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Should Conditions Regarding Non-Discrimination Be Imposed in Vertical Mergers? The Surface Transportation Board on the Acquisition of the Kansas City Southern Railway by the Canadian Pacific

Russell Pittman[1]

Abstract

In its 2023 decision approving the acquisition of the Kansas City Southern Railway by the Canadian Pacific, the U.S. Surface Transportation Board conditioned its approval on the merged railway's commitment "to keep gateways open on commercially reasonable terms" – that is, to allow shippers and non-merging railroads to continue to enjoy the option of using joint-line service, despite the merger's creation of the alternative of single-line service on the merged railroad. A century has passed since the Board's predecessor agency, the Interstate Commerce Commission, first imposed a condition of the maintenance of open gateways as a condition for approving a rail merger. This paper asks three questions. First, exactly what, in practice, are open gateways? Second, how have the two regulatory agencies dealt with the inherent tension between maintaining open gateways and achieving merger efficiencies? Third, what is the current state of play?

1. Introduction

In its decision of March 15, 2023, approving the acquisition of the Kansas City Southern (KCS) Railway by the Canadian Pacific (CP), the U.S. Surface Transportation Board (STB) followed its long-standing precedent, and that of its predecessor agency the Interstate Commerce Commission (ICC), in conditioning its approval on the merged railway's commitment "to keep gateways open on commercially reasonable terms" (Decision, at 173) – that is, to maintain pre-existing joint-line routes with connecting railroads not involved in the merger. The two agencies have over the past century implemented such conditions in response to concerns that their approval of rail mergers, especially those with end-to-end (vertical) components, would, by creating new single-line movements, disadvantage and even bankrupt railroads that had previously interconnected with one of the merging firms over such routes. Thus already in 1939 an ICC merger approval decision imposed the "usual requirement that existing gateways and through routes be maintained",[2] and the ICC's approval in 1950 of the acquisition of the Detroit, Toledo & Ironton Railroad by the Pennsylvania imposed what came to be known as the "standard DT&I conditions" with an order that

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[2] *Gulf, Mobile & Ohio Railroad Co. Merger*, 236 I.C.C. 61 (1939), cited in RAILROAD CONSOLIDATIONS AND THE PUBLIC INTEREST – A PRELIMINARY EXAMINATION, Staff Study by Bureau of Transport Economics and Statistics, Interstate Commerce Commission, 1962.

the merged firm “maintain and keep open all routes and channels of trade via existing junctions and gateways”.[3]

The imposition of these conditions on a merger-created, longer-haul railroad raises two important questions – and these questions are, *mutatis mutandis*, not unfamiliar to antimonopoly enforcers seeking to protect possibly disadvantaged firms following vertical mergers in other sectors of the economy.[4]

First, single-line freight rail service is generally considered to be less costly and more efficient than joint line service – indeed, the possibility of single-line service is often cited as an important prospective efficiency of a rail merger.[5] An “open gateways” order may be considered an order by the regulator for the merged firm to hold back from implementing the efficiencies promised by – indeed that might have motivated – the merger.

Second, it is not completely clear what constitutes an “open gateway”, nor how a regulator or a court could confidently declare a gateway NOT open.[6] The Union Pacific Railroad, one of several class I railroads expressing their concerns about the CP/KCS merger to the STB, explained:

> Applicants want credit for promising to keep existing gateways open on “commercially reasonable” terms without providing a concrete, enforceable commitment.... A shipper could *never* prove a particular gateway rate is not “commercially reasonable” unless the Board establishes a rule for judging whether such a rate is “commercially reasonable.” (UP Final Brief at 15; emphasis in original)

Ironically, these words echo those of the KCS itself in litigation following the imposition of the same conditions in the 1964 acquisition of the Kansas O&G by the Texas & Pacific: “The condition is inadequate because it is so imprecise and ambiguous that effective enforcement and protection of competition is precluded”.[7]

In this paper, we trace the history of the DT&I conditions as well as their (unnamed) predecessors, noting in particular the gradual acceptance by the agencies of the argument that the strong form of such conditions likely harmed shippers and the public in addition to interfering with merger efficiencies. We proceed to discuss and evaluate mechanisms used by the agencies and/or

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[3] *Detroit, Toledo & Ironton R. Co. Control*, 275 I.C.C. 455, 492 (1950).

[4] See, for example, Michael Klass and Michael Salinger, *Do new theories of vertical foreclosure provide sound guidance for consent agreements in vertical merger cases?* 40 ANTITRUST BULL. 667 (1995); James Langenfeld, *Non-Horizontal Merger Guidelines in the United States and the European Commission: Time for the United States to Catch Up*, 16 GEO. MASON L. REV. 851 (2009); and Steven Salop, *Invigorating Vertical Merger Enforcement,* 127 Y. L. J. 1742 (2018).

