives
1	314	MC	M Of W Curfew
1	36	YG	Yard Congestion
1	130	YL	Late Make Up
1	15	YO	Track Warrant / Bulletins
1	60	YT	Train Interference



BNSF Delays By Type

Number Of Trains	Total Delay Minutes	Delay Code	Delay Description
21	700	TM	Train Meets
5	206	TT	Train Ahead
1	86	MR	Rail Defect
1	30	MS	Slow Track
1	20	TE	Undesired Emergency
1	627	TU	Tie Up Hours Of Service



GRUPO TMM

Tex Mex Delays By Type

Number Of Trains	Total Delay Minutes	Delay Code	Delay Description
7	446	TM	Train Meets
3	139	TT	Train Ahead
1	372	FR	Held Out Connecting RR Congestion
1	9	MG	M Of W Gang
1	19	TW	Flagging
1	4	UF	Adjust Schedule Early Foreign Trainsheet

Date	RR	Train Symbol	Station	IN OS	LV OS	Delay	Shift?	Delay	Code	Daily Resn	Resn
11/14/02	TM	2AJANXJ-11	SINTON	7:00	8:05	65	1		TM	Train Meets	MEET GEBWFW-13
11/15/02	TM	2AJANXJ-12	BLOOMINGTON	22:00	22:24	24	2		TM	Train Meets	MEET MBVEW-15

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All Tex Mex Delays

November 13, 2002 @ 0630 to November 16, 2002 @ 0630 CST

Date	RR	Train Symbol	Station	IN OS	LV OS	Delay	Shift?	Delay Code	Daily Resn	Resn
11/13/02	TM	AJAMXJ-09	WOODSBORO	11:10	11:19	9	1	MG	M Of W Gang	MW VANECEK AHEAD INSPECTING TRACK.
11/13/02	TM	AJAMXJ-12	BLOOMINGTON	18:15	19:15	60	2	TM	Train Meets	MEET LHC03-13. MCCHO-13 AHEAD CHANGING CREWS.
11/13/02	TM	AMAJAJ-12	ODEM JCT	14:20	15:35	75	1	TT	Train Ahead	MCCHO-13 WORKING SINTON AHEAD. HOLD TRAIN AT ODEM OFF XINGS.
11/13/02	TM	AMXJAJ-12	ROBSTOWN	7:30	13:42	372	1	FR	Held Out Connecting RR Congestion	TRAIN ANNOUNCED BY KCS CONSOLE 4 TO BE AT ROBSTOWN AT 0830. CREW HOS 1300. NO RESTED CREW AT VICTORIA UNTIL 1645. TM INSTRUCTED TO HOLD TRAIN UNTIL THEY COULD MEET GBMMXJ-10 AT INARI. AMXJAJ-12 FOLLOWING MCCHO-13 NORTH.
11/13/02	TM	AMXJAJ-12	INARI	17:20	17:57	37	2	TM	Train Meets	
11/13/02	TM	GBMMXJ-10	BLOOMINGTON	16:36	16:55	19	2	TW	Flagging	SIGNAL PROBLEM IN OS AT CP H219.
11/13/02	TM	GBMMXJ-10	INARI	17:34	18:48	74	2	TM	Train Meets	MEET MCCHO-13. AMXJAJ-12 AND MBVEW-13
11/14/02	TM	AJAMXJ-12	INARI	15:08	16:56	108	2	TM	Train Meets	MEET MCCHO-14. MBVHO-14 AND QLDTEJ-14
11/14/02	TM	AJAMXJ-12	SINTON	18:30	19:48	78	2	TM	Train Meets	MEET MBVEW-14. AMXJAJ-13 AND MBVEW-14 S/O UNIT AT ODEM.
11/14/02	TM	AMXJAJ-13	ROBSTOWN	18:10	18:14	4	2	UF	Adjust Schedule Early Foreign Transheet	O/B CREW O/D 1510. TRAIN ANNOUNCED AT 1810.
11/14/02	TM	AMXJAJ-13	ODEM JCT	18:45	19:23	38	2	TT	Train Ahead	MBVEW-14 S/O UNIT AT ODEM AHEAD.
11/14/02	TM	AMXJAJ-13	SINTON	19:35	20:01	26	2	TT	Train Ahead	MBVEW-14 AHEAD. TRACK WARRANT CONGESTION. DISPATCHER SPACED TRAINS OUT FOR TRACK WARRANT ISSUANCE.

Thursday, December 12, 2002

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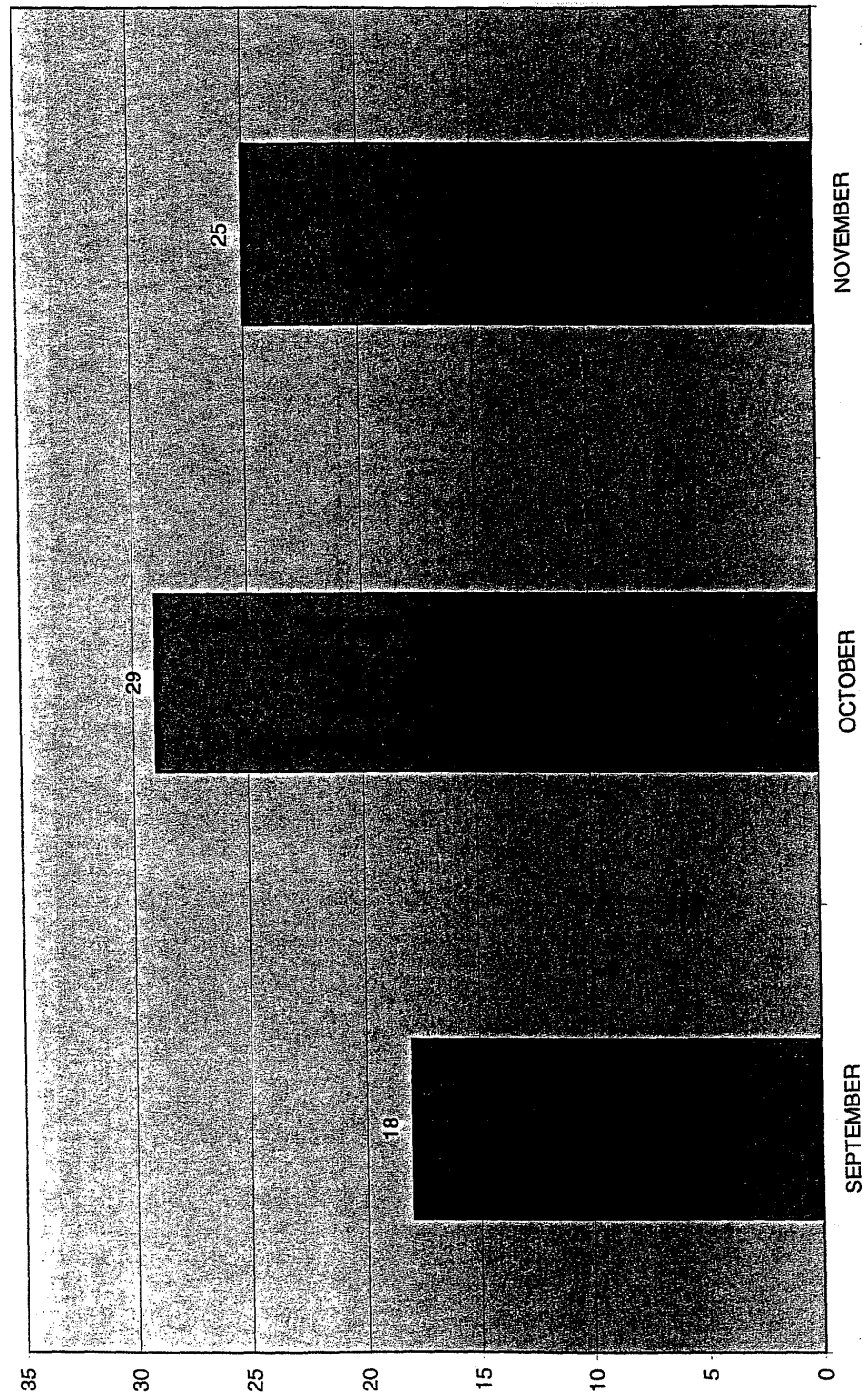
Texas Mexican Railway



