

Testimony of Linda J. Morgan  
Chairman of the Surface Transportation Board

Senate Committee on Commerce, Science, and Transportation  
Subcommittee on Surface Transportation and Merchant Marine  
Hearing on  
the Surface Transportation Board Decision  
Regarding New Major Rail Merger Rules

June 28, 2001

**Introduction**

My name is Linda J. Morgan, and I am Chairman of the Surface Transportation Board (Board). I am appearing today at the Subcommittee's request to review the Board's new rules governing mergers of large railroads adopted in *Major Rail Consolidation Procedures*, STB Ex Parte No. 582 (Sub-No. 1).

The Board's decision adopting new major rail merger policies and rules, which was issued on schedule on June 11, 2001, after a 15-month period of extensive notice and comment, significantly raises the bar for approval of a major merger. Merger applicants must clearly show that a merger is in the public interest by demonstrating that public benefits, such as improved service and enhanced competition, outweigh any negative effects, such as potential service disruptions and harm that cannot be mitigated. In particular, the Board indicated that it will be looking for merger proposals to add competition, and the new rules suggest ways in which that objective could be met in the original proposal filed with the Board or by way of conditions imposed by the Board. The rules also require that any merger application must include specific details about the service that would be provided, how service will be improved, and how service problems will be addressed. And in the decision, the Board stated that it will take a more skeptical view of claims of merger benefits, that it will hold applicants

more accountable for those claims if a merger is approved, and that applicants will be required to address whether claimed benefits can be achieved by means other than a merger.

### **Events Leading to Issuance of New Rules**

In recent years, the railroad industry in the United States has consolidated substantially. With those mergers came severe service disruptions and concerns about further concentration in the industry. Thus, the announcement in late December 1999 that the Burlington Northern Santa Fe (BNSF) rail system would seek to merge with the Canadian National Railway Company (CN), one of the two large Canadian railroads, drew strong expressions of concern from many quarters.

The Board, concerned that the BNSF/CN merger proposal would trigger another (and quite likely final) round of merger proposals, began a proceeding in January 2000 to elicit public comment on the future structure of the rail industry in the United States and the role of mergers today. The Board received well over 400 written comments. And during four days of hearings in March, the Board heard oral testimony from about 125 parties, including Senators and Congressmen, the Departments of Agriculture, Defense and Transportation, several ports, large and small railroads, numerous shipper associations, individual shippers of all sizes from every major industry, and the financial community.

The overwhelming message at the hearing was that the Board's then-existing merger policies and procedures -- as reflected in its rules, policies, and precedents -- were inadequate to deal with any new merger proposals, and that fundamental changes to that body of law were required to address any further mergers. Most witnesses also expressed the concern, which the Board shared based on its own experience with rail mergers over the previous 5 years, that additional mergers at that time would have disrupted the Nation's rail transportation network and disserved the public interest.

After evaluating these extensive comments, the Board agreed that a broad reexamination of the agency's merger policies was required, and concluded that the existing rules and policies were not adequate to address what could be the final round of consolidation in the rail industry leading to two transcontinental railroads. Accordingly, on March 17, 2000, the Board imposed a 15-month moratorium on the filing of major merger applications so that it could reexamine and revise its merger policies and procedures before considering any new merger proposals, including the anticipated BNSF/CN proposal (for which an application had not yet been filed). The Board's moratorium, about which I testified before this Subcommittee last year, was upheld in court.

### **The New Rules**

So that final rules could be in place by June 2001, in accordance with the moratorium period, the Board promptly initiated a rulemaking proceeding. In the proceeding, the Board issued an advance notice of proposed rulemaking, a notice of proposed rulemaking with a proposed set of rules, and a set of final rules. The final rules increase significantly the burden on major merger applicants. The new rules require applicants to demonstrate that, among other things, a proposed transaction would enhance competition where necessary to offset negative effects of the transaction, such as competitive harm, and to address fully the impact of the transaction on service, including plans for service reliability.

Overall Approach. The new rules reflect a significant change in the way the Board will apply the statutory public interest test to any major rail merger application. The Board stated that, because of the small number of remaining large railroads, the fact that rail mergers are no longer needed to address excess capacity in the rail industry, and the transitional service problems that have accompanied recent rail mergers, future merger applicants will be required to bear a heavier burden to show that a major rail combination is consistent with the public interest. This shift in policy, the Board noted, will place greater emphasis in the public interest assessment on enhancing competition, while ensuring a stable,

balanced, and reliable rail transportation system in a way that accounts for smaller railroads, ports, and passenger and commuter services.

Enhancement of Competition. The new rules reflect the Board's intent to offset, through the adoption of proposals made by merger applicants and as necessary through adoption of conditions for competitive enhancements, merger-related harms that cannot be directly or effectively mitigated. The Board indicated that such competitive enhancements could include, but would not be limited to, reciprocal switching arrangements, trackage rights, and efforts to eliminate restrictions on interchanges by shortline railroads. The Board also indicated that the quantity and quality of competitive enhancements that would be required relative to a particular transaction would depend upon a variety of factors, such as merger-related competitive harms for which feasible and effective remedies could not be devised, and the amount of public benefits that could be expected to flow from a particular transaction.

