Surface Transportation Board
Washington, D.C. 20423-0001

Office of the Chairman

November 1, 2007

The Honorable Herb Kohl
Chairman, Senate Judiciary Subcommittee on
Antitrust, Competition Policy and Consumer Rights
308 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Kohl:

This responds to your letter of October 18, 2007, which asks several follow-up questions regarding my testimony at the October 3, 2007 hearing on S.772, the Railroad Antitrust Enforcement Act of 2007. I appreciate the opportunities you have given the Surface Transportation Board to weigh in on these very important issues. Below, please find the answers to your questions.

1. In 1979, there were 42 class I freight railroads in the United States. Today, less than three decades later, only four railroads serve 90% of the nation's railroad traffic and there are only seven freight railroads remaining in total. Are you concerned about this level of consolidation?

As Chairman of the Surface Transportation Board, I am concerned about the effect any further consolidation of Class I railroads could have on the competitive environment in the rail industry. And my predecessors also shared these concerns. In 2000, after Class I carriers Burlington Northern Sante Fe and Canadian National proposed to merge, the Board temporarily halted all Class I merger reviews so that it could adopt new guidelines that better reflect the current competitive and economic impact such mergers could have. *See, e.g.*, *Public Views on Major Rail Consolidations*, 4 S.T.B. 546 (2000); *Major Rail Consolidation Procedures*, 5 S.T.B. 539 (2001). The Board explained that "additional consolidation in the industry is [ ] likely to result in a number of anticompetitive effects, such as loss of geographic competition, that are increasingly difficult to remedy directly or proportionately." 5 S.T.B. at 553; 49 CFR § 1180.1(c).

There is no doubt that serious service disruptions and implementation problems were associated with some of the more-recent Class I mergers and may be more pronounced in future major rail transactions. Therefore, under the Board's 2001 merger guidelines, to offset any negative aspects of a proposed Class I merger, merger applicants will now be required to prove that "substantial and demonstrable gains" will flow from the merger, such as improved service and safety, enhanced competition, and greater economic efficiency.

No Class I merger has been proposed since the 2001 rules were promulgated. Some suggest that this means that the Board's rules are untested, and therefore not to be relied upon. I prefer to believe that the rules sent the proper signal to industry – that mergers will be approved by the Board only to the extent that they bring significant public benefits.

Finally, there is a slight inaccuracy in your question, which indicates that there are only 7 freight railroads in the United States today. In fact, there are 7 Class I's and hundreds more other railroads operating in the United States today than existed in 1980. In 1980, there were approximately 190 short lines operating only 8,000 miles of track. Short line railroads are local and regional carriers with annual revenues of less than $250 million, in 1991 dollars. *See* 49 CFR § 1201.1-1. There are now more than 500 short lines operating nearly 50,000 miles of track, or approximately 30% of the national railroad system. And the rebirth of the short line industry has benefited many rail customers, as these short lines can often operate their lines at lower costs than could the larger carriers and can give specialized attention to the needs of the shippers on their lines.

Does the STB, or its predecessor agency, the ICC, bear any responsibility for this level of consolidation?

Yes.

How do you respond to your critics who argue that this drastic consolidation shows that the STB has been ineffective in preventing anti-competitive mergers in the railroad industry?

The short answer is that I do not believe that the agency has authorized a single anticompetitive merger. Let me elaborate.

To appreciate the full context of rail consolidation over the last 30 years, one must consider the state of the railroad industry prior to 1980. By the 1970s, the railroad industry was in dire financial straits. More than one-third of the Nation's railroads had gone into bankruptcy, including the Penn Central, the Erie Lackawanna, the Lehigh Valley, the Reading, Central of New Jersey, the Rock Island and the Milwaukee.

The Rail Revitalization and Regulatory Reform Act of 1976, Pub. L. No. 94-210, 90 Stat. 31 (1976) (4R Act) and Staggers Rail Act of 1980, Pub. L. No. 96-448, 94 Stat. 1895 (1980) (Staggers Act) were intended to improve the financial health of the railroad industry by allowing carriers to take steps to become more efficient and productive. More liberal rules on abandoning unprofitable lines and greater flexibility in setting rates were key components of this deregulatory effort. Consolidation of rail lines was also a major part of the industry's effort to become more efficient. The 4R Act encouraged a more lenient treatment of rail mergers with its general deregulatory thrust, the time limits it placed on ICC merger review, and its requirement that DOT participate more actively in rail mergers and facilitate them when possible. While observers may debate the optimal number of large railroads, few can argue that the consolidation was the result of market forces – a result directly encouraged by the deregulation of the late 1970s and 1980s.

