MEMORANDUM

March 19, 2023

TO: NITL

FROM: Karyn Booth

RE: STB Decision Approving CP/KCS Rail Merger

On March 15, 2023, the Surface Transportation Board ("STB" or "Board") issued a decision in FD No. 36500 that approves the merger of Canadian Pacific Railroad ("CP") with the Kansas City Southern Railway ("KCS") (collectively "Applicants"). The STB's approval is subject to multiple conditions to address anti-competitive concerns, capacity concerns, potential service disruptions, environmental issues, and various other concerns specific to individual stakeholders. The STB also denied competing applications filed by Canadian National, Norfolk Southern, and CSX requesting divestiture of certain KCS lines. The STB's decision takes effect on April 14, 2023.

This memorandum summarizes the Board's decision with a focus upon those issues that were of primary concern to the Joint Associations, which included the American Chemistry Council ("ACC"), The Fertilizer Institute ("TFI"), and The National Industrial Transportation League ("NITL"). It also includes a list of all conditions imposed by the Board.

General Overview

1. **Merger Benefits Outweigh Potential Detriments**. The Board concluded that the benefits of the merger greatly outweigh the potential detriments. Although it expressed concerns with some of the Applicants' benefit calculations, the Board still indicated that they were sufficient to establish the existence of substantial benefits. With respect to many of the detriments alleged by other Class I railroads, the Board noted that mostly they were speculative and represented attempts to protect those railroads from stronger competition created by the merger. The Board concluded that:

> Although the Board finds some of the benefits from rail-to-rail diversion may be overstated, the new service will nonetheless create a more competitive option for current rail shippers, be attractive to those presently shipping by truck, and cultivate other new rail traffic. And while uncertainty about the precise level of traffic diversions necessarily leads to uncertainty about the revenues to be achieved as a result of the Transaction … Applicants will have adequate funds to pay down their

> debt and make capital investments regardless of the level of those new revenues. (p. 36)

2. **Some Vertical Competitive Concerns Exist**. The Board, however, rejected Applicants' contention that the end-to-end nature of their merger would not pose risks to vertical competition, such as the foreclosure of gateways through which interline service currently exists. In reaching that conclusion, the Board overturned its so-called "one-lump" precedent, which had established a rebuttable presumption that vertical mergers do not harm competition (p. 4). Moreover, the Board deemed the Applicants' commitment to maintain open gateways insufficient due to the absence of any standard for assessing compliance with, and an insufficient definition of the scope of, that commitment. As discussed in greater detail below, the Board imposed certain conditions to remediate any harm to vertical competition. With those conditions the Board determined "that this proposed vertical transaction is unlikely to lead to any significant competitive harms, and … will in fact enhance competition by creating a stronger competitor against BNSF, UP, and CN." (p. 48)

   In its review of the many requested conditions by stakeholders, the Board took note of the many commitments that the Applicants have made in their pleadings throughout the course of this proceeding to address those concerns. Although the Board has held applicants to their commitments as a general merger condition in past proceeding, its most recent decisions had moved away from that practice. In this case, however, the Board held that, because the "Applicants' many representations underlie critical Board findings regarding the Transaction's impact on service, competition, and the public interest, and the fact that the Board has relied on the entirety of the record in reaching its ultimate decision on the Application, the Board will impose a condition requiring Applicants to adhere to all representations made on the record in this proceeding." (p. 143) To minimize ambiguity and disputes, the decision attempts to identify each such commitment from the record when discussing the issues to which those commitments pertain.

3. **7-Year Oversight Condition**. The Board intends to rely extensively upon its post-merger oversight to assess the efficacy of its conditions, capacity and service issues, and the attainment of merger benefits. In an unprecedented step, the Board extended the oversight period from the traditional 5 years to 7 years and noted the potential for extensions. Also, the Board imposed unprecedented data reporting requirements to facilitate its oversight with some data submitted monthly and other data semi-annually. If any concerns that the Board has opted not to address through conditions materialize, the Board has reserved the right to impose additional requirements at a later date.

   Finally, the Board acknowledged many stakeholder concerns that there has been too much consolidation in the rail industry, but noted that:

   > Regardless of which side one takes in that debate, the Board is charged by Congress with reviewing the proposed merger in light of the state of the industry as it actually exists. Given the current realities and the limited opportunities to provide meaningful competition for the largest Class I railroads, as outlined above and discussed at length in this

> decision, the Board concludes that this transaction should improve rather than degrade the performance of the industry. It is for these reasons that the Board approves the merger.