Benefit Assessment. The new rules also reflect the Board's view that, because the realization of benefits in recent mergers has been delayed or frustrated by transitional service problems, future merger proposals should be met with a more skeptical, "show me" attitude toward claims of merger benefits and toward claims that transitional service problems will not occur. The Board said that it will also consider the extent to which various claimed merger benefits can be achieved, short of merger, through cooperative agreements among railroads. The Board further indicated that, given the size of the transactions that may be proposed in the future, and, given the dangers involved should such transactions fail, the benefits claimed by future merger applicants will be very closely scrutinized.

Service Assurance Plans. The Board's new rules require merger applicants to submit a Service Assurance Plan with their initial application and operating plan. The Board stated that, given the importance of service to shippers and that implementation of any merger plan necessarily has an element of uncertainty, applicants' Service Assurance Plan for each major merger proposal must provide certain essential information, such as plans to deal with any potential adverse service effects

during implementation and plans to accommodate such less-than-optimum operations. The Board indicated that, in particular, a Service Assurance Plan must include information about proposed operational integration, training, information technology systems, customer service, freight and passenger operations coordination, yard and terminal operations management, service disruption contingency plans, how traffic-level changes or increases will be accommodated by the combined system, infrastructure improvement, labor issues, service benchmarking, and timetables for the completion of implementation activities, as appropriate. The Board stated further that the Service Assurance Plan must provide for the establishment of problem resolution teams and describe specific procedures to be used toward problem resolution.

Downstream Effects. The new rules reflect the Board's determination to "look down the road" to ascertain whether approving not just the immediate proposal that may be before the Board, but also others that are expected to flow from it, would ultimately result in a rail industry structure that would continue to provide at least the existing level of competitive options for shippers. The Board stated that merger applicants will not be required to present alternative benefit calculations based on specific alternative possible responses that could be filed by other railroads; yet, merger applicants will be required to initiate a commentary, to which other parties may respond, that would give the Board the information needed to rule on what would likely be the first step in an end-game situation in which only two transcontinental railroads would remain in North America. The Board made clear that it is also prepared to use its power to apply conditions to a transaction to repair conditions previously imposed on rail mergers that might be substantially impaired by a new major rail merger.

Employee Concerns. The Board indicated that it is extremely pleased with the privately negotiated "historic settlement agreement" on the issue of collective bargaining agreement (CBA) overrides recently signed by most of the larger railroads and by unions representing most rail employees. The Board stated that, to the extent there is still any live issue relative to CBA overrides, the new rules, which reaffirm that the Board supports negotiated agreements wherever possible, respects the sanctity of CBAs, and looks with disfavor on overrides, properly implement the Board's

statutory mandate concerning overrides.

Transnational Issues. The Board stated that, because future major transnational mergers are likely to raise novel jurisdictional, national interest, and public interest issues, it will be necessary to gather information about relevant facts, laws, and policies important to an accurate and comprehensive understanding of such merger applications. The new rules therefore provide that, in addition to full-system competitive analyses and operating plans required of applicants with transnational operations, all applicants will be required to address any ownership restrictions (by law or corporate initiative) and any pertinent governmental restrictions or preferences.

Oversight and Monitoring. The new rules codify the Board's recent practice of formal oversight for a period of no fewer than 5 years following each merger. With respect to operational monitoring, the Board noted that, because its monitoring of previous transactions has proven vital to identifying and correcting operating deficiencies during implementation, the new rules also provide for expanded post-approval monitoring of the implementation of mergers to help ensure that adequate service is provided during the crucial transitional period, and beyond. The Board further indicated that, if substantial service disruptions occur as the result of a merger's implementation, the Board will consider alternative service arrangements.

Kansas City Southern. Finally, a majority of the Board granted a waiver to KCS from the application of the new major rail merger rules. The majority indicated that parties could attempt to show in a particular case that this waiver should not be allowed. I dissented to this aspect of the decision. I do not believe that KCS adequately demonstrated why it should have been given special treatment. Also, I am concerned that, given KCS' strategic position, any merger involving KCS and another large railroad will likely trigger the final round of consolidations leading to only two systems of large North American railroads. It seems incongruous to me to exempt a carrier transaction that could trigger the final round from the very rules that have been promulgated to address the final round and the interests of rail customers and other parties affected by further consolidation.

## **Summary**

Overall, the Board's new rules for major rail mergers will make merger approval more difficult, reflecting a greater skepticism about the benefits of more consolidation and a greater concern about the potential harm of more consolidation. The rules make clear in this regard that in order for the scales to be clearly tipped in favor of a merger proposal, that proposal will have to offer competitive enhancements. And any proposal will have to have been subjected to significant pre-filing analysis and planning as to the type of service to be provided and the actions to be taken in the event of service failures. Given the risks and finality associated with what could be a final round of consolidation leading to two transcontinental railroads, the final rules ensure that any further consolidation will be approved only if it is truly in the public interest.

I would be pleased to answer any questions that you might have.