Before the
Surface Transportation Board
Washington, D.C.

Kansas City Southern -- Control -- The Kansas City Southern Railway Company, Gateway Eastern Railway Company, and The Texas Mexican Railway Company	Finance Docket No. 34342

Supplemental Comments of the United States Department of Transportation

Introduction

The Surface Transportation Board ("STB" or "Board") in this proceeding has before it the application of the Kansas City Southern Railway Company ("KCS") to acquire the Texas Mexican Railway Company ("Tex-Mex").[1] KCS also seeks to acquire a major Mexican railroad (TFM, S.A. de C.V. ("TFM"), which transaction is not subject to STB regulatory approval. The combination of KCS, Tex-Mex, and TFM would form a coordinated international rail system called NAFTA Rail.[2]

Roughly one year ago the STB suspended the procedural schedule in this docket when it became apparent that KCS was no longer in position to consummate either

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1/ Technically, the application seeks approval for the joint control of KCS, the Gateway Eastern Railway Company (a wholly-owned subsidiary of KCS), and the Tex-Mex, via the purchase of a controlling interest in Mexrail, Inc., which owns 100 percent of Tex-Mex stock.

2/ The first transaction above is referred to herein as the "Tex-Mex transaction" and the second as the "TFM transaction." The details of all the relevant corporate relationships, and the complicated series of interrelated transactions among the corporations involved, are summarized in Decision No. 2 (served June 9, 2003) at 3-7.

transaction. Decision No. 10, served October 8, 2003. On August 16 of this year, KCS informed the STB that it had reached a new agreement to purchase a controlling interest in Tex-Mex, and accordingly requested reinstatement of the procedural schedule. [3] The Board agreed and invited interested parties to submit additional comments. Decision No. 11, served August 31, 2004.

The Tex-Mex transaction presents, now as before, a classic end-to-end combination of railroads; as such it neither offers great public benefits nor threatens significant public harms. The major point of contention is the handling of trains at the International Rail Bridge ("IRB" or "Bridge") at Laredo, Texas, by far the most prominent gateway for U.S.-Mexican rail traffic. DOT submits again that this issue is best resolved through reliance upon the intercarrier agreements that govern operations at the Bridge, reaffirmation of the Board's longstanding authority over those agreements, and holding KCS to its commitment to continue to cooperate in good faith toward efficient use of the Bridge.

The parties' primary focus in this proceeding has always been KCS's intended acquisition of the largest Mexican railroad, the TFM, and the effects of that consolidation on international rail traffic through Laredo. Although questions remain about the extent of the STB's jurisdiction, the Department urges the Board to adopt a condition -- contingent upon KCS's acquisition of the TFM -- keeping the Laredo gateway open to the extent possible, holding KCS to its commitments with respect to this traffic, and monitoring merger-related developments during an oversight period.

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[3]/ KCS is continuing its efforts to purchase the TFM.

Discussion

A. The Tex-Mex Transaction

Prior to the suspension of this proceeding last year, the Department concluded that the acquisition of the Tex-Mex by KCS was a straightforward end-to-end consolidation presenting few public benefits or harms. DOT-4, filed September 2, 2003. We identified two competitive issues raised by the transaction, however: BN access to Tex-Mex at Robstown for Laredo and Brownsville, Texas, traffic (via trackage rights over the lines of the Union Pacific railroad ("UP")), and control over operations at the IRB. Id. at 9. [4]

1. BN Trackage Rights

The STB granted BN these trackage rights in order to address competitive losses for Laredo traffic threatened by the merger of the UP and Southern Pacific ("SP") railroads. Id. at 16. [5] BN has expressed concern on this record that the merged KCS/Tex-Mex would "shorthaul" BN and carry this traffic itself, to the detriment of shippers and competition. KCS has committed to "continue to interchange traffic with

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[4]/ KCS will acquire one-half of the IRB, on the U.S. side of the Mexican border, upon consummation of its purchase of the Tex-Mex. The half of the IRB on the Mexican side of the border is owned by TFM.

[5]/ KCS emphasizes that these trackage rights arose from an agreement between UP and BN, and maintains that the Board "never considered" these trackage rights "as a sufficient replacement for the loss of competition that otherwise would have occurred at Laredo" from the UP/SP merger, but rather awarded trackage rights to KCS to serve that purpose. KCS-19/TM-18 at 13, note 13. In point of fact the STB relied upon both BN and KCS to remedy competitive problems for Laredo traffic in the UP/SP merger case. 1 S.T.B. 233, 422-24 (1996). The Board specifically noted that "Tex Mex envisions its proposed trackage rights as an addition to those competitive safeguards [provided by BN's trackage rights], not as a replacement." Id. at 422.

[BN] at Robstown" but has not disclaimed any intent to extend hauls on its own system. KCS-19/TM-18 at 13.[6]

DOT acknowledged that such routing changes are commonplace after mergers and generally without competitive impact. DOT-4 at 16. However, we also noted that because the Board is responsible for the presence of BN in the Laredo market, "only the Board can decide whether [its] purpose can be met through the substitution of KCS for BN" whenever the former would shorthaul the latter. Id. In other words, KCS should not be free to reduce BN's role in providing competition to UP absent assent by the STB.