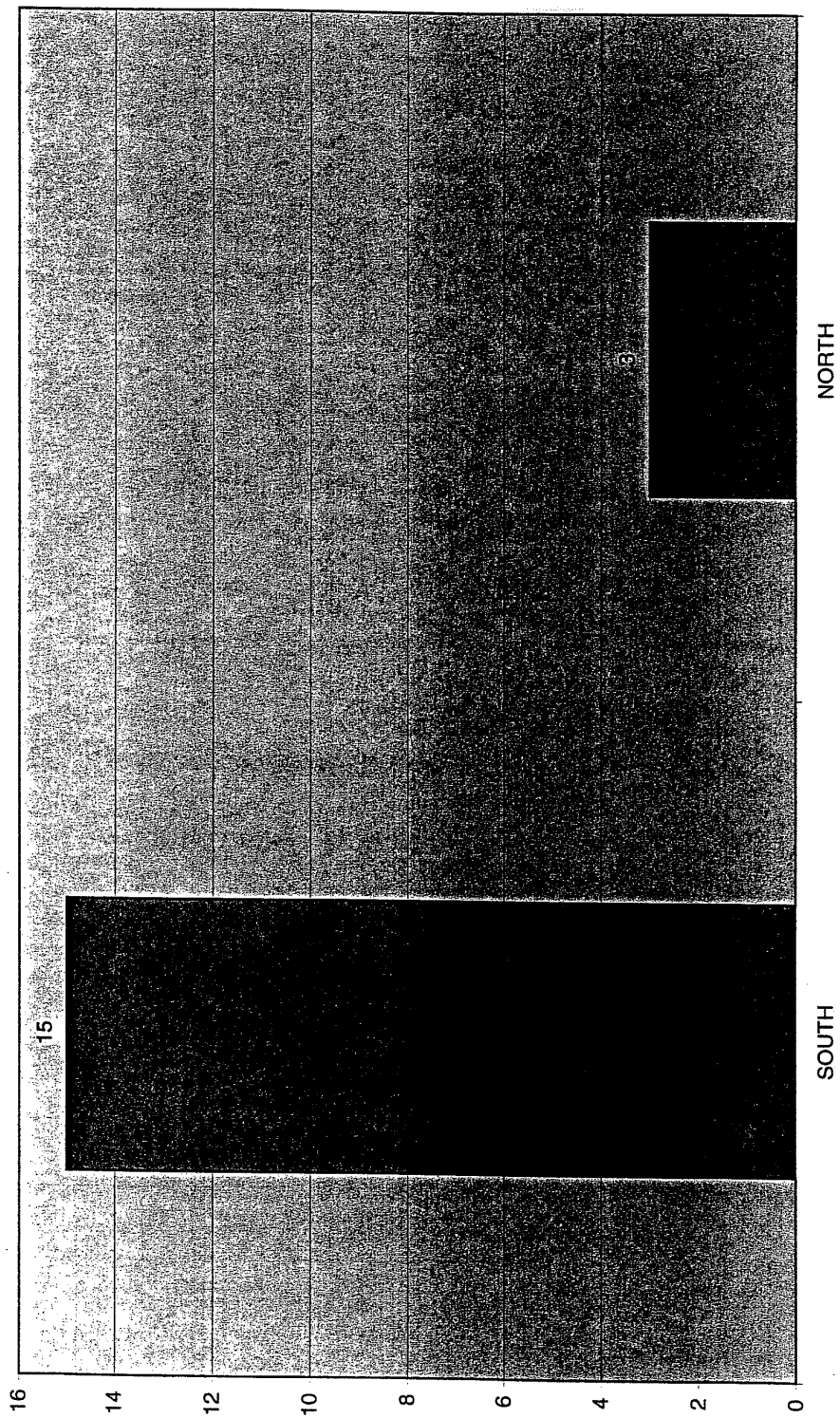
TEX-MEX

Houston, TX
December 13, 2002

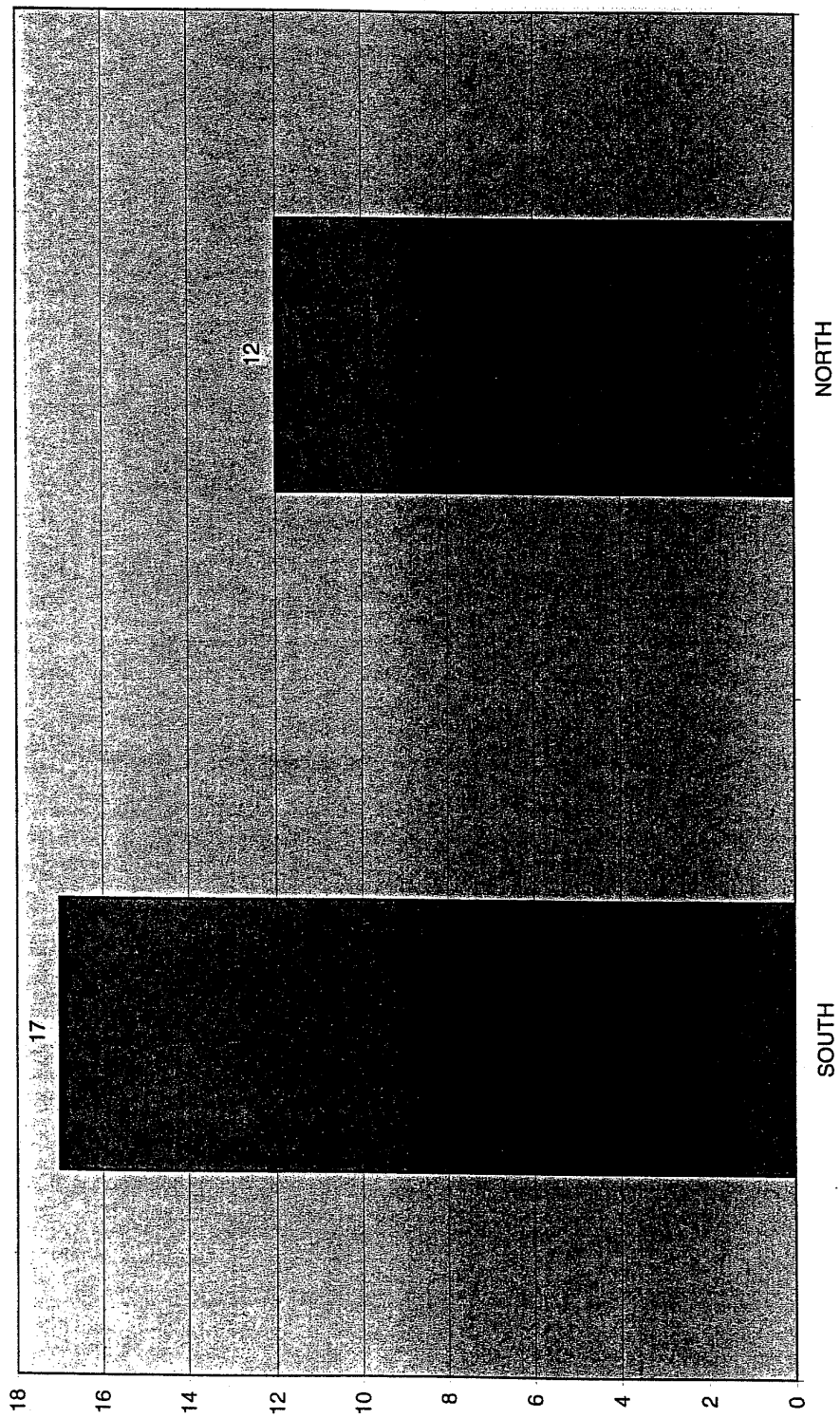
TRAINS ON THE LAW



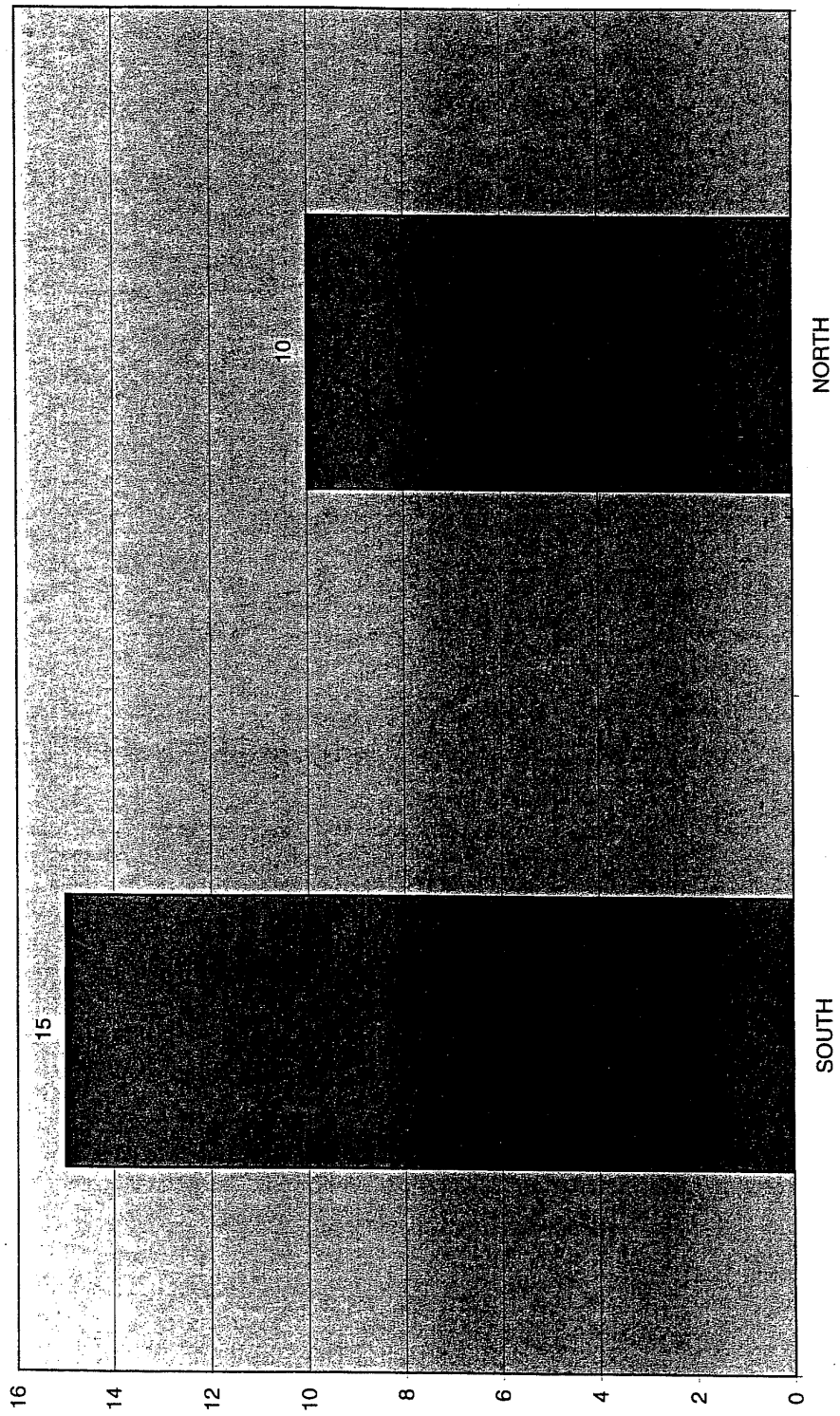
DIRECTION OF TRAINS ON THE LAW
SEPTEMBER



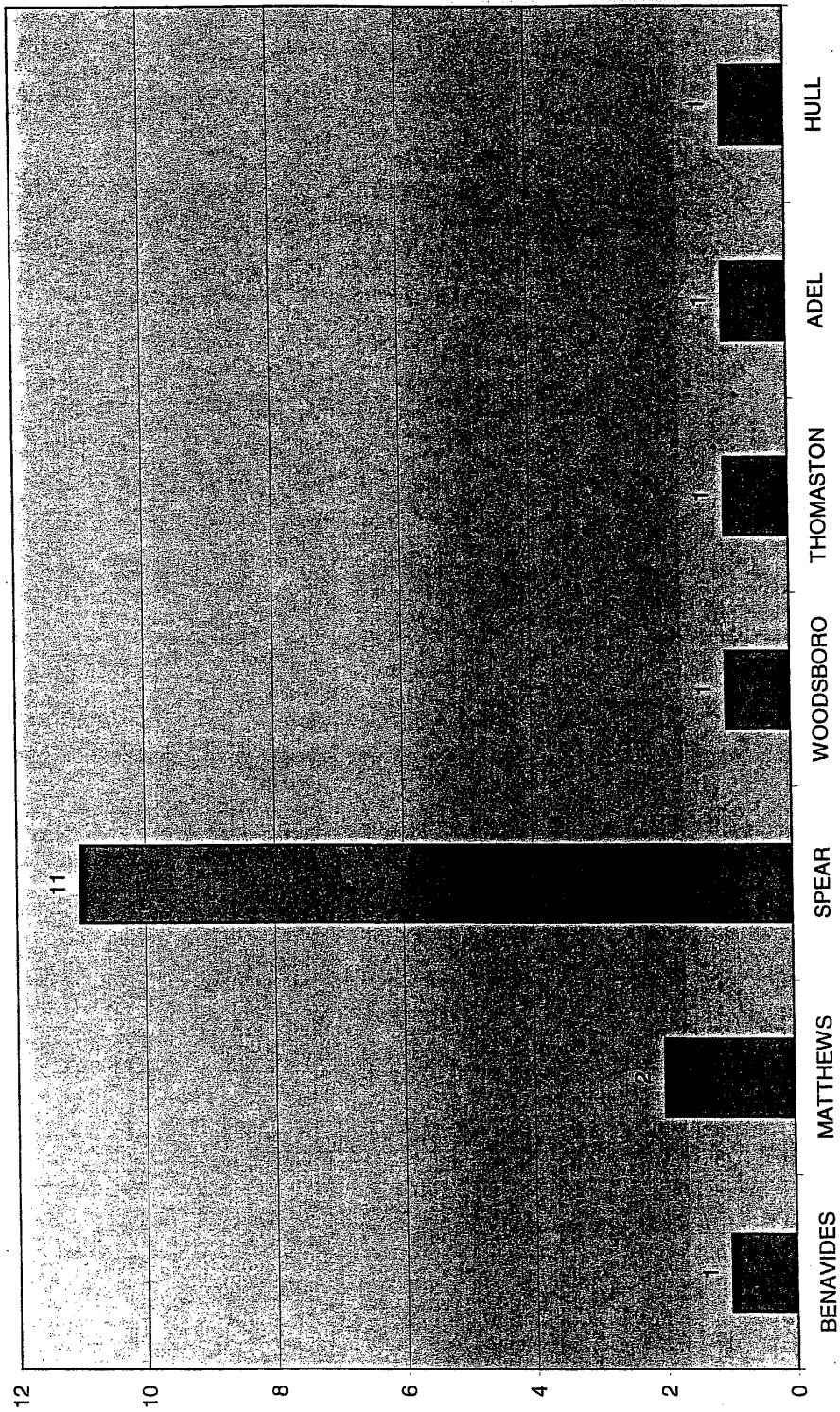
DIRECTION OF TRAINS ON THE LAW
OCTOBER



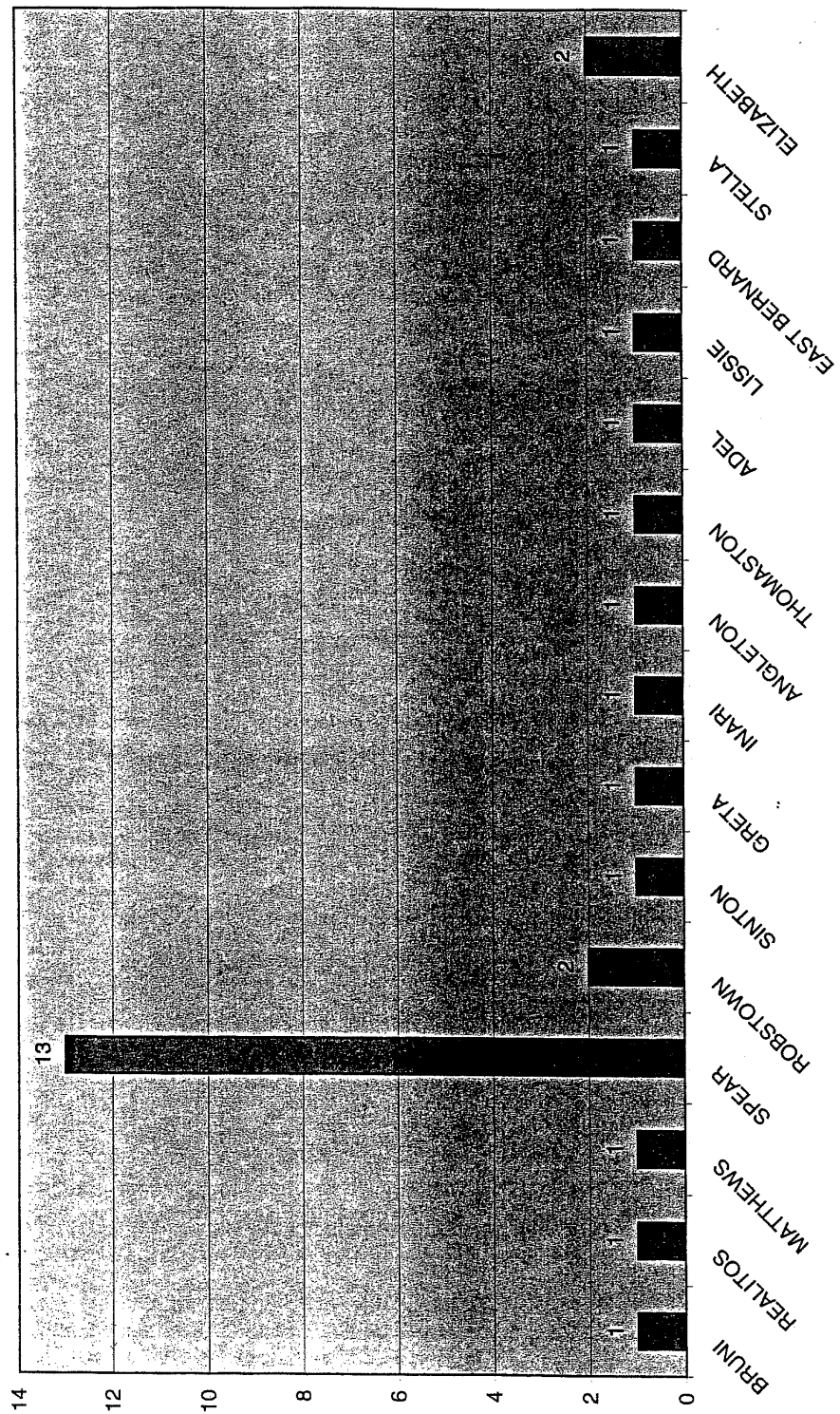
DIRECTION OF TRAINS ON THE LAW
NOVEMBER



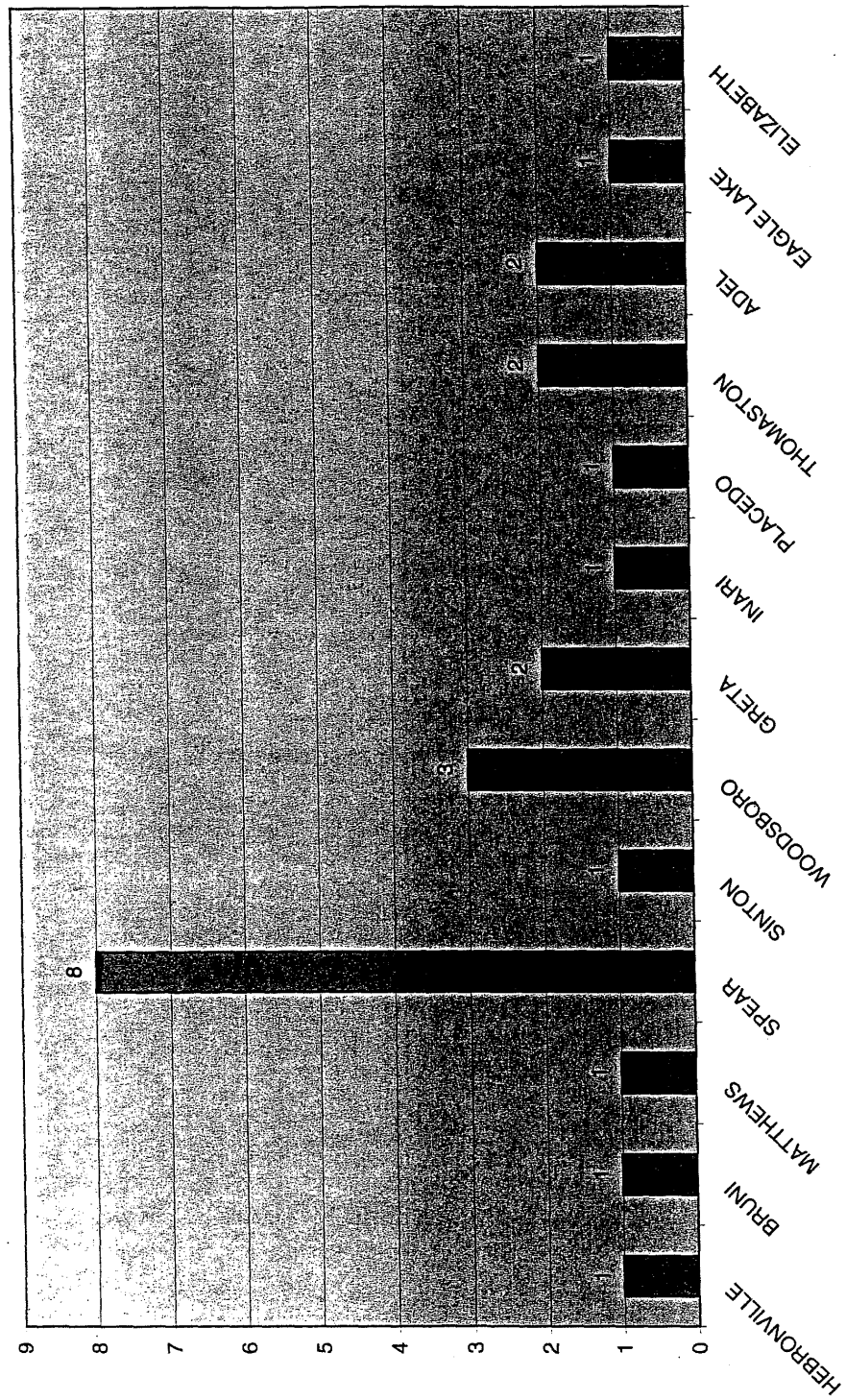
LOCATION OF TRAINS ON THE LAW SEPTEMBER



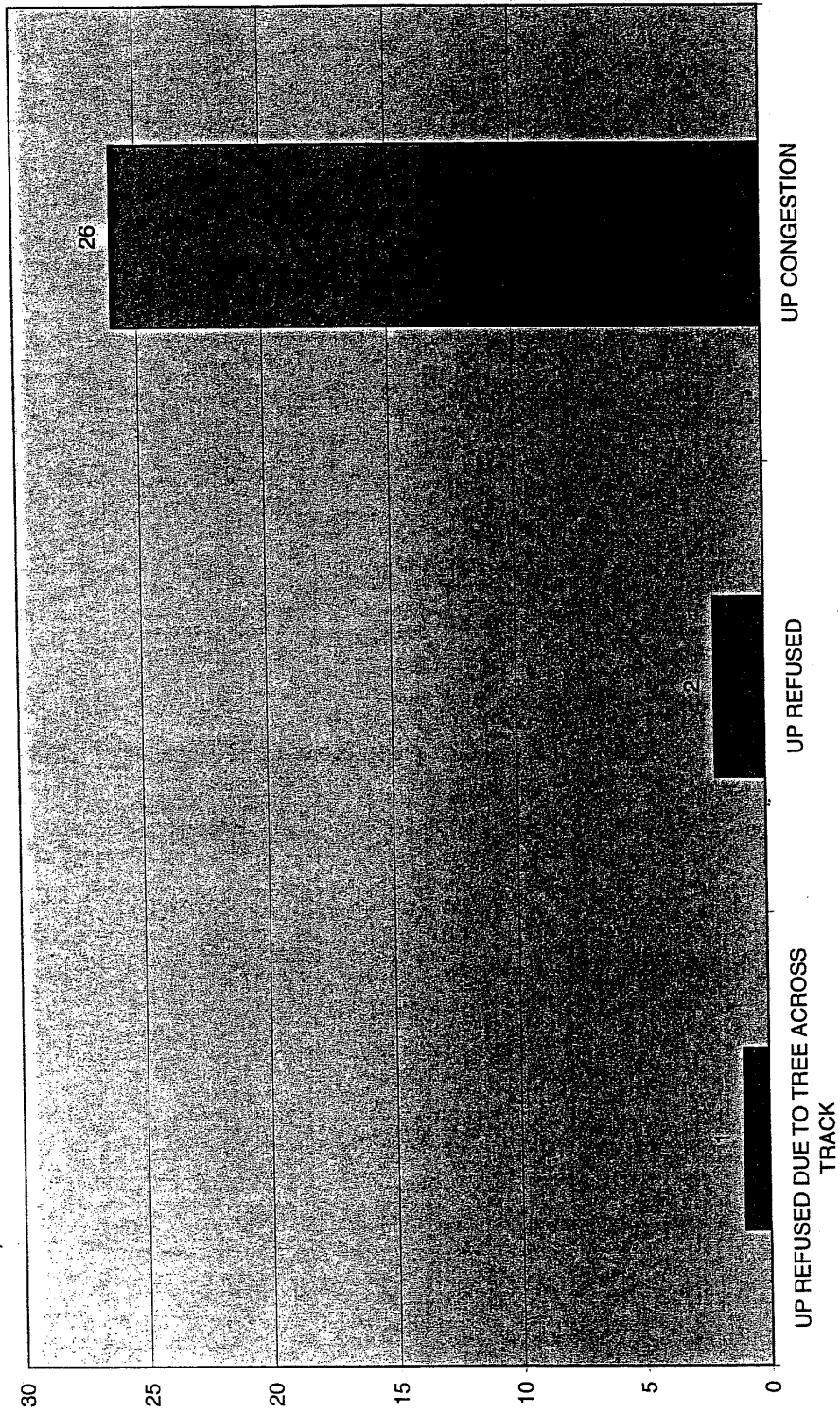
LOCATION OF TRAINS ON THE LAW OCTOBER



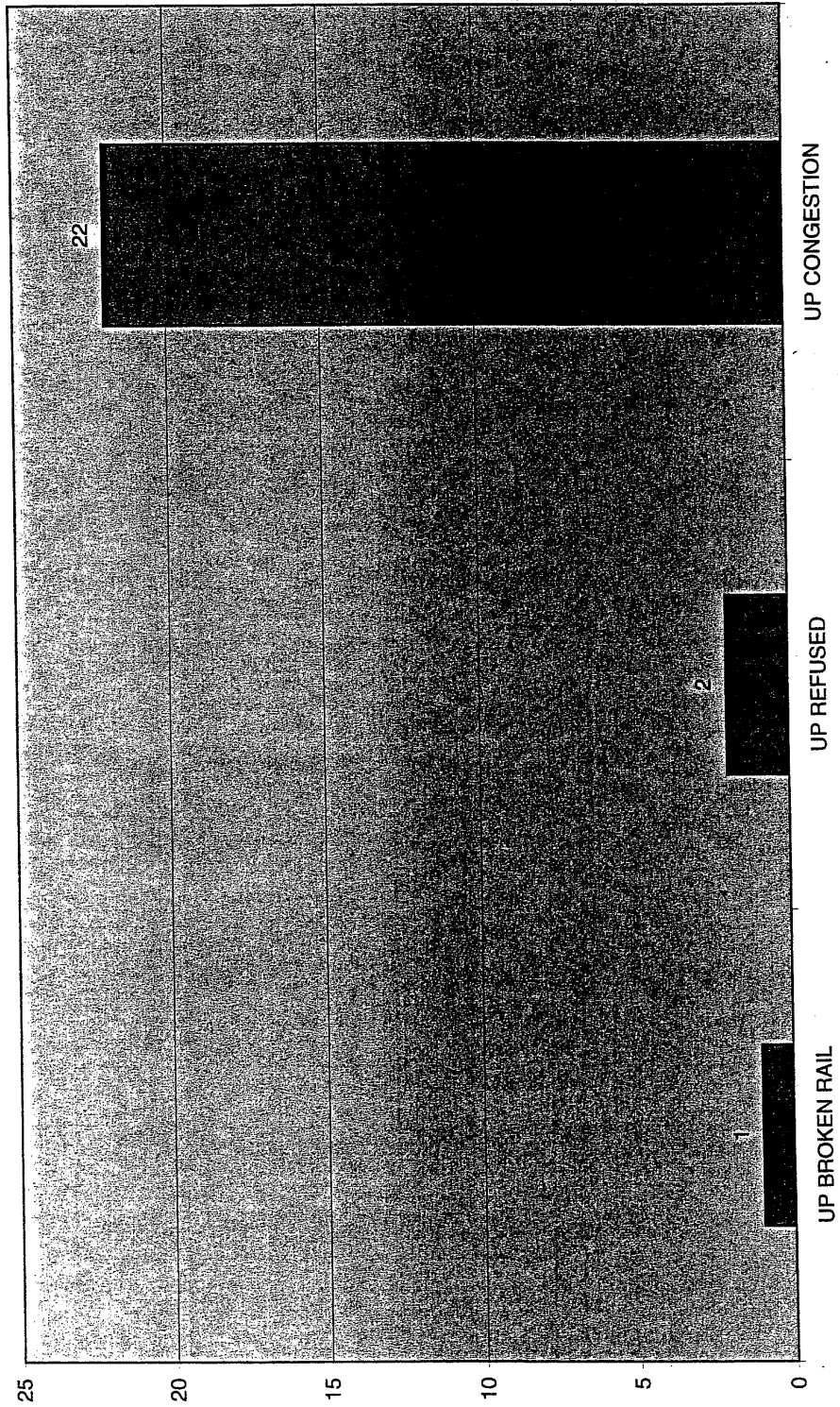
LOCATION OF TRAINS ON THE LAW NOVEMBER



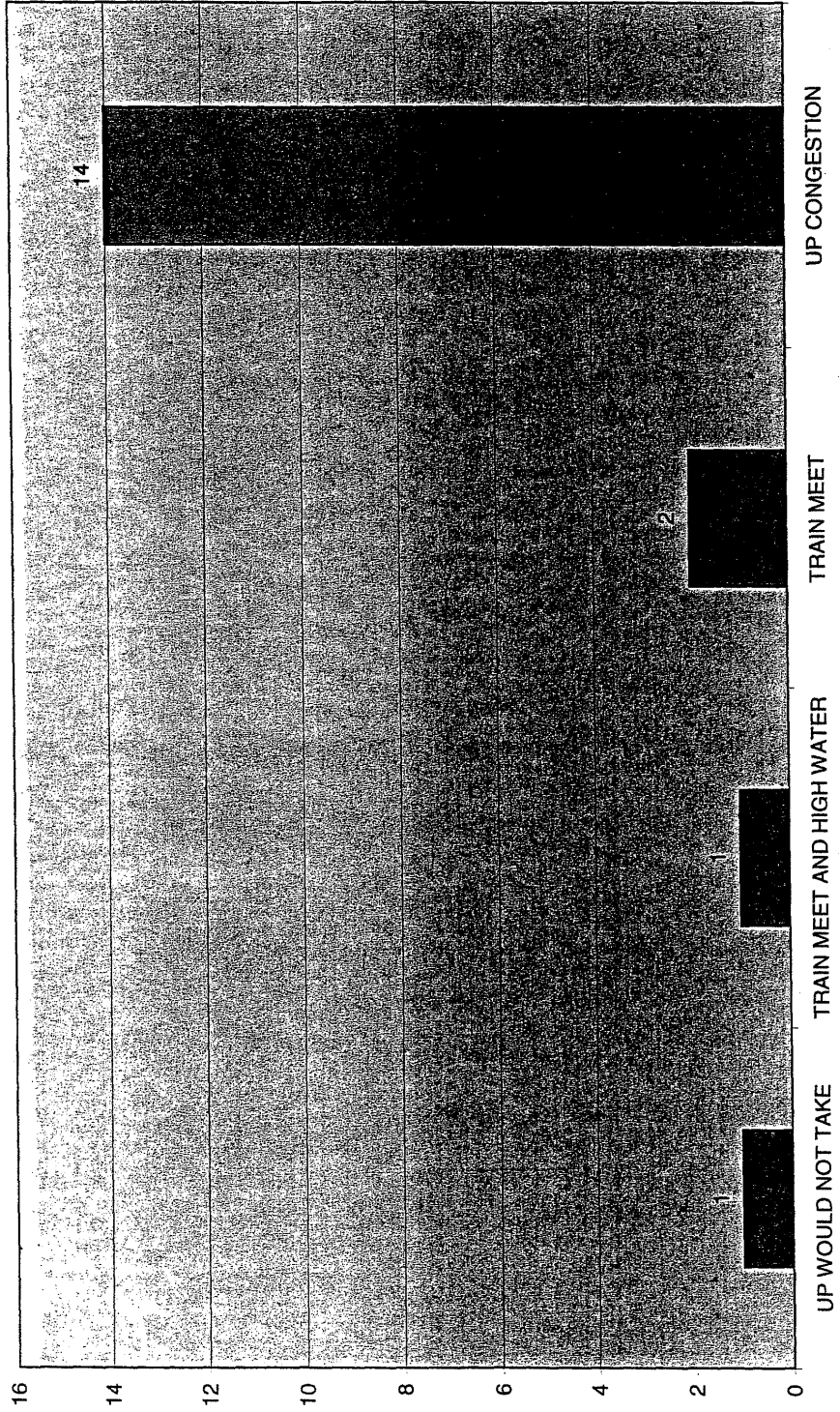
REASON FOR TRAINS ON THE LAW OCTOBER



REASON FOR TRAINS ON THE LAW
NOVEMBER



REASON FOR TRAINS ON THE LAW SEPTEMBER



THE TEXAS MEXICAN RAILWAY COMPANY				
TRAINS, CREWS, & TIE UPS ON TRACKAGE RIGHTS				
DATE	TRAIN ID	DEPARTED FROM	TIED UP LOCATION	CREWS USED
9/1	AMXMAJ-31	ROBSTOWN		3
9/1	AMXJAJ-01	ROBSTOWN		3
9/1	AJAMXJ-29	BEAUMONT		3
9/1	MSHCPJ-01	BEAUMONT		2
9/2	AJAMXJ-30	HOUSTON	GLIDDEN	3
9/2	AMXJAJ-02	ROBSTOWN		3
9/4	AMXJAJ-03	ROBSTOWN		4
9/4	AJAMXJ-03	BEAUMONT		3
9/4	MSHCPJ-04	VICTORIA	GRETA	4
9/5	AMXJAJ-04	ROBSTOWN		4
9/5	AJAMXJ-04	BEAUMONT		4
9/6	AMXJAJ-06	ROBSTOWN		4
9/6	AJAMXJ-05	BEAUMONT		3
9/7	AMXJAJ-07	ROBSTOWN	GRETA	4
9/7	AJAMXJ-06	HOUSTON	THOMASTON	3
9/8	AMXJAJ-08	ROBSTOWN		3
9/8	AJAMXJ-07	BEAUMONT		3
9/9	AMXJAJ-09	ROBSTOWN		3
9/9	AJAMXJ-08	BEAUMONT		2
9/10	AJAMXJ-09	BEAUMONT		3
9/11	AMXJAJ-10	ROBSTOWN		3
9/11	AJAMXJ-10	BEAUMONT		4
9/12	AMXJAJ-11	ROBSTOWN		3
9/12	AJAMXJ-11	BEAUMONT		3
9/13	MMXSHJ-12	ROBSTOWN		3
9/13	AMXJAJ-13	ROBSTOWN	PORT LAVACA	3
9/13	AJAMXJ-12	BEAUMONT		3
9/14	AJAMXJ-13	BEAUMONT		3
9/15	MMXSHJ-14	ROBSTOWN		4
9/15	AMXJAJ-15	ROBSTOWN		3
9/15	AJAMXJ-14	BEAUMONT		4
9/16	MMXSHJ-16	ROBSTOWN		3
9/16	AJAMXJ-15	BEAUMONT		3
9/17	AMXJAJ-16	ROBSTOWN		3
9/17	MMXSHJ-17	HOUSTON	ADEL	2
9/17	AJAMXJ-16	BEAUMONT		3
9/18	AMXJAJ-18	ROBSTOWN		3
9/18	MMXSHJ-18	ROBSTOWN		3
9/18	AJAMXJ-17	BEAUMONT		4
9/19	AJAMXJ-18	VICTORIA	GRETA	5
9/20	AMXJAJ-19	ROBSTOWN		3
9/20	AJAMXJ-19	VICTORIA	GRETA	4
9/21	AJAMXJ-20	HOUSTON	ADEL	4
9/22	AMXJAJ-20	ROBSTOWN		3
9/22	AMXJAJ-21	VICTORIA	ADEL	4
9/22	AJAMXJ-21	BEAUMONT		3
9/23	AMXJAJ-22	ROBSTOWN		3
9/23	AJAMXJ-22	BEAUMONT		3
9/24	AMXJAJ-23	ROBSTOWN		3
9/24	AMXJAJ-24	ROBSTOWN		3
9/24	MSHCPJ-24	BEAUMONT		3
9/25	AJAMXJ-24	BEAUMONT		3

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THE TEXAS MEXICAN RAILWAY COMPANY					
TRAINS, CREWS, & TIE UPS ON TRACKAGE RIGHTS					
DATE	TRAIN ID	DEPARTED FROM	TIED UP LOCATION	CREWS USED	
9/26	MMXSHJ-25	ROBSTOWN		3	
9/26	AJAMXJ-25	BEAUMONT		4	
9/27	AMXJAJ-26	ROBSTOWN		3	
9/27	AMXJAJ-27	ROBSTOWN		4	
9/27	AJAMXJ-26	BEAUMONT		3	
9/28	AJAMXJ-27	BEAUMONT		3	
9/29	AMXJAJ-29	VICTORIA	ADEL	4	
9/29	AMXJAJ-30	ROBSTOWN		3	
9/29	AJAMXJ-28	BEAUMONT		3	
9/30	AMXJAJ-30	ROBSTOWN		3	
9/30	2AMXJAJ-30	ROBSTOWN		3	
9/30	AJAMXJ-29	HOUSTON	LISSIE	2	
9/30	AJAMXJ-29	LISSIE	FLATONIA	2	
				208 CREWS	64 TRAINS

THE TEXAS MEXICAN RAILWAY COMPANY				
TRAINS, CREWS, & TIE UPS ON TRACKAGE RIGHTS				
DATE	TRAIN ID	DEPARTED FROM	TIED UP LOCATION	CREWS USED
10/1	AJAMXJ-30	BEAUMONT		3
10/1	AMXJAJ-01	VICTORIA	ADEL	3
10/2	AMXJAJ-02	ROBSTOWN		3
10/3	AJAMXJ-01	BEAUMONT		3
10/3	MMXSHJ-03	ROBSTOWN		3
10/3	AMXJAJ-03	ROBSTOWN		3
10/3	AJAMXJ-02	BEAUMONT		3
10/4	2AMXJAJ-03	ROBSTOWN		3
10/4	MMXSHJ-04	ROBSTOWN		3
10/4	AMXJAJ-04	VICTORIA	ADEL	4
10/4	AJAMXJ-03	BEAUMONT		3
10/5	2AJAMXJ-03	BEAUMONT		3
10/5	AMXJAJ-05	ROBSTOWN	PORT LAVACA	3
10/6	AMXJAJ-06	ROBSTOWN		4
10/6	AJAMXJ-04	BEAUMONT		3
10/6	AMXJAJ-07	ROBSTOWN		3
10/7	MSHMXJ-07	BEAUMONT		3
10/8	AJAMXJ-05	BEAUMONT		3
10/9	AMXJAJ-08	ROBSTOWN		3
10/9	AMXJAJ-09	ROBSTOWN		3
10/9	AJAMXJ-06	HOUSTON	ADEL	3
10/9	MSHMXJ-08	BEAUMONT		3
10/10	MMXSHJ-10	HOUSTON	ELIZABETH	4
10/10	AJAMXJ-07	BEAUMONT		3
10/11	AMXJAJ-11	ROBSTOWN	PORT LAVACA	3
10/11	AJAMXJ-08	BEAUMONT		3
10/12	MMXSHJ-12	ROBSTOWN		3
10/12	AJAMXJ-09	BEAUMONT		3
10/13	MMXSHJ-13	ROBSTOWN		3
10/13	AMXJAJ-13	ROBSTOWN		4
10/13	AJAMXJ-10	BEAUMONT		3
10/14	AMXJAJ-14	ROBSTOWN		3
10/14	AJAMXJ-11	BEAUMONT		3
10/15	AMXJAJ-15	ROBSTOWN		3
10/15	AJAMXJ-12	BEAUMONT		4
10/16	MMXSHJ-16	ROBSTOWN		3
10/16	AJAMXJ-13	BEAUMONT		3
10/16	MSHMXJ-17	HOUSTON	ADEL	3
10/17	AMXJAJ-16	ROBSTOWN		3
10/17	AMXJAJ-17	ROBSTOWN		2
10/17	AJAMXJ-16	BEAUMONT		4
10/18	AMXJAJ-18	ROBSTOWN		3
10/18	AJAMXJ-17	BEAUMONT		3
10/19	MMXSHJ-19	ROBSTOWN		3
10/19	AJAMXJ-18	BEAUMONT		3
10/19	MSHMXJ-18	BEAUMONT		3
10/19	AMXJAJ-20	ROBSTOWN		3
10/20	AJAMXJ-19	BEAUMONT		4
10/20	MSHMXJ-20	BEAUMONT		3
10/21	AJAMXJ-20	BEAUMONT		3
10/22	AMXJAJ-22	ROBSTOWN		4
10/22	AJAMXJ-21	HOUSTON	WEIMER	4

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THE TEXAS MEXICAN RAILWAY COMPANY					
TRAINS, CREWS, & TIE UPS ON TRACKAGE RIGHTS					
DATE	TRAIN ID	DEPARTED FROM	TIED UP LOCATION	CREWS USED	
10/23	AMXJAJ-23	ROBSTOWN		4	
10/23	AJAMXJ-22	BEAUMONT		4	
10/24	AMXJAJ-24	ROBSTOWN		3	
10/24	2AMXJAJ-24	ROBSTOWN		3	
10/24	AJAMXJ-23	BEAUMONT		3	
10/25	AMXJAJ-25	ROBSTOWN		3	
10/25	AJAMXJ-24	BEAUMONT		3	
10/26	AMXJAJ-26	VICTORIA	ADEL	3	
10/27	AMXJAJ-27	ROBSTOWN		3	
10/27	2AMXJAJ-27	ROBSTOWN	PLACEDO	3	
10/27	2AMXJAJ-27	VICTORIA	ADEL	3	
10/27	AJAMXJ-25	HOUSTON	LISSIE	4	
10/28	AMXJAJ-28	ROBSTOWN		3	
10/28	AJAMXJ-26	BEAUMONT		3	
10/29	AMXJAJ-29	ROBSTOWN		3	
10/29	AJAMXJ-28	BEAUMONT		3	
10/30	AMXJAJ-30	ROBSTOWN		3	
10/30	AJAMXJ-29	BEAUMONT		3	
10/31	AMXJAJ-31	ROBSTOWN		3	
10/31	AJAMXJ-30	BEAUMONT		3	
				227 CREWS	71 TRAINS

THE TEXAS MEXICAN RAILWAY COMPANY				
TRAINS, CREWS, & TIE UPS ON TRACKAGE RIGHTS				
DATE	TRAIN ID	DEPARTED FROM	TIED UP LOCATION	CREW USED
11/1	AMXJAJ-01	ROBSTOWN		3
11/1	2AMXJAJ-01	ROBSTOWN		5
11/1	AJAMXJ-31	BEAUMONT		4
11/2	AMXJAJ-02	VICTORIA	ADEL	3
11/2	2AMXJAJ-02	ROBSTOWN		3
11/2	AJAMXJ-01	BEAUMONT		3
11/3	AMXJAJ-03	ROBSTOWN		3
11/3	MSHMXJ-03	BEAUMONT		3
11/4	AMXJAJ-04	ROBSTOWN		3
11/4	AJAMXJ-02	HOUSTON	ADEL	3
11/5	AMXJAJ-05	ROBSTOWN		3
11/5	AJAMXJ-03	BEAUMONT		3
11/6	2AMXJAJ-06	ROBSTOWN		3
11/7	AJAMXJ-04	BEAUMONT		4
11/7	AMXJAJ-07	ROBSTOWN		3
11/7	2AMXJAJ-07	ROBSTOWN		3
11/7	MSHMXJ-04	BEAUMONT		3
11/8	AMXJAJ-08	ROBSTOWN		3
11/9	AMXJAJ-09	ROBSTOWN		3
11/9	AJAMXJ-07	BEAUMONT		3
11/9	AJAMXJ-08	BEAUMONT		3
11/10	AJAMXJ-09	HOUSTON	ADEL	3
11/11	AMXJAJ-10	ROBSTOWN	PLACEDO	3
11/11	AMXJAJ-11	ROBSTOWN		4
11/11	AJAMXJ-10	BEAUMONT		3
11/12	MMXSHJ-12	ROBSTOWN		3
11/12	AMXJAJ-12	ROBSTOWN	PLACEDO	3
11/12	AJAMXJ-11	BEAUMONT		3
11/13	AMXJAJ-13	ROBSTOWN		3
11/13	AJAMXJ-12	VICTORIA	PLACEDO	4
11/14	AMXJAJ-14	ROBSTOWN		3
11/14	AJAMXJ-13	BEAUMONT		3
11/15	AMXJAJ-15	VICTORIA	ROSENBERG	3
11/15	MMXSHJ-15	ROBSTOWN		4
11/15	AJAMXJ-14	HOUSTON	ADEL	3
11/16	AJAMXJ-15	HOUSTON	CUERO	3
11/16	AMXJAJ-16	ROBSTOWN		3
11/17	MMXSHJ-17	ROBSTOWN		4
11/17	AJAMXJ-16	BEAUMONT		3
11/18	AMXJAJ-17	ROBSTOWN		3
11/18	MMXSHJ-19	VICTORIA	ROSENBERG	3
11/18	MMXSHJ-19	ROSENBERG	DYERSDALE	3
11/18	AJAMXJ-17	BEAUMONT		3
11/19	AJAMXJ-18	BEAUMONT		3
11/19	AMXJAJ-19	VICTORIA	FLATONIA	3
11/19	AMXJAJ-19	SUGARLAND	ELIZABETH	3
11/20	AMXJAJ-20	VICTORIA	ROSENBERG	3
11/20	AJAMXJ-19	BEAUMONT		3
11/21	MSHCPJ-20	HOUSTON	ADEL	4
11/21	AJAMXJ-20	HOUSTON	WEIMER	3
11/23	AMXJAJ-23	ROBSTOWN		3
11/23	2AMXJAJ-23	VICTORIA	EAGLE LAKE	3

THE TEXAS MEXICAN RAILWAY COMPANY					
TRAINS, CREWS, & TIE UPS ON TRACKAGE RIGHTS					
DATE	TRAIN ID	DEPARTED FROM	TIED UP LOCATION	CREW USED	
11/24	AMXJAJ-24	ROBSTOWN		3	
11/24	AJAMXJ-21	HOUSTON	YOAKUM	3	
11/25	AMXJAJ-25	ROBSTOWN		3	
11/25	AJAMXJ-23	HOUSTON	ADEL	3	
11/25	AJAMXJ-24	BEAUMONT		3	
11/26	AMXJAJ-26	ROBSTOWN		3	
11/26	MSHCPJ-26	BEAUMONT		3	
11/26	2MSHCPJ-26	HOUSTON	FLATONIA	2	
11/27	2MSHCPJ-26	VICTORIA	PORT LAVACA	3	
11/26	AJAMXJ-25	BEAUMONT		3	
11/28	AMXJAJ-28	VICTORIA	WEIMER	4	
11/28	AJAMXJ-26	HOUSTON	FLATONIA	4	
11/29	AJAMXJ-27	HOUSTON	EAST BERNARD	3	
11/29	AJAMXJ-27	EAST BERNARD	FLATONIA	2	
11/29	AJAMXJ-27	FLATONIA	WOODSBORO	2	
11/29	AJAMXJ-28	HOUSTON	ADEL	3	
11/30	AMXJAJ-30	ROBSTOWN	INARI	3	
11/30	AJAMXJ-29	BEAUMONT		3	
				218 CREWS	67 TRAINS

PUBLIC VERSION

208826
KCS-18B
TM-17B

BEFORE THE
SURFACE TRANSPORTATION BOARD

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -



THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
and
THE TEXAS MEXICAN RAILWAY COMPANY

RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION

VOLUME 2 OF 2: VERIFIED STATEMENTS

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Railway Company

September 2, 2003

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PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

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PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB A

VERIFIED STATEMENT OF

MICHAEL R. HAVERTY

REBUTTAL VERIFIED STATEMENT OF MICHAEL R. HAVERTY

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
and
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

My name is Michael R. Haverty. I am Chairman of the Board, President and Chief Executive Officer of Kansas City Southern ("KCS"), applicant in this proceeding. I previously submitted a verified statement as part of the May 14 application in this proceeding, and testified in support of the application at the Board's July 31 public hearing. I would like to briefly reiterate why we believe that KCS's application to take control of The Texas Mexican Railway Company ("Tex Mex") should be approved. I will then address the false impression manufactured by Canadian National Railway Company ("CN") regarding KCS's motivation for acquiring an increased stake in Grupo Transportacion Ferroviaria Mexicana, S.A de C.V. ("Grupo TFM"). Finally, I would like to address some of the questions regarding the status of our plans to acquire control of TFM and Tex Mex.

The competitive assumptions behind the KCS/Tex Mex and KCS/TFM transactions are simple - to build a better, more coordinated railroad system that will provide an efficient and cost-effective alternative for both domestic and international traffic. Indeed, these benefits have been clearly recognized by the shipping public as to date, over 90 parties, including shippers, ports, and governmental bodies, have expressed support for the two transactions. We are grateful

that many of the U.S.'s largest shippers, including Daimler/Chrysler, Mazda, J. B. Hunt Transport, the Mississippi State Port Authority at Gulfport, Dow Chemical, and Dupont have taken the time and effort to examine our transactions and determine that they will bring about a pro-competitive strengthening of rail transportation between Mexico and the U.S. Many other ports, grain shippers, shortline railroads, and other shippers and receivers have similarly taken positions in favor of our control of Tex Mex and TFM. We appreciate their support, particularly in light of the vigorous adverse campaigns waged by some of our Class I brethren who fear a stronger competitor. We have also reached a private agreement with the National Industrial Transportation League ("NIT League"), the nation's largest transportation-related trade association representing over 700 parties. NIT League now fully endorses and supports the transactions.

These parties all recognize that regardless of the benefits of the TFM transaction, common control of our Class I subsidiary, The Kansas City Southern Railway Company ("KCSR") and Tex Mex, standing alone, will provide more efficient routing and service options to shippers, will lead to better coordination of marketing and customer service operations, and will help secure the financial stability of Tex Mex, which in recent history has occasionally found itself in challenging economic situations. Our supporters also recognize that these benefits do not change if one considers the effects of the TFM transaction.

Unified control of KCSR, Tex Mex, and TFM will financially strengthen KCS and will enhance our ability to compete in the NAFTA trade corridor. Common control will also provide an effective alternative to Union Pacific Railroad Company ("UP") and The Burlington Northern and Santa Fe Railway Company ("BNSF") in some markets, while continuing the current close coordination with those carriers in other markets. In fact, because TFM depends upon traffic

from UP and BNSF for the great majority of its revenues, and because UP and BNSF serve many more markets than KCSR or Tex Mex, TFM must and will continue to work with these carriers. It is in our financial interest to do so. Most importantly, given that the dominant means of transportation for U.S./Mexico trade is trucks and barges, for any of us to grow the market share of rail, we must work together to lower prices and improve our efficiencies. If we do not continue to press for progress in those areas, all rail carriers will lose market share to these other modes.

Because of the pro-competitive nature of the transactions, we believe the Board should move forward as expeditiously as possible and approve our plans to acquire control of Tex Mex without conditions. No party has shown (and almost no one has even tried to show) that the KCS/Tex Mex transaction will have anticompetitive effects so as to warrant the imposition of conditions. Virtually all of the conditions that have been urged upon the Board arise not from the KCS/Tex Mex transaction, but from the KCS/TFM transaction. Many of the proposed conditions would require the Board to regulate transportation matters in Mexico, which would represent, from what I am told, an unprecedented expansion of the Board's jurisdiction.

Legal issues aside, we were approached by some parties that expressed concerns over both of our transactions. When those parties wanted to sit down and talk about their concerns, we met with them in an attempt to reach an agreement that would be mutually beneficial to all parties and the public interest. It is through that process that we were able to reach agreement with NIT League. In addition, in the spirit of the Board's new merger guidelines, and in an attempt to resolve concerns raised by other parties, KCS has made certain public commitments. We will abide by those commitments.

While most of the issues have been thoroughly reviewed, and I will leave it to others to address some of the competitive arguments, CN did raise an issue at the July 31 hearing that bears directly on our motivations for undertaking the two transactions. CN asserts that KCS agreed to acquire an increased stake in TFM to exploit efficiencies so as to gain traffic and revenue, or KCS agreed to acquire an increased stake in TFM to generate added revenues through diversions caused by anticompetitive actions against other carriers. For example, CN's counsel stated the following at the Board's July 31 hearing:

The Board has long recognized that there are two basic reasons why a railroad would pay the market value of a bottleneck railroad.

The first is that the purchaser believes it can reduce the cost of its service in conjunction with the bottleneck railroad, and thereby earn its cost of capital on its investment. Second, the purchaser believes it can better exploit the market power of the bottleneck railroad without any new efficiencies.

July 31 STB Hearing Transcript, Page 45, Line 19 through Page 46, Line 6.

The problem with CN's argument is that it sets up a false impression by ignoring KCS's existing stake in TFM, the importance to KCS of TFM's profitability, and the damage to KCS threatened by the potential harm to TFM from the precarious financial condition of our Mexican partner, Grupo TMM. As I stated in my testimony just a few minutes before CN's counsel spoke,

[T]he reason we're doing what we're doing, if you look at this company's [KCS's] earnings over the last year or two, half or more than half of our earnings come from Mexico. I don't think it's any secret that our partner was having financial difficulties, TMM, and we felt that we could not allow this investment to get away from us, when over half of our earnings are created from this investment. For us to let that get away, it was more important for us to get control of the company than it was to start trying to figure diversion studies and so on. Since we already were invested in it, we knew about the company, we knew about the traffic it handled and so on, and we just felt it was absolutely critical that we needed control of it, and that's why we negotiated a deal with our partner, and that's why we're here today.

July 31 STB Hearing Transcript, Page 24, Line 15 through Page 25, Line 8. At several other points in the hearing as well, I emphasized to the Board the importance to KCS of maintaining control of its investment in TFM, so that investment was not impaired as a result of financial problems afflicting Grupo TMM. *See* July 31 STB Hearing Transcript, Page 24, Lines 4-10 and Page 26, Lines 6-7.

The bottom line is that KCS's investments in Tex Mex and TFM have led to tremendous improvements in TFM's efficiency and profitability, and have made TFM a substantial contributor to KCS's own profitability in recent years. Thus, when it appeared that Grupo TMM's financial problems had even the slightest potential to adversely affect TFM, KCS needed to protect itself and its shareholders by moving to protect its stake in TFM. That was, from KCS's view, the motivation for agreeing to acquire an additional interest in TFM.

So, the impression posed by CN – that KCS agreed to acquire TFM in order to increase revenues through additional efficiencies or through anticompetitive behavior – is simply wrong. A third possible reason, which in this case is the real reason, was KCS's desire to protect the value of its existing investment in TFM against uncertainties arising from Grupo TMM's financial difficulties. Whether controlled by Grupo TMM or by KCS, there is no need for TFM to act anticompetitively in order to achieve growth or to generate sufficient revenues to support the costs of KCS's agreed-upon acquisition.

In the end, we must grow TFM's revenues by adding more traffic through pro-competitive actions, not anticompetitive actions that will drive UP and BNSF to no longer use TFM. The Board should allow the marketplace to dictate routings and rates, and I believe that this very competitive marketplace will work, in conjunction with the agreement with NIT League and our stated willingness to continue to work with all parties. The proposals set forth by UP

and BNSF would interfere with the marketplace, create inefficiencies, and impose unnecessary government oversight. These anticompetitive conditions are designed to suppress NAFTA Rail's competitive abilities and shield the existing domination that UP and BNSF hold over U.S.-Mexico rail transportation. The conditions should not be imposed.

Of course, given the events of the past two weeks, the Board may be asking whether or not it should even move forward with its review of our application under the existing schedule. We believe the answer to that question is unequivocally yes, and we urge the Board to deny the request of any party seeking to delay regulatory approval of our control of Tex Mex. As the Board is no doubt aware, on Monday, August 18, our Mexican partner, Grupo TMM announced that its shareholders had voted unanimously against the sale of Grupo TMM's interests in TFM to KCS. The vote did not encompass the Tex Mex transaction, however. Despite that unexpected vote, KCS remains committed to the TFM and Tex Mex transactions as they were agreed to under the agreements pursuant to which we will secure control of those entities (the "Acquisition Agreements"), and will take all necessary steps to protect our rights under those agreements and through any other legal or administrative options that may exist under U.S. or Mexican law.

KCS learned about the vote by Grupo TMM's shareholders through a telephone voice mail message following Grupo TMM's action on Monday, August 18. We were, to say the least, stunned by this turn of events, particularly after having received on the previous Friday the personal assurance of TMM's CEO, Mr. Javier Segovia, that the TFM sale would be approved. Further lending to our surprise was the fact that TMM's chairman, Mr. Jose Serrano and his nephew, Mr. Segovia, signed the Acquisition Agreements on behalf of Grupo TMM, obligating

themselves under the transaction agreements to recommend approval of the agreements to their shareholders.

These same individuals also control the voting of Grupo TMM's stock. Together, the Serrano and Segovia families control the vast majority of Grupo TMM stock, and Mr. Serrano himself had the right to vote the Serrano and Segovia family shares. Therefore, the two individuals who control the voting of Grupo TMM's shares, who were parties to and directly involved in the negotiations between KCS and Grupo TMM that lasted over 14 months, resulting in a 55-page comprehensive Acquisition Agreement, and who both signed that agreement obligating themselves to recommend its approval, apparently rejected their own recommendation and voted against the agreement. This mystifying turn of events was quite unexpected.

KCS has notified Grupo TMM of its intent to move forward with the TFM Acquisition Agreement and has advised them of its intent to exercise all legal and administrative means available to protect its rights under the Acquisition Agreements. KCS believes the TFM Acquisition Agreement is still valid and effective, and that both parties are still bound by that Agreement. KCS is continuing its efforts to make NAFTA Rail a reality and, in furtherance of that goal, KCS has delivered a notice of dispute to TMM in accordance with the dispute resolution provisions of the Acquisition Agreement. This written notice of dispute will initiate a 60-day negotiation period between KCS and TMM. If the parties are unable to resolve the disputes within that period of time, KCS intends to initiate a binding arbitration in accordance with the terms of the Acquisition Agreement.

In addition to the Acquisition Agreement, which remains valid through December 31, 2004, KCS has, under the TFM bylaws, a right of first refusal regarding the sale of TMM's interest in TFM. As KCS has noted previously, it will enforce its rights and will pursue all

appropriate legal or administrative actions against any person or entities involved in interfering with KCS and its agreements with TMM.

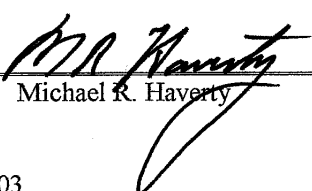
Prior to August 27, 2003, none of the actions with respect to TFM impacted our plans to acquire control of Tex Mex. As the Board is aware, KCS has purchased 51% of the shares of Mexrail and placed those shares in an independent voting trust. On August 27, 2003, Jose Serrano Segovia, in his capacity as Chairman of TFM, requested that on September 4, 2003 the voting trust be dissolved and the Mexrail shares returned to TFM. After reviewing its contractual obligations, KCS will honor its obligations and will comply with the request. The effect of such an action will be to return the shares to TFM and TFM will once again be the 100% owner of Mexrail.

Nonetheless, we believe the TFM Acquisition Agreement remains valid and fully enforceable. We are pursuing all legal actions to enforce that agreement. KCS fully intends to acquire control of Tex Mex, even if that control cannot be immediately achieved. These plans have not changed even though KCS will return the Mexrail shares. Because KCS believes it will eventually resolve its issues with TMM and eventually control both Tex Mex and TFM, the Board should proceed with its review and decision.

In the end, KCS plans to achieve its goals to create NAFTA Rail. When those goals are achieved, NAFTA Rail will be good for both the U.S. and Mexico. It will assure an economically viable rail competitor to provide competition in the highly important NAFTA trade rail corridor. We remain committed to completing the transactions that will create NAFTA Rail. Although at this point in time it is uncertain by what means that objective will ultimately be achieved, it remains KCS's intent to achieve our goals and to take control of both the Tex Mex transaction and the TFM transaction.

VERIFICATION

I, Michael R. Haverty, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.



Michael R. Haverty

Executed on 28 of August 2003.

STATE OF MISSOURI)

COUNTY OF Jackson)

ss.

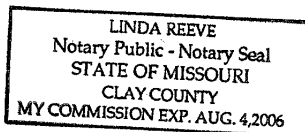
Subscribed and sworn to before me
on this 28 day of August 2003.



Notary Public of the State of Missouri

My commission expires:

August 4, 2006



PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB B

REBUTTAL VERIFIED STATEMENT OF

DR. CURTIS GRIMM

REBUTTAL VERIFIED STATEMENT OF CURTIS M. GRIMM

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY
AND
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

My name is Curtis M. Grimm, and I am Dean's Professor of Supply Chain and Strategy, Robert H. Smith School of Business, University of Maryland at College Park. I have been a member of this College since 1983. I received my B.A. in economics from the University of Wisconsin-Madison in 1975 and my Ph.D. in economics from the University of California-Berkeley in 1983. My Ph.D. dissertation investigated competitive impacts of railroad mergers. Further details may be found in the vitae attached to my previous statement.

I have previously submitted two statements in this case on behalf of Kansas City Southern ("KCS") and The Kansas City Southern Railway Company ("KCSR"). My initial statement responded to a request by KCS to perform an economic analysis of the KCS purchase and control of The Texas Mexican Railway Company ("Tex Mex"), with particular emphasis on the impact on competition. My analysis showed that the control transaction, which is entirely end-to-end in nature, would result in no anticompetitive effects. There are no locations or routing options that would be reduced from two-to-one or even from three-to-two. I was subsequently asked by KCS to address whether my findings that were explained in my initial statement would still be the same if I also took into account a second transaction, the KCS

acquisition of the shares of TFM that are currently owned by Grupo TMM. I did so and concluded that there would be no adverse competitive effects from either transaction.

Consistent with the Surface Transportation Board's ("STB") precedent and economic analysis of similar transactions, the main body of my initial statement examined the horizontal competitive effects from the transaction. Consistent with the U.S. Department of Justice ("DOJ") and Federal Trade Commission ("FTC") Horizontal Merger Guidelines, I examined whether the KCSR-Tex Mex consolidation would reduce the number of independent rail alternatives in any market. Accordingly, I focused my analysis primarily on instances where the proposed common control will reduce the number of independent railroad routings between a particular origin and destination pair, with particular attention given to instances where the consolidation produces a bottleneck carrier. I concluded in my previous statement that as a result of the KCSR-Tex Mex transaction, there are no markets that will see a reduction in the railroad routing options available in that corridor from "two to one" nor from "three to two." The common control of KCSR and Tex Mex is purely end-to-end and has no anticompetitive horizontal effects. This conclusion also extended to the TFM consolidation, which is also purely end-to-end with regard to Tex Mex. This finding of no horizontal effects does not depend upon the presence of intermodal competition; my conclusion was reached using a conservative assumption of rail as the relevant product market.

Importantly, my conclusion that both transactions have no horizontal competitive effects has stood completely un rebutted. Indeed, Professor Hausman stated: "Based on a purely horizontal competitive analysis, I agree with Professor Grimm that no problems arise because no 2-to-1 (or other) reductions in the number of competing carriers will occur." (Hausman V.S. at 20-21.)

While conceding the absence of horizontal effects, Professor Hausman argues that the Union Pacific Railroad Company ("UP") will be vertically foreclosed by NAFTA rail following the consolidation. The legal comments of UP raise the question as to why my initial competitive analysis did not discuss vertical foreclosure issues. The remainder of my statement will address this question.