Moreover, permitting the 42 Class I railroads (arranged in a jigsaw fashion around the nation) to slowly merge into larger, stronger, and more efficient networks had a tremendously positive impact on the railroad industry and its customers. In constant 2005 dollars, the numerous Class I railroads that operated in 1985 reported operating expenses of $40.8 billion, which permitted them to handle only 19.4 million carloads and generate 876 billion revenue ton-miles. Yet by 2005, the admittedly fewer but financially stronger Class I railroads reported operating expenses of $37.8 billion, which permitted them to handle 31.1 million carloads and generate 1,696 billion (1.7 trillion) revenue ton-miles. As such, since 1985 railroad productivity improved 130%, as measured annually by the Board in Ex Parte 290 (Sub-No 4), *Railroad Cost Recovery Procedures-Productivity Adjustment*.

And as the Board's Office of Economics reported in 2000, the bulk of the productivity improvements created by railroads were passed along to shippers in the form of lower transportation rates. This is the strongest possible evidence that competition in the railroad industry was working precisely as the framers of the Staggers Act had hoped. I am mindful that shippers themselves may not always have "enjoyed" the benefits of these lower rates; shippers, too, were forced by competitive pressures to pass along the bulk of these savings to consumers in the form of lower prices. Thus, at the end of the day, the ultimate beneficiary of railroad productivity improvements was the American consumer.

Without those improvements, the only way the railroads could have achieved stronger financial health would have been to dramatically increase transportation rates. Fortunately, that did not happen. Rather, the vast majority of rail shippers (and their customers) have benefited from transportation rates that are lower today than they were in 1985, adjusted for inflation. While other costs for rail customers were rising (such as labor, fuel, and electricity costs), rail rates simply did not keep pace. Permitting the industry to consolidate and evolve from a patchwork of smaller, financially weakened Class I railroads into the current system was a large part of this story.

The fact that the industry has consolidated does not mean that any of the approved mergers were anticompetitive mergers. Similar consolidation has taken place over the past 25 years in countless industries under the watchful eye of the Department of Justice Antitrust Division or the Federal Trade Commission. Industries consolidate to take advantage of natural economies of scale and scope, the benefits of which are passed back to consumers in lower prices and better service. When an agency stands in the way of *beneficial* consolidation – as the ICC may have before the Staggers Act – it only harms the industry and the general public.

I have seen no evidence of an *anticompetitive* merger that has occurred under the Board's watch. DOJ has participated in every major rail merger since Staggers and provided its informed merger analysis to guide the agency. In that 25-year period, DOJ has recommended denial of merger approval authority only twice: the proposed Southern Pacific/Sante Fe merger (where the ICC denied merger authority) and the Union Pacific/Southern Pacific merger (where the Board granted merger authority with significant conditions and 5-year post-transaction oversight). And in the single instance of disagreement between the two agencies, DOJ did not challenge the STB's decision in court. (The Board's UP/SP decision was challenged by other parties and was upheld by the court of appeals.) One disagreement over a 25-year period can hardly constitute evidence that the existing merger review process is flawed or that the agency has been ineffective in preventing anticompetitive mergers. Moreover, as I observed in earlier testimony, the Board imposed significant conditions with the UP/SP merger that addressed the competitive issues raised by the transaction. The merger has been intensely studied, with elaborate pricing information provided to DOJ every year for 5 years during the Board's oversight period. During that oversight period, no party presented evidence that that merger was anticompetitive. Rather, the evidence showed the Board acted prudently in permitting UP to acquire the SP before that struggling carrier descended into financial ruin.

2. At the hearing, you stated that you would respond later to my question about how many mergers or acquisitions between class I railroads the STB (or its predecessor the ICC) had blocked since 1979. Please provide this information and identify any mergers or acquisitions blocked, and their dates.