[5] See, for example, this from the STB’s decision in the CP/KCS merger: “The new single-line routes made possible by the Transaction will give ... shippers more efficient options to reach more markets and will provide receivers served by KCS with more efficient access to more sources for the commodities they receive.”

[6] *Cf.* Salop, *Invigorating Vertical Merger Enforcement, ibid.*: “Remedies such as firewalls, exclusion prohibitions, and antidiscrimination provisions have loopholes and may be unable to be effectively enforced by the agencies or a court.” Cf. also Fiona Scott Morton, *The Strategic Response by Pharmaceutical Firms to the Medicaid Most-Favored Customer Rules*, 28 RAND J. ECON. 269 (1997), which finds that firms subjected to non-discrimination requirements in the form of most-favored-nation clauses may increase their prices as a result.

[7] *KCS v. U.S.*, 288 F. Supp. 742, 746 (1968).

urged by intervenors in their efforts to enforce such conditions and/or to compensate victims of post-merger traffic diversion. Finally, we note with approval a mechanism adopted by the STB in the CP/KCS decision that addresses what we may call the DT&I conundrum – how to encourage vertical mergers that increase efficiency while offering some protection to competitors and shippers from unnecessary harm – in what may be the best available (or least objectionable) way.

2. A Long-Standing Merger Condition: Maintaining Open Gateways

2.1 The Early Years

Railroads were not exempt from the Sherman Antitrust Act (1889), and early U.S. antitrust litigation included important cases involving railroads.[8] The subsequent Clayton Act (1914) was motivated partly by a desire for antitrust legislation more specifically targeting corporate mergers as opposed to the interfirm agreements and single firm conduct that were the focus of the Sherman Act, and Section 7 of the Clayton Act applied to railroad mergers as well as to others. It was the Transportation Act of 1920 – also known as the Esch-Cummins Act – that assigned to the ICC exclusive jurisdiction over mergers between railroads, and indeed both encouraged industry consolidation and tasked the Commission with assembling a national master plan that would combine weaker lines with stronger ones while preserving competition – a thankless task performed by Harvard's Professor William Ripley that the railroad companies ignored.[9] Also relevant for our purposes, the Hepburn Act of 1906 had given the ICC "power to establish through routes and joint rates where no reasonable through route exists."[10]

The earliest ICC merger decision imposing gateway and access restrictions was not long in coming. As the ICC noted in its *Rulemaking Concerning Traffic Protective Conditions in Railroad Consolidation Proceedings* (1982): "Protective conditions were first imposed by the Commission in the Chicago Junction Case [of 1922] .... In that case, they were considered necessary to ensure the neutrality of a terminal company that, prior to merger with the New York Central Railroad Company, performed switching functions for the 23 line-haul carriers entering Chicago."[11] Already by 1939 in

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[8] There is a large literature on the history of U.S. railroads and their regulation. Among the sources relied on here are Neil McEwen, *The Role of Antitrust Law in Railroad Mergers - A Case Study: The Great Northern and Northern Pacific Merger*, 41 N. D. L. REV. 40 (1964); Carl Helmetag Jr., *Railroad Mergers: The Accommodation of the Interstate Commerce Act and Antitrust Policies*, 54 VA. L. REV. 1493 (1968); Michael Crum, *A Critique of and Recommendations for the ICC's Evaluation of Proposed Railroad Mergers*, 51 ICC PRAC. J. 368 (1983); Daniel Smith, *The Evolution of Rail Merger Policy*, 24 PROC. TRANS. RES. FORUM 558 (1983); *Detroit, T. & I.R. Co. v. United States*, 725 F.2d 47 (1984); and Michael Crum and Benjamin Allen, *U.S. Transportation Merger Policy: Evolution, Current Status, and Antitrust Considerations,* 13 J. TRANS. ECON. 41 (1986).

[9] See, for example, George P. Baker, *The Possibilities of Economies by Railroad Consolidation and Co-ordination*, 30 AMER. ECON. REV. 140 (1940); Charles F. Phillips Jr., *Railroad Mergers: Competition, Monopoly, and Antitrust*, 19 WASH. & LEE L. REV. 1 (1962), and John H. Williams, *A Revised Public Policy Toward a Restructured Railroad Industry*, 19 PROC. TRANS. RES. FORUM 112 (1978).