First of all, horizontal competitive effects are present in most predominantly end-to-end rail mergers, so that it is crucial to formally and comprehensively screen for such effects when analyzing end-to-end transactions. Second, I note that my competitive analysis of this transaction is completely consistent with my previous competitive analyses of rail transactions and accompanying submissions to the Interstate Commerce Commission ("ICC") and STB. More specifically, I conducted a comprehensive evaluation of competitive effects of the Union Pacific/Southern Pacific ("UP/SP") merger, and followed precisely the same methodology as in this case, examining reduction in competitive alternatives. I was also asked to evaluate competitive effects for applicants in the Gateway Western case; the competitive analysis I submitted to the STB in KCS-GWWR-GWER also addressed competitive impacts with the same methodology. I did not identify or address any vertical competitive effects in either of the two cases.

Third, the orientation of my analysis with focus on horizontal effects is consistent with applicant's competitive analyses in previous rail merger cases. For example, in the major railroad mergers of the 1990's, the focus was on identification of horizontal effects, in particular, reduction of competition from two to one where shippers were directly served by the two merging railroads. There was little or no attention to vertical issues in initial filings of the

applicant even though all these mergers were described as primarily end-to-end.¹ Vertical issues were addressed on rebuttal when and if specific issues were raised in comments by protestants. Applicant has followed the same format here, and will address in rebuttal the vertical foreclosure issues raised; *see*, in particular, the Verified Statement by Professor Andrew Kleit.

Finally, the focus on horizontal effects is completely consonant with the long-standing views of the ICC and STB, which have consistently viewed competitive effects as synonymous with horizontal effects. Vertical foreclosure, traffic diversion and the like have long been viewed as relevant to effects on competitors, but not to effects on competition. Moreover, vertical foreclosure arguments have consistently been dismissed as a basis for imposing conditions such as those requested here by UP and The Burlington Northern and Santa Fe Railway Company ("BNSF"). And, as discussed in detail by Professor Kleit, UP's arguments that shippers will be adversely affected are totally without merit. As such, my un rebutted finding that the transaction entails no horizontal effects remains the cornerstone of the STB's evaluation of competitive effects in this case.

As noted, the vertical foreclosure issues will be addressed on rebuttal by Professor Kleit. However, I fully concur with his finding that there will not be anticompetitive effects from vertical foreclosure in this case. While I might in some cases have concerns in end-to-end mergers if an unintegrated carrier's bargaining position over divisions was substantially weakened and that carrier had no countervailing power, for example, if a short line or small railroad lost a friendly connection in conjunction with a consolidation of two mega-railroads, such a circumstance is clearly not present in this case. UP is far from defenseless were the KCS

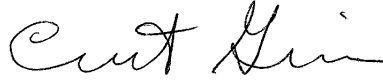
¹ This is also consistent with the practice of the DOJ. For example, the evaluation of the competitive effects of the UP/SP merger by DOJ's W. Robert Majure focused solely on horizontal competitive effects (DOJ -- 8; F.D. 32760).

to attempt any foreclosure strategy. Indeed, UP has enormous countervailing power, deriving from its overall size, its dominant U.S. market share for U.S.-Mexico traffic along with a large number of captive shippers, its ability to shift traffic from TFM to Ferromex, and its linkages and long-term contracts with many key shippers. A *sine qua non* of a vertical foreclosure or price squeeze strategy envisioned by UP is superior power in the vertical relationship. Clearly, NAFTA Rail will not even come close to having the upper hand with regard to power in its relationship with UP following the consolidation.

I would like to address one final issue in my statement, the suggestion in the UP testimony that the DOJ review and early termination of its Hart-Scott-Rodino process regarding the TFM transaction should be downplayed by the Board: "Given DOJ's limited enforcement resources, its limited enforcement options relative to the Board's broad remedial authority, and its awareness of the Board's pending proceeding, it should not be too surprising that DOJ did not take action regarding the TFM acquisition". UP-7A at 33. I participated in the DOJ investigation and it was clear that the DOJ thoroughly investigated the issues raised here by UP prior to their decision to issue an early termination. DOJ assigned an attorney and an economist to review the competitive effects, including the international competitive effects, of KCS's plans to acquire control of Tex Mex and TFM, with a particular focus on the TFM transaction. On two occasions, I participated in meetings between KCS representatives and DOJ staff. UP's vertical foreclosure arguments were a prominent topic for discussion, and I certainly had the sense that UP had communicated these concerns to DOJ staff. The DOJ staff on the case had substantial experience in evaluating competitive effects of railroad mergers, and, in my view, investigated the potential anticompetitive effects of the TFM transaction thoroughly and professionally before making their decision to issue an early termination.

VERIFICATION

I, Curtis M. Grimm, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.



Curtis M. Grimm

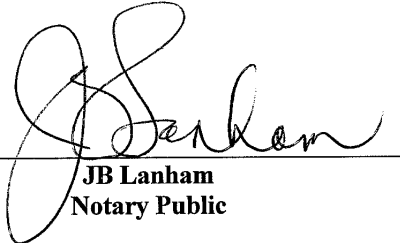
Signed: August 29, 2003

DISTRICT OF COLUMBIA

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ss.

Subscribed and sworn to before me
this 29th day of August, 2003.


JB Lanham
Notary Public

My commission expires: September 14, 2003.

PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

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**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
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VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB C

REBUTTAL VERIFIED STATEMENT OF

JAMES L. RINEY

REBUTTAL VERIFIED STATEMENT OF JAMES L. RINEY

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY
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THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

My name is James L. Riney. I am General Manager of the Texas Mexican Railway Company ("Tex Mex"). My business address is Walker Plaza Bldg., Suite 350, 5810 San Bernardino Avenue, Laredo, Texas 78041.

Purpose of Reply Statement

I have previously submitted a Verified Statement in this proceeding. It is reproduced at pages 130 - 134 of the Railroad Control Application. I hereby reconfirm all of the statements made therein.

In this Reply Statement, I respond to certain statements and arguments made by Stephen R. Barkley in his Verified Statement submitted on behalf of Union Pacific Railroad Company ("UP"). My responses are based on over 30 years of experience in the railroad industry, my knowledge of the international operations of Tex Mex and TFM, S.A. de C.V. ("TFM") in Laredo, and my knowledge of Tex Mex's operations over UP tracks pursuant to trackage rights granted by the Surface Transportation Board ("STB" or "Board") as a condition imposed upon the merger of UP and Southern Pacific Transportation Company ("SP").

Overview

Based on my knowledge of operations over the Laredo Bridge, I believe that UP's professed concern that NAFTA Rail would take subtle, incremental steps that would disadvantage UP and cause its service to deteriorate is unfounded and ludicrous. It is my belief that following creation of NAFTA Rail, that the three railroads must continue to work together as they have in the past with a common goal of maintaining the fluid movement of cars over the International Bridge. As a result, I see no valid reason for the Board to impose any of the conditions that UP is seeking. Imposition of those conditions would not improve operating conditions at the Bridge, nor would they foster competition. Instead they would create rigid barriers that would artificially freeze the status quo in terms of usage of the Bridge. Therefore, rather than imposing conditions, the Board should allow and encourage the three railroads to continue to work together as they have done in the past pursuant to a privately negotiated Agreement that has withstood the test of time.

As UP has been forced to admit, current operations at the Bridge are fluid even though over the past few years there has been a substantial increase in the number of cars that cross the Bridge on a daily basis. Despite that increase, operations are more efficient today than they have ever been. As a result, the capacity of the bridge has been greatly expanded.

Given the tremendous strides that have been made in improving efficiency, there is no incentive to take any steps that would adversely impact the efficiencies that have been achieved. In addition, because the physical layout and location of the UP and Tex Mex tracks, there is little that could be done to disrupt the operations being conducted by

the other railroad without seriously disrupting one's own operations. In short, UP's concerns that NAFTA Rail will engage in activities at the Laredo Bridge that will be harmful to UP are and its shippers are baseless.

The only real threat to competition associated with NAFTA Rail does not involve the Laredo Bridge. Instead, the threat involves the Tex Mex trackage rights over lines that are controlled by UP. The congested nature of those lines, the need for significant infrastructure improvements that UP has refused to make, and the discriminatory treatment that is given to Tex Mex trains present a real cause for concern. Simply put, those problems, if not addressed, will prevent NAFTA Rail from providing shippers with a competitive alternative to UP. It is virtually impossible to market one's services when you constantly have to contend with excessive transit time and crews sitting idly in a siding because UP has refused to expand the capacity of the line by building additional sidings. While the lack of infrastructure provides UP with a convenient excuse or cover for holding Tex Mex trains, it highlights the undeniable fact that UP's policy is to build its own operations through Laredo, while maintaining an ever increasing chokehold on potential competitive services over the trackage rights. If the existing line is unable to handle the current level of traffic, how could it possibly handle the traffic that UP claims that NAFTA Rail is secretly plotting to divert from it.

The Laredo Bridge

I agree with Mr. Barkley's assessment of the current operations over the bridge. It is true that great strides have been made in improving the efficiency of movements over the Bridge. Those improvements reflect the extensive infrastructure improvements that have been made by the railroads, particularly TFM. Since 1997, TFM has greatly

expanded the capacity of its Sanchez Yard. As a result, it can handle more and longer trains, which has greatly reduced many of the problems of congestion at the Bridge. At this time, TFM generally handles up to 12 UP trains a day and as many as 6 Tex Mex trains. TFM is capable of taking an additional 6 to 8 additional trains a day.

Because of these improvements, the Bridge is not at or near capacity. I anticipate that it will be several years before the bridge has reached the point where it will be at capacity.

I must disagree with the impression that is left by Mr. Barkley's statement that "trains must be staged so that they are ready to move as soon as the previous train has moved off the Bridge."¹ While that is the goal, the truth of the matter is that trains are not always staged and ready to go when the window opens. It has recently been estimated that approximately 40 minutes of downtime are encountered at the beginning of each window. This results in between 2 and 3 hours being lost during a twenty-four hour period.

The need to work with Mexican and United States Customs places some constraints on the line in terms of capacity. At present, trains move across the bridge at only 5 mph. This is done to accommodate Customs's Vehicle and Cargo Inspection System or "Gamma Ray." It is anticipated that train speeds will increase in the future to 15 mph, which should further increase the operational capacity of the Bridge.

With all improvements in place, it is estimated that the Bridge will accommodate up to 32 cuts per day. Today the best showing would be about 24 cuts.

¹ V.S. Barkley at 5.

At the current time, the Bridge is operated with four windows of six hours, two of them are for northbound trains and two are for southbound trains. The northbound trains are scheduled between the hours of 2:00 p.m and 8:00 p.m and between 2:00 a.m. and 8:00 a.m. Southbound trains move between 8:00 p.m. and 2:00 a.m. and between 8:00 a.m. and 2:00 p.m. The windows are not rigid, but can be expanded or retracted to accommodate the movement of trains. This is done on virtually a daily basis. In fact, I am aware of hundreds of instances where exceptions have been made to extend the windows in order to accommodate UP trains. While the same is done for Tex Mex trains, the extensions are far fewer and are limited to those instances where a train is running a few minutes late due to some unforeseen problem.

The decision about whether a window is to be extended is made by the Bridge Superintendent. I am not aware of a single instance when I, or any other Tex Mex employee, have ever interfered with the Superintendent. I should note that it would be difficult for Tex Mex to interfere with the Bridge Superintendent due to the fact that he is physically located in an office in a UP facility located a few hundred feet from the Bridge.

While UP raises the theoretical possibility that a Bridge Superintendent "might decide to extend interchange windows to permit Tex Mex trains to move south over the Bridge, while making no such exceptions for UP trains,"² that claim ignores the simple fact that Tex Mex is not likely to have multiple trains on hand that would not have moved during the normal hours. In any event, given the close working relationship that exists between UP and TFM, which is going to continue after the creation of NAFTA Rail,

² V.S. Barkley at 10.

there is no likelihood that a Bridge Superintendent would not make exceptions for UP trains. After all, the goal is to move trains across the Bridge, not tie them up at the International Border.

I also disagree with the statement that a "Border Superintendent affiliated with Nafta Rail is much more likely to take the position that Tex Mex trains should have Bridge access 50 percent of the time, even though Tex Mex currently carries only 25 percent of the traffic."³ There is absolutely no basis for that statement.

I must also take issue with UP's example at page 10 of Mr. Barkley's statement regarding the 10-train allocation. If UP has eight trains and Tex Mex has two (which will not be the case due to the fact that Tex Mex cannot block downtown Laredo), the trains would be rotated based on availability. If Tex Mex has the first and third train over the bridge, UP will have the second train. Thereafter, UP would have an uninterrupted run as Tex Mex would not have any additional trains. Even though Tex Mex might have the right to claim the fifth spot in the rotation, it would not block UP. Instead, in such instances, Tex Mex routinely cedes time to UP. Given the importance of keeping the Bridge open, this will not change in the future.

There is no strict formula that governs the use of the Bridge. Instead, the current system allows and encourages flexibility. Most importantly, it reflects the imbalance in the amount of traffic handled by UP and Tex Mex. When UP has multiple trains staged and ready to cross and Tex Mex does not have one, the UP trains will move. The same is true when UP does not have a train waiting to cross. In those instances, the Tex Mex train would move, rather than wait for a UP train that might not arrive for hours.

³ V.S. Barkley at 11.

The Board should also be aware that the physical constraints that Tex Mex faces with regard to its street crossings and the relatively distant location of its staging areas, as compared with those of UP, will not be changed with the creation of the NAFTA System. Tex Mex's one line runs east to west through the heart of the Laredo business district. Therefore, it cannot stage a 7,000 foot train at or near the bridge for any prolonged period. If it were to do so, it would block vehicular traffic throughout the downtown area. Obviously, this is a very sensitive issue.

Furthermore, because Tex Mex has only one track, if the last northbound train in a window is delivered to it, that train must clear the track before Tex Mex can move a single southbound train. This will take at least 45 minutes. During that time, UP is able to begin the southbound movement of trains that it has staged on its three lines located a few hundred feet from the Bridge. This, of course, provides UP with a built-in advantage over Tex Mex that will not change in the future.

Most importantly, the Bridge capacity will continue to be allocated in proportion to each railroad's share of traffic at the Laredo crossing. In this regard, I take exception to the claim that "Tex Mex has argued that its southbound trains, or blocks of cars TFM is sending northbound to Tex Mex, should receive 50 percent of the available slots."⁴ I am not aware of a single instance when such an argument would have been made. As noted above, exceptions are made time after time to extend the windows so that UP trains, which are staged before the closing of the slot, will be allowed to cross the Bridge, rather than wait for the next window.

⁴ V.S. Barkley at 9.

I disagree that there is any need to establish a joint operations center that would control the dispatching of trains from UP's Port Laredo Yard to Tex Mex's Serrano Yard, across the Bridge, to TFM's Sanchez Yard. Given the fact that the Bridge is operating efficiently and has adequate capacity for the foreseeable future, a joint operations center is not needed. Moreover, there has been no showing that all three railroads are not being treated in a neutral manner. Nor has any showing been made that the situation is going to change following the creation of NAFTA Rail. Not only will the Bridge Superintendent continue to work at UP's facility near the Bridge, but he can be expected to follow the same basic approach that has guided him for the past years.

Second, the Bridge is being operated in a non-discriminatory fashion. While UP has expressed "concerns" that this may change, it has not identified one piece of evidence that would indicate that NAFTA Rail would take any steps that would do other than maximize the total capacity and operating efficiency of the Bridge.

Third, there is nothing to UP's professed fears that a "50-50 allocation of available Bridge slots"⁵ would be implemented by NAFTA Rail in order to take slots away from UP. NAFTA Rail will continue the current practice of ceding time and slots to UP when Tex Mex has no trains of its own that are ready to move. Any other approach would be nonsensical. Simply stated, the railroads have managed to improve the efficiency of operations without devising a formula to govern the slot allocation process and without having the Board monitor the situation. Until such time as UP can demonstrate an actual need for the Board to involve itself in determining the details of a rigid slot allocation process, the Board should decline UP's invitation.

⁵ V.S. Barkley at 17.

Tex Mex Trackage Rights Operations

The current track rights involve the only real impediment to competition. Until such time as steps are taken to improve and expand the infrastructure on UP's Brownsville Subdivision, NAFTA Rail will suffer competitive injury due to the fact that there is insufficient capacity to handle the existing trains, much less additional trains that may be generated in the future.

I strongly disagree with UP's contention that "Tex Mex should be able to add traffic without the need for additional investment"⁶ in the infrastructure over which it operates between Robstown and Beaumont. I must also challenge Mr. Barkley's comment that UP's Network Planning Department has prepared studies which have caused UP to find that "there is more than enough capacity to accommodate actual traffic volumes on *most* of the lines Tex Mex uses" and that "[f]or *a portion* of the Brownsville Subdivision, Network Planning has concluded that there is sufficient capacity to carry current traffic volumes, although traffic would exceed capacity if several trains per day were added."⁷ Nothing could be further from the truth. The qualifying words "most" and "a portion" are misleading in that they deflect attention from those lines which Tex Mex uses that are already over capacity, including a critical portion of the Brownsville Subdivision.

In my original Verified Statement, I testified that the traffic levels today are twice what UP believes the capacity of the Brownsville Subdivision to be. I continue to adhere to that statement, which is not seriously challenged by UP.

⁶ V.S. Barkley at 23.

⁷ V.S. Barkley at 23 (emphasis added).

The congestion can be attributed to a number of factors, including UP's decision to move a large number of empty railcars southbound to TFM at Matamoros/Brownsville. While that has relieved congestion at Laredo, it has increased the delays that are routinely faced by Tex Mex. Given the fact that UP is aware that the Brownsville Subdivision is over capacity, the question may be raised why it has not chosen to route the empties over Eagle Pass. If that were to be done, it would relieve a significant portion of the congestion that interferes with Tex Mex operations.

The many delays that Tex Mex encounters have little to do with the length of its crew districts. Based on my knowledge of railroad operations, with proper dispatching and adequate capacity, the existing crew districts are not too long. However, when Tex Mex trains are deliberately detained in sidings for up to 10 hours, while other UP slow trains are allowed to run past them in the sidings, re-crewing becomes a problem.

I must also dispute UP's claim that it does not discriminate against Tex Mex. Contrary to its claim of non-discrimination, UP does discriminate against Tex Mex trains. Not only does UP give priority treatment to its 'Z' and 'A' trains, which involve high speed trains, but it routinely moves slow trains past Tex Mex trains which are being held up by UP dispatchers on the UP-controlled lines.

UP seeks to avoid the charge of discrimination by claiming that its own studies show that "UP trains suffered the most minutes of delay per train,"⁸ and that "the impact of the delays on these lines falls much more heavily on UP than Tex Mex, in part because

⁸ UP Comments at 80.

UP operates many more trains than Tex Mex over these lines.”⁹ Those claims cannot be substantiated.

While it may be that UP sustained the largest number of minutes per train, that is but one way to view the statistics. If viewed on a train-mile basis, which takes the number of trains, as well as the mileage traveled, into consideration, Tex Mex trains, on average, were delayed 1.45 minutes per mile operated. By way of comparison, UP’s trains were only delayed .84 minutes per train-mile.¹⁰ In addition, during the study period, Tex Mex trains were not put into sidings. As a result, the study does not reflect standard operating procedures.¹¹ In short, UP’s claim that “Tex Mex trains suffered the fewest minutes of delay per train”¹² is highly misleading.

Tex Mex also undertook its own congestion study in December of 2002.¹³ In the September-November 2002 period covered by the study, Tex Mex had 72 trains delayed due to hours of service limits that were caused by UP congestion or UP’s refusal to take Tex Mex’s trains. Accordingly, the diagnosis by both railroads is the same: there is substantial congestion on the Brownsville Sub that is causing delays in service and increased crew costs.

UP has suggested several remedies that supposedly would protect Tex Mex from delays caused by UP. UP first claims that Tex Mex is free to participate in its Spring

⁹ UP Comments at 79.

¹⁰ These averages assume that Tex Mex trains traveled 85 miles per train and that UP trains traveled 343 miles per train.

¹¹ V.S. Riney at 130-34.

¹² V.S. Barkley at 21.

¹³ See Exhibit D.

Dispatching Center in order to head off delays.¹⁴ Tex Mex cannot afford the \$100,000 annual cost of placing an individual in the Spring facility in order to oversee the UP dispatchers.¹⁵ In addition, the Board should be aware that Tex Mex pays UP over \$700,000 per month to handle dispatching. Therefore, there should be no need for Tex Mex to incur additional costs. Furthermore, even when Tex Mex originally assigned an Assistant Train Master to work with UP, that did not translate into fair, non-discriminatory treatment over the trackage rights. In any event, participation in the Spring Dispatching Center would not alleviate the congestion on the Brownsville Subdivision.

UP also claims that although Tex Mex has the right to “identify and fund construction of sidings and other capital improvements on the trackage rights lines” under the 1996 trackage rights agreement that it has never done so. That statement is false. To help alleviate the capacity problems on UP’s lines, Tex Mex spent \$2.25 million of its own funds in 1999 to construct an additional siding on UP’s line between Placedo and Flatonia at Adel. While UP professes to lack knowledge of it, UP’s dispatchers routinely uses the Adel siding as a “parking spot for [Tex Mex] trains to allow their traffic to keep moving rather than equally dispatching all trains on a first come/first served basis.”¹⁶

Last, UP notes that it has sold the old SP Wharton line to Tex Mex. That line runs between Victoria and Rosenberg. To date, Tex Mex has not yet been able to begin the rehabilitation of that line due to ongoing litigation. While rehabilitation will alleviate

¹⁴ V.S. Barkley at 22.

¹⁵ In addition, Tex Mex would incur expenses associated with office furniture, computers and the like.

¹⁶ E-mail, Ronney O. Nichols, 6/21/00, attached as Exhibit D.

some problems, it will not cure the problems associated with the lack of adequate infrastructure on UP's Brownsville Subdivision.

Even after rehabilitation is completed, Tex Mex still must operate over the Brownsville Subdivision between Robstown and Victoria, which lies within the portion of the Brownsville Subdivision between Bloomington and Robstown. Not only is that key section of UP track used by KCS/Tex Mex for NAFTA traffic, BNSF also uses that portion of UP's line for both its Laredo traffic that it interchanges with Tex Mex at Robstown, and local and through traffic from Houston to Corpus Christi and Brownsville, including NAFTA traffic interchanged with TFM at Brownsville. In addition, UP traverses that segment for its local and through traffic from Houston to Corpus Christi and Brownsville, including any NAFTA traffic interchanged through Brownsville. As a result, this segment is heavily utilized by UP, BNSF, and Tex Mex. Indeed, UP's study indicates that the Bloomington to Kingsville Segment (Kingsville is slightly south of Robstown) has a capacity of 11 to 13 trains per 24 hour period. In UP's study period, which included a 15-day period in October of 2002, the traffic on the line equaled or exceeded capacity for 9 of those 15 days. Therefore, as I have previously noted, even when the Wharton Line is rehabilitated, the lack of capacity on the Bloomington to Kingville Segment will continue to allow UP to exercise control over NAFTA Rail's operations.

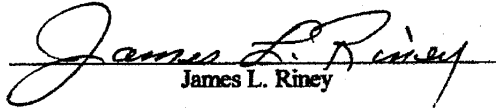
Simply stated, siding capacity on the Robstown to Bloomington portion of the Brownsville Sub is grossly inadequate for the current traffic volume on the line. While UP has been aware of this for years, and said in 1998 that it would remedy the problem within 5 years, each year it has put off doing so.

There are too few sidings on the Bloomington to Robstown section of the Brownsville Subdivision. Current traffic volumes on the line are in the area of 19 to 22 trains per day.¹⁷ Most of these trains are 7000 feet long or longer, while there is only one siding on this 79-mile segment capable of siding a 7000-foot train. Most of the sidings are capable of siding only a 6,000-foot train. Therefore, the sidings are inadequate to allow the trains normally operating on this segment to pass each other. On top of this, power switches are needed to reduce the delay involved in having a crew member climb down from the cab of the locomotive after the train enters the siding and walk the entire length of the train - over a mile ordinarily - to line the switch so that another train can pass on the main line. These simple improvements (which UP said five years ago that it would make, but still has not made) would tremendously improve the operating efficiency of the Bloomington-Robstown segment for all the using railroads. That they have not been made is yet a further, not so subtle, indication that UP is using its control over Tex Mex's operations in an anticompetitive fashion.

¹⁷ V.S. Riney at 135.

VERIFICATION

I, James L. Riney, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.


James L. Riney

PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB D

**VERIFIED STATEMENT OF

ERASMOS SANTOS**

VERIFIED STATEMENT OF ERASMO SANTOS

**RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
and
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

My name is Erasmo Santos. I am employed by TFM, S.A. de C.V. ("TFM") as the Border Superintendent of the Laredo Bridge. My formal business address is Walker Plaza Bldg., Suite 350, 5810 San Bernardino Avenue, Laredo, Texas 78041. However, I actually occupy an office at 2115 Farragut Street, which is located in the UP facility adjacent to the Laredo Bridge.

I am offering this Verified Statement with regard to the Application filed by Kansas City Southern Railway Company ("KCSR"), Gateway Eastern Railway Company ("Gateway") and the Texas Mexican Railway Company. I have carefully reviewed the Verified Statement of Stephen R. Barkley and wish to correct certain misstatements that appear in that Statement.

I have acted as the Border Superintendent since November 2001 and have been involved with border operations since 1994. During that time, I have worked closely with all three railroads that use the bridge.

I believe that I have always administered Laredo Bridge operations in an even-handed manner and have never showed any favoritism to any of the railroads. Also, even though I am employed by TFM, I have never been instructed or ordered to discriminate against UP. Instead, as UP admits, I have routinely "cleared UP trains to cross first more than half the time, reflecting

UP's higher percentage of the southbound traffic. The same has been true for northbound TFM blocks intended for UP.¹ No one at Tex Mex has disputed this pattern.

In his Verified Statement, Mr. Barkley claims that "Tex Mex has argued that its southbound trains, or blocks of cars TFM is sending northbound to Tex Mex, should receive 50 percent of the available slots."² During the nine years that I have been employed by TFM, no one from Tex Mex has ever made such an argument.

Although I firmly believe UP has received fair treatment, I have received complaints from UP that Tex Mex has received favorable treatment in instances when Tex Mex was able to move all of its trains during a particular window, but UP was not able, for whatever reason, to clear all of its trains. I should note that this rarely happens. However, using UP's example of 8 UP trains and 2 Tex Mex trains, assuming that Tex Mex would be able to move both of its trains, while UP might only get 6 across, UP will inevitably complain that it has been treated unfairly. That UP was given the use of the clear majority of openings does not seem to make a difference. In response to such complaints, we have requested UP to come up with a set formula. No one has ever given us one.

I must challenge the legitimacy of the comments that "a Border Superintendent affiliated with Nafta Rail is much more likely to take the position that Tex Mex trains should have Bridge access 50 percent of the time, even though Tex Mex currently carries only 25 percent of the traffic to and from the Laredo Bridge."³ UP lacks any basis for making that statement. Anyone who is responsible for maintaining the efficiency of operations at the Bridge is well aware that a

¹ V.S. Barkley at 9.

² V.S. Barkley at 9.

³ V.S. Barkley at 10-11.

dysfunctional allocation of trains would result in chaos. The only way to ensure fluid movement is to handle the trains on a “first come, first served basis.”

The Board should also note that claim that the “Bridge is operating close to capacity now” is incorrect.⁴ Each day, several hours are wasted because neither of the railroads has trains available when the previous window closes. In fact, there are times when a gap of 3 to 4 hours will occur before UP or Tex Mex will show up with a train.

Also, while the windows are established on a six-hour basis, considerable flexibility exists to enlarge a window in order to accommodate a late arrival, especially if the train carries a priority label. In some instances when it is known that a southbound train is going to be a late arrival, a northbound train, rather than waiting, will be moved before the northbound window is formally opened. Of course, if a train is drastically late, it will have to wait for the next window.

In order to make the system work, there are two daily calls. One is at 9:00 am and the other is at 6:30 pm. All three railroads participate in each call. The calls average between 30 and 40 minutes. The first order of business during the calls involves a review of the movements during the previous northbound window. Any delays and other problems are addressed. Next, a verbal list of southbound trains for the next window is prepared. Once a final figure is determined, the schedule will be established.

Because the number of trains will vary from window to window, and because there is substantial imbalance in the number of trains handled by UP and Tex Mex, the system must be flexible and not rigid. There are, however, a few basic factors that must be taken into consideration. If the closing of the northbound window coincides with a Tex Mex train, I know that it will take Tex Mex 45 Minutes to clear its track. Rather than wait for Tex Mex to return,

⁴ V.S. Barkley at 11.

UP will be the first train to cross the Bridge if it has an available southbound train staged and ready to go.

I categorically deny the allegation in Mr. Barkley's statement that I have "been less accessible than previously."⁵ Nothing could be further from the truth. Nothing has changed since KCS announced its proposed transaction. I know of nothing that would substantiate UP's claim that it has.

Mr. Barkley also claims that if the Nafta transaction goes forward, "there is a real danger that UP will be shut out of the decisionmaking process and that TFM employees will make unilateral decisions that favor TFM-Tex Mex movements over TFM-UP movements."⁶ That will not happen. Based on its participation in the daily phone calls, UP knows that it would be impossible for the Bridge to function efficiently if any one of the three railroads were excluded from the calls. Therefore, its professed fears are unfounded.

UP's belief that "TFM and Tex Mex will reduce the level of communication and coordination ... and deny UP an influential role in management of the Bridge crossing operation" is baseless and misleading. Based on my knowledge of how the Bridge works, there will be no reduction in the level of communication and coordination.

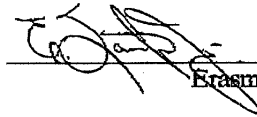
Last, because UP does not have an ownership interest, it currently has no say in the management of the Bridge. That will not change. However, the lack of management has not interfered with UP's access to the Bridge, or with its operations over the Bridge.

⁵ V.S. Barkley at 11.

⁶ V.S. Barkley at 15.

VERIFICATION

I, Erasmo Santos, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.

 09/01/03

Erasmo Santos

PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB E

VERIFIED STATEMENT OF

DR. ANDREW KLEIT

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PUBLIC VERSION

VERIFIED STATEMENT OF ANDREW N. KLEIT

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY
AND
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

I. INTRODUCTION

My name is Andrew N. Kleit. I am Professor of Energy and Environmental Economics at the Pennsylvania State University, having received my Ph.D. in economics from Yale University. I have been at Penn State since 1998. From 1992 to 1998 I was on the faculty at Louisiana State University. Prior to coming to LSU I worked for four years at the Federal Trade Commission. From 1989 to 1991 I served as Economic Advisor to the Director of the FTC's Bureau of Competition. I also spent a year on detail to the Government of Canada, where I served as Senior Economic Advisor to the Director for Investigation and Research, the chief competition law enforcement officer of Canada. I have published a number of articles on railroad and antitrust issues. I was named as one of the top competition economists in the world by *Global Competition Review* (London) in 1998, 2000, and 2002. I previously submitted comments to the Interstate Commerce Commission ("ICC") in the *Union Pacific/Chicago Northwestern* matter on behalf of the Union Pacific Railroad Company ("UP").¹

I have been asked by Applicant, Kansas City Southern ("KCS") in Surface Transportation Board ("STB") Finance Docket No. 34342, to review objections to their

¹ Finance Docket 32133, 1995 ICC LEXIS 37, February 21, 1995.

application made in various statements on behalf of the UP, The Burlington Northern and Santa Fe Railway Company ("BNSF"), and the Canadian National Railway Company ("CN").

In Section II of this document I will review the "one lump" theory of profits that apply to vertical mergers in the railroad industry and the related theory that efficient interline routes will not be foreclosed. Sections III and IV rebut the economic arguments that Professor Jerry Hausman has made on behalf of UP. Section V reviews arguments made by Dr. David Reishus for BNSF and Dr. Christopher Velluro for CN. Section VI analyzes the economic implications of the *pro rata* division sharing rule proposed by the UP. Section VII contains my conclusions.

II. THE STANDARD THEORY OF VERTICAL FORECLOSURE, A CORNERSTONE OF ICC AND STB MERGER POLICY FOR OVER 20 YEARS, FINDS NO ANTICOMPETITIVE MOTIVES OR EFFECTS FROM END-TO-END CONSOLIDATIONS²

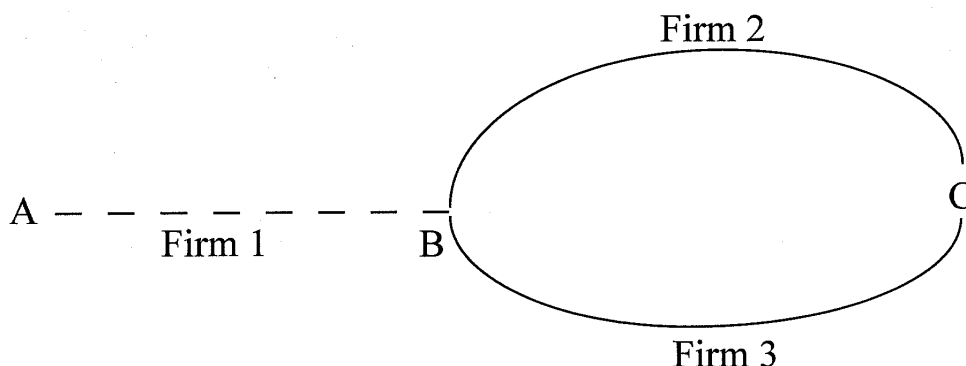
A. The Standard Theory

The argument has been presented by UP, BNSF, and CN that applicants have an anticompetitive motive for the NAFTA Rail consolidation, and that the consolidation will have an anticompetitive effect. In particular, the three railroads argue that the intent of KCS and the result of the consolidation will be to vertically foreclose rival railroads. This argument is diametrically opposite from standard economic theory on vertical foreclosure, which has been consistently applied by the ICC and the Surface Transportation Board ("STB") to evaluate end-to-end mergers for over 20 years. The ICC/STB theory, drawing on the relevant economic learning, clearly states that any market power resulting from a bottleneck can be fully exploited without vertical integration and that there is no vertical foreclosure incentive to engage in end-to-

² This section draws upon Kleit, "The Unclogged Bottleneck: Why Competitive Access Should Not Be an Antitrust Concern," 26 Logistics and Transportation Review, No.3 at 229-47 (September 1990); and Kleit and Reiffen, "Terminal Railroad Revisited: Foreclosure of an Essential Facility or Simple Horizontal Monopoly?," 33 Journal of Law and Economics, No.2 at 419-38 (October 1990) 419-438.

end mergers. This is commonly referred to as the “one-lump” theory. Moreover, the theory clearly states that efficient interline options will not be vertically foreclosed.

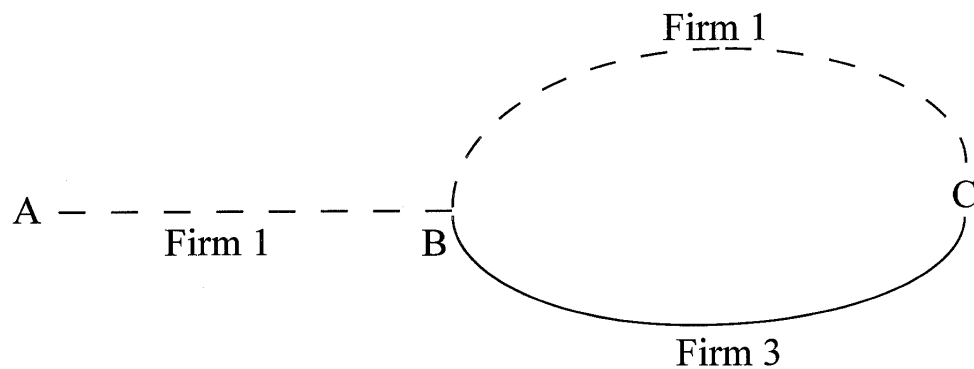
Figure 1



For example, in Figure 1, assume Firm 1 has a monopoly from point A to point B. From Point B to Point C both Firm 2 and Firm 3 have tracks and can supply services. Given its monopoly on AB, Firm 1 is in position to capture the full monopoly profit on this route. In addition, with reference to Figure 1, assume that the maximum rail rate for AC traffic is \$200; any rate higher than \$200 would result in loss of traffic to an alternative mode. Firm 1’s variable costs for the AB portion are \$50. Firms 2 and 3 both have variable costs of \$60 for the BC portion. Because there is competition in the BC segment, Firms 2 and 3 will both have an incentive to move traffic at any division of \$60 or higher. Their competition will drive their division down to \$60, with Firm 1 netting a division of \$140 and a profit of \$90. Now suppose Firm 1 acquires Firm 2 and forecloses Firm 3, so that Firm 3 can no longer participate in interline traffic. The profit for the merged Firm 1 will still be \$90. Thus, Firm 1 cannot leverage its monopoly power through an end-to-end merger. In general, there is no anticompetitive rationale for a firm to engage in an end-to-end merger.