The ICC denied the application for a proposed SP/SF merger in June 1986. *See Sante Fe Southern Pacific Corp. – Control – Southern Pacific Transportation Co.*, 2 I.C.C.2d 709 (1986). The agency's decision found that the transaction's anticompetitive effects on the West Coast, Central and Southern corridors outweighed the substantial public benefits. The ICC also concluded that the conditions proposed by the parties, including rate freezes and trackage rights agreements with other carriers, would not sufficiently have addressed the near "absolute monopoly" that would result in a number of geographic areas.

While the STB has heavily conditioned virtually all of its merger approvals to mitigate potential competitive harm, the agency has also taken less traditional actions that served to effectively discourage two other major rail mergers. For example, shortly after the Board's 15-month moratorium on mergers – imposed in 2001 to revise the merger rules – the Burlington Northern Sante Fe and Canadian National rail lines abandoned their proposed merger. In 1996-1997, CSX and Norfolk Southern were submitting bids to Conrail's shareholders, with both companies competing to acquire Conrail. In January 1997, then-Board Chairman Linda Morgan gave a speech that was perceived as suggesting that any proposed acquisition of Conrail by a single Eastern railroad would face significant hurdles at the agency because of the anticompetitive effects such a merger would have. *See Feds Prepared to Split Conrail, Official Says but a Settlement Between CSX and Norfolk Southern Preferred*, VIRGINIAN-PILOT, Jan. 21, 1997 at A1. CSX and Norfolk Southern subsequently submitted a merger application to the Board that would split Conrail among the two carriers, which was approved in 1998.

3. What would be wrong with the Justice Department having the authority to review railroad mergers, and the ability to take action to block them by filing suit under the Clayton Act, just as the Justice Department has such authority for other transportation industries, such as aviation and trucking, and with respect to other regulated industries, such as telecommunications?

In my written testimony, I have identified what I believe to be the practical problems inherent in a dual review scheme. However, should Congress determine that dual merger review under both the Interstate Commerce Act and the Clayton Act is appropriate, I am confident that the Board and the Justice Department would work together to minimize those problems and coordinate our competitive analysis and remedies.

However, the proposed legislation provides more than just concurrent review by DOJ, but would open these rail transactions to challenge by private parties in any of the more than 90 federal district courts throughout the country. If Congress believes it is prudent to have DOJ provide a backstop to the agency's own merger analysis, I would recommend it consider the Federal Reserve model for bank mergers. Under that model, the initial analysis is performed by the agency with the advice and input of DOJ. Then, if DOJ is not satisfied with the agency's decision, it may seek to block the merger in district court within 30 days of the decision. (It should be clearly stated, however, the DOJ already has the ability to challenge a STB decision to approve a rail transaction in any of the federal courts of appeals).

The public comments of the Federal Reserve and DOJ before the Antitrust Modernization Commission (AMC) suggest this model works well and would have multiple benefits. This approach would permit the agency to seek to address DOJ's competition concerns without forcing the carriers to participate in the expensive Hart-Scott process. And if Congress limited the second merger review to just DOJ, this approach would not open the door to duplicative review by private parties who may seek to use the antitrust laws as a tool to block or delay rail transactions that might increase traffic flows in their neighborhood, but which are in the larger public interest. Also, by permitting DOJ exclusive authority to seek to block a Board-approved transaction, Congress would dramatically reduce the potential for conflict between district-court injunctive orders and the integrated economic regulation of the rail industry by the Board.

However, even that model carries with it a major transportation policy change that would result from dual review. The Board is required to consider a variety of public interest factors when reviewing Class I mergers, including, but not limited to, competition. *See* 49 U.S.C. § 11324(b). The other factors that must be considered by the Board include (1) the effect of the proposed transaction on the adequacy of transportation to the public, (2) the effect of including or failing to include other rail carriers in the area involved in the proposed transaction, (3) the total fixed charges that result from the transaction, and (4) labor issues. *Id.* Although Congress did not explicitly indicate that competition should be weighed more heavily than other factors, analysis of competitive effects is the cornerstone of Board merger review. Assume that the Board determined in a particular merger that the other public interest factors outweighed any potential anticompetitive effects or that such anticompetitive effects were sufficiently remedied by Board-imposed conditions. Presently, if the Justice Department disagrees with the competitive analysis or remedial provisions, it can go to court (under the Interstate Commerce Act) and argue that the Board got the competitive analysis wrong. The court would then decide whether the Board properly considered the evidence, properly weighed the competitive harms against the other public interest benefits, and properly determined that its conditions would alleviate the competitive problems. In that scenario, I expect that the Board would get far less deference from a court than it does in cases where DOJ is not the petitioner.