[10] *Interstate Commerce Commission v. Northern Pacific Railway*, 216 U.S. 538 (1910); Scharfman, THE INTERSTATE COMMERCE COMMISSION (1931), 216-219; *Division of Joint Rates and the Baltimore & Ohio Case*, 46 Y. L. J. 811 (1937). The much earlier Act to facilitate commercial, postal, and military Communication among the several States (1866) had *permitted* the railroads to form joint routes and charge joint rates voluntarily. John Turney, *The Price of Open Gateways*, 187 ANNALS OF AMER. ACAD. POLIT. & SOCIAL SCIENCE 22 (1936).

[11] 366 I.C.C. 112.

its *Gulf, Mobile & Ohio* decision the Commission was labeling as its "usual requirement" that "existing gateways and through routes be maintained."[12]

In 1950, the Pennsylvania and Wabash Railroads proposed to purchase control of the Detroit, Toledo & Ironton Railroad Company. The Nickel Plate, New York Central, and Baltimore & Ohio Railroads complained to the Commission that this merger would result in a loss of "operational integrity and independence" of the Ironton (as it was called), leading to their own losses of traffic. The ICC approved the merger while imposing conditions designed so that "the identity of the Ironton as an operating railroad entity is to remain exactly as it is today." A later Commission staff study noted that in imposing the conditions, "the Commission's intention was to preserve the identity of a particular line – in that case, the DT&I."[13]

To this end, it reported a set of six related merger conditions to be imposed going forward that were later labeled the "DT&I Conditions".[14]

A later Commission decision summarized the DT&I conditions as follows:

- Condition 1 requires a consolidated carrier to "maintain and keep open all routes and channels of trade via existing junctions and gateways" unless otherwise authorized by the Commission.
- Condition 3 requires a consolidated carrier to continue "present traffic and operating relationships".
- Conditions 2 and 4 prohibit discrimination "in the arrangement of schedules" and "in promptness [and] frequency of service," respectively.
- Condition 5 precludes a consolidated carrier from restraining "the right of industries located on the acquired line to route traffic over any or all existing routes and gateways."
- Condition 6 ... provides standing to seek later modification of the Conditions.[15]

Seven years later, the Commission added a seventh condition that arguably merely restated (or emphasized) the first:

- Applicant shall refrain from closing any existing route or channel of trade with any carrier on account of its control of the acquired railroad.[16]

The DT&I conditions, sometimes modified, were routinely imposed by the ICC on merger proposals that it accepted well into the 1970's, and, as noted above, the "open gateways" condition in

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[12] *Gulf, Mobile & Ohio RR Merger*, 236 I.C.C. 61 (1939).
[13] Rail Services Planning Office, RAIL MERGER STUDY: IMPACTS ON OTHER CARRIERS, Issue Paper No. 2, 1977.
[14] *Detroit, Toledo & Ironton R. Co. Control, op cit.* See also Rail Services Planning Office, RAIL MERGER STUDY, *ibid.*
[15] *Rulemaking Concerning Traffic Protective Conditions, op. cit.;* see also, for example, Rail Services Planning Office, *op. cit.*
[16] *Toledo, Peoria & Western*, 295 I.C.C. 523 (1957).

particular has persisted through the STB's most recent major merger decision, that approving the acquisition of KCS by CP in 2023.[17]

2.2 A Break in the Chronology: What Are "Open Gateways"?

Before we address the welfare issues in "open gateways" requirements, it may be useful to address the definitional issues. When is a gateway "open"? Or, conversely, what constitutes the "closing" of a gateway? The STB has declined opportunities to define the term more precisely, including in the recent CP/KCS decision ("The Board will not impose a formulaic principle or attempt to provide a specific definition"). However, over the years, both the agencies and the courts have sought to put some meat on the bones:

- In 1961, a connecting railroad complained to the Commission that the merged Louisville & Nashville Railroad had evaded its "open gateways" commitment by refusing to reduce its portion of a joint line rate to a level that would allow the joint haul to compete with the new single line rate. The ICC noted that "no traffic has moved over the petitioners' routes since the establishment of reduced rates over competitive routes, and [thus] they are for all practical purposes closed."[18]
- In 1962, the Commission reached a similar conclusion adjudicating complaints regarding the behavior of the newly created Soo Line and stated its point perhaps more clearly: "The Commission will consider anything which effectively stops traffic on a line to be, in effect, a closing."[19]
- In 1968, a federal court cited these two cases, among others, in noting that the clear policy of the ICC was that neither physical nor commercial closing of an affected gateway was permitted.[20]
- However, in that court proceeding, the ICC risked muddying the waters by arguing in its brief that "A proposed transaction, otherwise consistent with the public interest will be approved when, as conditioned, it will not result in *diversion of an undue amount of traffic* from competing lines."[21]
- In 1977, a second federal court ruled that a merged railroad's cancellation of a shipper's existing "transit privilege" would "result in a commercial closing of the route" and thus violate the open gateways condition imposed on the merged railroad by the ICC. It further noted that "A commercial closing occurs where rates are so high that no shipper will ship his product on the route where they apply."[22]
- In the same year, the ICC noted, apparently approvingly, its history of ruling that selective rate reductions constituted commercial closings: "In a number of proceedings, reduced rates ..., restricted so as not to apply over a competitive route taking higher rates, were found to have the effect of closing the higher route." In this