Let us next turn to an example illustrating the principles that efficient interline routes will not be foreclosed. With reference to Figure 2, assume that Firm 1 has a monopoly from point A to point B. From Point B to Point C, both Firm 1 and Firm 3 have tracks and can supply services. Assume that the maximum rail rate for AC traffic is \$200. Firm 1 has variable costs of \$50 from A to B, and of \$100 from B to C. Firm 3 has variable costs of \$50 from B to C, and there are no interchange costs. Firm 1 makes a profit of \$50 by handling the traffic singleline. However, both carriers have an incentive to use the more efficient interline route. If the interline route is used, the combined profit for Firms 1 and 3 will be \$100. For example, if Firm 1's division is \$125, while Firm 3's is \$75, Firm 1 will have higher profits by interlining and Firm 3 will make a profit of \$25 by interlining (instead of zero if traffic moves over 1's singleline). Indeed, if the interline route is more efficient than the singleline route, Firm 3 can always offer Firm 1 a division which provides positive profits for Firm 3 and gives Firm 1 the incentive to choose the joint-line route.

Figure 2



Examining a second possible rate level makes the incentive to interline even clearer. Suppose the rate level for the AC traffic is \$150. Now, only by interlining can Firm 1 make any

profit at all from this traffic. If the traffic moves along the singleline route, profits will be zero. However, if Firms 1 and 3 cooperate on the interline move, there will be profits of \$50 to split between them. Indeed, when the interline route is more efficient, joint profits will always be higher when the traffic is interlined.

In general, Firm 1 will choose to send the shipments over Firm 3's BC tracks when Firm 3 has lower costs and the comparative efficiency of Firm 3 is greater than the interchange costs. Otherwise, Firm 1 will send them over its own tracks. Thus, Firm 1 will make its "make or buy" decision solely on the question of which firm has the lowest cost of supply from B to C. Therefore, there will be no anticompetitive foreclosure. Firm 1 has no incentive to foreclose a rival through the type of price and service "strategies" alleged by BNSF and UP. Efficient interline options and carriers forming these options will not be foreclosed.

B. The ICC/STB Position on This Issue

This "one monopoly" or "one lump" theory was initially adopted by the ICC in the early 1980's. Indeed, the examples above in Part A are drawn from the ICC's 1982 decision, which eliminated DT&I traffic protective conditions. In that decision, *Union Pacific -- Control -- Missouri Pacific, Western Pacific*, 366 I.C.C. 462, 538-39 (1982) ("*UP/MP/WP*"), the ICC stated,

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 the competing connecting carriers against one another in setting divisions. . . .

We are not convinced either that a carrier with a destination monopoly for steam coal traffic will generally be unable to execute the described rate strategy or, **on the other hand, that a neutral destination carrier that is unable to execute the strategy would be significantly more capable of raising the through rate... after affiliation with an origin carrier. . . .**

(emphasis added to original in *CSX/NS/Conrail*, 3 STB 196 (1998)).

The ICC and STB have supported this position a large number of times. As the ICC stated in the *BN/Santa Fe* matter, 10 ICC 2d 661 (1995), “Simply put, there is no reason for a carrier to foreclose an efficient connecting carrier just to achieve a long haul. If a connecting carrier can provide service at a lower cost than can BN/Santa Fe, it is in the interest of all the carriers to reach an agreement for a joint service.” Similarly, in the *CSX/NS/Conrail* decision 3 STB 196 (1998), the STB stated that, “Merger of the bottleneck destination rail carrier with one or more origin rail carriers will not increase whatever market power it does have.”

In the *UP/CNW* merger case, the ICC rejected an argument for gateway protection, noting, that “[w]e have concluded, in similar circumstances, that the vertical foreclosure of efficient interline connections is not a likely outcome in end-to-end consolidations.”³ Further, in a 1995 decision, the ICC stated: “Petitioner’s witnesses have shown that merged railroads -- regardless of whether they maintain bottleneck facilities or market dominance -- have the incentive to encourage full use of the most efficient routing, even when it entails a joint-line alternative to a single system route.”⁴

Therefore, market power is not created, nor increased, by consolidation of a monopoly destination carrier with an origin carrier. The STB, and its predecessor agency, the ICC, have recognized this for over 20 years, and repeatedly reaffirmed this position.

C. The Previous Positions of Petitioner Railroads

In reviewing this matter, I would ask the STB to also consider the previous positions taken on this issues by UP and BNSF. Both UP and BNSF have engaged in many rail mergers over the decades, and have consistently found no competitive problems with end-to-end aspects

³ Finance Docket No. 32133, 1995 ICC LEXIS 37, February 21, 1995.

⁴ Finance Docket No. 21215, Sub. No. 5, p. 5.

of their consolidations or associated traffic diversions from rivals. Indeed, UP has often extolled the virtues of letting the market place, not government regulators, handle issues of traffic interchange, rates and routes. As UP wrote in its 1996 STB filing in the bottleneck rate proceeding,⁵

The Board does not administer prices or prescribe interchanges or dictate routes. It lets railroads decide what prices make sense in each market, what interchanges are most convenient and efficient, and what routes should carry which traffic. The result is that today there is virtually no litigation between railroads concerning rates, routes, interchanges, or revenue shares.

Along the same lines, UP Chairman Richard Davidson, in a 1998 statement to the STB during the Houston/Gulf Coast Oversight Proceeding, concurred with this position, “Compulsory access or ‘bottleneck’ rate schemes do not create genuine competition: they try to force artificial competition – which is by nature unsustainable, and thus illusory.”⁶

Robert Willig, a frequent witness for major railroads at ICC and STB hearings, has provided a clear explanation of the standard theory as discussed above along with a forceful defense for a regulatory “hands-off approach” on issues of traffic interchange and protection of interline carriers:

For this reason, railroads – whether or not they own bottleneck facilities and possess market dominance – have an incentive (in the absence of regulatory distortion and so long as the connecting carrier’s rates and revenue divisions reflect its relative cost efficiency) to encourage full use of the efficient services and facilities of connecting carriers. Thus, in the domain of end-to-end joint rates and divisions of joint rates between connecting carriers, the proper role of regulation is to encourage voluntary negotiations among the carriers so that the incentives for the acceptance of offers for efficient joint service are fully preserved.

⁵ STB Finance Docket No. 41242, 41295, and 41626, Comments of Union Pacific Railroad Company, October 15, 1996, p. 7.

⁶ UP Chairman Davidson’s Verified Statement to the STB in conjunction with STB Hearings, Houston/Gulf Coast Oversight Proceeding, March 31, 1998, p. 3.

Why does regulatory intervention in determination of such joint rates and divisions not accomplish the same purpose? The answer is that neither regulators nor anyone else can calculate efficient prices as well as the market. A voluntary negotiation must [emphasis original] end up with results that are mutually advantageous, because otherwise the losing party would simply withdraw. This is the basis for the noted “mutual gains for voluntary trade” theorem that goes back to Adam Smith.⁷

The standard theory as discussed above is directly relevant to the vertical foreclosure issues raised in this case. The fundamentals are the same here as in the many past cases where the STB has consistently recognized that end-to-end mergers provide no incremental opportunity for the exercise of market power, and that no regulatory remedy is required. The context here, where international traffic is a component of the larger transaction, does not affect this result. Basic economic principles remain in force. Thus, the arguments of UP and others that NAFTA control of the Laredo bridge provides a justification for regulatory action must also be rejected.

A rail carrier with a bottleneck segment or captive shippers always has the physical potential to alter rates with regard to interline routes. Moreover, because a bottleneck carrier controls the dispatching over its lines, it always has the physical potential to engage in strategies to diminish service for interline traffic. The presence of the international bridge controlled by NAFTA rail is no different from the usual context. But the “one-lump” theory clearly implies that it would not be profit maximizing for a bottleneck carrier to use that potential.

Thus, the standard theory, which has been the ICC/STB position for over two decades, directly rebuts the arguments of CN that KCS has engaged in this consolidation for purposes of anticompetitive foreclosure. It also rebuts the arguments of BNSF that KCS will have an incentive to foreclose BNSF following the consolidation. I will discuss in more detail the

⁷ ICC Finance Docket No. 21215 (Sub-No. 5), Verified Statement of Robert D. Willig, Jan. 4, 1993, pp. 17-18.

arguments of CN and BNSF later in my statement. The theory also rebuts the arguments of UP that its interline route at Laredo will be foreclosed. To demonstrate this, the following section will examine more closely the theory presented by Professor Hausman which is the basis of the UP argument that its efficient interline routes will be vertically foreclosed.⁸

III. HAUSMAN'S THEORY OF VERTICAL FORECLOSURE SHOULD BE REJECTED IN FAVOR OF THE STANDARD THEORY

UP contends that this consolidation is motivated by anticompetitive vertical foreclosure on the part of the applicants, and that UP's interline routes will be vertically foreclosed following the consolidation. UP's argument is based on the economic analysis of Professor Jerry Hausman. Professor Hausman's model yields results opposite from the standard theory. His analysis, contrary to the standard theory, posits that TFM and KCS gain market power from the consolidation and will be able to vertically foreclose UP and raise rates to shippers. The Hausman analysis, however, is deeply flawed and should be rejected by the Board.

Hausman's contrarian conclusions are based on inaccurate assumptions, which, when corrected, lead us back to the conclusions of the standard theory. In addition, there are a number of other problems with his analysis. In this section of my statement, I will detail and rebut the key assumptions of the Hausman model that lead to the results counter to the standard theory.

⁸ There are two theoretical exceptions to the "one lump" theory. First, assume that the rates on the AB portion of Figure 3 above are regulated at a level below the monopoly price. Firm 1, from above, can evade the regulation by adding the remaining monopoly premium to the charge for shipping on its rails for the BC route, and foreclosing traffic from Firm 3. This theory does not apply to the matter here, as several witnesses have stated that Mexico does not have maximum railroad rate regulation. The second theory relates to what economists refer to as "double marginalization." If the ongoing rate is above marginal cost on the BC portion, the two firms are imposing externalities upon one another. Each of them acts to mark up the price, resulting in a rate that is actually above the monopoly price. Vertical integration would result in a lower net price on Firm 1's routes from A to C. This would result from reducing the number of mark ups from 2 to 1. Firm 3 is "foreclosed" from B to C, but only because a lower price is available to Firm 1. Again, this theory does not appear relevant to this proceeding.

In Section 4 of the statement, I will elaborate upon the many other infirmities of the Hausman analysis.

Among the problems with Professor Hausman's theory are that the theory contradicts the testimony of other UP witnesses, it contradicts Professor Hausman's previous writings, and it does not deal with the factual situation at hand.

A. Summary of the Hausman Theory

This Part summarizes the key elements of the Hausman theory.⁹ TFM has market power on Laredo gateway routes, but cannot currently exploit it because Mexican law prohibiting price discrimination prevents differential rail pricing. Thus, TFM is forced to charge the same (supra-competitive) rate to all customers. Therefore, TFM is leaving money on the table because of this proscription; there are many shippers for whom rail rates could be raised without defection to another mode. In addition, intense rail competition from KCS north of the border prevents UP from raising rail rates above competitive levels. In addition, KCS's current ownership share of TFM and the Tex-Mex does not provide incentive to utilize TFM's market power.

Following the consolidation, TFM, now acting in consort with KCS, can exploit its market power. TFM raises its uniform rate, with KCS adjusting its portion depending on shipper elasticity. Where there is no room to raise the overall rate, KCS adjusts its portion of the joint rate downward to maintain the overall rate at the shippers "reservation price."¹⁰ However, for the (assumed) many shippers for whom rail rates can be raised without defection to another mode, the overall rate goes up.

⁹ More detail on the theory, and its implications, is provided in the Appendix.

¹⁰ The reservation price is the price at which consumers are indifferent between purchasing and not purchasing the relevant product.

Continuing with the Hausman theory, UP's more efficient route is foreclosed in the process, and it has no way to counter the NAFTA Rail foreclosure strategy. Because TFM must charge the same elevated rate for all traffic, the entire TFM-UP traffic captive to UP in the U.S. is lost to both TFM and UP. TFM loses substantial revenues as a result, but the strategy is still profitable for TFM because of the combination of elevated rates and traffic diversions from UP.

When confronted with the essence of the Hausman theory, its utter implausibility is readily apparent. Nonetheless, I will dissect the theory more carefully with a focus on scrutinizing the assumptions necessary to reach the opposite result from the standard theory.

1. Hausman's theory falsely assumes that TFM is a monopoly bottleneck but does not exercise its market power prior to the merger.

- a) *The critical assumption that TFM cannot differentially price is inaccurate.*

Contrary to standard one-lump theory, Hausman assumes that TFM is a monopoly bottleneck but does not exercise its market power prior to the merger. His argument is that Mexico's price discrimination law prevents TFM from differentially pricing rail traffic. Without this crucial assumption, Hausman's entire model falls apart. As discussed in the Rebuttal Verified Statement of Gerald Davies ("R.V.S. Davies"), however, both TFM and the Ferromex (which is partially owned by the UP) can engage in differentially rail pricing under Mexico law. According to Gerald Davies, Executive Vice President of the KCS (R.V.S. Davies at 33-35):

...although Mexican law does require TFM to charge the same rate for identical traffic moving to/from the same origins or destinations and in the same volumes, that same law allows Mexican carriers to differentially price between connecting carriers and similarly situated shippers if such differential pricing is the result of different services provide[d] by rail carriers. Thus, in many respects, Mexican law regarding rail pricing is not that much different than the U.S. law contained at 49 U.S.C. Section 10741. Furthermore, while TFM is required to register the maximum rate with the SCT, such a rate is the maximum rate that can be charged. TFM is free to discount from that

maximum rate based upon differences between the transportation services provided by connecting carriers or based upon individual circumstances between shippers.

As a result, almost all Mexican traffic moves under contract, and each contract provides for a “promotion” or discount from the registered rate. The extent to which this promotion is offered is based upon different services. For both Ferromex and TFM, rates and service terms provided to connecting U.S. carriers or to shippers are based upon differences between car types, lading weights, origins and destinations, train size, car hire amounts, switching services, length of the contract, volume differences, and other differences between shipments.

Accordingly, TFM can currently fully benefit from any market power it possesses on U.S.-Mexico traffic, as follows from the one-lump theory, without undertaking this transaction.

Indeed, UP’s own testimony supports the ability of TFM to differentially price, and undermines a critical assumption of Professor Hausman’s model. In particular, the Verified Statement of Fuentes Ostos (“V.S. Fuentes”) makes it clear that differential pricing of rail traffic is clearly permitted under Mexican regulation. According to Mr. Fuentes Ostos (V.S. Fuentes at 4) Mexican railroads are allowed to offer discounts to shippers “in accordance with the specific characteristics of each service.” In the railroad sector, “specific characteristics” include the good being shipped, the volume of the good being shipped, and the quality of service of the relevant shipment; indeed all of the factors discussed by Mr. Davies above. These are the standard bases for rail differential pricing.

The ability of TFM to differentially price is supported by other UP witnesses. John Gray for the UP, in his statement (Appendix C at 58) submitted a proposed agreement between the UP and the KCSR for interline traffic at Laredo. The statement provides that “[t]he Agreement may provide for separate TFM rate factors applicable to different geographical regions within Mexico

or the United States/Canada.” Thus, the UP also foresees that differential pricing will occur based on geographic destinations and origins.¹¹

In sum, UP and its witnesses, as well as Mr. Davies, confirm differential pricing based on the good being shipped, the volume of the good being shipped, the quality of service of the relevant shipment, and geographic destinations and origins is allowed in Mexico. Given this, it is very difficult to see how Mexican regulation precludes TFM from effective differential pricing. Indeed, with a set of rail shippers, each with a unique rail price based on commodities, volumes and origin/destination, it is implausible that a strict price discrimination law could prevent effective rail differential pricing without the presence of an extremely proactive regulatory agency which gathered detailed information on prices charged for various shipments along with estimated costs. Clearly such a regulatory structure does not exist in Mexico.¹²

- b) *With its substantial ownership stake in TFM, KCS would already be engaging in the strategy discussed by Professor Hausman if it were profitable.*

In describing his theory, Professor Hausman (V.S. at 10) states “[c]urrently TFM has an economic incentive to cooperate fully with all three competing railroads to maximize traffic using the Laredo gateway. . . . However, subsequent to the transaction the economic incentive for TFM will change.” What Professor Hausman appears to be saying is that the TFM is currently

¹¹ It should also be noted that UP has not provided evidence to support its position on this issue from its affiliate Ferromex.

¹² Even if somehow the KCS were to violate Mexican regulations on this point, it is unclear what steps the Mexican authorities would take against the KCS. According to Mr. Fuentes Ostos (V.S. Fuentes at 2), the Mexican legal authority for the UP, “there is considerable uncertainty regarding how regulators and courts would respond to a complaint of discriminatory treatment. What is certain, however is that a dispute that raises novel theories of discrimination would likely take years to resolve.” There is no mention of any pending or previous cases on price discrimination before Mexican authorities in Mr. Fuentes Ostos’ statement.

independent of the KCS, and of the Tex-Mex, and that will no longer be the case after this transaction.

This is clearly incorrect. Prior to the instant transaction, KCS owned 49 percent of the Tex-Mex, with the remainder of the Tex-Mex owned by TFM. KCS also owned 47 percent of Grupo TFM, which itself owned 80 percent of TFM.¹³ (The Mexican conglomerate TMM owns the remainder of Grupo TFM.) Thus, the framework to impose Professor Hausman's theory was already in place prior to this transaction. Both TFM the corporate entity and KCS operating through its partial ownership of the Tex-Mex and partial ownership of Grupo TFM already had incentives to undertake Professor Hausman's scheme. So if Professor Hausman's theory were correct, his foreclosure would already have been implemented by the TFM and the KCS. The TFM as a corporate entity would desire to use this strategy through its partial ownership of the Tex-Mex. The KCS would have desired to use this strategy through its ownership share in the TFM and the Tex- Mex. Thus, two parties had incentives previously to enact Professor Hausman's strategy.

Did the TFM and the KCS conduct this strategy prior to the acquisition? The record is clear. UP's own submissions to the record in a number of places make it apparent that TFM is currently dealing with UP in an appropriate manner.¹⁴ The BNSF takes the same position -- that "the past and current TFM management practice has been one of neutrality generally over the Laredo gateway for U.S. carriers."¹⁵ This indicates that Professor Hausman's theory is yet again

¹³ The Mexican government owns the other 20 percent of TFM, although I understand that it only has rights to approximately 2 percent of TFM's profits.

¹⁴ See, for example, Gray V.S. at 22.

¹⁵ BNSF Brief, August 2, 2003, at 21.

severely flawed. If Professor Hausman's theory were correct, there would already be significant evidence of "foreclosure." But as UP's statements make clear, there is not.

UP's President Richard Davidson addressed precisely this point in an April 24, 2003 conference call with industry analysts when answering a question about whether this transaction would result in KCS discriminating against the UP at Laredo:¹⁶

We worried about that, quite honestly, back in 1996, when TFM was first conveyed to TMM and KCS, and it turned out to be something not to worry about. We became quite a good business partner down there, and I would anticipate that would continue.

Thus, UP's President has stated that there is no reason to worry about foreclosure from this transaction. The same alleged incentives for foreclosure have existed since 1996. Foreclosure has not occurred, and because of that the UP does not expect it to occur as a result of this transaction.

STB Chairman Roger Nober addressed precisely this issue in the July 31, 2003 hearings on this matter. Chairman Nober asked Michael Haverty, KCS's president, "[b]ut presumably, if it's now in your larger interest to raise rates and, you know, utilize access of the bridge for more revenue, it would have been in Tex-Mex' interest in the last several years and they didn't do that." Mr. Haverty: "That's correct." Chairman Nober: "So would you see any incentive as changing?" Mr. Haverty: "Well, I don't see that." (July 31, 2003 Hearing Transcript at 21.)

Both UP's President Davidson and STB Chairman Nober were exactly on point. Given that Tex-Mex is now controlled by TFM directly and indirectly by the KCS, the framework to adopt the Hausman strategy is already in place. TFM could raise its rates, and Tex-Mex could offer lower prices to elastic customers. So if this were to happen, it would have happened

¹⁶ Supplement to Application of KCS, June 23, 2003, at 23.

already. But it has not – indeed, the UP and the BNSF are clear that they are currently receiving good treatment from the TFM and the Tex-Mex in and around Laredo.

2. Hausman's theory falsely assumes that UP could not retaliate against KCS.

Under Professor Hausman's theory, the UP would see a significant reduction in its traffic as a result of the KCS "foreclosing" its traffic. Professor Hausman implicitly assumes that the UP would be defenseless were the KCS to adopt this strategy. This assumption is clearly incorrect. UP has enormous countervailing power to combat the TFM strategy envisioned in Hausman's model.

In particular, every single KCS shipment to or from Mexico must go on UP's line from Placedo to Robstown. Therefore, all KCS shipments to/from Laredo are subject to retaliation by the UP. William Hawks, representing the Department of Agriculture at the July 31, 2003 hearing on this transaction (July 31, 2003 Hearing Transcript at 34), explained this source of UP leverage in the following manner:

Finally, Tex-Mex operates over 379 miles of Union Pacific railroad lines between Robstown and Beaumont, Texas to connect with Kansas City Southern in Beaumont. The terms and price of these trackage rights are negotiated by the parties involved without Board interference. Therefore, Union Pacific has considerable leverage over Kansas City Southern, which should ensure commercially reasonable terms for rail interchange at Laredo.

Thus, as Mr. Hawks implies, the UP could use its control of the NAFTA routing by reducing KCS's access to the Placedo-Robstown line or by increasing the number of uncrewed UP trains on this line. UP could simply reduce the flow of replacement crews to the bottleneck. This would slow down all trains on the line, reducing even further the KCS's ability to profit off Professor Hausman's hypothetical scheme. In sum, the standard theory that efficient interline

options will not be foreclosed should be applied with regard to the Laredo gateway. There is no basis to reject the long-standing finding in this case.

IV. THE HAUSMAN THEORY CONTAINS NUMEROUS OTHER FLAWS WITH RESPECT TO THIS TRANSACTION

The previous section showed that the Hausman theory should be rejected in favor of the standard theory on vertical foreclosure as key assumptions of the theory are incorrect or inaccurate. There are several additional problems with the Hausman theory, which this section will detail.

A. The Hausman theory assumes that the KCS can make more money on its remaining inelastic customers then it loses on customers who are foreclosed.

Crucial assumptions underlying the Hausman model are incorrect. Even if one accepts the model's assumptions, however, the logic of the model clearly breaks down upon further scrutiny. As I have previously noted in summarizing the Hausman theory, because TFM must charge the same elevated rate for all traffic, all of the TFM-UP traffic captive to UP in the U.S. is lost to both TFM and UP as UP presumably is currently charging what the traffic will bear with these captive shippers. TFM loses substantial revenues as a result, but the Hausman model concludes that the strategy is still profitable for TFM because of the combination of elevated rates and traffic diversions from UP.

Thus, the profitability of the Hausman strategy depends on 1) that not too many shippers are lost due to foreclosing the UP; and 2) rates on the remaining shippers can be raised to make up for the shippers lost due to factor 1. It also depends implicitly on a third assumption, that on the interline routes where NAFTA Rail raises rates, NAFTA Rail interline partners do not take an additional part of the increased rate. I will take up each of these points below.

1. Hausman assumes only a limited number of captive shippers will be lost if NAFTA Rail undertakes his strategy.

Let us next closely examine the traffic base upon which NAFTA rail could gain from this foreclosure strategy. According to Hausman (V.S. Hausman at 16), with interline connections “approximately 75 percent of existing UP traffic could be served by the KCS,” and then he cites to see Exhibit J to V.S. Gray. Note that even under Hausman’s assumptions, the TFM would lose 25 percent of its assumed profitable traffic. But even this may be an understatement.

In the Rebuttal Verified Statement of Bengt Mutén (“R.V.S. Mutén”) for KCS, Mr. Mutén breaks down the southbound and northbound markets through Laredo by their competitive status at the U.S. origin/destination (4 or 6 digit SPLCs).¹⁷ These figures are reported in R.V.S. Mutén Attachments A and B.

Table 1 breaks down the Muten figures at the 6 digit SPLC level. At this level, UP has captive 53 percent of the northbound traffic, and 36.5 percent of the southbound traffic. In total, UP has 45 percent of the traffic captive. This implies that were NAFTA Rail to adopt the Hausman strategy, it would lose 45 of its profitable shipments through Laredo. At the 4 digit SPLC level (reported in R.V.S. Mutén at Attachment B), which may be more appropriate for intermodal shipments, UP has captive 16 percent of the northbound traffic and 24 percent of the southbound traffic. However, intermodal shipments are of little relevance to the profitability of the Hausman strategy, as they largely represent elastic shippers. As KCS Executive Vice President Gerald Davies (R.V.S. Davies at 2) explains, “[f]or the bulk of Laredo gateway traffic, KCSR does not even serve the origins or destinations so as to have an incentive to foreclose UP

¹⁷ “SPLC” refers to the Standard Point Location Code, a code used on all interline freight accounting forms to identify all U.S. points served by rail or motor carriers. It may have up to six position numbers, identifying a geographic area in the first position, the state in the second position, the county in the third and fourth positions, and the station in the city or town in the fifth and sixth positions.” *UP/SP Decision No. 44*, 1 STB 233 at 373, note 102.

or BNSF. If KCSR did attempt to foreclose these routings, TFM would lose a substantial amount of revenue, as this traffic would switch to other modes or other Mexican gateways.”

Table 1
Laredo Traffic by Market Type (Markets Defined By 6-Digit SPLC)
Source: R.V.S. Mutén, Attachment A

	Northbound		Southbound		Total	
	Cars	%	Cars	%	Cars	%
UP-Served Only	101,736	53.23%	62,068	36.53%	163,804	45.37%
BNSF--Served Only	6,960	3.64%	10,720	6.31%	17,680	4.90%
KCS-Served Only	148	0.08%	4,182	2.46%	4,330	1.20%
BNSF and UP Served	51,001	26.69%	27,714	16.31%	78,715	21.80%
BNSF and KCS Served	42	0.02%	230	0.14%	272	0.08%
UP and KCS Served	0	0.00%	3,149	1.85%	3,149	0.87%
KCS, BNSF, and UP Served	1,116	0.58%	5,867	3.45%	6,983	1.93%
Other BSNF Served	321	0.17%	1,527	0.90%	1,848	0.51%
Other UP Served	1,160	0.61%	10,268	6.04%	11,428	3.17%
Other KCS Served	40	0.02%	963	0.57%	1,003	0.28%
Other	28,596	14.96%	43,226	25.44%	71,822	19.89%
Total	191,120		169,914		361,034	

Mr. Davies goes on (R.V.S. Davies at 21) to give an important example of the type of traffic TFM would lose if it adopted Professor Hausman’s strategy:

IMC Chemicals (“IMC”) ships “all” of its Mexico shipments via the UP through Laredo from its facility in Trona California, apparently a UP solely-served facility as it makes no reference to being able to use BNSF. Of course, KCSR does not serve this facility, and thus IMC does not benefit from UP and KCSR competition. IMC does not oppose the transaction but wants a condition for the protection of UP’s routing option. It has not shown why such a condition is necessary. Indeed, why KCS would use its control of TFM to purposely make the UP/TFM routing for 20,000 tons of chemicals “inefficient” for traffic that KCSR does not even serve, and that apparently could be routed over non-TFM gateways at El Paso, Nogales or Calexico, is not explained. The UP/TFM routing for IMC provides TFM with revenue, revenue that KCS could not replace and which KCS depends upon to provide an earnings stream from TFM in order to recoup KCS’s investment. KCS has no incentive to stop this traffic.

UP's President Davidson, in an April 24, 2003 call with industry analysts,¹⁸ laid out another problem that KCS would have in acquiring such traffic:

As you well know, from a route standpoint, if you look north of the border, Union Pacific route is, pick any point you want to- Chicago or Kansas City – as origin or destination, we've got about a 40 or 50 percent natural route advantage in terms of mileage, curvature, rise and fall and all the other physical characteristics, plus it's [the UP] a lot better railroad.

In addition, an argument made by UP witnesses implies that the foreclosure strategy would be even more costly. In several places (*i.e.*, V.S. Gray, Table 1) UP briefs and witnesses incorrectly assume, counter to the principles of the “one lump” theory, that divisions between vertically related carriers are fixed. If that is indeed the case, KCS would lose even more traffic.

Under the Hausman strategy, KCS would have to interline a large majority of its potential Laredo gateway traffic with other carriers. Again referring to R.V.S. Mutén, Attachment B, KCS could only serve the origin on 8 percent of Laredo Southbound traffic, and could only serve the destination on 1.4 percent of Laredo Northbound traffic. If NAFTA Rail raises the net rate on its portion of the move, as the Hausman theory indicates, and divisions are somehow fixed, the interline carriers will insist on a higher share of the net rate. Thus, on the traffic that remains, KCS would have to share part of the increased profits. But more damaging to the theory, the required increase in net rates would drive elastic shippers (likely the largest proportion, see the section below) off Laredo bound railroads. This would further reduce the NAFTA Rail profits from executing the Hausman strategy.

To summarize, executing the Hausman “merge and foreclose” strategy would undoubtedly be costly, especially when considering that the alternative is simply to charge the profit-maximizing single price on the TFM. Recall that, according to Professor Hausman's

¹⁸ Supplement to Application of KCS, June 23, 2003, at 23.

theory, the TFM is currently earning supra-competitive profits on Laredo routings. Professor Hausman's theory would call for a substantial reduction in TFM traffic, with a resulting decrease in TFM profits.

2. Who are the inelastic demanders?

The second prong of the profitability of Hausman strategy is the ability of NAFTA Rail to increase its rates to the remaining "inelastic" shippers. In this context, "inelastic shippers" are shippers who would not switch to other modes of transportation or routes and destinations were their rates to/from Mexico through Laredo to increase. Professor Hausman's analysis would be far more credible if he would have attempted to define exactly which shippers he believed were inelastic.

It would appear, however, that such shippers would seem to be in short supply. In general, shippers can be viewed as inelastic if they do not have competitive alternatives to switch to if their rail rates increase. Obvious shipments that are not inelastic are intermodal shipments, as they can easily stay on trucks rather than switching to railroads.

Three of the major categories of shipments to/from Mexico are agricultural products (largely grains), auto parts, and a category deemed "intermodal."

" These three categories together therefore constituted almost percent of UP's Mexico traffic. A UP document of the same date, entitled "

It would appear that the demand for rail shipments for each of these three categories is not inelastic. For “intermodal” shipments, they are by definition elastic and subject to competitive pressures.

With respect to agricultural products, UP witness Gray asserts (implicitly, V.S. Gray at 35) that the demand for grain shipments to Mexico is inelastic. However, Davies (R.V.S. Davies at 17)

Almost all of the “grain” going to Mexico is corn. The Ohio and Mississippi river systems serve the primary corn growing states, including Ohio, Indiana, Illinois, Iowa, Minnesota, and Missouri. The vast majority of corn that is grown in the U.S. grows in these states. That corn easily flows by barge to the Gulf, where it is loaded into ships, is then shipped to Mexico, and then either is railed or trucked to interior Mexico locations. [footnote omitted] Mr. Gray’s statement either ignores these facts as set forth by both my earlier statement in the Supplement [footnote omitted] and by the USDA, or is intended to mean that from the Mexican ports to San Luis Potsoi and Querétaro, rail is the only option. If the latter, KCS control of TFM will do nothing to change or impact those moves from the ports to interior points within Mexico.

Similarly in the Verified Statement of Peter Rickershauer (“V.S. Rickershauer”), Vice President for Network Development for BNSF, he states, “Because it is such a widely available commodity, grain traffic is particularly sensitive to even small changes in shipping price and delivered cost.” (V.S. Rickershauer at 19) Mr. Davies also notes:

Similarly, wheat to Mexico primarily comes from Canada and flows by rail to Canadian ports, is shipped to Mexico, and then is railed or trucked to interior Mexican points. KCS control of TFM will not impact these flows.

(R.V.S. Davies at 17.)

The third important commodity is auto parts. As Mr. Davies explains:

While automobiles and auto parts represent a very substantial percentage of the U.S./Mexico trade, trucks, not rail, dominate this market with about 60% of southbound shipments (1.1 million tons by truck v. 740,000 tons by rail). With an intermodal ramp, it is relatively easy to ship to the border by train and then take

the parts into Mexico by truck. The same is true with the reverse routing of auto parts or finished automobiles

(R.V.S. Davies at 17.)

Thus, the available evidence in this proceeding indicates there are very few “inelastic” shippers, the term used by Professor Hausman to describe shippers for whom rates could be raised as part of the NAFTA Rail vertical foreclosure strategy. Without the presence of these shippers captive to rail service, the Hausman strategy would not be profitable for KCS to undertake.

3. Professor Hausman assumes increased NAFTA Rail profits will not be shared with interline partners.

All of NAFTA Rail’s lost profits from the Hausman strategy due to traffic reductions on the TFM would accrue solely to NAFTA Rail. It is likely, however, contrary to Professor Hausman’s implicit assumption, that some or a large part of the increased profits through vertical foreclosure would flow to NAFTA Rail’s interline partners.

As discussed above, and implied by the presentation in the Rebuttal Verified Statement of Bengt Mutén, a very large part of KCS’s shipments to/from Laredo are interlined with other carriers in the U.S. In each interline shipment the interline carrier negotiates with the KCS for a share of the net profits on the route. If the net profits on the route rise (as implied by the Hausman strategy), the interline carriers can be expected to increase their total amount of profit on the route, assuming that the interline carriers do not have zero bargaining power with respect to the KCS.

A simple example may make this point clearer. Assume, for example, a CN-KCS-TFM joint shipment from Toronto to Monterrey through Laredo. Also assume that the shipper is willing to pay \$180.

Currently, due to competition with UP and its interline partners, the CN-KCS-TFM joint rate is \$160. This revenue is split \$80 for the CN, \$40 for the KCS and \$40 for the TFM, and each carrier makes a positive profit on the move.

Now, assume that UP is foreclosed along the lines of the Hausman strategy. NAFTA Rail is able to increase the total shipment costs to \$180. If NAFTA Rail has all the bargaining power in its relationship with the CN, it will keep the additional \$20, perhaps allocating \$80 to TFM and \$20 to KCS.

The assumption of the KCS possessing all of the relevant bargaining power, however, is unlikely to be true. Given that it has some bargaining power, CN will negotiate to take part or a majority of the \$20 increase. Thus, NAFTA Rail will be forced to share a part of its hypothesized increased profits with its interline partners. Those partners, however, will not share in the losses forced upon NAFTA Rail were it to undertake the Hausman strategy. Thus, this “bargaining effect” with interline carriers would serve to reduce any profits that might accrue to NAFTA Rail were it to execute Professor Hausman’s strategy.

B. The Hausman theory assumes KCS can expand its output on UP trackage rights from Beaumont to Placedo to Robstown to meet the increased demand on trains no longer routed down UP’s mainline from San Antonio to Laredo.

Currently, the KCS’s share at Laredo-north is extremely small. According to UP document UP-H-1394 of

. (Similarly, the Verified Statement of Curtis Grimm, submitted with the Application on May 14, 2003 at 85, estimates that UP controls 91 percent of southbound traffic though Laredo, and 79 percent of northbound traffic.) Assuming that the KCS could increase its shipments to 75 percent of current Laredo shipments would imply a **535 percent increase** in KCS’ traffic.

All of this traffic, however, must go through UP's lines. In particular, it must go through the UP tracks on the route Placedo to Robstown, which is part of UP's Brownsville subdivision. On this route must travel all of KCS's traffic to Laredo from Beaumont, BNSF's traffic to Laredo from Houston, BNSF's traffic to Brownsville from Houston, and UP's traffic from San Antonio and Houston to Brownsville. The result has been serious schedule delays and a lack of available capacity. The evidence indicates that this track is not equipped to deal with the traffic it has, let alone a large increase in that traffic.