There is nothing in the revival of the Tex-Mex transaction that changes the Department's view. We therefore continue to urge the STB to assess whether the merged KCS should be free to reduce BN's role as the major competitive spur to UP in the affected region.

2. The International Rail Bridge

The International Rail Bridge at Laredo is by far the most important rail gateway between the United States and Mexico. The record reflects some parties' concern that the Tex-Mex transaction, particularly in conjunction with KCS's announced intention to merge with the TFM, would allow KCS to manipulate cross-border traffic to the detriment of competition and the public interest. *See* Id. at 6, 11, 17.

DOT previously found that the Tex-Mex transaction standing alone "would give KCS control of access to, and operation of, the U.S. side of the Bridge." Id. at 17. We urged that the proper resolution of the parties' concerns rested in private enforcement of

[6]/ KCS considers its commitment fully contained within the settlement agreement it entered into with the National Industrial Transportation League ("NITL"). Id.; NITL-3, Attachment 1 at § 2(a).

the intercarrier agreements governing the Bridge (which KCS has pledged to honor), reaffirmation of the Board's jurisdiction over these agreements in order to forestall future disputes, and holding KCS to its commitment to extend fair and nondiscriminatory treatment to other carriers' trains at the Laredo Bridge. Id. at 17-18, 22.

Once again, there is nothing that would prompt the Department to change its prior view. The combination of KCS and the Tex-Mex presents few competitive issues; those that have surfaced are well within the Board's ability to correct.

B. The TFM Transaction

As noted, it is the TFM transaction that has always drawn the most attention in this proceeding. Notwithstanding a lack of jurisdiction over that consolidation itself, the prominence of the Laredo gateway and support for the economic integration embodied in the North American Free Trade Agreement ("NAFTA") properly led the Board to compile a record on the likely effects of the TFM transaction in the United States. Decision No. 2, served June 9, 2003.

In the face of concerns about possible manipulation of rates, divisions, and routings, as well as discriminatory handling of trains at the IRB, KCS committed to continue to cooperate with other railroads on use of the Bridge, to "keep the Laredo gateway open on commercially reasonable terms," and to "require TFM to cooperate" with UP and BN on "providing excellent service." *See* DOT-4 at 7-8. The Department concluded that Laredo's central role in U.S.-Mexico rail traffic, the policies underlying

NAFTA and the STB's merger rules for Class I carriers, [7] and concern for the TFM transaction's effects on competition in the region (as ordered by UP/SP merger conditions) supported a requirement to keep the Laredo gateway open. DOT-4 at 10-15.

We remain of this view. There may be uncertainty about the extent of its jurisdiction, but the Board clearly has authority over the reasonableness of international through rates, and KCS has made commitments on which the STB can and should rely. Id. at 17-20, and notes 12, 13. [8] DOT accordingly urges the Board to impose a contingent condition upon its approval of the Tex-Mex transaction. This condition would be triggered by KCS's consummation of the TFM transaction; it would require KCS to adhere to its commitments on this issue, and would also establish an oversight period during which parties could bring to the Board's attention evidence of merger-related harms and/or violations of relevant KCS commitments.

Safety

The KCS continues to work with the Federal Railroad Administration ("FRA") to complete the Safety Integration Plan ("SIP") for implementing the Tex-Mex transaction. FRA has not yet approved a final SIP, but anticipates no difficulty on this matter. FRA will report directly to the Board when it has approved the SIP in this case.

7/ 49 C.F.R. § 1180.1(c)(2)(iv).

8/ It also remains doubtful whether the terms of the NITL settlement, which may embody some or even all of these commitments, are fully commensurate with a physically and economically open gateway. Id. at 20 and note 16.

Conclusion

No material factor in this proceeding has changed over the past year. In these circumstances neither has the Department's view of the appropriate outcome. We therefore again urge the Board to consider whether KCS's unfettered control of the Tex-Mex would adversely affect conditions imposed with respect to Laredo traffic in the UP/SP merger. DOT also continues to recommend that issues arising out of KCS's control of the U.S. side of the IRB be resolved, at least as an initial matter, by reliance upon the terms of existing agreements and negotiations among interested parties. The Board can always exercise its jurisdiction if that is ultimately necessary.

The STB should also condition its approval of the Tex-Mex transaction in two respects. First, KCS should be held to the commitments it has made on the record, particularly those concerning operations at the IRB and the interchange of traffic with BN. Second, contingent upon KCS's acquisition of control of the TFM, the Board should require KCS to honor its commitment to keep the Laredo gateway physically and economically open, and initiate a three to five year oversight period. During that time parties would be free to bring evidence to the STB of merger-related harms and/or violations of KCS's commitments.

Respectfully submitted,

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September 30, 2004