Under the dual review scheme, if the Justice Department disagreed with the Board's competitive analysis, it could seek to block the merger strictly on competition grounds under the Clayton Act. That means that evidence on all of the other public interest factors, which must *by statute* be considered by the Board, would be irrelevant to the reviewing court for determining whether the merger can go forward. Thus, the entire notion of balancing of competitive harm against other public interest factors would disappear. This major policy shift is clearly for Congress to decide and the Board takes no position on whether such a change is preferable.

4. Do you agree with the recommendation of the Antitrust Modernization Commission, that "even in industries subject to economic regulation, the antitrust agencies generally should have full merger enforcement authority under the Clayton Act?" If not, why not? If you do agree with this recommendation, explain how your position with respect to Justice Department merger authority in the railroad industry is consistent with this recommendation?

Yes. I agree with the recommendation, which states that antitrust agencies "generally" should have full merger authority. This suggests AMC believed there would be exceptions based on countervailing policies and statutory goals. The STB's merger review authority would be an example of one of these exceptions, where duplicative review may make it more difficult to maintain a uniform regulatory policy for regulating the railroad industry.

5. (a) The Antitrust Modernization Commission's April 2007 Report stated:

> **Statutory immunities from the antitrust laws should be disfavored. They should be granted rarely, and only where . . . [the immunity] is necessary to satisfy a specific societal goal that trumps the benefit of a free market to consumers and the U.S. economy in general.**

Do you agree with this principle? If so, please specify the "societal goal" warranting an antitrust exemption that "trumps the benefit of a free market" in the railroad industry?

I agree with this principle. As indicated in my written testimony, the STB supports the elimination of several of the immunities currently enjoyed by rail carriers, including immunity flowing from the *Keogh* doctrine and immunity for collective rate-related agreements.

From my perspective, the societal goal that should be considered when determining whether to terminate other immunities is the desire for efficient and centralized economic regulation of the rail industry. Because market competition is not always possible in the rail industry, Congress created a regulatory body that is charged with protecting captive shippers, while still allowing the railroads to earn sufficient revenues to re-invest and attract capital. *See* 49 U.S.C. §§ 10101(3) and (6). The Board's charge is intimately connected to, but broader than, the goals of the antitrust laws. Congress must decide whether further splitting up competition enforcement responsibilities is consistent with or preferable to centralized monitoring of the industry by the Board.

(b) On October 3, 2007 the Federal Trade Commission sent us a letter regarding S. 772 explaining that they were against antitrust exemptions in general, citing to their "long standing view that antitrust exemptions should bear a heavy burden of demonstrating, with factually-supported reasons, the need for a departure from the nation's competitive model." Likewise, in 2004, the Justice Department wrote a similar letter to Congressman Sensenbrenner regarding the appropriateness of the railroad antitrust exemption stating "such exemptions can be justified only in rare instances, when the fundamental free-market values underlying the antitrust laws are compellingly outweighed by a clearly paramount and clearly incompatible public policy objective." Shouldn't the fact that the nation's antitrust enforcement agencies oppose antitrust exemptions like this one carry great weight with us?

Yes, the views of the Justice Department and the Federal Trade Commission should always carry great weight with Congress as it determines how to best assign competition-related enforcement duties in any industry, including rail. Likewise, we appreciate the Committee's consideration of the Board's views on how repeal of certain immunities will affect the administration of the Interstate Commerce Act.

I note that both letters acknowledge the need for narrow exceptions in the public interest. I believe that several of the existing, narrow exemptions are in the public interest, such as the limitation on injunctive relief, which traces back to the original Section 16 of the Clayton Act of 1914. As the Supreme Court itself explained, that provision's "obvious purpose is to preclude any interference by injunction with any business or transaction of interstate carriers of sufficient public significance and importance to be within the jurisdiction of the [agency], except when the suit is brought by the Government itself." *Central Transfer Co. v. Terminal R.R. Ass'n*, 288 U.S. 469, 475 (1933).