Currently, it appears that Tex Mex is running about 3 to 4 trains a day each way, with serious delays, through this bottleneck. One example of the delays are incidents of "crews on the law." These events occur when the crew on a train has run out of time (12 hours) on their shift. By law, the relevant train must stop until a new crew has arrived. The Tex-Mex reports that during October of 2002 they had 29 "trains on the law," while in November they had 25 "trains on the law." This is a significant number, when one recalls that the KCS-TM are only running 6 to 8 trains (both ways together) through UP lines. "UP congestion" is given as the reason for about 85 percent of the need to change train crews. (KCS-P-0050 through 0057).

The Verified Statement of James Riney submitted with the Application on May 14, 2003 at 135 indicates that the Placedo-Robstown line has a capacity of 11 to 13 trains each way per day, but that between 19 and 22 trains per day currently use the track. In the Rebuttal Verified Statement of James Riney ("R.V.S. Riney"), he notes that this position has not been "seriously challenged" by the UP. (R.V.S. Riney at 9.) Indeed, as Mr. Riney later points out studies by both UP and Tex-Mex have come to the same conclusion, "there is substantial congestion on the Brownsville Sub[division] that is causing delays in service and increased crew costs." (*Id.* at 10.)

Professor Hausman's theory would posit a huge increase in KCS traffic through Placedo-Robstown. As these delay figures attest, this would be an increase that is nowhere near feasible.

This problem can be expected to worsen over time, if KCS truly carried out the theory that Professor Hausman outlines. According to UP documents [UP-H-1394, August 14, 2002] demand for use of the Laredo gateway has been growing at a rate of 12.4 percent per year. UP's President Davidson has stated "[w]e are expecting double-digit growth rates in years ahead as we introduce new services that will win business from trucks."¹⁹ This would put even more strain on the Placedo-Robstown bottleneck if KCS were to adopt Professor Hausman's strategy.²⁰

C. The Hausman model defines the public interest in terms of shippers only.

Another difficulty with Professor Hausman's analysis is how he defines the "public interest." It is clear that Hausman's conclusion that shippers will be harmed by the transaction is false. However, even accepting Hausman's conclusion that the perfect price discrimination scheme results in higher prices for some consumers, in his model net economic efficiency (consumer plus producer surplus) is still maximized.²¹ Of course, maximizing economic efficiency is the standard economic objective for public policy.

¹⁹ Richard Davidson, 2003 Railtec Conference, Guadalajara, Mexico, January 20, 2003. <http://www.uprr.com/newsinfo/speeches/2003/railtec.shtml>. Mr. Davidson's statement implies that the marginal shipments in the Mexico market come from trucks, which therefore represent elastic demand with respect to the price of rail services.

²⁰ I note that the Tex-Mex has acquired from the UP the rights to former SP line between Victoria and Rosenberg, in order to reduce circuitry north of Placedo. It is not clear, however, if the Tex-Mex will be able to run trains on that line. Even if the Tex-Mex is able to reestablish this line, however, it will not eliminate the need to run trains on the Placedo-Robstown UP bottleneck.

²¹ See the discussion along these lines in the Appendix.

Thus, Professor Hausman must substitute another standard besides net efficiency to support his economic arguments. Therefore, according to Professor Hausman (V.S. Hausman at 4.),

[T]he DOJ and FTC have determined that consumer welfare should be the objective in evaluating transactions. [Professor Hausman then cites in his footnote 2 to the agencies' *Merger Guidelines*.] I agree with this approach. Consumers are harmed when prices increase or product quality decreases. Thus, while a transaction may lead to more efficient and lower cost product, the relevant question is whether consumers will benefit from lower prices.

Thus, Professor Hausman would have the STB in its proceedings give no weight to the economic benefits accorded railroads through a transaction. Professor Hausman contends the STB should be solely focused on the welfare of consumers.

There are a number of problems with Professor Hausman's statement on the goals of this proceeding as reflected in the antitrust laws. First, as prosecutors, the DOJ and the FTC do not determine the goal of antitrust law. Unlike the STB, the DOJ and the FTC are not administrative agencies. They are merely in the position of proposing how to interpret these laws. It is the Supreme Court that makes the final determination.²² Indeed, as discussed below, Professor Hausman believes the Supreme Court has taken a different position on this question.

Second, Professor Hausman has stated previously that it is unclear that the agency *Merger Guidelines* are truly solely interested in the welfare of consumers. Professor Hausman, in the law review article that he cites in his statement (V.S. at 4) discusses the difficulties with the interpretation that only the welfare of consumers matters for antitrust.²³

A gain in productive efficiency increases the amount of output the economy can produce. Indeed, deviations from productive efficiency cause a "first order" welfare loss to the economy while deviations from allocative efficiency caused by

²² See Kleit, "Common Law, Statute Law, and the Theory of Legislative Choice: An Inquiry into the Origins of the Goal of the Sherman Act," 31 *Economic Inquiry* (1993) 647, 660.

²³ Jerry A. Hausman, and Gregory K. Leonard, "Efficiencies from the Consumer Viewpoint" 7 *Geo. Mason L. Rev.* 707 (1999), 713-714.

monopoly cause "second order" welfare losses to the economy, which are typically smaller welfare losses. [footnote omitted] This observation forms the basis for Professor Oliver Williamson's classic article discussing the tradeoff between productive and allocative efficiency in antitrust. [footnote omitted]

The MG [*Merger Guidelines*] never directly address this basic economic point. Presumably, an objection to recognition of the overall gain in economic efficiency created by a transactional efficiency arising from a merger is based on distribution considerations. That is, if the price increases to consumers while the stockholders of the firm receive most of the gains of increased efficiency through increased profits, social welfare may well decrease depending on the relative weights used for consumer welfare and for firms' profits. [footnote omitted] We would expect the antitrust agencies to exercise discretion here since a very small increase in price could be outweighed by a large increase in productive efficiency. Section 4 of the MG seems to recognize the scope of such discretion, and the agencies often weigh expected efficiencies in their decisions.

Thus, Professor Hausman notes difficulties with the welfare of consumer standard, and states that the *Merger Guidelines* "never directly address this basic economic point." This is in contradiction with his assertion about the *Merger Guidelines* discussed above.

Second, Professor Hausman, contrary to his own writings on this issue, misdefines the objective function he lays out. It is not "consumer welfare." It is "consumer surplus." According to Carlton and Perloff,²⁴ "Consumer surplus is the amount above the price paid that a consumer would willingly spend, if necessary, to consume the units purchased."

One might think that such a small difference in economic jargon would make little difference in this matter. But this would be incorrect. It can be seen that without this "misdefinition" of consumer welfare, Professor Hausman's theory would not imply an anticompetitive transaction. As discussed in the Appendix, were Professor Hausman's strategy to be undertaken, it would reduce the welfare of consumers, but increase the net surplus to society. Thus, only under a consumer surplus standard would Hausman's theory imply anticompetitive behavior.

²⁴ Carlton and Perloff, *supra* at 71.

Indeed, Professor Hausman has already advocated that a proper total efficiency standard is relevant in antitrust and regulatory proceedings. According Professor Hausman and Gregory Sidak, in their review of telecommunications regulation:²⁵

We will use the phrase "the public interest" more precisely and restrictively than do the Communications Act, the FCC, and the state public utility commissions. It will connote economic efficiency, or the maximization of the general welfare of consumers and producers - that is, the maximization of the sum of consumers' surplus and producers' surplus. Often this criterion is referred to in the abbreviated form "consumer welfare maximization." [footnote omitted]

The primacy that economists ascribe to economic efficiency and to the maximization of consumer welfare has a related benefit: It harmonizes economic regulation and antitrust law. For in the latter, the Supreme Court [citing *NCAA v. Board of Regents*, 468 U.S. 85, 107 (1984); *Reiter v. Sonotone Corp.*, 442 U.S. 330, 343 (1979)] has contributed a muscular jurisprudence asserting that the first goal of the Sherman Act and other federal antitrust statutes is to be a "consumer welfare prescription."

Note two important points from these paragraphs. First, Professor Hausman defines "consumer welfare" as the sum of consumers' and producers' surplus, or net economic efficiency. Second, Professor Hausman asserts that the Supreme Court has accepted that maximization of this combination is the "first goal" of the antitrust laws. His statement in this proceeding, asserting a different definition of consumer welfare and asserting that the antitrust agencies had adopted that definition as the relevant standard, explicitly contradicts the first point, and implicitly contradicts the second.

Thus, Professor Hausman's theory can only be justified as a reason to stop this transaction if consumer surplus', rather than consumer welfare, is the goal of the STB. Such a standard would contradict Professor Hausman's own writings on this issue. Instead, if the STB is also interested in the welfare of railroads (by adopting a true "consumer welfare" standard or

²⁵ Jerry A. Hausman and J. Gregory Sidak "A Consumer-Welfare Approach to the Mandatory Unbundling of Telecommunications Networks" 109 Yale Law Journal, December, 1999, 417, 451

some variant thereof) it should reject Professor Hausman's theory, even without considering whether or not it properly explains the economic effects of the transaction at hand.

Professor Hausman's theory is also flawed because he assumes that the STB has the same mandate as the antitrust agencies. As I understand the relevant law, this is incorrect. As the STB is undoubtedly well aware, "Congress has directed the Board to allow rail carriers to earn "adequate" revenues and to maintain standards and procedures for measuring such revenue levels. 49 U.S.C. 10101(3), 10704(a)(2)."²⁶ There is no such similar mandate for the antitrust agencies. Thus, even if the antitrust laws are unconcerned with producer effects, that does not imply that the STB is not concerned with such effects.

D. Conclusion -- Professor Hausman's Theory Should Be Rejected.

Professor Hausman's theory is remarkable for the number of faulty assumptions and conclusions that it makes. It assumes that the TFM cannot currently engage in any type of price discrimination, contrary to the statements of the UP's own witnesses. It assumes that the TFM, the Tex-Mex, and the KCS are all independent from each other, when the KCS has a large ownership stake in both the Tex-Mex and the TFM, while the TFM has its own ownership stake in the Tex-Mex. It abstracts from the large amount of profitable traffic the TFM would lose were the KCS to adopt this strategy. It assumes that the UP could not retaliate against the KCS were it to undertake this strategy, while all of the relevant KCS traffic would be flowing on UP lines. It assumes, without evidence, that there is a substantial population of "inelastic shippers," ignoring the evidence that most shippers on U.S./Mexico routes have elastic demands. It assumes that KCS would not have to share part of its increased profits on particular routes with

²⁶ Cited from STB Ex Parte No. 575, *Review of Rail Access and Competition Issues*, April 16, 1998.

its interline partners. It assumes that KCS can divert a large amount of traffic through the Placedo-Robstown bottleneck when that corridor is already heavily congested. It assumes that the STB should adopt the alleged antitrust standard of the welfare of consumers, in contrast to Professor Hausman's own writings on this issue. Finally, it assumes that the STB has the same mandate as the antitrust laws, when the STB has a particular mandate from Congress to be concerned about the welfare of producers. Needless to say, I do not believe that Professor Hausman has presented any reason for the STB to stop this transaction, or to place competitive conditions upon it.

V. COMMENTS BY BNSF AND CN PROVIDE NO RATIONALE FOR CONDITIONING THIS TRANSACTION.

In this section I will address comments made on behalf of the BNSF and the CN. As I stated previously, the standard theory of end-to-end mergers rebuts both BNSF's claim that its efficient interline routing will be foreclosed, and CN's argument that the consolidation is motivated by an anticompetitive extension of TFM's alleged market power in Mexico. This section will elaborate on these points.

A. Comments of BNSF.

In a brief and two supporting statements the BNSF asserts that it would be appropriate for the STB to freeze BNSF-Tex-Mex-TFM interline rates for a period of five year. BNSF presents no analysis for why this transaction would create a competitive problem. In particular, BNSF does not explain why the "one lump" theory does not apply here. BNSF simply asserts that it would be highly inefficient were the KCS to engage in anticompetitive foreclosure. But, by showing how much it would cost to engage in such foreclosure, BNSF simply shows the

economic rationale why the KCS would not foreclose the BNSF, and therefore why the one lump” theory holds in this matter.²⁷

Thus, BNSF’s brief discusses “forced diversions” over KCS by simply assuming that they will happen, rather than putting forward any logical reason why the Board’s “one lump theory” does not apply. The BNSF brief does have the virtue of following its own analysis out to its logical end, stating (at 14) “The delays imposed by forced diversions to KCS’ lines would likely makes KCS’ service uncompetitive for much traffic going to Mexico, particularly grain, motor vehicle and auto parts, which collectively account of almost half of BNSF’s traffic.”

BNSF’s statement can be seen as the basic rationale behind the “one lump theory.” KCS would have the physical ability to force the divisions the BNSF is referring to. But then KCS would lose a great deal of money on lost shipments through the TFM. Further, on much of the shipments it retained, shippers would be willing to pay less, or KCS would have far greater costs than BNSF. Far better in these circumstances to take the one “lump” available by charging for services on the TFM, and allowing access to BNSF in an efficient manner.

Dr. David Reishus provides an economic analysis for BNSF that might appear to argue that a five year freeze on rates is necessary. A closer look at his statement, however, reveals that it provides no such argument.

The Verified Statement of Dr. David Reishus (“V.S. Reishus”) for BNSF provides a four paragraph summary of his position. (V.S. Reishus at 2-3.) (The statement has no concluding section.) A summary of each paragraph is as follows:

²⁷ The BNSF position is somewhat ironic in arguing that BNSF would be foreclosed by NAFTA Rail, as it stands in sharp contrast to UP’s position that UP would be foreclosed as a result of this transaction in favor of BNSF. Of course, both theories cannot be correct.

Paragraph One: Laredo is an important rail gateway to Mexico. As part of the UP/SP merger proceedings, BNSF received trackage rights to Laredo.²⁸

Paragraph Two: A BNSF-Tex-Mex-TFM routing through Laredo and Brownsville competitively disciplines the rates that shippers obtain through Laredo from the UP.

Paragraph Three: Requiring a rate freeze for five years would preserve U.S. shipper interests at Laredo and Brownsville.

Paragraph Four (quoting directly): “Imposition of such an open gateway protection is a reasonable and prudent regulatory safety net against a lessening of competition if the market does not act to provide for efficient outcomes for shippers.”

Note what is missing from Dr. Reishus’ statement. He provides absolutely no reason to believe that this transaction would generate any type of anticompetitive behavior. Instead, he simply assumes a problem, and asserts he has a solution. This is obviously not a basis for STB action.

In summary, the witnesses for BNSF provide no reason to believe that the “one lump” theory does not apply to this transaction. Thus, they have not identified a competitive issue that pertains to this matter. Therefore, there is no reason for the STB to adopt their proposed solution, as it is a solution to a problem they have not asserted would exist.

B. Comments of Dr. Velturo for CN.

Writing for CN, Dr. Christopher Velturo contends that

1. Merger payments often have premiums attached to them;
2. Because TFM is not publicly traded, one cannot determine if there is any merger premium in KCS’ acquisition of TFM. But, given point (1) above, a premium is likely.

²⁸ As I understand the matter, the last sentence is not quite factually correct. UP and BNSF negotiated the relevant traffic rights prior to the submission of the merger to the ICC.

3. Merger premiums are the result of either a) lower costs because of the merger; b) expanded output because of the merger; or c) anticompetitive behavior.

4. Because KCS has not claimed any efficiencies because of this merger, it can be assumed points a) and b) above do not apply. Therefore, one can infer that KCS' desire to purchase TFM is motivated by point 3-c), the potential for anticompetitive behavior.

Note what Dr. Vellturo does not contend. He does not contend that the KCS is paying an anticompetitive premium for TFM. He does not contend that any part of the transaction is anticompetitive. He is merely putting forward an unsupported hypothesis.

There are two important flaws in Dr. Vellturo's analysis. The first is the presumption that KCS paid a premium for TFM. Merely because most merger purchase include control premium does not imply that all mergers include such premiums. The second flaw in Dr. Vellturo's analysis is that he does not properly summarize the incentives for mergers. In their textbook on antitrust and regulation, Professors Kaserman and Mayo²⁹ lay out the three basic rationales for merger:

1. To create market power and therefore engage in anticompetitive behavior;
2. To improve operating efficiency;
3. To improve firm management.

Carlton and Perloff³⁰ summarize the economic literature in this area as follows:

Overall, total shareholder value of the combined [merging] companies rises about 7.5 percent after the transaction. The increased value of the transaction is not typically due to the creation of market power.

²⁹ Kaserman and Mayo, *Government and Business: The Economics of Antitrust and Regulation* (1995) 217.

³⁰ Carlton and Perloff, *supra* at 27.

Thus, in general, mergers create increased stock value, but this increase is not generally due to the anticipation of increased anticompetitive behavior.

As my discussion above, and the statement above from Professors Carlton and Perloff indicates, there is no reason to believe this transaction is motivated by a potential for anticompetitive behavior. My understanding is that KCS has not previously presented any specific studies analyzing how this merger would create efficiencies in the interconnection between the TFM, the Tex-Mex, and KCS, although KCS management has asserted as much.

That leaves point number three above, to improve management. I have not examined directly the management improvements KCS plans to attempt. But a large number of mergers, and any resulting merger premiums, are motivated the potential for improved management. In particular, I find it intuitive that KCS would believe it could run the TFM more efficiently. As I have indicated in a published article,³¹ railroad firms do not find out immediately how to compete in a deregulated environment. It takes time to learn the most efficient management practices. Given this, it is not improbable that KCS, with its much longer experience with railroad deregulation, would believe it can do a better job of running a railroad that has only been deregulated for seven years.

VI. THIS DEBATE MAY BE ABOUT DIVISIONS AND "PROFIT STEALING".

An examination of UP's arguments and remedies makes it clear that UP is focused on the division in the rates between UP and TFM/KCS on traffic across Laredo. One simple method of capturing more divisions for the UP from the TFM would be for the STB to impose *pro rata* divisions on joint rates through Laredo, as UP has proposed. Under this proposal, each railroad

³¹ Barnkeov and Kleit, "The Efficiency Effects of Railroad Deregulation in the United States," International Journal of Transport Economics, 17:1 (February 1990) 21-36.

in a joint rate through Laredo would receive a share of the rate equal to its mileage share on the shipment.

This proposal may make the impression that it is somehow “equitable” or “fair”. Such an impression would be incorrect. Rather such a *pro rata* sharing would generate what I call “profit stealing” for UP. The following example may make this issue clear.

Assume a joint routing on the TFM to Laredo and then onto UP. Also assume that the TFM has less competition for its part of the route than UP has for its part of the route. In the examples I present below, a relevant shipment will cost \$50 to ship for each 100 miles of its journey. TFM is able to collect \$100 per 100 miles, while the UP is only able to collect \$60 per 100 miles.

Table 2 considers the impact of *pro rata* division sharing when both the TFM and the UP have 100 miles of the shipment.

Table 2
The Impact of Pro Rata Divisions on TFM/UP Profits
100 Mile Shipment on Each Railroad
Total Shipper Rate: \$160

(a.) Initial Rate Structure						
	TFM Miles:	100		UP Miles:	100	
TFM Cost	TFM Rate	TFM Profits		UP Cost	UP Rate	UP Profits
\$50	\$100	\$50		\$50	\$60	\$10
Pro rata Rate Sharing						
	TFM Miles:	100		UP Miles:	100	
	TFM Mileage Share:	0.5		UP Mileage Share:	0.5	
TFM Cost	TFM Rate	TFM Profits		UP Cost	UP Rate	UP Profits
\$50	\$80	\$30		\$50	\$80	\$30
Change in TFM Profits		-\$20		Change in UP Profits		\$20
Increase in UP profits by “stealing profits” from TFM:						\$20

Given the formula stated above, the rate to the shipper of this entire movement is \$160.

The pre-*pro rata* division order is represented in the top part of the table. The TFM is able to

charge \$100 for a shipment that costs it \$50, for a TFM profit of \$50. The UP charges \$60, with a cost of \$50, for a profit of \$10.

The bottom part of the table outlines what occurs with *pro rata* sharing. Since each firm has a 100 mile shipment, each gets one-half of the \$160 fee for the total shipment, or \$80. This results in an allocation of \$20 from the TFM to the UP. Thus, imposed *pro rata* divisions between railroads with differing competitive situations can serve to take money away from the railroad which faces fewer competitive constraints, here the TFM.

This “profit stealing” effect increases the longer the UP’s part of the relevant shipment. Table 3 lays out the effect for when the UP has a shipment length of 400 miles. Here the total cost to the shipper is \$340, calculated as outlined above. Before pro rata sharing, the TFM has a profit of \$50, the UP \$40. After *pro rata* sharing (where TFM would only get 20 percent of the revenues) UP profits would increase \$32, all taken from the pocket of the TFM. Thus, increasing the mileage of the shipment on the UP increases the “profit stealing” effect, here raising it from \$20 to \$32.

Table 3
The Impact of Pro Rata Divisions on TFM/UP Profits
100 Mile Shipment on TFM, 400 Mile on UP
Total Shipper Rate: \$340

(b.) Initial Rate Structure						
	TFM Miles:	100		UP Miles:	100	
TFM Cost	TFM Rate	TFM Profits		UP Cost	UP Rate	UP Profits
\$50	\$100	\$50		\$200	\$240	\$40
Pro rata Rate Sharing						
	TFM Miles:	100		UP Miles:	400	
	TFM Mileage Share:	0.2		UP Mileage Share:	0.8	
TFM Cost	TFM Rate	TFM Profits		UP Cost	UP Rate	UP Profits
\$50	\$68	\$18		\$200	\$272	\$72
Change in TFM Profits		-\$32		Change in UP Profits		\$32
Increase in UP profits by “stealing profits” from TFM:						\$32

Tables 2 and 3 illustrate that *pro rata* divisions can be used for one railroad to “steal” profits from another. The STB should not be confused that somehow such divisions are competitively neutral or “fair.”

In addition, BNSF has contended that this transaction should be conditioned upon a rate freeze for five years, though BNSF does not bother to explain what problems such a freeze would solve. In any event, this proposal can be seen as an attempt to capture from NAFTA Rail some of the investment in service that KCS and the TFM have undergone over the past several years. (R.V.S. Davies at 39.) The Board has long held the view that revenue divisions amongst interlining railroads are best settled by market forces and private agreements, not by regulatory fiat. The STB should maintain that policy with regard to divisions on Laredo traffic.

VII. CONCLUSION

As the STB has stated before many times over a period of more than two decades, there is only one monopoly profit available in a vertical relationship. Thus, a vertical merger between railroads does not change the “one-lump” available for railroad profit, and therefore does not pose any threat to competition. Furthermore, there is no basis for the contention that UP’s and BNSF’s efficient interline routings will be foreclosed.

Professor Hausman’s more complex theory does not apply with respect to this transaction for a large number of reasons. In addition, Dr. Reishus does not make any relevant arguments to contradict this theory. Finally, Dr. Velturo’s assertion that the KCS’s acquisition price for the TFM includes a payment for increased anticompetitive behavior is clearly unsupported. Thus, there has been no argument made that implies that this transaction poses any anticompetitive threat.

In addition, I would ask the STB to consider that UP's position in this matter is not a result of its fear of anticompetitive foreclosure. Rather, it may be the result of UP's perceiving a chance to engage in "profit stealing" to capture some of TFM's profits through the use of equal divisions of through rates. BNSF, through its desire to freeze divisions for a period of five years, may well have a similar desire.

There is powerful evidence that this transaction will have no adverse effect on competition. The Board should therefore allow this transaction to proceed without conditions.

APPENDIX:
Further Analysis of Professor Hausman's Theory

In more formal terms, the Hausman theory can be summarized as follows: with the merger, KCS will increase the price of shipping on the TFM on Laredo-south routes to a very high level. This price, plus the cost of shipping to markets on UP lines, will just equal the reservation price of the least "elastic" customer whose product goes through the Laredo gateway.

KCS will then set the price of KCS (here, from the north, KCS to KCS's trackage rights on the UP via Beaumont, Placedo, and Robstown, to the Tex-Mex) part of the route, such that the TFM price plus the KCS price just equals the relevant shippers "reservation price" of shipping through Laredo. Thus, "inelastic" customers would receive high prices on the KCS, and "elastic" customers would receive low prices. All traffic north of Laredo will be shifted off UP to KCS.

Professor Hausman appears to envision "perfect" or first degree price discrimination, rather than third degree price discrimination. In first degree price discrimination, each customer is charged its reservation price. This type of discrimination actually increases net welfare above what would occur were TFM to continue to charge the monopoly "one price." The reason is that KCS would be able to fit a rate to every customer whose reservation price of shipping was greater than the costs of that shipment. Thus, unlike what would occur were TFM to continue charging its monopoly price, every shipment whose value to the shipper was greater than the costs of shipment would be undertaken. This is precisely what occurs in a competitive market.

As Carlton and Perloff explain: "There is no ambiguity about the welfare effects of perfect price discrimination. Output is at the efficient competitive level, but consumers are poorer than they are under competition; therefore perfect price discrimination does not distort

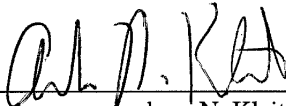
efficiency, but does affect the distribution of income.”³² Since the other possibility is supra-competitive pricing by the TFM, were the KCS to adopt Professor Hausman’s strategy it would actually increase net efficiency in the economy.

Since shippers are harmed, however, Professor Hausman, following his interpretation of the DOJ *Merger Guidelines*, says this is sufficient to deem the transaction anticompetitive. According to Professor Hausman, the benefits railroads receive from the transaction should not weigh in the STB’s calculations. That is simply an incorrect impression of the statute which, if anticompetitive effects to shippers are discovered, allows the STB is to balance such effects against the public interest and still approve the transaction despite the existence of harms to shippers.

³² Carlton and Perloff, *Modern Industrial Organization* (3rd edition, 2000) at 289. I make a similar argument in Kleit, *Logistics and Transportation Review*, *supra*, at 233-4. Under 3rd degree discrimination, where different classes of consumers get different prices, producer welfare rises, consumer welfare falls. The net welfare effects with respect to the monopolist charging one price are ambiguous.

VERIFICATION

I, Andrew N. Kleit, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.



Andrew N. Kleit

STATE OF Pennsylvania)
COUNTY OF Centre) ss.

Subscribed and sworn to before me
this 28th day of August 2003.



Notary Public

My commission expires: 11-10-03

Notarial Seal Ronald E. Flebotte, Notary Public State College Boro, Centre County My Commission Expires Nov. 10, 2003
--

ANDREW N. KLEIT

June 2003

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Ph.D in Economics, 1987, M.Phil., 1987, M.A. 1983. Fields of Study: Industrial Organization and Public Finance. Dissertation: "The Economics of Automobile Fuel Economy Standards."

Middlebury College, Middlebury VT.

B.A. *cum laude* in Mathematics and Political Science, 1982. Mathematics thesis: "The Core of an N-Person Game."

PROFESSIONAL EXPERIENCE:

Professor of Energy and Environmental Economics July 2002-Present, Associate Professor of Energy and Environmental Economics, July 1998 to June 2002, Research Associate, the Center for Health Care Policy Research, Professor-In-Charge, Global Business Studies (GBS) Program, The Pennsylvania State University, University Park, PA.

Teaching classes in energy and mineral economics, and benefit-cost analysis, engaging in research on energy, health care, and antitrust issues. Adminstrating the College of Earth and Mineral Sciences GBS minor, which involves recruiting students, designing curriculum, bringing guest speakers to class, and assisting fundraising among university alumni.

Associate Professor of Economics, Ourso School of Business Administration, Louisiana State University, Baton Rouge, LA, August 1994 - June 1998, Assistant Professor, August 1992 - July 1994.

Taught classes in introductory (honors), intermediate, and graduate microeconomics, undergraduate and graduate industrial organization, and undergraduate environmental economics. Received Departmental Award for Excellence in Undergraduate Teaching, 1996.

Senior Economic Adviser to the Director for Investigation and Research, Consumer and Corporate Affairs Canada, Ottawa/Hull, Canada, September 1991 - August 1992.

Assigned to review all significant antitrust and regulatory matters for the chief antitrust law enforcement officer of the Canadian government. Analyzed merger and monopolization cases, as well as reviewed competition policy issues in interagency settings.

Economic Advisor to the Director, Bureau of Competition, Federal Trade Commission, Washington D.C. November 1989 - January 1991.

Reviewed all significant antitrust matters and advised the FTC's chief antitrust attorney. Analyzed mergers, horizontal restraints cases, comments to other agencies, and additional competition matters. Served on the Administration Staff Working Group on Automobile Fuel Economy, 1990.

Economist, Division of Economic Policy Analysis, Bureau of Economics, Federal Trade Commission, Washington, D.C. September 1987 - August 1991.

Conducted research on railroad, trucking and airline regulation. Prepared Bureau comments to the National Highway Traffic Safety Administration on automobile fuel economy standards, to the Environmental Protection Agency on marketable permits for pollution abatement, and to state agencies on trucking regulation. Served as staff antitrust economist on major food industry merger. Prepared to testify as antitrust expert witness in major chemical industry merger case. Served as staff economist on consumer protection case. Member, Secretary of Transportation's Task Force on Competition in the U.S. Domestic Airline Industry, 1989-90. Reviewed and critiqued drafts of the Secretary's Airline Competition Report.

Junior Staff Economist, Council of Economic Advisers, Executive Office of the President, Washington, D.C., July 1984-July 1985.

Responsible for monitoring transportation and regulation issues. Wrote comments to the Civil Aeronautics Board on allocating landing rights at capacity-constrained airports. Edited chapters in the Economic Report of the President on contests for corporate control and health care. Devised the pricing plan for the space shuttle cargo bay that was adopted by the Administration.

Lecturer and Teaching Fellow in Economics, Yale University, 1983-84, 1985-87.

Taught undergraduate seminar on topics in Industrial Organization. Assisted in a graduate course in microeconomics, an undergraduate seminar in macroeconomics, and intermediate level courses in industrial organization and regulation.

PUBLISHED ARTICLES IN REFEREED JOURNALS:

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"How to Streamline Antitrust," Wall Street Journal, March 4, 1997.

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Journal of Consumer Research 1999-Present

Journal of Regulatory Economics 1999-Present

Energy Studies Review, 2001 to Present

REFEREE:

Advances in Econometrics

American Economic Review

Australian Economic Papers

Bulletin of Economic Research

Economic Inquiry

Energy Journal

Health Economics

Journal of Consumer Research

Journal of Economic Education

Journal of Environmental Economics and Management

Journal of Industrial Economics

Journal of Law and Economics

Journal of Transportation and Statistics

Journal of Regulatory Economics

Logistics and Transportation Review

Managerial and Decision Economics

Quarterly Review of Economics and Business

Research in Law and Economics

Research in Transportation Economics

National Science Foundation

RESEARCH GRANTS

Estimating the Settlement Process in Environmental Litigation: A Game-Theoretic Approach (Principal Investigator), National Science Foundation, Law and Social Science Program, \$60,000, September 2002 to August 2003.

“Advanced Telecommunications in Rural Pennsylvania (Co-Principal Investigator), Center for Rural Pennsylvania, \$49,000, January 2002-March 2003.

“The Economics of Electricity Metering,” Principal Investigator, Alberta Ministry of Energy, September 2001-December 2001, \$4000.

“The Impact of Automobile Fuel Economy Standards,” Principal Investigator, General Motors Corporation, June 2001-December 2001, \$12,400.

“Comparing Electricity Deregulation in California and Pennsylvania: Implications for the Appalachian Region,” (Co-Principal Investigator) Appalachian Regional Commission Number CO-12884, \$89,000, June 2000-May 2001

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“Extension of The Role of Technology in Health Care Costs,” Department of Energy, Sandia National Laboratories, Contract No AN6261. September 1997 to December 1999 (\$1 million). Varying Percentage Effort.

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“Cogeneration and Electric Power Industry Restructuring,” (Co-Principal Investigator with David Dismukes). Louisiana Energy Enhancement Program, 1996-97, \$22,401.

“The Role of Technology in Health Care Costs,” Department of Energy, Sandia National Laboratories, Contract No AN6261 May 1995 to April 1997 (\$1.2 million). Varying Percentage Effort.

OTHER ACTIVITIES:

Named as one of the top competition economists in the world by *Global Competition Review* (London) 1998, 2000, 2002.

Consultant for Pennsylvania Legislative Budget and Finance Committee on gasoline market report, July – October, 2000. Testified before the committee, October 2000.

Testified before Pennsylvania House of Representatives Consumer Committee on oil price increases, April 2000.

PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB F

REBUTTAL VERIFIED STATEMENT OF

GERALD K. DAVIES

REBUTTAL VERIFIED STATEMENT OF GERALD K. DAVIES

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REBUTTAL VERIFIED STATEMENT OF GERALD K. DAVIES

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY
AND
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

My name is Gerald K. Davies. I am the Executive Vice President & Chief Operating Officer of The Kansas City Southern Railway Company ("KCSR") and have served in this capacity since 1999. I have been intimately involved with the efforts of Kansas City Southern ("KCS"), our holding company, to create and develop NAFTA Rail, through its acquisition of control of The Texas Mexican Railway Company ("Tex Mex") and Grupo Transportacion Ferroviaria Mexicana, S.A de C.V. ("Grupo TFM"). I am well versed in the anticipated operational and competitive effects of the KCS/Tex Mex transaction as set forth in the Application and the competitive effects of the KCS/TFM transaction. In addition, my educational background includes a Ph.D. in transport economics. I provided a statement in KCS-10/TM-10, Supplement To Application, filed in response to Decision No. 2. The purpose of this statement is to address some of the issues raised in the August 4th Comments.

I have reviewed all of the comments filed August 4, 2003 (the "August 4th Comments" or the "Comments"), and I saw nothing in those Comments to shake my belief that the acquisition of control of Tex Mex by KCS not only will not have any adverse competitive effects on shippers, customers, or receivers in the U.S., but will make the NAFTA corridor more competitive and the combined KCSR/Tex Mex more efficient. These conclusions are even

stronger when one considers the implications of the TFM transaction on the KCS/Tex Mex transaction.

Unlike the claims made by Union Pacific Railroad Company ("UP") and The Burlington Northern and Santa Fe Railway Company ("BNSF"), the successful consummation of the TFM transaction, combined with the KCS/Tex Mex transaction, will not allow KCSR to raise prices to shippers or divert traffic away from UP/TFM routings or BNSF/Tex Mex/TFM routings to less efficient KCSR/Tex Mex/TFM routings. KCSR has no incentives to do so, and market forces would prevent KCSR from doing so even if it desired to try and foreclose UP and BNSF routings. For the bulk of Laredo gateway traffic, KCSR does not even serve the origins or destinations so as to have an incentive to foreclose UP or BNSF. If KCSR did attempt to foreclose these routings, TFM would lose a substantial amount of revenue, as this traffic would switch to other modes or other Mexican gateways. Additionally, most of this traffic is locked-up under long term contracts that would further preclude any re-routing.

Indeed, UP and BNSF have plenty of ways to protect themselves and to retaliate against NAFTA Rail if it tried to impose inefficient routes. Because of their size, their reach in the U.S. market, the number of U.S.-Mexico gateways they serve, and UP's significant ownership share in Ferromex – TFM's principal rail competitor in Mexico – BNSF and UP will have substantial leverage over NAFTA Rail. And they will use that leverage as much as they can to hamper NAFTA Rail's ability to compete. No one should forget that UP controls the trackage rights that connect KCSR and Tex Mex, an area where Tex Mex continues to suffer substantial operating difficulties because of UP's failure to meet commitments to build and maintain infrastructure that is adequate to maintain service quality.

In the end, UP and BNSF are not truly concerned about being foreclosed, but rather are concerned that in future division negotiations with TFM and Tex Mex, there may be a modest erosion in the substantial leverage they currently hold and, as a result, they may have to accept a lower division in some instances. The Surface Transportation Board ("STB") should realize what this case is truly about: the age-old arguments between the railroads on what the level of divisions should be. Issues surrounding division arrangements and the related terms and conditions can and should be worked out in private negotiations. Toward that end, KCS has said that it will honor all existing Tex Mex and TFM agreements for their existing term. When those agreements expire, we will renegotiate them, just as the parties contemplated when we negotiated expiration dates.

Additionally, I note that KCS has also entered into an agreement with the National Industrial Transportation League ("NITL") that resolves the potential concerns expressed by NITL members. The pledges set forth in the NITL agreement provide further assurances that NAFTA Rail will be operated in a pro-competitive manner.