The Board also noted that CP and KCS have not suffered the pandemic-related service meltdowns of the other Class I railroads and have the strongest safety records.

Joint Association Requests for Conditions

The Joint Associations expressed general support for the merger provided that the following concerns would be mitigated through the imposition of appropriate conditions, including:

- Preservation of gateways for interline movements both physically and commercially. For commercial protections, the Joint Associations proposed a mechanism to establish a bottleneck segment rate to/from gateways on interline routes as a mileage prorated proportion of the Applicants' market-based rate on their single line route. This was similar to proposals offered by Union Pacific ("UP") and BNSF Railway ("BNSF").

- Protections in the event of merger-related service disruptions, including capacity constraints on UP lines in the Gulf Coast over which BNSF and KCS also operate. The Joint Associations requested conditions similar to those imposed upon the merger of Canadian National Railroad ("CN") and the Wisconsin Central Railroad, but with stronger enforcement mechanisms.

- Protections against the extension of CP's tariff liability provisions for toxic-inhalation hazards to traffic on the KCS network. The Joint Associations asked the STB to prohibit CP from applying its tariff liability terms to traffic when moving on the KCS network.

The STB has attempted to address these issues, but not through the specific conditions requested by the Joint Associations or any other party to this proceeding.

1. **Gateway Protections.** The Board agreed with the Joint Associations, UP and BNSF that the scope of Applicants' open gateway commitment is inadequately defined, lacks an enforcement mechanism, and lacks a standard for effective monitoring and oversight. To define the scope of the open gateway condition, the Board adopted the Joint Associations' proposal to use January 1, 2018 as the cut-off date for identifying "existing" interchanges and to apply the condition to all traffic over such interchanges for which the merger will create a longer haul than was available on the CP or KCS system pre-merger. The Board also clarified that new traffic over a gateway is eligible so long as *any* shipper has used that gateway routing during the prior five years.

   Next, the Board will hold Applicants to the following commitments that they made in the record, several of which responded to Joint Association requests (p. 71-73):

- Applicants' open gateway commitments means that CPKC "will continue to offer commercially reasonable rates and terms capable of supporting the continued movement of traffic via the gateway"; Applicants "will not make it impossible to construct viable interline options for shippers by refusing to quote commercially reasonable rates."

- Applicants' obligations regarding open gateways will apply in perpetuity and to all traffic, including intermodal and other traffic that is exempt.

- Applicants will quote a Rule 11 rate in the shipper's choice of a tariff or contract.

- Applicants will not take the position that the open gateway commitment does not apply because of a lack of market dominance, including by not taking the position that the Board lacks jurisdiction because the revenue-variable cost percentage generated by the traffic is less than 180%.

- Applicants represent that the Transaction does not affect the requirements to which KCS is subject under the agreement it entered with NITL in connection with the KCS-Tex Mex merger.

Although the foregoing provisions are consistent with the Joint Associations' requests pertaining to the scope of gateway protections, the Board rejected the proportional rate proposals sought by the Joint Associations, BNSF, and UP to protect commercial access to gateways as insufficiently tailored to the effects of the merger and having potential unintended consequences. Instead, the Board has developed and imposed the following alternative:

- Upon written request by a shipper submitted by certified mail or email to the applicable CPKC account representative, CPKC must provide a written response (Written Response) identifying its justification(s) for any rate increase above the applicable rate of inflation for interline movements subject to the open gateway obligation within 15 days of its receipt of the shipper's request.[1]

- The Written Response must include sufficient detail to enable the shipper to make a meaningful preliminary assessment of the reasonableness of the justification(s) identified by CPKC for the rate increase.

- If the shipper challenges the commercial reasonableness of CPKC's actions regarding the rate increase, CPKC will be estopped from presenting any justification that is (i) inconsistent with justification(s) identified in the Written Response or (ii) not previously identified in the Written Response. CPKC will be permitted to elaborate and produce supporting evidence relating to any justification identified and described in the Written

[1] The applicable rate of inflation shall be determined by the Rail Cost Adjustment Factor (unadjusted) ("RCAF") published by the STB or, if the rate includes fuel surcharge, the All-Inclusive Index Less Fuel ("AII-LF") published by the AAR.