6. Many captive shippers complain that it is ineffective and excessively expensive for a captive shipper to go to the STB for relief from rail rates they believe are expensive or unjustified. A recent Government Accountability Office Report appears to support this complaint. The October 2006 GAO Report on the freight railroad industry found that, according to the shippers it surveyed, it cost on average about $3 million to adjudicate a rate case at the STB. It also found that only ten cases have been filed since 2001, and these cases took an average of 3.3 years to complete. The GAO found that "only high volume shippers . . . have the money to afford the STB rate relief process. In addition, shippers said that they do not use the process because it takes so long for the STB to reach a decision." GAO Report 07-94 at 41.

Doesn't the great expense and long time delays demonstrate that the STB's rate relief process in an ineffective remedy for shippers victimized by excessive rates? What are you doing to remedy this situation?

The current Board recognizes that the former rail rate dispute resolution procedures were not adequately accessible and affordable to many shippers. We have replaced those procedures and remedied that situation.

In particular, in the past year, the Board has completed two large rulemakings to reform its rate review process and ensure that the rate review process at the agency provides an effective constraint on unreasonable pricing by carriers. *See Simplified Guidelines for Rail Rate Cases*, STB Ex Parte No. 646 (Sub-No. 1) (STB served Sept. 5, 2007) (*Simplified Guidelines*); *Major Issues in Rail Rate Cases*, STB Ex Parte No. 657 (Sub-No. 1) (STB served Oct. 30, 2006) (*Major Issues*).

In *Simplified Guidelines*, which have been challenged in court by the railroads, the Board greatly simplified the rail rate dispute resolution process for small and medium sized shipments. The Board's simplified guidelines allow freight rail customers with small shipments to obtain an award of up to $1 million in relief within 8 months of filing a complaint. The filing fee for such a complaint is $150. Shippers with mid-size shipments can pursue another simplified alternative that can provide up to $5 million in relief within 17 months of filing a complaint. The filing fee for the new procedures opened the doors to the more than 70% of challengeable rail traffic that had been effectively blocked from Board review due to the complexity and high costs of the Board's previous procedures.

In *Major Issues*, the Board similarly simplified its procedures for large rate cases. This decision is expected to reduce by 30% the cost of litigating coal rate cases. Because of the inherent complexity in determining rate reasonableness in such cases, I do not believe that they will ever be easy, quick, or cheap. However, I think the Board has made great strides in streamlining the process and making our procedures more efficient.

Any analysis of the reasonableness of rates will involve some litigation costs by the party seeking relief. But, while I am no litigation authority, I would expect that the litigation costs of pursing relief before the agency under our simplified procedures will pale in comparison to the litigation costs of an antitrust lawsuit.

7. In August 2006 the Attorneys General of 17 states and the District of Columbia wrote to the Senate and House Judiciary Committees in support of our legislation to repeal the railroad antitrust exemption. The letter stated that "rail customers in our states in a variety of industries are suffering from the classic symptoms of unrestrained monopoly power: unreasonably high and arbitrary rates and poor service."

What is your response? Are the Attorneys General of 17 states and the District of Columbia misinformed?

Yes, the referenced letter appears to be premised on an inaccurate understanding of federal rail regulation and policy. Numerous studies have concluded that since deregulation, shippers have in general enjoyed significant price reductions and improved service. It is a fact that "captive shippers," those with access to a single rail line and without other effective transportation options, are subject to pricing by a monopoly carrier. Imposition of the antitrust laws would not alter this fact, nor would the antitrust laws preclude a monopolist from charging monopoly rents in the absence of acts by the carrier to unlawfully maintain that monopoly. Rather, it is the Interstate Commerce Act that was enacted by Congress to protect captive shippers from the "classic symptoms of unrestrained market power." We routinely review such complaints and, where the facts support the allegations, will require the railroad to lower its rates and reimburse the shipper (with interest) for past shipments. *See, e.g.*, *Public Serv. Co. of Colo. d/b/a Xcel Energy v. Burlington N. & Sante Fe Ry.*, STB Docket No. 42057 (STB served June 8, 2004), *aff'd sub nom. BNSF Ry. v. STB*, 453 F.3d 473, 484 (D.C. Cir. 2006) (ordering BNSF to pay millions in damages and prescribing the maximum lawful rate it can charge until the year 2020).

I appreciate the Committee's interest in the Board's processes. If I can be of further assistance, please let me know.

Sincerely,

Charles D Nottingham /RDC

Charles D. Nottingham
Chairman