The Interstate Commerce Commission ("ICC") and STB have long allowed market forces and private agreements, not regulation, to determine rail routings and divisions. Certainly, given the disparities in size between the existing Class I rail systems and a commonly controlled NAFTA Rail network, there is an even greater imperative to let competitive effects provide the framework for arms-length negotiation. There is simply no need for the government to regulate NAFTA Rail's negotiations with these mega carriers over divisions arrangements, or to impose proportional rate agreements on a Mexican railroad, or to freeze existing interline rates in place for five years. Instead, market forces, private agreements, and existing STB remedies are more than adequate to address any concerns raised in the August 4th Comments. The STB should

allow those processes to work rather than impose burdensome and unjustified conditions, forced negotiations, or other forms of government interference in the marketplace.

**I. THERE WILL BE NO ANTICOMPETITIVE FORECLOSURE
OF UP AND BNSF ROUTINGS FOR U.S./MEXICO TRAFFIC**

**A. Whatever Incentives There Are To Foreclose UP and BNSF Routings
Exist Today, And Common Control Will Not Change Those Incentives.**

A basic premise of the arguments raised against the two transactions is that KCS's control will create new incentives for Tex Mex and TFM to take certain actions to either raise prices to shippers or force shippers to divert from efficient UP or BNSF routings to inefficient NAFTA Rail routings. The underlying assumption of that premise is simply wrong. Given the high degree of common ownership and coordination between KCSR, Tex Mex, and TFM today, the incentives to take the actions described by UP and BNSF will be the same after the NAFTA transaction as they are today. The fact that the alleged anticompetitive actions that could occur have, in reality, not occurred is strong evidence that existing market forces prevent these actions from occurring. The control transactions will not change or eliminate those market forces.

The fact is that KCS is a major owner of Tex Mex and TFM, and has been for several years. As this Board is fully aware, up until about a year and a half ago, KCS directly owned 49% of Tex Mex through its ownership share of Tex Mex's parent, Mexrail, while at the same time owning 46.5% of Grupo TFM, TFM's parent. While Mexrail was sold to TFM, KCS still remains the 46.5% owner of TFM. KCS, Tex Mex, and TFM share some common officers and/or common board members. There are numerous provisions in the corporate bylaws,

shareholder agreements, and operating agreements that give KCS a substantial voice in how the companies are run.¹

As soon as TFM was acquired jointly by Grupo TMM and KCS, KCS urged, supported and was directly involved in (1) upgrading TFM's physical plant to U.S. mainline standards; (2) upgrading and expanding the rolling stock fleet; (3) replacing the core of the locomotive fleet with new AC locomotives; and (4) upgrading the skill of the workforce and expanding effective computer support. During this time, KCS has not taken any capital out of Mexico, but has been focused on re-investment in Mexico (as opposed to UP who has declared that it has recovered all of its investment in Ferromex, but still has its 26% ownership). In the end, it was KCS's expertise that framed TFM's operating practices today. It was KCS that urged, and helped to complete, quick and massive investment in TFM. It was KCS who worked with TFM to raise TFM's service capability to provide highly efficient service, to develop new markets for TFM, and to improve what UP, itself recognizes as a high degree of cooperation and investment by KCS into TFM. *See* V.S. Gray at 9, 10, 22, and 38.

KCS's high degree of investment into and involvement with TFM was being done at the same time TFM and UP were coordinating their operations and developing their arrangements. Given UP's large market share of TFM interline traffic, approximately 80-85%, KCS knew that

¹ I find it ironic and telling that KCS's degree of ownership, investment, and control of Tex Mex and TFM is significantly greater than UP's prior ownership, investment, and control of the former Chicago and Northwestern Transportation Company ("CNW"). When UP decided to take 100% control of CNW, another purely end-to-end transaction, many parties raised the same issues in that proceeding, *i.e.* CNW would no longer have an incentive to interline traffic, would foreclose existing routing options, and that shippers' rates would increase. UP, of course, opposed all of these arguments on the bases that efficiency and shipper preferences should govern such matters, and the ICC agreed with UP's position. The STB should likewise follow its UP/CNW precedent, as well as its numerous precedents regarding end-to-end consolidations, and reject the now inconsistent claims raised by UP.

the vast majority of its investment would benefit UP/TFM routings. KCS understood that the vast majority of the growth on TFM was being fueled by UP/TFM routings, but as most of the UP/TFM traffic was traffic for which KCS/Tex Mex routings could not compete, and in fact moved to or from origins and destinations not even capable of being served by a KCSR routing, KCS never considered trying to stop these UP/TFM routings.

In light of the fact that a vast majority of KCS's investment in TFM benefits UP directly, one must ask why KCS has made those investments. Why haven't KCS and TFM today taken any of the alleged anticompetitive actions hypothesized by UP's witness, John Gray? The reason is simple: KCS invested in TFM to grow the market, thereby increasing the value of TFM, and this requires working with both UP and BNSF to increase traffic over the Laredo gateway.

UP states that this philosophy will change as soon as we control TFM, it will not. UP's position not only blatantly contradicts decades of claims that UP has made before the ICC/STB, it also ignores the reality of the past and of the marketplace as it exists today and will exist in the future. TFM will continue to be heavily dependent on UP's traffic to continue its growth and to increase TFM's value. The fact that KCS has not already prevented UP/TFM cooperation and routings proves that the marketplace, and its reliance on private agreements and private sector solutions, is more than adequate to "check" any alleged market power that KCS will gain due to the transactions.

Perhaps one of the most telling statements as to why KCSR and TFM have not undertaken the alleged anticompetitive strategies hypothesized by both UP and BNSF was made by UP's witness, John Gray, who, when responding to KCSR's arguments that it will have to lower rates to capture market share away from UP, claimed that if NAFTA Rail's true desire was to lower rates, then "it could take this step today." UP-7B, V.S. Gray at 34. Just as NAFTA Rail

could lower rates today, it could also raise them and undertake the various strategies outlined in Mr. Gray's statement. In fact, he even claims today that Mexican regulatory structures are so weak and ineffective that TFM could raise its rates at will, just as KCSR could lower its at will.

Given the assumptions that TFM could raise its rates today and KCSR could lower its rates -- the two premises of Mr. Gray's argument set forth in Table 1 at page 28 of his statement -- then it is fair to ask why KCSR and TFM are not doing so today. Under either of the scenarios set forth in the UP verified statements, the profits to both TFM and KCSR increase, not just KCSR's. As a result, one would expect KCSR and TFM to be undertaking this scenario today. For example, in Table 1 set forth by Mr. Gray, he claims that after control, TFM could increase its rate factors from \$100 to \$106 or from \$100 to \$120 and that KCS could reduce its rate factor from \$105 to \$99 or even to \$95. Under either "post-control" scenario, the shipper's rates would go up and "KCSR" supposedly would win by gaining new profits of \$5 or \$15.

Setting aside for the moment the fact that this analysis is based on numerous unrealistic and inaccurate assumptions,² Mr. Gray has already admitted that TFM could raise its rates today and KCSR could currently lower its rates. If TFM could increase its rate factors and KCSR reduce its rates so that the combined KCSR/TFM could gain an extra \$5 or an extra \$15, they would do so today because both would split that extra revenue in accordance with their respective equity ownership interests in TFM. If TFM could raise its factors from \$100 to \$106 or to even \$120 and still have the traffic move via the KCSR routing (with KCSR lowering its rates), it would presumably be in the interests of both TFM and KCSR to do so today because in doing so both would increase their revenues, not just KCSR.

² Of course, amongst the biggest shortcomings in Mr. Gray's and Dr. Hausman's analyses is that there are no references to costs, so we do not know what is the "profit" of each of the carriers involved.

Mr. Gray assumes that it is “control” of TFM by KCS that gives KCSR this incentive because KCS would “get those dollars back through its ownership of TFM.” V.S. Gray at 27. Yet, that ignores the fact that KCS today has effective equity ownership of 46.5% of TFM and would thus get at least 46.5 cents of every “extra” dollar earned back today. If KCSR and TFM would have an incentive to undertake these actions to gain an extra \$5 or \$15, they each have the same incentive to do so today, although each would have to divide the extra \$5 or \$15 between the two of them, but both would be better off. Nothing about going from 46.5% ownership to 100% ownership changes these incentives.

Dr. Hausman’s theory, as set forth in Table 2 of UP-7A at 55, suffers from the same faulty assumption, amongst many others. His theory starts with the premise that Mexican law constrains TFM’s ability to differentially price between KCSR and UP, forcing TFM to price all traffic at the rate that a shipper with demand for rail service is willing to pay. UP claims that common control would change the environment by giving the commonly controlled company the ability to price discriminate freely, with TFM raising its overall rate factor from \$100 to \$120 and KCS “manipulating the KCSR/Tex Mex rate factor north of the border” UP-7A at 55, so as to hold rates constant for elastic traffic (through KCSR’s reduction of its rate factor from \$100 to \$80) but raising rates for inelastic traffic.

The problem is that such a scenario could happen today, and common control does not change the incentives to do so. Indeed, his model depends upon KCSR’s ability, not TFM’s ability, to differentially price rail traffic, yet KCSR has that ability today. There is nothing about control or lack of control that prevents TFM from raising its rate factors from \$100 to \$120 and KCSR from reducing its rate factor for elastic traffic from \$100 to \$80 and holding constant its rate factor for inelastic traffic.

If it were in NAFTA Rail's self-interest to take the steps hypothesized by Mr. Gray and Dr. Hausman, it would be in both KCSR's and TFM's self-interest to take those steps today. It is not a satisfactory explanation to say that Mexican law requires TFM to charge the same "neutral" rates to both UP and KCSR/Tex Mex and that it is this constraint that somehow keeps TFM from undertaking the various scenarios today. If that is truly a constraint, then the same constraint will exist in a post-control environment as in a pre-control environment. If Mexican law is not the constraint, and TFM is free to differentially price between different origins and destinations (which is in fact the case), then TFM is free to so price today.³

The bottom line is that despite UP's argument that KCS control of TFM will create "new" incentives or opportunities to exploit TFM market power, there are no "new" incentives being created. Each of the proposed scenarios could happen today, with TFM raising its rate factors south of the border and KCSR reducing its factors north of the border. The fact that we have not taken those steps shows that such steps are not in NAFTA Rail's self-interest because they cannot be taken in light of existing competitive pressures. Common control will not change these factors.

B. Market Forces Prevent KCS From Using Its Control
Of TFM To Foreclose UP And BNSF Routings.

There are some basic inherent, structural reasons why the inefficient scenarios posited by UP and BNSF do not happen today. These same reasons will continue to exist in a post-control environment. First, the enormous market coverage of UP and BNSF provides TFM's customers

³ See V.S. Gray at 31, where he claims that if KCS's argument is correct that TFM could discriminate by charging lower rates to favor KCSR routings (which is in fact true), then it is also true that KCSR "could discriminate by charging higher rates to shift traffic away from efficient UP-TFM routings." Again, the fact that NAFTA Rail can discriminate in favor of KCSR today but has not foreclosed UP-TFM routings by charging higher rates to UP-TFM

with access to many geographic locations and sources of product or markets for products that KCSR simply could not provide to those customers. KCSR does not remotely possess the market scope that UP and BNSF have, so it is not in KCSR's interest to eliminate TFM access to UP and BNSF routings. Indeed, notwithstanding UP's comment that KCSR "and its connections, including BNSF" can compete for 80% of the traffic going through Laredo, KCSR competes with UP and BNSF at very few locations. Second, if NAFTA Rail did attempt to foreclose UP and BNSF, the inefficiently routed traffic would switch to other gateways or other modes, depriving TFM of needed revenues that could not be made up by relying on KCSR routings. Finally, because most of the traffic is locked up under long-term contracts between UP and the customer, BNSF and the customer, TFM and UP or TFM and BNSF, KCS could not utilize its control of TFM to eliminate UP or BNSF routings.

1. - UP and BNSF Markets Provide A
Significant Amount Of Traffic To TFM

UP's basic theory is that UP and KCSR are competitive for 80% of the traffic going through the Laredo gateway so that NAFTA Rail would have an incentive to make UP routings inefficient (through TFM raising its rates and KCSR lowering its rates) in order to favor KCSR routings.⁴ By contrast, BNSF's theory is exactly the opposite. BNSF's theory is not that KCSR market coverage and routings are so competitive with UP that KCS would have an incentive to foreclose UP, but rather that KCSR's market coverage is so limited that KCSR is not capable of competing against UP. Of course, both statements cannot be true. I can emphatically state that because the vast majority of traffic going through the Laredo gateway moves to or from UP or

routings clearly indicates that market forces are in place preventing such UP foreclosure from occurring.

⁴ Of course, as noted earlier, if this were so, KCS and TFM would already have those incentives and control will not change those incentives.

BNSF-solely-served locations or locations served by both UP and BNSF, NAFTA Rail will have no incentives to foreclose TFM from participating in these movements. If it attempted to do so, this traffic would switch to the other gateways or other modes and TFM would lose the revenue. It is these competitive pressures, premised upon geographic facts that prevent KCSR and TFM from undertaking the various foreclosure scenarios today. Undeniably, these scenarios will continue to exist in the future, but they will continue to be constrained by economics, shipper preferences, and the like. Common control does not change those competitive pressures.

In order to respond to the arguments raised by UP and BNSF, KCS asked Reebie and Associates to undertake a study of the origins and destinations of both northbound and southbound traffic going through the Laredo gateway. They were also asked to review how many of those locations were UP and BNSF-solely-served and how many were served only by both UP and BNSF. Reebie's data shows that there are 191 southbound UP solely served points (using SPLC 6) and 76 northbound locations. There are 296 BNSF solely-served southbound locations and 84 northbound locations. There are 57 southbound locations where UP and BNSF provide the only rail service and 21 northbound points. There are only two locations where KCSR and BNSF provide the only rail service for Laredo gateway traffic, a fact that I can independently verify. Only 7 origins for southbound traffic are served only by UP and KCSR and there are no UP/KCSR served destinations for northbound traffic. These facts give UP and BNSF vast economic leverage over TFM that checks any ability to foreclose UP and BNSF routings. Given the vast amount of TFM interchange traffic that comes or goes to UP and BNSF points that KCSR does not serve, NAFTA Rail will have no ability to foreclose this traffic in the future. Attempting to do so would result in a dramatic loss of revenue to TFM.

Given this environment, KCS has every incentive to maintain a positive business relationship with UP and other carriers using TFM, since NAFTA Rail's financial success will depend on the continued flow of traffic from various carriers at the Laredo Gateway. TFM must retain UP's and BNSF's business in order to be financially successful. These two carriers control 90% of the rail traffic in the entire Western U.S., and as they themselves make clear, they have much more extensive coverage than KCSR. UP has access to six Mexican gateways and BNSF has access to four. In contrast, KCSR/Tex Mex has only one gateway to Mexico at Laredo, and it depends on trackage rights over more than 350 miles of UP track in Texas to reach that gateway. UP and BNSF have direct access to Ferromex; KCSR/Tex Mex do not. Thus, KCS has no intention, nor incentive, to change the way TFM is operated so as to drive away UP and BNSF interchange business.

2. Laredo Traffic Can Switch To Other Gateways

UP and BNSF claim that is not an answer to say that other rail gateways between Mexico and the U.S. provide a check on KCS's ability to use its control of TFM to foreclose UP and BNSF routings because Laredo is the "preferred" and "most efficient" gateway; however, neither of them deny that the other rail gateways are being used and could be used for a good bit of the traffic. Indeed, a large part of the reason why the Laredo gateway is the most efficient rail gateway is because KCS and TFM have made it that way; precisely to encourage BNSF and UP to use it rather than use their own gateways. Again, because KCS and TFM need to pay for those improvements by putting as much traffic over the Laredo gateway as possible, there is no reason to foreclose BNSF and UP traffic.

BNSF in particular has historically made significant use of gateways other than Laredo.⁵ To a large extent, BNSF's own route structure facilitates this result. BNSF's routings from major cities in the western U.S. over El Paso are less circuitous than routings over Laredo. From aggregate data provided to me by Reebie and Associates and by Mike Rogers at Cogent Inc., it is clear that historically, BNSF almost evenly splits its U.S.-Mexico traffic between TFM interchanges at Laredo and Brownsville and Ferromex interchanges at El Paso and Eagle Pass. More recently, BNSF has been favoring Ferromex routings rather than TFM routings. If KCS were to use its control of Tex Mex to make the BNSF/Tex Mex routing inefficient, BNSF would simply shift this traffic to its Eagle Pass or El Paso gateways and an interchange with Ferromex.⁶

Like BNSF, UP also is able and willing to use other gateways as alternatives to Laredo.⁷ Gateway aggregate data provided by Reebie and Cogent show that in 2001, almost half of UP's U.S.-Mexico traffic was interchanged with Ferromex. UP also has a favorable connection at non-TFM crossings. All of UP's connections to Mexican gateways – Calexico, Nogales, El Paso, Eagle Pass and Brownsville – are via UP's own lines, not via trackage rights controlled by another carrier. Together, these gateways have greater capacity (*i.e.*, the capacity of UP's lines that serve them and ability to accommodate trains crossing the border), than does Laredo. In short, UP is fully capable of using alternative gateways to Mexico for much of its traffic. Because some difficulties involved with using other gateways arise in part from a shortage of

⁵ In the past, BNSF has diverted shipments away from Tex Mex and TFM due to service problems and there is no reason that it could not do so again if it was dissatisfied with Tex Mex or TFM.

⁶ In its comments, BNSF does not claim otherwise. In fact, BNSF states that El Paso and Eagle Pass are "out of route for most eastern shippers." BNSF-4 at 16. BNSF does not make the same claims with respect to Midwest, West Coast, Northwest, or Southwest shippers. Yet, it is precisely for such eastern shippers that the KCS/TM transaction will provide a new and efficient single-line option in competition to UP, BNSF and other modes.

railroad yards on the U.S. side of the border, where UP owns the track, UP is in a superior position to immediately improve the accessibility of Mexico via these other gateways. Such investments, were UP to make them, could improve alternative services available to shippers throughout the U.S.

3. If UP, BNSF, and KCSR Increase Rates To Shippers,
The Traffic Will Switch To Other Modes

The cross-border competitive strength of other transportation modes restrains all rail carriers from driving up prices or degrading service. Historically, truck and water transport have provided significant competition to railroads for shipments to and from Mexico. Only by competing with trucks on service and price have the railroads been able to grow their share of the market. Yet, despite these competitive incursions, government and railroad data show that trucks remain the dominant mode for cross-border traffic, functioning as a competitive constraint against any effort that railroads, including NAFTA Rail, could make to raise prices or reduce service quality.

Statistics clearly demonstrate that trucks remain the dominant mode of cross-border transportation today. Bureau of Transportation Statistics data show that for Laredo alone in 2002, the combined value of exports to and imports from Mexico by truck was approximately \$55.8 billion,⁸ while rail crossings at Laredo accounted for approximately \$6.4 billion of exports and \$16.9 billion of imports.⁹ Figures for other top U.S.-Mexico border crossings showed the following values for trade carried by truck: El Paso, TX: \$35,093,583,193; Otay Mesa Station,

⁷ Like BNSF, UP is a predominantly western carrier and has similar routing advantages over El Paso rather than Laredo for a significant amount of western traffic.

⁸ http://www.bts.gov/ntda/tbscd/reports/annual02/port/pt_2002_trk.html.

⁹ http://www.bts.gov/ntda/tbscd/reports/annual02/port/pt_2002_ral.html. The value of Mexico's imports to the U.S. indicates why the Mexican Competition Commission would review the effects of the TFM transaction on Mexican businesses that are exporting to the U.S.

CA: \$20,367,624,663; Hidalgo, TX: \$12,184,735,176; Brownsville/Cameron, TX:

\$9,455,249,911; Nogales, AZ: \$8,750,090,264; and Calexico-East, CA: \$8,278,428,327.

Altogether, the value of all U.S.-Mexico shipments transported by truck was \$161,518,340,301 in 2002.¹⁰ By contrast, the value of all exports to and imports from Mexico by rail in 2002 was less than one-fifth as much, only \$30,933,693,502.¹¹

The comments of Pacer International, Inc. ("Pacer") confirm the fact that trucks are the main competitive force for traffic to and from Mexico. "Over the next few years, Pacer projects that at least 500,000 carloads can be converted from truck to intermodal rail *assuming performance and pricing levels can continue to be improved at the rate they have in recent years.*" Comments of Pacer International, Inc. at 8. UP, BNSF and KCSR all recognize that to gain market share, they must improve service to attract traffic from trucks.

Water-borne transport is also a significant competitive constraint on railroads. The pricing for rail very much reflects, and is limited by, barge pricing, either down the Mississippi (for corn, the predominant grain moving from the U.S. to Mexico) or from Vancouver (for Canadian wheat) or from Mobile (for a wide variety of industrial and manufactured materials). For example, we know that approximately 4 million tons of grain is shipped to Mexico via truck, 10 million tons by vessel and 11 million tons by rail. And, for certain types of grain, barge is the dominant transportation provider. For export corn coming from U.S. grain producing regions and destined for Mexico and other export destinations, barge moves 68%, rail moves 26%, and truck moves 6%. These figures, which I presented in the Supplement, went unrefuted by UP, BNSF, or any other party.

¹⁰ http://www.bts.gov/ntda/tbscd/reports/us_mex_2002_Truck.html.

¹¹ http://www.bts.gov/ntda/tbscd/reports/us_mex_2002_Rail.html.

UP's witness, John Gray, claims that competition from trucks and barges do in fact provide a competitive check for some shippers and that rails are competing against these modes, rather than other railroads, for some of this traffic. He further claims that for "most shippers" these alternatives will not be effective. Curiously, this position is 180 degrees different from the position that UP took before this Board in its merger with the Southern Pacific Railroad ("UP/SP") where, in opposing Tex Mex's request for a condition at Laredo, UP argued that no such condition was needed because competition from trucks and water would constrain UP's rail rates at the Laredo gateway even though UP would have a monopoly at that gateway absent a condition. He likewise does not identify who the "most shippers" are that would not benefit from intermodal competition.

However, he does say that for grain traffic and automobile traffic, trucks and barges do not provide a viable competitive check on KCSR's and TFM's ability to raise rail rates. The problem with this analysis is that if UP were correct about the lack of intermodal competition and the ability of NAFTA Rail to raise rates, one would expect that grain interests would be kicking and screaming about the NAFTA Rail transaction. Instead, grain interests, as represented by the numerous grain shippers who have filed comments in support of NAFTA Rail and testified at the July hearing, support the NAFTA Rail transaction. Indeed, for the first time in my memory, the U.S. Department of Agriculture ("USDA") actually testified in support of a rail merger transaction.

Gray continues by asserting that:

For grain moving from most of the U.S. Midwest to large portions of eastern and central Mexico, rail is the only viable option, and for much of that traffic, including large receivers in San Luis Potsoi and Querétaro, the only rail service available is provided by TFM.

UP-7B, V.S. Gray at 36, is contrary to the position taken by UP in UP/SP and is either incorrect or misleading. Almost all of the “grain” going to Mexico is corn. The Ohio and Mississippi river systems serve the primary corn growing states, including Ohio, Indiana, Illinois, Iowa, Minnesota, and Missouri. The vast majority of corn that is grown in the U.S. grows in these states. That corn easily flows by barge to the Gulf, where it is loaded into ships, is then shipped to Mexico, and then either is railed or trucked to interior Mexico locations.¹² Mr. Gray’s statement either ignores these facts as set forth by both my earlier statement in the Supplement¹³ and by the USDA, or is intended to mean that from the Mexican ports to San Luis Potsoi and Querétaro, rail is the only option. If the latter, KCS control of TFM will do nothing to change or impact those moves from the ports to interior points within Mexico.

The story is similar with respect to automobile traffic. Mr. Gray claims that for “large volume shipments moving directly between parts manufacturers or consolidation centers in the East and Upper Midwest and automobile manufactures in Mexico,” rail is superior to truck. He cites Daimler Chrysler as the type of shipper who depends upon rail and points out that for Daimler Chrysler’s Toluca plant in Mexico, TFM is the only rail option.¹⁴ With this in mind and given UP’s arguments that KCS is going to make U.S./Mexico shipments inefficient and raise prices to shippers, one would expect Daimler Chrysler to oppose the transaction. In contrast to UP’s theory, Daimler Chrysler and Mazda actually have filed support statements with the Board

¹² Similarly, wheat to Mexico primarily comes from Canada and flows by rail to Canadian ports, is shipped to Mexico, and then is railed or trucked to interior Mexican points. KCS control of TFM will not impact these flows.

¹³ My comments in the Supplement with respect to the ability of large agribusiness concerns to shift their sources of supply based upon small movements in transportation prices went unrebutted.

¹⁴ As with Mr. Gray’s comments with respect to grain, to the extent TFM is the only rail option within Mexico, KCS control of TFM will do nothing to increase or decrease TFM’s market power within Mexico.

and fully support the NAFTA Rail concept. No automobile manufacturer or auto parts supplier has submitted comments backing UP's hypothetical concerns.

While automobiles and auto parts represent a very substantial percentage of the U.S./Mexico trade, trucks, not rail, dominate this market with about 60% of southbound shipments (1.1 million tons by truck v. 740,000 tons by rail). With an intermodal ramp, it is relatively easy to ship to the border by train and then take the parts into Mexico by truck. The same is true with the reverse routing of auto parts or finished automobiles.¹⁵ There is also strong intramodal rail competition for auto-related traffic within Mexico. As I set forth in my statement in the Supplement, which went unchallenged, besides competitive pressure by trucks and water, competitive rail options can and are maintained through drayage to and from TFM's and Ferromex's rail yards. Indeed, TFM and Ferromex are constantly competing for auto traffic, which is price sensitive.

UP, and not TFM, is the price-setter for the shipment of automobiles and auto parts between the U.S. and Mexico. UP has exclusive contracts with logistics management companies that have contracts with the auto companies. UP therefore controls this traffic and dictates the price that TFM must accept for its portion of the carriage. For example, a year ago, UP threatened to shift about 30% of the auto parts traffic it controls from the TFM to Ferromex. TFM responded with reduced prices and retained the business. The transactions necessary to effectuate NAFTA Rail will not change UP's role as price-setter. If KCS attempted to raise prices to shippers for these UP/TFM moves, the traffic simply would move by different means.

¹⁵ In fact, I understand that this is precisely what the UP planned to do to overcome certain potential problems with Ferromex: it planned to truck finished automobiles up to the Mexican border at Arizona where they would be loaded on railcars to complete the movement.

It is KCS's plan, however, that NAFTA Rail will finally offer shippers a more viable transportation alternative to UP.

Despite UP's arguments to the contrary, the story is simple: all of the growth in the TFM traffic base has come from taking traffic away from trucks and water and putting that traffic on rail, or by attracting plant expansions or new plants with its efficient service. If NAFTA Rail engaged in anticompetitive behavior that increased prices or reduced the value of services offered would simply undo the gains made by the rail industry in the past half-dozen years, and drive freight back to trucks. As stated in Pacer's comments, "[M]ost, if not all, of Pacer Stacktrain's U.S.-Mexico intermodal traffic [would be lost] to truck," if the Laredo gateway did not remain open to competition. Increasing rail market share requires cooperation by all railroads to provide improved, more competitive service offerings. Anticompetitive actions by any carrier will simply divert traffic back to truck, a lose-lose situation for all railroads.

C. The Shipper Statements Submitted By BNSF and UP Do Not Support UP's and BNSF's Claims.

It is true that grain, automotive, and intermodal represent the substantial majority of U.S./Mexico traffic, yet this is precisely the type of traffic that is most susceptible to diversion to other modes if TFM, under KCS control, were to attempt to "force" shippers to use NAFTA Rail routings at higher prices or worse service. For these commodities, it is simply not true that price and service competition between and among the railroads is driving the market. Instead, UP, KCSR, and BNSF have to constantly lower prices and improve their service capabilities in order to compete against truck and water competition. Shippers understand that the goal of NAFTA Rail is not to raise rail rates or reduce service but is precisely the opposite. Otherwise, this traffic will simply not go on rail.

UP and BNSF do point to a few shipper statements as backing their claims, but if grain, automotive, and intermodal are the commodities of concern, which UP and BNSF claim they are, one would expect any shipper opposition letters to be from those commodity groups. They are not. No grain shipper or automotive shipper has expressed support of UP's or BNSF's position. One intermodal equipment supplier, Pacer International, did make an evidentiary filing expressing concern over KCS's plans with respect to NAFTA Rail, but as I would like to explain, those concerns are unwarranted.

As an initial matter, Pacer's asserted concerns about anticompetitive activities by KCSR, Tex Mex and/or TFM ring hollow because Pacer's traffic is handled under long term contracts with UP and TFM. Pacer states that its traffic between the U.S. and Mexico travels "primarily under contracts with the UPRR in the United States and the TFM in Mexico." Pacer Comments at 8. Pacer has a contract with TFM that extends another nine years. KCS must abide by valid contracts. In addition to market forces, Pacer's contract with TFM protects Pacer against the type of anticompetitive conduct that it allegedly fears. Furthermore, all of the traffic that Pacer handles to and from Mexico is shipped in intermodal containers which, as Pacer itself has admitted, is precisely the type of traffic that can be easily transferred to trucks or shipped via water; thereby putting a further constraint on KCS incentives to raise rates to or reduce service for Pacer which, given the contract, we could not do.

Likewise the few shipper letters submitted by UP and BNSF do not support the theory of vertical foreclosure as set forth in UP's and BNSF's comments. Remember that the theory expressed by UP, and somewhat echoed by BNSF, is that there is intense competition between UP (or BNSF) and KCSR and that NAFTA rail will use its control of TFM to raise TFM's divisions so high on TFM-UP or TFM-BNSF traffic that this traffic will shift to a KCSR routing.

For UP's claim to be true, a shipper would have to establish that it benefits from the competition between UP and KCSR, and that trucks or other modes are so significantly more expensive than rail that these shipper would be "forced" to use an inefficient KCSR routing. As I've noted above, this theory does not hold true for grain, automotive, or intermodal shippers, and if one closely examines the few shipper letters that were submitted in support of UP's or BNSF's position, none of them support this theory.

IMC Chemicals ("IMC") ships "all" of its Mexico shipments via the UP through Laredo from its facility in Trona California, apparently a UP solely-served facility as it makes no reference to being able to use BNSF. Of course, KCSR does not serve this facility, and thus IMC does not benefit from UP and KCSR competition. IMC does not oppose the transaction but wants a condition for the protection of UP's routing option. It has not shown why such a condition is necessary. Indeed, why KCS would use its control of TFM to purposely make the UP/TFM routing for 20,000 tons of chemicals "inefficient" for traffic that KCSR does not even serve, and that apparently could be routed over non-TFM gateways at El Paso, Nogales or Calexico, is not explained. The UP/TFM routing for IMC provides TFM with revenue, revenue that KCS could not replace and which KCS depends upon to provide an earnings stream from TFM in order to recoup KCS's investment. KCS has no incentive to stop this traffic.

Both BNSF and UP quote from a letter written by AK Steel Corporation ("AK Steel"). AK Steel makes steel products used in automobiles, appliances and manufacturing. AK Steel ships 120,000 tons of steel per year to Mexico. AK Steel does not oppose the transaction but wants a condition to protect its UP routing option. CSX originates this traffic and interchanges it to UP in Illinois. UP, in turn, takes it to Laredo for interchange with TFM. AK Steel does not claim that it benefits from competition between KCSR and UP. Instead, it says it has "several

alternative routings that are available to move its product to the Mexican gateway [which gateway goes unsaid].” AK Steel is afraid that TFM will “favor” traffic that originates on KCSR over interchange traffic with UP or BNSF. AK Steel makes no attempt to prove that TFM is not already favoring steel originations on the KCSR, in which case the control transactions would have no impact on AK Steel’s traffic. In fact, AK Steel states its belief that TFM can exercise bottleneck control now. If it is not exercising bottleneck control today, there are likely other competitive pressures that are preventing it from exercising such control, and there is nothing in the TFM control transaction that will eliminate those existing competitive pressures. Likewise, AK Steel does not show that its current rail options are not already under contract. UP itself has admitted that most of the UP traffic is already locked up under contract and KCS’s acquisition of control cannot terminate those contracts. AK Steel also fails to show that there are originations on the KCSR that compete with AK Steel origins so that these origins could serve as an adequate substitute and that such substitutions, if they occurred, wouldn’t be at a lower price for the ultimate end user. AK Steel’s comments prove nothing other than an unsubstantiated fear about what might happen.

International Paper (“IP”) provided an interesting comment. IP does not oppose the transactions. It claims that Mexico, broadly defined, is an emerging market and that IP shipped 213,000 tons in 2002 and that volume is expected to grow significantly. While Laredo is the gateway of choice for IP, it also has other gateway options, which it uses. This option provides a check on KCS’s ability to inefficiently foreclose IP’s Laredo option. Furthermore, most of IP’s shipments to Mexico via Laredo are already controlled by UP/TFM contracts that KCS must and will abide by. In fact, IP praises KCSR as a valuable provider of service for their products. IP does have concerns about “possible” and “potential” discrimination, but does not claim it will

happen. In fact, its strongest statements are not about anticompetitive actions that KCS could take, but rather that UP would take anticompetitive actions by “not providing neutral treatment to Tex Mex trains that necessarily move over trackage rights on the Union Pacific.” This again confirms that KCS has consistently stated: UP has many more ways to retaliate against KCS and it is UP who has the chokehold over KCS, not the other way around.

One of the most often quoted letters by both UP and BNSF is the letter written by Mr. Mastandrea, Vice President/Distribution, for Unimin Corporation. Unimin is one of the nation’s largest producers of industrial materials, such as sand, ball clay, bentonite, and kaolin. Curiously, there are four ball clay producers in Tennessee, all solely served by CSX. One of those facilities is a Unimin facility and the other three are competitors to Unimin. Unimin has a Texas plant that is currently solely served by UP and which supplies Mexican receivers or users. It is this Texas plant that currently has an advantage over the Tennessee plants and Unimin’s competitors.

Unimin makes no claim that it currently benefits from competition between a KCSR/TM/TFM routing and a UP/TFM routing or that competition will be reduced in a post-control environment, which is the basis of UP’s economic arguments. Likewise, Unimin does not claim that its rail rates will increase or that UP is not already charging the highest rate possible. Rather, Unimin is concerned that the common control of Tex Mex and TFM by KCS will allow KCS to offer “preferential traffic packages to Tennessee customers to enable KCS to carry Gleason, Tennessee ball clay from New Orleans to Laredo.”¹⁶ In other words, Unimin’s

¹⁶ Unimin also expresses concern that its Mexican customers will shift their sources of supply for fractured sand to “Unimin’s major competitor that utilizes KCS.” Again, Unimin is expressing concern not about a reduction in competition between rail routings, but rather Mexican customers will now have additional sources of supply -- a procompetitive benefit of the two NAFTA Rail transactions.

concerns are not that the transactions will reduce competition between railroads, but rather the transactions will actually expand the sources of product for both U.S. and Mexican receivers. From the perspective of Unimin's competitors in Tennessee, I am sure that they look forward to the efficiencies of new NAFTA Rail service so as to be better able to compete against Unimin's Texas plant. From the Mexican receiver's standpoint, it will now have efficient access to five sources of ball clay for its manufacturing process.¹⁷

In review, most of the concerns expressed by the letters quoted by UP and BNSF are not that these shippers benefit from competition between KCSR and BNSF or between KCSR and UP so that the transactions would eliminate that competition, but rather that these shippers are afraid that KCS will use its control of Tex Mex and TFM, not to raise the rates charged by UP or BNSF (which of course assumes that UP and BNSF are not already charging the highest rate possible), but that KCS will lower rates on its own system in order to open up new origins of supply and expand the options of those who use NAFTA Rail routings. That is precisely what KCS must do to succeed with NAFTA Rail and such an action is not anticompetitive but procompetitive. That is why the vast majority of the shippers and shipping community support these transactions.

D. UP And BNSF Are Concerned About Their Own Divisions,
Not Shipper Rates.

As I've stated, for most of the U.S./Mexican traffic (grain, automotive, and intermodal), trucks and water actually dominate rail competition. Rail needs to lower prices and improve efficiencies if we are to grow this traffic. Thus, there is no incentive for KCS to use its control of TFM to raise prices to shippers or make service inefficient, because if we did, existing rail traffic

¹⁷ Unimin also admits that it has the option of routing its Troup, Texas shipments originating on UP to another gateway, Eagle Pass.

for these commodities would simply shift to these other modes. For this “elastic” traffic, to use Dr. Hausman’s phrase, rail rates simply cannot increase.