> Response; correspondingly, reasonable inferences may be drawn from the sufficiency of the initial description in any enforcement proceeding. (pp. 78-79)

In other words, increases to pre-merger gateway rates based upon the rate of inflation are presumptive evidence that the gateway remains open commercially. If a rate increase exceeds the rate of inflation, a shipper may invoke such increase as evidence of commercial closure that violates this merger condition and Applicants will have the burden to rebut that evidence. The STB clarifies that affected shippers may bring such challenges, but that neither the connecting railroad nor shipper associations would have standing to do so. A shipper may pursue its complaint through the arbitration process that Applicants proposed in their Final Brief, or it may ask the Board to resolve the matter. (pp. 74-77) The Board has committed to decide such cases with limited discovery and within 150 days. (p. 75) Nothing in the decision prevents the parties from agreeing to any other form of arbitration.

The STB's decision fails to specify the remedy for a finding that Applicants have violated the gateway protection condition, explicitly opting to leave that question to be determined case-by-case. (pp. 73-74). Finally, the Board has imposed certain merger oversight reporting requirements to monitor whether Applicants are keeping affected gateways open on commercially reasonable terms (pp. 80-83).

2. **Service Protections.** Based upon experience with prior major rail mergers, the Joint Associations sought conditions to mitigate the effects of merger-related service disruptions. Capacity constraints on UP lines in the Texas Gulf Coast over which both BNSF and KCS have extensive trackage rights operations is a particular concern. Both UP and BNSF raised concerns that Applicants' increased traffic projections would overwhelm those lines without any commitment by Applicants to fund necessary infrastructure enhancements. The Joint Associations sought protections in the event that service disruptions should materialize.

The Board rejected the specific conditions requested by the Joint Associations, concluding that the commitments in Applicants' "Service Promise," in combination with the Board's continuing oversight condition, "provides a fully effective mechanism for quickly identifying and addressing service disruptions should they arise." (pp. 141-42) Concerning the arguments raised by UP and BNSF over the Gulf Coast trackage rights lines:

> The Board notes that concerns about capacity are speculative—and based on the twin assumptions of both (1) a significant increase in traffic on the combined network and operations and (2) infrastructure remaining static. Many of the issues raised by CN, BNSF, and UP may never be realized if Applicants and other rail users of those lines implement the future operational adjustments and infrastructure improvements needed to ensure continued network fluidity. Applicants, in particular, will have a strong incentive to ensure that such changes are made, given their objective to divert traffic to CPKC from other rail lines as well as trucks. Fulfillment of that objective will depend on CPKC's ability to provide

> efficient, reliable service, which requires lines with sufficient capacity for such service. Other carriers that will share lines with CPKC will also continue to depend on those lines to serve their customers, thus providing an incentive to cooperate to ensure fluidity. The Board finds that the public benefits of the Transaction detailed in the Public Benefits of the Transaction section, including expansion of market opportunities and increased competition, outweigh the risks associated with the commenters' capacity concerns, taking into consideration the level of expected growth of traffic post-Transaction, carriers' incentives to cooperate to ensure fluidity on shared lines, and (as discussed below) the implementation of an oversight period that will allow the Board to address capacity issues if they develop following the Transaction. (p. 88)

Furthermore, "the Board will closely monitor capacity issues on certain portions of the combined CPKC network to evaluate and help ensure post-merger fluidity and, if warranted, order further action." (p. 31)

3. **TIH Tariff**. The Board rejected requests to condition the merger upon limiting CP's right to apply its TIH tariff liability, insurance, and indemnity terms to TIH traffic formerly governed by the less onerous KCS tariff because there is "no clear nexus between these concerns and the Transaction." (p. 137) To the extent shippers object to CP's tariff, the Board observes that the merger does not affect their rights to bring that challenge before the Board. (p. 138).