UP witness John Gray, in his Table 1 example, attempts to make no distinction between the type of traffic that is subject to competition from these other modes and the type of traffic that is truly rail dependent. His table simply assumes that rail rates could increase from the existing rate of \$200 to \$205 to \$215 and so on, and the shippers would just be “forced” to pay it. This of course assumes that (1) shippers cannot switch to trucks or water; (2) shippers do not have the choice to use UP and BNSF to ship via any other gateway but Laredo; and (3) that UP’s rail rates are below market rates. All three of these assumptions are incorrect. As I’ve already stated, trucks and water competition provide a check on rail rates, and TFM’s growth since privatization has been completely fueled by taking traffic away from trucks and water and putting it on rail. There is thus no room for KCS to use its control of Tex Mex or TFM to increase rail rates without reversing this trend.

As for the second assumption, while the Laredo gateway is the most important U.S.-Mexico rail gateway, it is not the only such gateway. Shippers can and do use UP and BNSF much more than KCS, and in fact, most shippers don’t have a choice but to use UP. UP and BNSF have access to other gateways, and they make considerable use of that access. KCSR has access to only one gateway. Because KCS’s goal is to grow traffic on TFM (and as previously noted, KCS undertook its massive investment in TFM knowing full well that UP would be the primary beneficiary, but it did so to grow TFM’s revenues) it would be contrary to KCS’s incentives and its past history for us to undertake actions that would drive UP and BNSF to use these other gateways or to drive rail rates to a level that would shift this traffic to other modes.

The third assumption in Mr. Gray's Table 1 means that rail rates could simply go up and shippers could do nothing about it. This same assumption is present in Table 2 in Dr. Hausman's analysis for the "inelastic" traffic of which there must be a substantial quantity for Hausman's NAFTA Rail vertical foreclosure strategy to be profitable. The assumption by both is that existing UP or BNSF rates to many shippers could be pushed higher without impact. This is simply not true because existing rail rates, including UP's and BNSF's, are already as high as they can go without having that traffic switch to other modes or to other origins and destinations. To assume otherwise is to assume that UP and BNSF are unknowledgeable about the market or that they know the market and are just charitable, together with an assumption of the power of KCSR competition far beyond that indicated by their market share and geographic coverage.

Furthermore, if the traffic is truly inelastic (which we know is not true for the vast majority of U.S./Mexico traffic), then given that the shipper desiring to ship to Mexico must accept whatever rail rate is offered via the Laredo gateway, then by definition the price must already be as high as possible without that traffic simply disappearing. Again, to assume otherwise is to assume that either TFM or UP or both is leaving money on the table. UP claims that "[f]or a number of reasons, TFM does not extract from each piece of traffic moving via Laredo the last dollar of revenue that might conceivably be available by virtue of TFM's market power." UP-7A at 52, V.S. Gray at 29. However, if for whatever reason TFM is not taking the full profit and is not extracting the last dollar, UP or BNSF certainly are. Given that most of the traffic going through the Laredo gateway is solely-served UP traffic, UP has every incentive to extract the last dollar, especially if the traffic is truly inelastic. UP simply says that TFM is not extracting the last dollar but it does not claim, nor can it, that it isn't extracting that last dollar north of the border. The Gray/Hausman assumption that KCS competition north of the border

depresses rail rates below prevailing rates by other modes for a significant share of traffic is simply not supported by the facts, and in particular, it is debunked by a cursory view of KCSR's limited geographic reach.

Boiled down to its essence, the arguments advanced by UP and echoed somewhat by BNSF, while disguised as arguments about concerns regarding an increase in rates to shippers, are in reality simply concerns about the revenue divisions that UP or BNSF will receive in a post-control environment. UP knows full well that rail rates to shippers cannot increase significantly, and what it is concerned about is that it will have to take less profit than it takes now. Indeed, if, upon expiration of an existing UP/TFM contract, TFM does raise its revenue requirements as contemplated by both the Gray and Hausman statements, all that UP needs to do to keep the traffic is to lower its division, a result that may not be palatable to UP, but that has no impact on the shippers.

E. Other Government Agencies With Expertise In Antitrust And Competitive Issues Have Not Agreed With The Claims Put Forth By UP and BNSF.

These issues of alleged vertical foreclosure of UP and BNSF routings, especially the notion that KCS would use its control of TFM to raise rates to shippers and decrease service, were reviewed by the Mexican Competition Commission ("MCC") and were extensively analyzed and reviewed by the U.S. Department of Justice ("DOJ"). While it is true that the MCC does not officially take public comment like the STB that does not mean that it is any less concerned with competition. UP's position that the MCC somehow should be discounted because its procedures are not the same as the STB's, or that the STB is the only agency capable

of performing a thorough analysis of the competitive effects of the proposed KCS/TFM transaction, is frankly an insult to the Mexican government and its dedicated economic staff.¹⁸

As one who personally participated in KCS/TFM's application to the MCC, I can say that it is not true that the MCC decision "included no analysis of effects on international transportation." UP-7A at 32. The MCC knew full well the international importance of TFM and its decision specifically notes that importance as a factor in its consideration. In the end, the vote was 3 to 2 in favor of the transaction, and from what I understand, one of the dissenters voted no because he felt the relevant product market should not be limited to rail to rail but should consider truck and water competition, while the majority only considered rail as the relevant product market. Thus, in reality, the vote was closer to 4 to 1 in favor of the transaction.

It is also not true that DOJ did not take action to issue a second request and further investigate the KCS/TFM transaction because of their "limited enforcement resources" and its "awareness of the Board's pending proceeding." UP-7A at 33.¹⁹ DOJ assigned an attorney and an economist to review the competitive effects, including the international competitive effects, of KCS's plans to acquire control of Tex Mex and TFM. There were numerous meetings and discussions between KCS representatives and DOJ staff. The very same issues here, vertical foreclosure, impacts on grain, automotive, and intermodal shippers, and KCS's ability to favor its shippers over UP or BNSF shippers, were fully discussed and analyzed in those meetings. In the end, DOJ decided that issuing a second request was not needed (which it would do if it

¹⁸ Indeed, UP was very active in Mexico and sent letters to shippers and others asking them to write to the MCC and express their views against the transaction. UP also attempted to file its own comments and to get the MCC to take public comment, which can be done under certain circumstances.

¹⁹ I note that when DOJ has significant concerns regarding the anticompetitive impacts of a rail merger, such as when UP sought to merge with SP, it finds the resources necessary to make its positions known to the Board.

believed the competitive concerns warranted it) but instead granted early termination. As DOJ had full statutory and legal authority to review the international competitive effects and the domestic effects of the KCS/TFM transaction and in fact conducted an extensive review, including input from UP and perhaps others, the notion that the STB needs to review these effects because the MCC or DOJ did not, is simply wrong.

II. COMMENTS WITH RESPECT TO THE MEXICAN MARKET FAIL TO ACCOUNT FOR THE DYNAMICS OF THE MARKETPLACE

A. The Mexican Government Is Fully Capable Of Resolving Rate Issues.

Much of UP's comments focus on the Mexican regulatory structure and the factors governing rates set in Mexico. I do not challenge the basic framework of Mexican railroad law as set forth in Mr. Fuentes' comments. Indeed, some of his comments mirror what KCS's own Mexican counsel told the Board in KCS's Supplement. What I do take issue with is the claim that just because the Mexican law is in its infancy and has not yet been fully developed, the STB should somehow review issues related to TFM's rates, or that the STB should become the NAFTA Transportation Board with expertise to review international railroad issues from Canada to Mexico.

UP, BNSF, CP, CSX, and somewhat NS and CN, have gone so far as to request this agency to order KCS (NAFTA Rail), as the proposed parent company of TFM, to require its proposed Mexican subsidiary, TFM, to take certain actions and to enter into rate agreements with these carriers. They are not merely requesting KCS to take certain domestic actions, but they want KCS to take actions that would specifically impact rates, rate factors and service in Mexico and the Mexican portion of international through rates. In my prior career at CN, I cannot remember any situation where the ICC felt that it could order CN to enter into certain agreements involving international through rates or to take certain actions with respect to what rates or rate

factors CN could establish in Canada. Indeed, unlike prior rail transactions involving Canadian carriers where those transactions were specifically presented to the ICC/STB because the STB clearly had jurisdiction over those transactions, the KCS/TFM transaction is not being presented to the STB. Thus, these parties are requesting the STB to use its authority to condition the KCS/Tex Mex transaction to resolve competitive concerns that arise from a transaction not even being presented to the STB for consideration. With all due respect, the STB should resist these calls to expand its jurisdiction and the scope of its conditioning power.

Mexican regulatory agencies and laws are in place that can and will resolve any concerns that these parties may have about TFM's ratemaking practices. Indeed, UP's witness, Francisco Fuentes Ostos, admits that Mexican law does contain procedures through which parties can challenge TFM's rates. There are also procedures and processes in place for reviewing the level of trackage rights fees that TFM and Ferromex charge each other and for ordering that certain geographic locations be opened up to mandatory reciprocal switching. The fact that these processes are still being developed and are the subject of litigation does not mean that the STB should take over that process.

Indeed, if the shoe were on the other foot, certainly the U.S. carriers would be vociferously objecting. For example, let's assume Ferromex owned UP and there was a Mexican shipper who felt that the UP was discriminating against TFM connections in favor of Ferromex connections or that UP was charging unreasonable rates for the U.S. portion of the move. Under the theories set forth by the other carriers, that shipper could go to Mexican authorities and point out the fact that the STB process for filing a rate complaint or gaining competitive access via mandatory reciprocal switching was burdensome, complicated, subject to numerous litigation

delays and uncertainties.²⁰ Therefore, the Mexican shipper would argue that Mexican authorities needed to order Ferromex, as the owner of UP, to order UP to undertake certain actions in the U.S. to reduce the shipper's rates or to enter into mandatory agreements with Mexican carriers so as to provide that Mexican shipper with competitive relief. Of course, not only would the STB be rightfully indignant, but UP would be the first to object to such an approach. Yet, in a misguided demonstration of paternalism, these same carriers suggest that it is both lawful and necessary for the Board to compel KCS's actions in Mexico.

In this vein, the litigation between Ferromex and TFM with respect to the level of trackage rights between those two carriers is a subject that is properly left to Mexican authorities. I would like to comment, however, that the trackage rights fee charged by TFM to Ferromex does not prevent Ferromex from being a fully effective competitor. As with fees established under the SSW Compensation formula used by the STB, the Mexican fee considers the amount of investment in the line, the density on the line, and other cost and revenue factors. Based upon its analysis, the Mexican Secretary of Communications and Transport ("SCT") determined the appropriate rate would be \$0.71 per-car-mile. UP claims that this rate is outrageous and prevents effective competition. However, such a rate is fully in-line with rates developed by this agency under its SSW Compensation formula. Curiously, in reviewing a dispute between CSX and CP regarding the appropriate trackage rights fee for CP's use of CSX's tracks east of the Hudson River, which this agency ordered in the CSX/NS/Conrail transaction, the STB said the appropriate fee should be \$0.71 per car-mile.²¹

²⁰ Indeed, I suspect there are many U.S. shippers who would argue that the U.S. process for obtaining rate relief and competitive access is inadequate and wish there was another forum to litigate their claims.

²¹ It is important to note that Mr. Gray misstates the fee charged to Tex Mex by UP for Tex Mex's use of UP's tracks. That fee is not \$0.31 per car-mile as claimed by Mr. Gray but rather

B. Under Certain Circumstances, Mexican Railroads
Are Allowed To Differentially Price.

A major premise of UP's and BNSF's analysis is that Tex Mex and TFM are currently "neutral" vis-à-vis KCSR with respect to divisions and rate factors.²² Tex Mex is not "neutral" as between BNSF and KCSR today, and does not demand as high of a division from KCSR as it does from BNSF, but given the close coordination and cooperation between Tex Mex and KCSR and common ownership, one would expect this result. As such, BNSF's premise that KCS's control of Tex Mex will cause Tex Mex to no longer be "neutral" with respect to BNSF and KCSR is simply wrong.

With respect to TFM, UP claims TFM is likewise neutral with respect to BNSF/Tex Mex routings or KCSR/Tex Mex routings. UP-7B, V.S. Gray at 20-22. UP provides no evidence for its claim that TFM is neutral with respect UP, BNSF, and KCSR routings. Is UP saying that it knows what divisions TFM requests from BNSF and Tex Mex and that UP's divisions are the same? Most likely it does not unless UP has had access to TFM rate information contrary to confidentiality provisions of various contracts. No, UP's only claim for such a broad statement is that TFM cooperates extensively with UP. As I noted earlier, such cooperation is a result of KCS's and TFM's desire to grow traffic on TFM by taking market share away from trucks and barges and the fact that TFM depends upon a significant amount of UP traffic to provide it with revenues. Given its route structure, KCS cannot provide an effective competitive option for

4.29 mills per GTM or \$0.56 per car-mile for a car loaded to 100 tons, and \$0.16 per car-mile for the typical empty car.

²² Dr. Hausman's and Mr. Gray's theories depend, in part, on the notion that TFM or Tex Mex treat UP and BNSF the same as they treat KCSR. From personal experience, I can say that is not true. In some instances, where market forces dictate, TFM or Tex Mex favor UP or BNSF over KCSR while in other instances the opposite is true. I have not attempted to address how such differentially pricing impacts the theories expressed by Dr. Hausman or Mr. Gray. That analysis is contained the statements of Dr. Kleit and Dr. Grimm submitted in this Reply and Rebuttal.

much of this traffic. Thus, it is market forces that have driven this cooperation, not a regulatory requirement that TFM remain neutral.

Indeed, although Mexican law does require TFM to charge the same rate for identical traffic moving to/from the same origins or destinations and in the same volumes, that same law allows Mexican carriers to differentially price between connecting carriers and similarly situated shippers if such differential pricing is a result of different services provided by rail carriers. Thus, in many respects, Mexican law regarding rail pricing is not that much different than the U.S. law contained at 49 U.S.C. Section 10741. Furthermore, while TFM is required to register the maximum rate with the SCT, such a rate is the maximum rate that can be charged. TFM is free to discount from that maximum rate based upon differences between the transportation services provided by connecting carriers or based upon individual circumstances between shippers.

As a result, almost all Mexican traffic moves under contract, and each contract provides for a "promotion" or discount from the registered rate. The extent to which this promotion is offered is based upon different services. For both Ferromex and TFM, rates and service terms provided to connecting U.S. carriers or to shippers are based upon differences between car types, lading weights, origins and destinations, train size, car hire amounts, switching services, length of the contract, volume differences, and other differences between shipments. It simply is not correct to say that TFM must be "neutral" with respect to UP routings versus Tex Mex routings. Such discrimination happens today and common control of TFM (or Tex Mex) by KCS will not change the incentives that either of these carriers have to discriminate either for or against KCSR routings. Market forces dictate those incentives, not government regulation.

III. THE CONDITIONS SUGGESTED BY UP AND BNSF WOULD INTERFERE WITH THE MARKETPLACE

As demonstrated above, no one has shown that any anticompetitive effect is likely to result from this transaction, whether or not the effects of the TFM transaction are also considered. The strength of intermodal competition, the competitive leverage of KCSR's much larger rival railroads, and the number of Mexican gateways leaves KCSR no room to raise prices, either on its own lines or on those of TFM, without suffering a substantial loss of traffic, revenue and efficiency. Rather, KCSR and NAFTA Rail must prosper by growing the traffic base through more competitive rates and services, just as they have done over the past six years. Simply, this transaction has no anticompetitive effects, and no remedial conditions are warranted.

Several parties, most of them KCSR's competitors, have asked the Board to impose a variety of conditions on the Tex Mex transaction. For the most part, those requests really ask the Board to reach across the U.S. border and to regulate TFM's behavior. For a variety of legal and policy reasons explained elsewhere in this filing, the Board should not accept those invitations to regulate activity in Mexico, any more than the SCT in Mexico should regulate rail operations in the U.S.

Even if the Board did have the authority to reach across the border, it should not do so. The MCC, which has looked at the competitive effects of the TFM transaction on Mexican companies (including those that ship across the border), and DOJ, which has also looked at the cross-border impacts of the TFM transaction, both determined that the transaction did not present competitive problems. These agencies clearly had authority to examine these effects. The Board should not attempt to overrule their conclusions.

The principal requests for conditions relate to either the operation of the International Bridge at Laredo or to the rates available from TFM, Tex Mex and KCSR for movements to and from the international border. Aside from the fact that no party has justified imposing conditions because no party has shown a likelihood of substantial anticompetitive effects, the Board should not impose requested conditions because they would all impair efficient cross-border transportation.

Requests for conditions on operation of the bridge essentially seek some neutrality in bridge operations, even going so far as to suggest that a neutral operator of the bridge be imposed.²³ The problem with these requests is that the bridge already operates on a principle of neutrality; namely, efficiency. The Board should not interfere with the flexibility needed to operate the bridge efficiently.

The efficiency of operations at the Laredo Bridge is probably at an all time high, due to cooperation among Tex Mex, KCSR and UP. Studies of the bridge have shown that the bridge has substantial remaining additional capacity, and options have been discussed as to how to further increase that capacity, including the concept of increasing train speeds on the bridge and allowing crews to operate from one carrier's yard to another's, rather than having to change at the bridge. With the substantial additional capacity available at the bridge, the possibility of creating even greater capacity through further operational improvements, and the good cooperation among the affected parties, the Board should not intervene in the absence of a proven problem at the bridge.

²³ This situation is not equivalent to the Spring Dispatching Center, which was voluntarily created by UP and BNSF in response to the demonstrable service problems in Texas in the late 1990's and which manages, among other things, jointly-owned UP/BNSF properties.

While I am aware that UP sent a letter to shippers stating that Tex Mex had “attempted” to interfere with UP’s operations at the bridge at times over the past 50 years, the fact that UP has dramatically increased its traffic, crosses many more trains than Tex Mex and that UP has an approximate 80% market share at Laredo indicate to me that the bridge’s operations serve UP’s interests quite well. Occasional complaints do occur when, for example, six UP trains and 2 Tex Mex trains cross the bridge during a crossing window while UP still has trains waiting, as referred to by Mr. Barkley, but there are also times when the bridge is idle for lack of trains ready to cross. Occasional complaints do not equate to a systemic problem that requires a drastic solution imposed by the Board.

As KCS has said a number of times, operations of the Laredo Bridge are not managed at the whim of KCS, Tex Mex, or any other party. Rather, operations are governed by a series of contracts that have been in place for a number of years and reflect the negotiated opinions of parties that have operated over the bridge for decades. The Board should not disturb the long-standing private agreements under which the bridge is presently operated. Rather, if there is to be a change to those agreements, the parties should negotiate one. KCS has been in talks with UP to address UP’s concerns. Such talks are complex because the operational issues of the bridge bring together three railroads and the Customs services of two countries. Therefore, the fact that we have not yet reached a solution does not mean that one will not be reached. In the meantime, the bridge is operating well and talks are progressing. In the absence of a proven problem,²⁴ the Board should not intervene.

²⁴ The proposed operational monitoring to which KCS has agreed with NITL will help show whether there is a problem with the operations of the bridge.

Requests to regulate rates for cross-border movements, such as BNSF's proposal to freeze rates and UP's proposal for an I-5-type rate matrix, are also a bad idea. First, again, it has not been shown that the transaction before the Board will cause anticompetitive effects which would require either of these remedies. Second, these conditions presuppose that the Board may exercise its jurisdiction to control rail rates in a foreign country. Third, neither of these "remedies" is closely tailored to any anticompetitive effect. Rather, they are broad brush attempts to treat TFM like a shortline railroad connection of UP and BNSF, allowing UP and BNSF to quote rates between points on their lines and points on TFM without consulting TFM. While major railroads sometimes deal with each other in this manner, they do so only for limited types of traffic and only if they have a voluntary agreement to do so, not by administrative imposition. To treat the entire TFM system, which handles 40% of the rail traffic moving within Mexico, as a mere extension of UP and BNSF, would be paternalism run amok, and would insult both TFM and Mexico.

Another effect of these proposals, particularly BNSF's proposal to freeze rates for five years, would be to override private agreements. KCS has said that NAFTA Rail would honor existing agreements on Tex Mex and TFM to their current expiration. BNSF, however, wants to extend any agreement that would expire in the next five years until the end of the fifth year. The effect of this condition would be to override the terms negotiated by the parties in favor of randomly-selected agency fiat. I also notice that although BNSF seeks this five-year override on all existing contracts, it is particularly concerned with a divisions arrangement that it has with Tex Mex. As BNSF indicates, KCS has indicated its belief that a 1998 agreement creates costs for Tex Mex which are out of balance with the revenues Tex Mex earns. Tex Mex, a carrier that operates at a deficit and which cannot currently afford needed track rehabilitation without the

support of its owners, cannot afford to have non-compensatory agreements forced upon it for the next five years. Moreover, as I have often said, this issue is not one of rates for shippers; rather, it is one of divisions between carriers. Competitive options will restrain the carriers from increasing rates to shippers and causing traffic to be lost. Because this is merely an issue of divisions between carriers, and because I understand the Board's precedent to say that the Board's goal is to protect *competition*, not *competitors*, BNSF's request for a systemic rate freeze for five years should not be imposed to protect BNSF's division on certain freight handled by Tex Mex.

I would also caution that it would be very unwise for the Board to tie rates for Mexican rail operations to RCAF-U, as BNSF has suggested. RCAF-U is a U.S.-based index of rail costs. It does not account for currency and inflation differences between the U.S. and Mexico. Tying Mexican rates to a U.S. inflation index could be an economic catastrophe for TFM in light of the currency and inflation rate differences of the U.S. and Mexico, particularly since Ferromex, TFM's primary competitor for U.S.-Mexico rail traffic, would not operate under such a mandated cap..

UP's and BNSF's rate requests also are, in essence, attempts to capture the benefits of the investments that TFM has made over the past six years by freezing in place current rate and service provisions. Much of the traffic growth between U.S. and Mexico is due to NAFTA, but much of the rail traffic growth is due to the investment of more than \$1 billion that TFM has made in the past six years to make itself a first class railroad. As I said at the Board's July 31 hearing, it is those investments, supported by KCS, which make possible competition by Pacer (and others) in Mexico.

In one form or another, UP and BNSF seek to freeze current operations of TFM in place, or at least to prevent TFM's operations from being changed without their consent. This is an extraordinary request from parties that don't own TFM and have not made any of the \$1 billion investment made in the last six years in TFM. It is particularly ironic coming from UP, which was very critical of the price KCS and TMM paid for TFM in 1996. Now, UP wants the use of that investment restricted to its benefit.

Quite simply, tying TFM and Tex Mex operations to what exists now will impair their ability to react to market conditions, innovate, and improve services. Any requirement that they maintain certain rates or services unless UP and BNSF agree otherwise will tie their capital and operating funds to existing service patterns or to approval of UP and BNSF. That restriction will, of course, help perpetuate UP's dominance on U.S.-Mexico rail transportation, and will help keep KCSR firmly in third place. UP and BNSF both have the ability to make transportation between the U.S. and Mexico more competitive by investing in their facilities and capabilities on the U.S. side of the border, and UP has the ability, as a major shareholder of Ferromex, to push Ferromex toward making the types of investments that TFM has made to improve the competitiveness of rail service in Mexico. Neither UP nor BNSF has shown the dedication to improvement of cross-border competitiveness that TFM and its owners have shown through their investments.

There is still a tremendous untapped market for rail transportation in Mexico. TFM should not be compelled to compete in that market with one hand tied behind its back by restrictions that tie its capital and operating expenditures to whether UP or BNSF will agree to market-driven changes.

No party to this proceeding has shown that any substantial competitive problem is likely to result from KCS's acquiring control of Tex Mex. Hypotheticals and theoretical possibilities are the most anyone can muster in opposition. "Might's," "could's," and "if's" litter our opponents' pleadings. And even those hypotheticals relate to the TFM transaction, a matter which already has been considered by the major competition-protecting agencies in the U.S. and Mexico and found to present no problems.

In the absence of a demonstrable competitive problem, the Board cannot and should not stifle innovation and efficiency improvements by imposing government solutions on private business. Private agreements have succeeded in fostering and growing rail business across the border for decades. The KCS agreement with NITL is the epitome of that type of solution, a private agreement which deals with concerns that the shipping community has, and gives shippers the confidence to move forward with their business. Even without being imposed as a condition, it is a functional, enforceable agreement that assures shippers that their needs will be met.

If a competitive problem arises, the Board should address it in a focused fashion. The Board should not, however, attempt to create broad brush solutions to hypothetical problems which only "might" or "could" exist sometime in the future.

CONCLUSION

It is clear that KCS's control of Tex Mex and TFM will not give KCS the ability to raise prices to shippers or to force inefficient joint-line routings between TFM and UP or Tex Mex and BNSF. Market forces simply wouldn't allow NAFTA Rail to do so even if it tried. Due to the fact that UP and BNSF have substantial bargaining power and leverage and the fact that TFM depends upon traffic from these carriers for its revenues, TFM and KCS have cooperated with

these carriers in the past and must continue to do so in the future if NAFTA Rail is to grow.

Common control will not change those incentives.

If KCS attempted to use its control of TFM or Tex Mex to raise prices to shippers or to demand inefficient divisions from UP or BNSF, this traffic would switch to other modes. There are millions of truck movements across the border each year and trucks play a powerful role in constraining rail prices for U.S./Mexico traffic. Likewise, ship and barge transport to and from Mexican and U.S. ports is also very competitive for a number of commodities. UP and BNSF also have the ability to shift to alternate rail gateways, again providing a check on any efforts by NAFTA Rail to raise prices or force inefficient routings.

The vast majority of shippers support our transactions. Our support comes from all commodity types, including grain, automotive, and intermodal shippers, who UP claims would be hurt by the transactions. The only substantial opposition has come from our competitors. The reason our competitors oppose our transactions is simple: NAFTA Rail will provide stronger competition to UP and BNSF by allowing NAFTA Rail to improve service, not worsen it, and to lower rates, not raise them. Simply put, the UP and BNSF don't want stronger competition from KCSR-Tex Mex-TFM because it will force them to improve the quality of their service offerings, and will put pressure on their pricing.

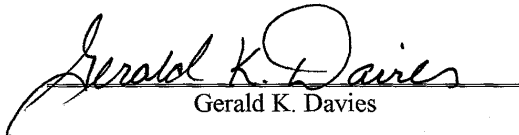
UP and BNSF couch their arguments in terms of protecting competition, but in reality they are concerned about potential diversions away from their systems onto the NAFTA Rail system. Even if diversions don't occur, they are afraid that in the future they may have to take a lower division of the overall through rate because they face a more efficient competitor. These are not concerns of the type that the Board is charged to consider. As the Board has often said, its goal is to protect competition, not competitors.

In the end, the type of competition that NAFTA Rail will offer is exactly the type of competition that the Board seeks to foster. Protecting and improving the quality of service to shippers is the Board's goal; not protecting competitors. This transaction meets that goal. KCSR, Tex Mex, and TFM will be able to provide better coordinated, more efficient, more reliable, more cost-effective service as a result of their strengthened affiliation. The ultimate beneficiaries of all of these improvements will be transportation customers.

The questions here is simple: should the STB continue to rely upon market forces, private agreements (such as the NITL agreement and the agreements governing the Laredo bridge), the existence of post-transaction remedies both here and in Mexico, and continuing oversight, or should the STB freeze rates, involve itself in rate negotiations between domestic and foreign carriers, and impose government regulation over a bridge that has successfully operated handling both UP and Tex Mex traffic for over fifty years. The correct choice is simple: the STB should resist efforts to hamper those competitive benefits by imposing unnecessary conditions, and should instead allow the market to work. It should approve the Tex Mex transaction without conditions.

VERIFICATION

I, Gerald K. Davies, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.


Gerald K. Davies

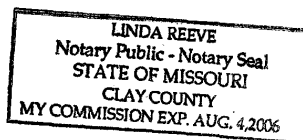
Executed on 28 of August 2003.

STATE OF MISSOURI)
)
COUNTY OF Jackson) ss.

Subscribed and sworn to before me
on this 28 day of August 2003.


Notary Public of the State of Missouri

My commission expires: August 4, 2006



PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB G

**REBUTTAL VERIFIED STATEMENT OF

BENGT MUTÉN**

REBUTTAL VERIFIED STATEMENT OF BENGT MUTÉN

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
and
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

Introduction

My name is Bengt Mutén. I am a Principal of Reebie Associates, a transportation consulting firm with its primary office in Stamford, Connecticut. A more complete statement of my qualifications is included in my initial verified statement contained at pages 118-129 of the Application in this proceeding.

The purpose of this statement is to briefly address two issues – (1) arguments by Burlington Northern and Santa Fe Railway Co. (“BNSF”) which misconstrue the meaning of the traffic diversion study that I performed in connection with the Application, and (2) the vast misimpression left by Union Pacific Railroad Company (“UP”) about the number of points at which it and KCS provide head-to-head competitive rail service.

BNSF’s Mischaracterization of Diversion Study Results

In its filing concerning KCS’s Application, BNSF states that the Application shows that KCS will route traffic away from BNSF-Tex Mex routings inefficiently. Apparently these arguments rely on the diversion study in the Application, which I performed. BNSF’s argument on this point is a distortion of the meaning and intent of a diversion study.

BNSF said in its August 4 filing with the Board that “KCS’ diversion analysis confirms KCS’ intent to divert traffic from BNSF, even if that diversion results in inefficient routings of rail traffic.” BNSF Comments at 12. This is simply wrong.

A diversion study is, in essence, a best estimate of the amount of existing traffic that will be attracted to rail routings that become more efficient and more competitive due to the merger or common control of two rail carriers. It is not, as BNSF construes it, a statement of intent by the merging carriers to force traffic over new, albeit inefficient single-line routings.

My initial verified statement made clear that my diversion study was an estimate of potential diversions based on anticipated efficiencies. I pointed out that the study was “a diversion *estimate* of the impact on existing railroad traffic of operating . . . KCSR [and] Tex Mex[] as a single system.” (Emphasis added.) Application, p. 118. I noted that among the premises of the study were that KCS and Tex Mex would be operated as a single system, that Tex Mex’s physical plant would be significantly upgraded, and that Tex Mex’s access over UP’s lines via trackage rights would be equivalent to the quality of access available if Tex Mex owned the lines. *Id.* at 119. Each of these facts would represent an efficiency improvement with respect to KCS-Tex Mex traffic as compared to current circumstances.

I further explained that rules and diversion percentages employed with the standard diversion model that I used take into account the competitive advantages of the historic and diverted routes (including number of junctions), circuitry, competition at origin and destination, and traffic type. *Id.* at 120. The diversion model develops alternative routes for existing traffic via the ‘merging’ carriers, using a minimum impedance algorithm, constrained by existing junctions and availability of service at the origin and destination points (or, in the case of intermodal or auto traffic, nearby alternative points). *Id.* I specifically pointed out that “if the

route is too circuitous to be regarded as competitive vis-à-vis the historic route, it is rejected, and the movement is assumed not to be divertible.” *Id.* at 121. If the route is considered a plausible candidate for diversion, then the diversion rules are applied to estimate the number of total movements which may be diverted to the ‘merging’ carriers’ improved route. *Id.*

The diversion study does not attempt to determine whether a specific shipper’s traffic would be diverted, but rather the likelihood that a portion of the traffic bearing common characteristics would prefer using the ‘merging’ carriers’ improved route. The study does not mandate routing of future traffic movements, nor does it override a shipper’s normal ability to choose the route for its traffic. Rather, the study is merely used to estimate what types of traffic might use an available route if the efficiency of moving traffic over that route were improved through merger or common control of carriers that each operate a part of that route. Thus, BNSF’s claim that the study shows that KCS will reroute traffic inefficiently is a gross mischaracterization of the purpose and results of the diversion study that I presented in the Application.

It should also be pointed out that in some instances, additional information that I did not have in doing the study might change the study’s result. For example, in its filing, BNSF asserts that the study shows that a commonly-controlled KCS/Tex Mex would force traffic that BNSF interchanges at Brownsville for delivery by TFM at points in Mexico near Brownsville, to move over KCS/Tex Mex to Laredo, and then via a circuitous route over TFM to its Mexican destination.

If the study indicated such a diversion, then it was an unintended outcome of the study, resulting from the fact that I did not have available to me information about destinations in Mexico of most of the study sample traffic. The majority of U.S.-Mexico movements in the

2001 STB Carload Waybill Sample that I used for the study appear as movements that originate or terminate at the border gateway, apparently due to separate billing of the movements on each side of the border. Consequently, I would not have known from the data that particular BNSF movements to Brownsville were ultimately to be delivered to a nearby point in Mexico rather than to Mexico City or another destination. Had I known that, and assuming the extreme circuitry of the alternative routing as posited by BNSF, I am confident that the study would not have shown such movements as shifting to a KCS/Tex Mex route to Laredo. Again, however, it must be emphasized that even in the unlikely event that the study still showed such a diversion, it would not mandate rerouting of the traffic.

In short, my diversion study in the Application provides no basis for BNSF's claims of "forced" rerouting of traffic to inefficient routes. Rather, a diversion study is simply a sophisticated means of estimating the possible preferences of existing traffic to use improved routings available as a result of efficiencies resulting from merger or common control of 2 or more carriers. Such a study does not mandate a new route for any traffic, but is simply a tool to estimate the financial and operating effects of the transaction on affected carriers.

UP's Overstatement of Markets in Which KCS and UP Compete

In its comments and requests for conditions in this proceeding, UP stated that KCS "*and its connections in the United States, including BNSF,*" could compete with UP for approximately 80% of the traffic moving over the Laredo Gateway and that, as a result, KCS stood to gain a great deal of divertible traffic by discriminating against UP. *See* Verified Statement of John T. Gray at 25. The data, however, shows that UP has greatly exaggerated the potential benefit to KCS of such discrimination.

First, it must be noted that UP's data has been combined so that effectively UP is comparing the routes of KCS, Tex Mex, and every other carrier in the country against UP's own lines. Even with that basis of comparison, UP by its own admission still has no competition at 20% of the points involved. Moreover, UP assumes that merely because a carrier other than UP reaches the origin or destination of the traffic, KCS/Tex Mex would behave anticompetitively to divert traffic away from UP.

To look more directly at points where KCS and UP compete head-to-head, I used the 2001 Carload Waybill Sample and identified all 1,099 six-digit Standard Point Location Codes¹ ("SPLCs") that served as origins for movements to Laredo. Results of this analysis, and the same for the 388 markets served from Laredo, are shown in Attachment A.

Most telling, UP and KCS compete head-to-head with each other exclusively at only 7 of 1,099 origins for traffic moving to Mexico in 2001. That is a mere 0.6% of the origins for traffic moving over Laredo, accounting for 1.9% of the carloads. Indeed, points that are "UP-served only" are fully 17.4% of all origins combined. It is clear, therefore, that discrimination against UP by KCS or NAFTA Rail could obtain a long haul over the combined KCS/Tex Mex from at most 0.6% of origins, not 80% as UP claims.

Looking at northbound traffic, the case becomes even more extreme, with UP and KCS not competing exclusively in any currently existing market.

What defines a "market" for railroad purposes is subjective. For some shippers or commodities, if the carrier does not serve the shippers siding directly or through reciprocal

¹ "'SPLC' refers to the Standard Point Location Code, a code used on all interline freight accounting forms to identify all U.S. points served by rail or motor carriers. It may have up to six position numbers, identifying a geographic area in the first position, the state in the second position, the county in the third and fourth positions, and the station in the city or town in the fifth and sixth positions." UP/SP Decision No. 44, 1 S.T.B. 233 at 373, n. 102.

switching, it is immaterial how close a carrier comes, it is not efficient to use it. For other commodities, transloading or intermodal services are a convenient way to access competing carriers in the same general vicinity. In order to eliminate any bias from the 6-digit SPLC definition defining markets too narrowly, I also looked at the distribution of competition using 4-digit SPLC as the definition of a competitive market. These results are displayed in Attachment B. As can be seen, neither the number of markets, nor the share of markets served by UP and KCS exclusively, is significantly changed by this approach.

Attachment A
Laredo Traffic by Market Type (Markets Defined by 6-Digit SPLC)

Northbound Laredo Traffic						
			Cars Terminating in Markets Served By			
	Markets	Cars	BNSF	UP	KCS	Other
UP-Served Only	76	101,736	-	101,736	-	-
BNSF-Served Only	84	6,960	6,960	-	-	-
KCS-Served Only	11	148	-	-	148	-
BNSF and UP Served	21	51,001	51,001	51,001	-	22,373
BNSF and KCS Served	1	42	42	-	42	-
BNSF, UP, and KCS-served	2	1,116	1,116	1,116	1,116	-
Other BNSF Served	5	321	321	-	-	321
Other UP Served	2	1,160	-	1,160	-	1,160
Other KCS Server	1	40	-	-	40	40
Other	185	28,596	-	-	-	28,596
Total	388	191,120	59,440	155,013	1,346	52,490
Share		100%	31%	81%	0.7%	27%

Southbound Laredo Traffic						
			Cars in Markets Served By			
	Markets	Cars	BNSF	UP	KCS	Other
UP-Served Only	191	62,068	-	62,068	-	-
BNSF-Served Only	296	10,720	10,720	-	-	-
KCS-Served Only	46	4,182	-	-	4,182	-
BNSF and UP Served	57	27,714	27,714	27,714	-	15,399
BNSF and KCS Served	1	230	230	-	230	-
UP and KCS Served	7	3,149	-	3,149	3,149	328
BNSF, UP, and KCS-served	5	5,867	5,867	5,867	5,867	1,046
Other BNSF Served	7	1,527	1,527	-	-	1,527
Other UP Served	4	10,268	-	10,268	-	10,268
Other KCS Server	3	963	-	-	963	963
Other	482	43,226	-	-	-	43,226
Total	1,099	169,914	46,058	109,066	14,391	72,757
Share		100%	27%	64%	8%	43%

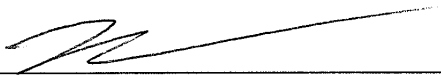
Attachment B
Laredo Traffic by Market Type (Markets Defined by 4-Digit SPLC)

Northbound Laredo Traffic						
			Cars in Markets Served By			
	Markets	Cars	BNSF	UP	KCS	Other
BNSF-Served Only	56	10,086	10,086	-	-	-
UP-Served Only	45	33,390	-	-	-	-
KCS-Served Only	10	148	-	-	148	-
BNSF and UP Served	28	83,557	83,557	83,557	-	24,964
BNSF, UP, and KCS-served	3	2,561	2,561	2,561	2,561	-
Other BNSF Served	7	1,103	1,103	-	-	1,103
Other UP Served	4	41,068	-	41,068	-	41,068
Other KCS Server	1	122	-	-	122	122
Other	163	29,442	-	-	-	29,442
Total	317	201,477	97,307	127,186	2,831	96,699
Share		100%	48%	63%	1.4%	48%

Southbound Laredo Traffic						
			Cars in Markets Served By			
	Markets	Cars	BNSF	UP	KCS	Other
BNSF-Served Only	182	22,557	22,557	-	-	-
UP-Served Only	110	47,350	-	47,350	-	-
KCS-Served Only	23	3,280	-	-	3,280	-
BNSF and UP Served	70	47,651	47,651	47,651	-	20,636
BNSF, UP, and KCS-served	8	9,213	9,213	9,213	9,213	1,441
BNSF and KCS Served	1	268	268	-	268	-
UP and KCS-served	9	2,469	-	2,469	2,469	328
Other UP Served	11	16,595	-	16,595	-	16,595
Other BNSF Served	11	4,913	4,913	-	-	4,913
Other KCS Server	3	1,006	-	-	1,006	1,006
Other	360	45,824	-	-	-	45,824
Total	788	201,126	84,602	123,278	16,236	90,743
Share		100%	42%	61%	8%	45%

VERIFICATION

I, Bengt Mutén, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.



Bengt Mutén

STATE OF CONNECTICUT

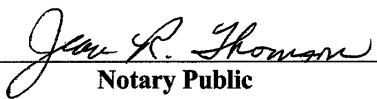
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COUNTY OF FAIRFIELD

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ss. *Grainich*

Subscribed and sworn to before me
this 29th day of August 2003.



Notary Public

My commission expires: *June 30, 2008*

PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB H

VERIFIED STATEMENT OF

MICHAEL H. ROGERS

VERIFIED STATEMENT OF MICHAEL H. ROGERS

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY
AND
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

My name is Michael H. Rogers. I am President of Cogent Solutions, LLC ("Cogent"), a transportation consulting and technology development firm located in Princeton, New Jersey. My qualifications include fourteen years of experience performing railroad traffic diversion studies and competitive analyses in support of rail industry corporate restructurings and strategic planning assignments. I have participated in numerous industry transactions, including BNSF-CN, CN-IC, CSX/NS-Conrail, UP-SP, KCS-GWWR, SP-CMNW and the TFM privatization process. I formerly held various titles with ALK Technologies with the last being Vice President, Strategic Consulting and Decision Support Services. I received my M.B.A. from Columbia University with honors and concentrations in corporate finance and operations strategy. My undergraduate degree is a B.S.E. from Princeton University in Electrical Engineering and Computer Science with a Certificate in Engineering and Management Systems from the Civil Engineering and Operations Research department. I have also completed a short, non-degree program in Mergers and Acquisitions at the University of Pennsylvania's Wharton School of Business.

SUMMARY

I was asked by the Applicants to review the Union Pacific comments and request for conditions on TFM rate factors at the Laredo gateway. Specifically, I studied their proportional rate proposal, which was modeled after a voluntary agreement between Union Pacific and Burlington Northern Santa Fe regarding the I-5 corridor as part of the UP-SP transaction.

My analysis has led me to two conclusions. First, there is no clear need arising from the proposed KCS-Tex Mex and KCS-TFM transactions for any remedial condition to ensure that shippers continue to have competitive options for U.S.-Mexico traffic. Second, even if a remedy was recommended, the proposed proportional rate mechanism is not narrowly tailored. Each of these conclusions is explained in detail below.

RESULTS

1. The need for a condition has not been demonstrated

a. The request for a condition has little to do with the proposed KCS-Tex Mex transaction

Union Pacific has requested that the STB impose a condition that regulates TFM interline rate factors with UP and KCS. I use the term 'regulate' because the proposed mechanism is an involuntary condition designed to keep TFM rate factors with KCS and UP at the Laredo gateway at similar levels rather than allow the market to efficiently set these prices as it does currently. My understanding is that this proceeding addresses whether the KCS-Tex Mex transaction is likely to result in a substantial reduction of competition in U.S. freight transportation. The condition requested by UP from the Surface Transportation Board clearly applies to the KCS-TFM transaction, which falls under the authority of other regulatory bodies. Those agencies with authority to impose remedies to address anti-competitive concerns include

the U.S. Department of Justice and the Mexican Competition Commission. Each has approved the KCS/TFM transaction without conditions.

b. The Union Pacific case for a rate condition is based on a hypothetical argument

The Union Pacific rationale for a condition that keeps the Laredo gateway open is based on a hypothetical argument. It basically claims that, post KCS-TFM transaction, NAFTA Rail might raise rate factors to interline carriers and possibly even rates to shippers. In fact, they suggest that KCS will do this to their own financial benefit and the detriment of shippers.

The reality is that there are many possible scenarios regarding future rate levels and traffic flows. These potential scenarios are based on various market forces that change over time. Dynamic market forces are what prompted the proposed KCS-Tex Mex and KCS-TFM transactions. These transactions reflect the desire of KCS to strengthen its ability to compete and serve shippers in NAFTA traffic lanes. By establishing a financially healthy, efficient alternative to compete with UP and BNSF for U.S.-Mexico cross border traffic, KCS is enhancing competition in a market that is currently dominated by one carrier.

The Union Pacific prediction of higher rates and lower service is not only based on what might or could happen, it also focuses on just one potential and intermediate outcome. For example, there is also a possibility that, through the potential transaction synergies of the combined system, NAFTA Rail will be able to offer lower combined TFM, Tex-Mex and KCS rates to shippers than today. All things being equal, this outcome would likely result in NAFTA Rail gaining additional traffic volumes, whether from new business in this growing market or from other routes. It should be recognized that any market is a dynamic environment and competitors will continue to react to intermediate outcomes. Under this scenario, for example,

UP may in turn be influenced by the market changes described above to respond to NAFTA Rail's competitive maneuvering.

c. End-to-end, "bottleneck" transactions in the rail industry have consistently been determined not to harm shippers

The ICC and STB have been clear and consistent on the question of potential vertical foreclosure concerns in rail transactions. The Board has consistently found that end-to-end rail mergers between one carrier and a connecting, "bottleneck" carrier are highly unlikely to result in the reduction of competitive interline route options and higher rates to shippers. In the BN-SF decision, the ICC stated:

Our experience has been that where a single rail carrier controls a destination segment, and no transportation alternatives are available, the shipper will be captive and the single rail carrier will be able to capture the preponderance of the economic profits. Conversely, when certain factors are present that limit a carrier's ability to take full advantage of a bottleneck, those factors will remain in place as effective safeguards after the merger.

Burlington Northern Inc. – Control and Merger – Santa Fe Pacific Corp., 10 I.C.C.2d 661, 751 (1995).

The proposed KCS-Tex Mex and KCS-TFM transactions are no different. Based on their decisions on these transactions, the U.S. Department of Justice and Mexican Competition Commission apparently agree.

TFM is currently a bottleneck rail carrier in Mexico for cross-border routes via Laredo. UP's own comments suggest that TFM has provided UP with reasonable rates and rate factors to enable effective competition between UP-TFM routes and those involving KCS-Tex Mex and BNSF-Tex Mex. They also suggest that, in their opinion, TFM's rates do not exploit the measure of TFM's potential market power today. As described by the ICC decision above, analysis of bottleneck cases has consistently agreed that the market forces directing efficient,

competitive pricing before a merger will also exist after the transaction and thus restrict any potential negative effects. In the case of TFM, these market forces include, but are not limited to, effective competition from truck in Mexico and the U.S., rail carrier options in Mexico and the U.S. and gateway routing options.

In addition to the broadly accepted economic principles involved with these situations, and the considerable history of the ICC and STB applying them, KCS has committed to keeping the Laredo gateway open on commercially reasonable terms.

d. NAFTA Rail has economic incentives to grow their business through competitive rates and service offerings

NAFTA Rail's economic self-interest demands competitive rates and service levels for shippers. KCS has chosen to undertake significant risk and make major capital investments to create NAFTA Rail and develop an efficient network for shippers. To earn an adequate return on this investment, KCS has an economic incentive to attract customers and traffic to this cross-border routing alternative over time. However, competitive rates and service levels will be required to grow the NAFTA Rail traffic volume.

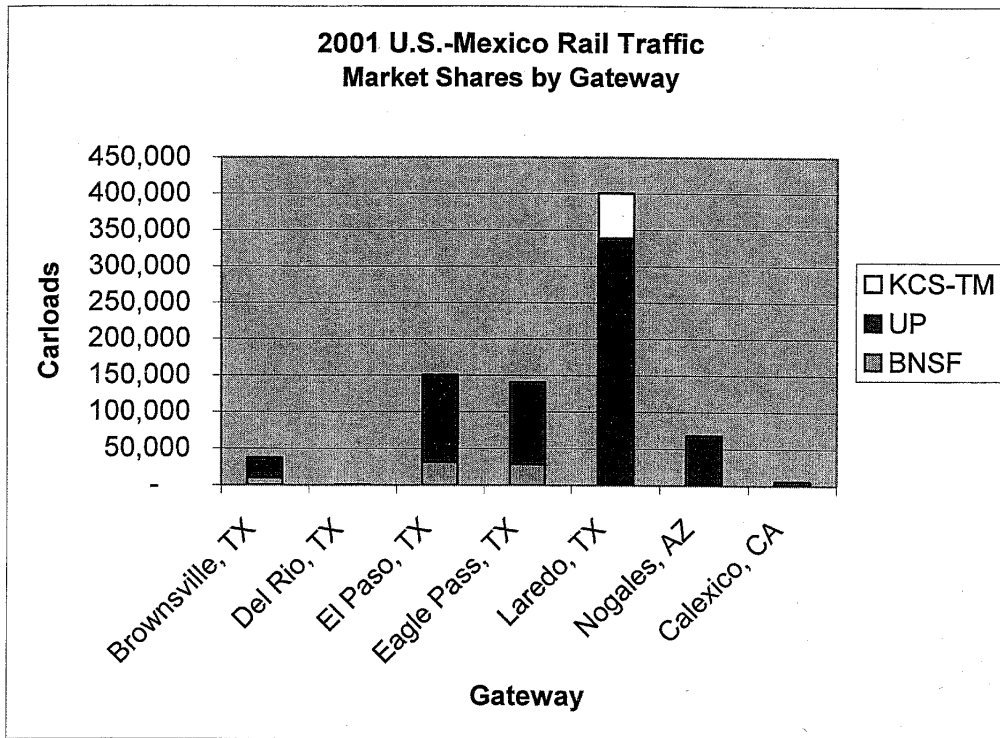
Market forces will drive customers to other competitive options if KCS attempts to raise rates and exercise (non-existent) market power. Shippers have the option of utilizing any number of carriers, routes and modes to transport goods to and from Mexico.

Through my experience with the TFM privatization process in 1996, it was clear that rail as a mode in Mexico had seen its share of the country's freight transportation consistently and dramatically reduced in favor of truck. Much of this traffic involved the rapidly growing U.S.-Mexico cross-border trade and typically relied on either truck routing from origin to destination or possibly a combination of rail in the U.S. and truck in Mexico. One of TFM's major opportunities was to create a competitive alternative to truck and win back some this traffic

within Mexico. It is my understanding that TFM has demonstrated success with customers but that truck still represents a major source of competition.

Beyond the enormous volume of cross-border truck shipments, it is clear from the actual volumes that competitive rail route alternatives for U.S.-Mexico traffic also exist. Laredo represents an important gateway for many reasons, but the other border crossing points also handle significant volumes of traffic today. Exhibit 1 presents the rail volumes moving through the U.S.-Mexico gateways according to the 2001 STB Carload Waybill Sample ("CWS").

EXHIBIT 1



COLOR FIGURE 1

It is clear from this data that rail carriers currently use many different gateways along the U.S.-Mexico border to provide efficient routes. While Laredo is the largest single gateway, significant volumes of cross-border rail traffic pass through Eagle Pass, El Paso and Nogales, suggesting that these additional gateways offer viable routing alternatives to Laredo.

UP demonstrates a strong market presence at each of the gateways. BNSF routes traffic through El Paso, Eagle Pass and Brownsville. To provide service via Laredo, BNSF has negotiated arrangements with Tex-Mex via the Corpus Christi/Robstown interchange. KCS-TM serves only the Laredo gateway directly.

The U.S.-Mexico gateway rail options also provide important connections to Ferromex ("FXE") for BNSF and UP. FXE serves the Eagle Pass, El Paso, Nogales and Calexico border-crossings and provides service to key industrial points as a competitor to TFM in Mexico and more broadly to TFM interline routes with U.S. carriers for certain lanes and commodities.

It is important to recognize that these gateway choices enhance competition by creating route options for rail shippers. Depending on several competitive and market factors, including service network and interline pricing structures, traffic may be shifted from one gateway to another as conditions warrant. Because of their extensive service networks and the availability of gateway options, UP and BNSF are in particularly strong positions to flexibly respond to changes in the market conditions.

Another example of how market dynamics and competition creates new route alternatives is the use of rail-barge-rail routes from southern Mexico to the eastern U.S. The 2001 CWS includes a few examples of this type of routing using Mobile, AL as the gateway location.

The U.S.-Mexico freight transportation market has many competitive options in terms of carriers, routes, gateways and modes, both north and south of the border. This dynamic leaves

relatively little room for any carrier to attempt to exercise pricing power without a negative consequence.

2. The proposed rate condition is too broad and inefficient

As part of its request for a regulatory condition on Laredo rate levels, the Union Pacific has proposed a proportional rate mechanism. The proposal is modeled after the UP-BNSF I-5 Corridor agreement. The mechanism would provide UP with rate factors for its interline traffic with TFM in certain Laredo gateway lanes, namely those in which UP and KCS compete directly, UP competes with KCS in connection with ICE and DME, and eastern U.S. points. UP may propose end-to-end rates to customers moving traffic in these lanes, with the knowledge that the proportional rate matrix will govern TFM's revenue division. The matrix would be populated with rate per ton-mile factors that are indexed by commodity, car type and car ownership for each of the lanes in question. These factors would be computed as an average of the actual TFM net revenue divisions from a prior time period for the traffic type and is updated on a quarterly basis. It appears mathematically fair because TFM will receive a division commensurate with what TFM has been receiving from KCS routes for similar business. Because of the consolidation of all traffic of a similar type into a rate per ton-mile factor, there is a provision for individual customer rate privacy built into the mechanism.

a. There are major differences between the I-5 corridor and TFM

The proposal is based on an agreement between UP and BNSF as part of the UP-SP merger that addressed the I-5 corridor. It is important to recognize that there are major differences between the I-5 and TFM situations.

First, BNSF and UP negotiated and entered the I-5 agreement voluntarily as part of the UP-SP merger. The I-5 agreement was not an involuntary condition imposed on the carriers, as

would be the case in the KCS-TFM transaction. KCS has expressed a continued willingness to negotiate voluntary agreements with other carriers.

Second, the I-5 corridor represents a fraction of UP's and BNSF's overall traffic and was a relatively small component of the UP-SP merger. In contrast, the proposed condition on Laredo rates is so broadly defined on a relative basis, that it would affect virtually all of TFM's traffic and a major growth segment of the North American rail industry.

b. The proposal would create unnecessary administrative complexity

The proportional rate mechanism proposed by Union Pacific would be difficult to administer and create unnecessary complexity. The work required, not only to compute and populate the rate matrix, but to support, audit and resolve the inevitable problems with this mechanism in an involuntary context should not be underestimated. Even the voluntary UP-BNSF I-5 PRA has resulted in ongoing disagreements, disputes and audits. For example, BNSF's Quarterly Progress Report from April 2, 2001 states:

BNSF-PR-19, *BNSF's Quarterly Progress Report*, April 2, 2001 (Section J, Page 24)

UP asserted in its January 2, 2001 progress report that the I-5 Proportional Rate Agreement ("PRA"), which was imposed by the Board as a condition of its decision approving the UP/SP merger, is not working as intended and the UP often cannot compete effectively with BNSF. UP alleged that BNSF rates in the proportional rate matrix are remaining steady or increasing, pricing UP out of markets, despite reports from customers that BNSF's rates are declining. UP stated that BNSF had recently acknowledged to UP that it had not developed computer systems it had agreed to provide, which are necessary to supply accurate rate information to create the matrix of proportional rates. Furthermore, UP claimed that the rate data contain frequent errors, virtually all of which competitively favor BNSF. Finally, UP alleged that BNSF had failed to cooperate with an informal audit of the I-5 PRA by ceasing its cooperation with the audit when the initial results suggested "serious questions" about BNSF's data and by failing to respond to UP's inquiry for additional information.

In response to the UP allegation that the I-5 PRA is not working as intended and that UP cannot compete effectively, BNSF notes that the volume of BNSF-UP Portland interchange traffic moving under the PRA over the last two years does

not support UP's position. In fact, BNSF's analysis of UP traffic volumes moving under the PRA during 1999 and 2000 shows that UP has enjoyed considerable success.

Imposing this kind of bureaucratic process on the rapidly growing and vital Laredo rail gateway as an involuntary transaction condition seems both overly broad and onerous from an administrative perspective.

c. The proposal would restrict KCS' ability to create a strong alternative route option

The proportional rate mechanism would undermine the commercial flexibility and competitiveness of NAFTA Rail. For it to be successful in establishing a strong, alternative route option for shippers, NAFTA Rail must have the ability to operate as a single, integrated system.

In the U.S., KCS and Tex Mex represent a more circuitous route in many Laredo lanes than UP's route. This greater circuitry, as compared with the UP route, logically translates into a higher variable cost of transportation and makes it more challenging for KCS and Tex Mex to offer an effective competitive option in many lanes.

The KCS-Tex Mex and KCS-TFM transactions change the economic perspective for NAFTA Rail. By combining the carriers into a single, integrated system, the new entity may evaluate business on a complete route rather than individual segment basis. As an example, suppose there is a customer who is 750 miles from Laredo via the UP route and 825 miles via KCS (10% more circuitous). The KCS revenue requirement for this customer is currently evaluated on the basis of that degree of circuitry relative to the alternative UP route. Assume also that the Mexico City is the source of that customer's traffic and is handled by TFM via Laredo, which represents an additional 740 miles. Under NAFTA Rail, the total route is now the basis for evaluating the business and it only 5% more circuitous than the UP route. The proposed

transactions will obviously not make the routes shorter but the revenue requirement perspective will change from that of an individual carrier to that of an integrated, single-line system, which can allocate the variable cost across the entire route. The benefit of this shift in economic perspective and incentives goes to shippers who would now have a stronger competitive option.

This perspective, coupled with transaction efficiencies, will provide NAFTA Rail with the flexibility to offer shippers service and rates from points within Mexico directly to U.S. interchanges like Jackson, MS and Meridian, MS for connections to other carriers for destinations in the Eastern U.S. and Midwest. This single-line service perspective may be more attractive to shippers than existing approach that is constrained by the revenue requirement of each individual carrier in the route.

If the proposed proportional rate condition were imposed, NAFTA Rail's ability to compete would continue to be restricted by its relative circuitry north of the border. Through the proportional rate mechanism, UP would be effectively given the same TFM rate factors as KCS south of the border. This, in turn, would provide UP with the knowledge of KCS' approximate TFM rate factors as well as their relative circuitry for specific lanes and customers. The result would be a continuation of the current environment in which relative circuitry north of the border is a major competitive factor because variable costs south of the border are equalized across connecting carriers. It would be difficult for NAFTA Rail to operate as an effective, single-line competitor under these conditions.

CONCLUSION

Union Pacific's proposal for a condition on TFM rate factors at Laredo is both unnecessary and overly broad. My analysis produced two basic conclusions.

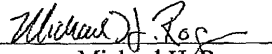
First, the rationale for a condition has not been established. The proposed condition directly addresses the KCS-TFM transaction, which is not the subject of this proceeding, and is based on a hypothetical argument that disregards two decades of STB and ICC decisions on these types of bottleneck cases.

Second, the proposed remedy is not narrowly tailored. The proportional rate matrix creates an involuntary administrative burden and affects nearly all of TFM's traffic. The proposed mechanism actually does little to prevent higher rates to shippers and more to protect the UP against the uncertainty that their current TFM rate factors may change. KCS has expressed a commitment to keep rate factors at Laredo at a commercially reasonable level and a willingness to negotiate commercial agreements with other carriers.

I find that the proposed condition would severely and unnecessarily restrict NAFTA Rail's ability to provide a stronger rail option via Laredo and enhance competition in the important U.S.-Mexico transportation market.

VERIFICATION

I, Michael H. Rogers, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.



Michael H. Rogers

Dated: August 31, 2003

PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

- CONTROL -

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

**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
AND REBUTTAL IN SUPPORT OF APPLICATION**

VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB I

VERIFIED STATEMENT OF

RONALD G. RUSS

VERIFIED STATEMENT OF RONALD G. RUSS

**IN SUPPORT OF THE
RAILROAD CONTROL APPLICATION
OF THE KANSAS CITY SOUTHERN RAILWAY COMPANY,
GATEWAY EASTERN RAILWAY COMPANY,
and
THE TEXAS MEXICAN RAILWAY COMPANY**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

FINANCE DOCKET NO. 34342

My name is Ronald G. Russ. I am Executive Vice President and Chief Financial Officer for Kansas City Southern ("KCS"), a holding company that controls The Kansas City Southern Railway Company ("KCSR"), a Class I common carrier by rail, and Gateway Eastern Railway Company ("Gateway Eastern"), a Class III rail carrier. I joined KCS in 2002. Previously, I served in several capacities for Wisconsin Central Transportation Corporation ("WCTC"), including two years as Executive Vice President and Chief Financial Officer, and five years as Executive Manager and Chief Financial Officer for Tranz Rail Holdings Limited, a New Zealand affiliate of WCTC. My twenty-six year railroad career has also included service with Soo Line Railroad and the Chicago, Milwaukee, St. Paul and Pacific Railroad Company. I received a B.S. in Commerce from DePaul University in Chicago, IL.

The purpose of my Verified Statement is two-fold. First, I intend to rebut the statements of some parties (especially Canadian National Railway Company ("CN")) contained in their August 4, 2003 Comments to the effect that KCS intends to pay an inordinate "acquisition premium"¹ for the controlling interest it will buy in Grupo Transportacion Ferroviaria Mexicana,

¹ While Dr. Velturo speaks of a "control premium" in his Verified Statement, I am advised that the more commonly used phrase before this agency is "acquisition premium."

S.A de C.V. ("Grupo TFM"). Primarily through rebutting the comments of CN's only witness, Christopher A. Velturo, I will demonstrate that the price KCS is paying for expanding its ownership of TFM is within a reasonable range for acquisition of a controlling interest in a railroad of this size. Second, I will discuss how the debt that KCS is taking on to accomplish its enhanced ownership of TFM will be repaid through the ordinary course of business, again supporting this discussion by contrasting it to the unsupported supposition put forth by Dr. Velturo.

Before I begin my discussion, I am constrained to point out that KCS' detractors who have expressed concern about an "acquisition premium" and how the purchase will be financed have focused on our acquisition of control of Grupo TFM, a transaction that is not before the Surface Transportation Board (the "Board") for review, and not on our purchase of a controlling interest in The Texas Mexican Railway Company ("Tex Mex"), the minor transaction which the Board is currently reviewing. KCS has actually already paid cash for the shares of Mexrail that it is acquiring, and has placed those shares in a voting trust pending the outcome of this proceeding. I will leave it to our counsel to argue the specifics of the Board's jurisdiction and why the TFM transaction is outside of Board purview. For my purposes, I will merely point out that these discussions by opposing parties focus on pricing behavior for Mexican rail transportation. Just as we would react unfavorably to Mexican efforts to regulate rail pricing in the U.S., so too would I urge the Board to approach with great trepidation requests to render agency decisions that attempt to regulate Mexico's transportation policies.

Assuming the relevance of the price that KCS is paying for control of TFM, it is informative to note the very limited nature of Dr. Velturo's analysis, and what he does not conclude. For example, Dr. Velturo does not conclude that KCS is paying an acquisition

premium for control of TFM. Dr. Vellturo does **not** conclude that any aspect of KCS's acquisition of control of TFM (or Tex Mex, for that matter) is anticompetitive, or even that the transaction will have any adverse impacts in the U.S. All that Dr. Vellturo has put forth is an assumption that KCS, like most other entities acquiring control of another entity, is paying an acquisition premium for control of TFM, and that he cannot conclude what effect the need to pay off that premium will have on U.S. rail transportation. As I explain below, even these constrained suppositions are at odds with well-known, verified facts.

Acquisition Premium

Although it is sometimes used in a pejorative sense, an acquisition premium is nothing more than the reality that control over an entity is often worth more (or, viewed in another manner, costs more) than a simple ownership share. While minority corporate ownership brings with it a limited voice in the corporate direction, along with the right to share in the success or failure of the enterprise, a controlling ownership share allows the owner to chart the corporate destiny, along with a concurrent increased stake in the corporation's financial progress. Two other factors that might contribute to an acquisition premium include the need to pay a higher price to command sufficient shares to vote favorably for the sale, and the potential synergies of combining two or more entities. Whatever the cause(s), acquisition premiums are nothing out of the ordinary. The publication *Mergerstat Review* is dedicated to measuring the acquisition premium paid for significant (\$1 million plus) merger transactions, and even Dr. Vellturo recognizes that acquisition premiums are nothing surprising (Vellturo Verified Statement (hereinafter "Vellturo V.S.") at 2). I understand that the Board has been called upon a number of times to resolve issues related to acquisition premiums, most recently holding in *Major Rail*

Consolidate Procedures, 2001 WL 648944, *18 (2001)² that an acquisition premium would be relevant to the Board's analysis in the required review of the resulting entity's ability to pay fixed charges would be impaired under 49 U.S.C. Section 11324(b)(3). No issue of our future ability to pay our debts as due has been raised in this case.

From the basic premise that acquisition premiums are common, Dr. Vellturo blithely assumes that TMM has negotiated an acquisition premium from KCS for control of Grupo TFM. Vellturo V.S. at 2. This assumption is premised upon the fact that Dr. Vellturo can think of "no evident reason" why a premium would not have been paid. Vellturo V.S., at 2. Of course, this analysis simply ignores several factors, the most important of which is the much-publicized financial distress that TMM is currently experiencing, including its mid May 2003 technical default on \$177 million in Yankee bonds and subsequent technical default on \$200 million additional Yankee bonds. It seems logical to me to conclude that an entity that is facing a severe cash crunch might be inclined to sell portions of its corporate holdings without demanding a burdensome acquisition premium. Additionally, it is possible that the right of first refusal that KCS holds over TMM's sale of its interest in TFM would potentially reduce any acquisition premium that a third party would be willing to pay for that interest. These possibilities are not even considered by Dr. Vellturo.

Moreover, I do not believe that the multiple of earnings that KCS is paying for TFM is out of line with that paid in other railroad control transactions. For example, I was the Chief Financial Officer for WCTC when it was acquired from private ownership by CN in 2001. I am confident that the price per earnings that KCS is paying for TMM's controlling interest in

² I note that the current transaction is not a "major" transaction, and in any event, major transactions involving KCSR are presumptively exempt from the Board's recently revised major merger rules. *Major Rail Consolidation Procedures*, 2001 WL 648944, *34 (2001).

Grupo TFM is very close to that paid by CN for control of WCTC. Thus, contrary to Dr. Velturo's implications, I do not believe that the price that KCS has offered to TMM is anything out of the ordinary, or that deserves extended analysis by the Board.

Paying for Control of TFM

Dr. Velturo's second point concerns KCS's options for paying for control of TFM. Premised from the fact that KCS does not intend to alter the manner in which TFM is currently operated to any significant degree, Dr. Velturo concludes that it is *possible* that KCS intends to exploit TFM's alleged market power at the Laredo gateway in order to pay for control. While Dr. Velturo fails to reach any conclusions on this point, instead opting to point out several possibilities, even those possibilities he references are neither plausible nor adequately explored.

As an initial matter, the "market power" that Dr. Velturo believes to be held by TFM is constrained by very significant competitors in the U.S.-Mexico freight market. Trucks carry the majority of this traffic, and a half-dozen other gateways exist for alternative rail routings. Even barge competition is present for some bulk commodities, as is demonstrated by an existing movement involving Canadian National Railway Company, CSX Transportation, and Ferrosur over Mobile, Alabama. In short, although Dr. Velturo assumes that the Laredo rail gateway is a "bottleneck" (Velturo V.S. at 2), a review of the map and existing competitive factors indicates otherwise.

Moreover, even if the Laredo rail gateway imposed a bottleneck in favor of TFM, Dr. Velturo's assumption that KCS would increase TFM's rates to pay for its acquisition of TFM is directly contrary to the "one lump" theory, which has previously been accepted as a presumed

economic effect by the Board.³ The “one lump” theory holds that the integration of network elements will not result in a significant market increase in prices if one element controls a bottleneck, because the bottleneck segment of the movement has presumably already maximized the price that a shipper will pay for use of that element of the network. Thus, using Dr. Velturo’s own assumption that TFM has no viable competition for the traffic it carries, the “one lump” theory would indicate that KCS cannot raise TFM’s rates to pay for the purchase, because TFM has every incentive to have done so already.

In addition, Dr. Velturo’s analysis fails to take into account the fact that post-acquisition, KCS will be receiving a greater share of TFM’s profits. In fact, given TFM’s profitability over the past few years, I expect the transaction to begin paying for itself within the first year. The chart reproduced below demonstrates the accretive effect that I predict the transaction will bring about: Income Statement Data.⁴

	2002 Revenue	2002 EBITDA	2002 EBIT
KCS Domestic	\$566	\$109	\$48
KCS 37.3% in TFM	\$265	\$97	\$66
U.S. plus 37.3% in TFM	\$832	\$206	\$114
TMM’s 38.8% in TFM	\$276	\$101	\$68
NAFTA Rail	\$1,108	\$307	\$182

It should be noted that this accretive effect will be enhanced through the purchase of the Mexican Government’s interest in Grupo TFM later this year.

Finally, Dr. Velturo’s analysis ignores one critical aspect of KCS’s purchase of control of TFM: because TFM is operating in Mexico, where the rail industry is not as mature as that in

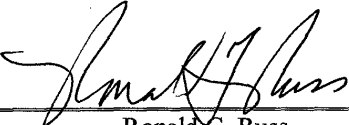
³ *Burlington Northern, Inc. et al. – Control and Merger – Santa Fe Pacific Corp. et al.*, 1995 WL 528184 (1995); *CSX Corp. et al. – Control and Operating Leases/Agreements – Conrail Inc. et al.*, 1998 WL 456510 (1998).

⁴ Figures in millions of dollars U.S.

the U.S., it is reasonable to conclude that the improved infrastructure and service that TFM has been providing will continue to attract new rail customers and expand existing business. I base this comment on the steady improvement that TFM has been making to its physical plant and technology. Although I was not employed by KCS at the time it acquired its interest in Grupo TFM, I am told that the track infrastructure in place at the time of the acquisition suffered from a lack of technology. Since that time, TFM has invested nearly \$1 billion in infrastructure to provide improved service, leading to an increased market share as indicated by market information. Thus, regardless of the ownership structure of TFM, it is reasonable to expect that its profitability will continue to expand, as its operators become more familiar with recently-implemented changes, traffic densities continue to improve, and marketing efforts increase in effectiveness as its customers become accustomed to more predictable and reliable service levels.

VERIFICATION

I, Ronald G. Russ, verify under penalty of perjury that I have read the foregoing statement and that it is true and correct. Further, I certify that I am qualified and authorized to file this verified statement.



Ronald G. Russ

Executed on 28 of August 2003.

STATE OF MISSOURI)
)
COUNTY OF Jackson) ss.

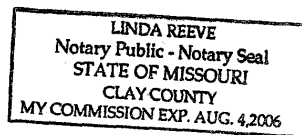
Subscribed and sworn to before me
on this 28 day of August 2003.



Notary Public of the State of Missouri

My commission expires:

August 4, 2006



PUBLIC VERSION

**KCS-18B
TM-17B**

**BEFORE THE
SURFACE TRANSPORTATION BOARD**

Finance Docket No. 34342

KANSAS CITY SOUTHERN

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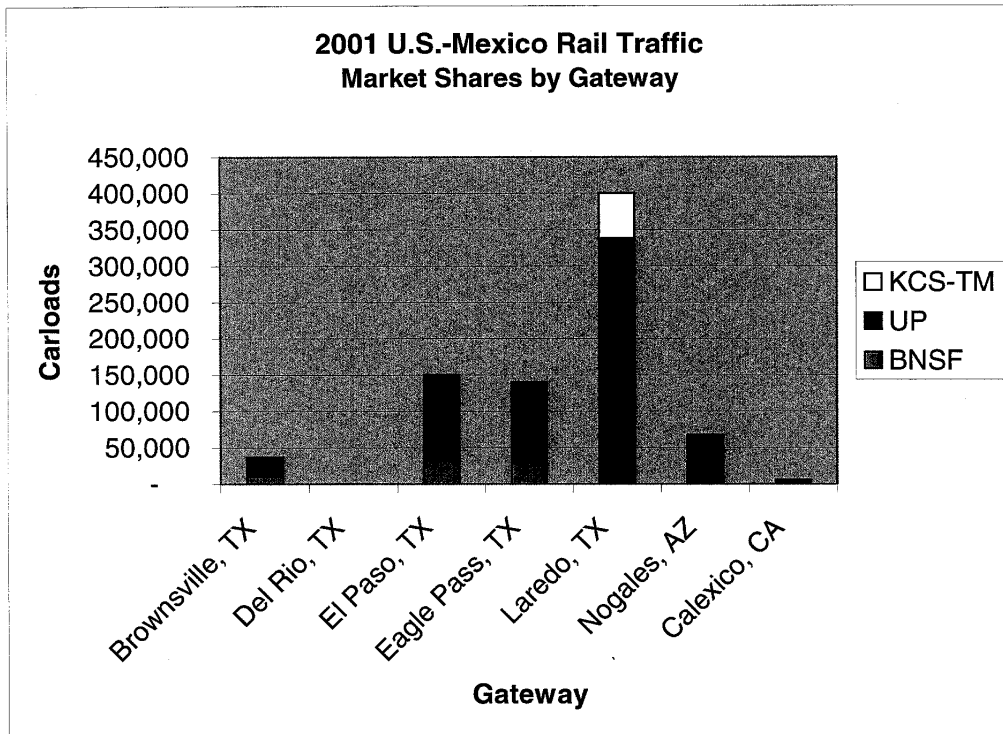
**RESPONSE TO COMMENTS, PROTESTS, REQUESTS FOR CONDITION
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VOLUME 2 OF 2: VERIFIED STATEMENTS

TAB J

APPENDIX OF COLOR FIGURES

EXHIBIT 1



COLOR FIGURE 1