   Nevertheless, the Board will hold Applicants to their commitment to negotiate the same terms with other TIH shippers on the KCS network that they negotiated in a settlement with Bayer over objections to the CP tariff (p. 138). Under the CP-Bayer Settlement Agreement, CP commits to providing Bayer with three-years' notice before revising the indemnity provisions applicable to the TIH/PIH shipments on KCS's pre-Transaction U.S. network to conform with the provisions of CP's tariff, in exchange for the commitment of Bayer and its suppliers to use the safest-available rolling stock for shipments of these commodities. The specific terms of the condition state:

> As a condition of its approval of the Transaction, the Board will hold Applicants to this commitment, i.e., will require as a condition to the Transaction that Applicants extend the terms of the CP-Bayer Settlement Agreement to any shipper of TIH/PIH commodities on the former-KCS network whose rail traffic is subject to one or more applicable KCS rules tariffs as of the date of this decision. The Board will further require Applicants to provide notice of this commitment, along with a copy of the CP-Bayer Settlement Agreement, to any eligible shipper by May 1, 2023, to help ensure shipper awareness of this commitment. And the Board will modify the commitment such that shippers wishing to participate, and that have in fact been provided the required notice of the

commitment and a copy of the CP-Bayer Settlement Agreement, must notify CPKC by May 30, 2023.

<u>List of STB Conditions</u>

Below is a list of the conditions imposed by the STB upon its approval of the CP/KCS merger:

1. Applicants' commitments to keep gateways open on commercially reasonable terms and to create no new bottlenecks, with the clarifications and enhancements described herein, including a requirement that Applicants provide to a shipper, upon request, a written justification for any rate increase above the rate of inflation during the oversight period for interline movements subject to the open gateway condition, and a requirement that Applicants adhere to their "Binding Agreement to Arbitrate," as modified by the Board.

2. CPKC shifting its train crew change location near Ottumwa, Iowa, to a point farther west and south on the CP Laredo Subdivision.

3. Applicants' commitment to providing a dispute resolution process to address certain possible commuter rail disruptions in Chicago, Ill., as modified and improved by the Board.

4. The terms of the settlement agreement entered into by CP with Iowa Interstate Railway, LLC.

5. Applicants' adherence to any and all of the representations they made on the record during the course of this proceeding, whether or not such representations are specifically referenced in this decision, including Applicants' commitments to:
   - Honor CP's commitments made under the settlement agreement with Amtrak, including CP's agreement to support certain planned expansions of Amtrak passenger service;
   - Not initiate the termination of reciprocal switching access for any shipper facility directly served by CP or KCS that has such access as of the date of the decision authorizing the Transaction;
   - Cooperate with UP and BNSF to ensure adequate capacity along the Texas Gulf Coast Route;
   - Unless otherwise agreed to by CPKC and Metra, not implement an ordinary course operating plan directing CPKC through-freight trains operating between Kansas City, Mo., and St. Paul, Minn., over certain Metra Lines, except in emergency or other non-routine situations, a condition that sunsets on January 1, 2043; and
   - As modified by the Board, extend the terms of the settlement agreement reached with Bayer CropScience LP to eligible shippers.

6. Applicants must comply with the oversight condition imposed in this decision, and, in connection therewith, must report numerous service, operational, competition-related, and other metrics at prescribed frequencies, as described in Appendix B to this decision. Docket No. FD 36500 et al. 174.

7. Applicants must adhere to the terms of the CPKC Service Promise to address any post-Transaction service disruptions, including the development and reporting of customized "Service Action Plans" to address specific issues when certain thresholds are triggered.

8. Approval of the Application is subject to the employee protective conditions set out in New York Dock Railway—Control—Brooklyn Eastern District Terminal, 360 I.C.C. 60 (1979), aff'd New York Dock Railway v. United States, 609 F.2d 83 (2d Cir. 1979), and subject to Applicants' representation that they will honor the obligations established in "Revised Standards for Preemption of Collective Bargaining Agreements for Transactions Initiated Pursuant to Section 11323 of the Interstate Commerce Act."

9. Approval of the Application is subject to the environmental mitigation conditions set forth in Appendix C to this decision.

10. Applicants must comply with the SIP, which may be updated as necessary, and must continue to coordinate with FRA in implementing the SIP during the operations integration period. The ongoing safety integration process shall continue until FRA has informed the Board that the integration of Applicants' operations has been safely completed.

11. By May 15, 2023, Applicants shall participate in a technical conference with Board staff to discuss issues relating to reporting methodologies, formatting, and the scope of any further reporting that may be warranted.

****