[17] A similar condition was imposed in the year previous in *CSX – Control and Merger – Pan Am Systems*, FD 36472 (2022).
[18] *Petition for Enforcement of Conditions in Merger Proceeding*, 313 I.C.C. 191 (1961).
[19] *Rates, Various Commodities - Canada, Midwest and East*, 318 I.C.C. 522 (1962).
[20] *Kansas City Southern v. United States*, 288 F. Supp. 742 (1968).
[21] *Ibid.*, emphasis added.
[22] *Burlington Northern v. United States*, 561 F.2d 167 (1977).

case, however, the Commission arguably risked further muddying the waters by noting that since the affected, formerly connecting railroads, the Santa Fe and the Union Pacific, remained financially healthy and had suffered "no substantial harm" from the closing, it would decline to order the merged railroad (the Southern Pacific) to change its pricing.[23]

- A ruling two years later adopted a similar pose – and contrary to both the ruling of the administrative law judge in the case and two dissenting commissioners. "Diversions that may occur could lead to a loss of revenue, but it is not our responsibility to insulate carriers from competition. Harm to a particular carrier becomes relevant only if there is a corresponding impact on the public interest by impairing a carrier's ability to provide essential service."[24]
- Also in 1979, an ICC administrative law judge found that the merged Seaboard Coast Line had allowed conditions at the Moncrief Yard in Jacksonville, FL, to deteriorate to such an extent that the gateway there was "effectively closed."[25] In the same year and regarding the same past merger, an appeals court ruled that lower rates on the post-merger single-line route, unavailable to joint-line partners, was a violation of the conditions: "It is not contended that SCL's action in restricting routing of the traffic through its affiliate and denying Southern the opportunity to offer service at the lower rate did not constitute a closing of Southern's opportunity to move this traffic, often referred to as a 'commercial closing'."[26]
- Finally, in 1983, a third federal court ruled that cancellations are a public interest problem "only if the closed routes are more efficient than the open ones."[27] Fifteen years later, the STB cited this precedent in its ruling permitting the CSX and Norfolk Southern Railroads to acquire and divide the assets of Conrail, noting that "CSX and Norfolk Southern have agreed to keep open all major interchanges with other carriers *as long as they are economically efficient*. This comports fully with our statutory mandate to preserve *efficient* routings."[28]

As noted above, intervening shippers and railroads have not hesitated to complain about the inexactness and ambiguities in open-gateways conditions and commitments. In the recent CP/KCS merger, the UP argued that "a shipper could *never* prove a particular gateway rate is not 'commercially reasonable' unless the Board establishes a rule for judging whether such a rate is 'commercially reasonable.'"[29] In fact CP and KCS conceded this point in a discussion of the conditions imposed in the earlier Tex/Mex merger:

> The Board did not define "commercially reasonable" in its 2004 Tex Mex decision.... There are no set metrics; there are no dollar caps. There is no rule by which UP could even

[23] *Southern Pacific Company – Merger – Pacific Electric Railway Company*, 354 I.C.C. 100 (1977).
[24] *Norfolk & W. – Merger – Detroit, Toledo & Ironton R. Co.*, 360 I.C.C. 448 (1979).
[25] *Seaboard Coast Line*, 360 I.C.C. 582 (1979).
[26] *Seaboard C. L. R. Co. v. United States*, 599 F.2d 650.
[27] *Chesapeake & Ohio v. United States*, 704 F.2d 373 (1983).
[28] *CSX Corporation*, 3 STB 196 (1998); emphasis added.
[29] UP Final Brief at 15; emphasis in original.

> determine, at this later date and with full hindsight, whether a particular rate ... is "commercially reasonable".[30]

The KCS itself made the same point in litigation following the imposition of the same conditions in the 1964 acquisition of the Kansas O&G by the Texas & Pacific: "The condition is inadequate because it is so imprecise and ambiguous that effective enforcement and protection of competition is precluded".[31]

2.3 The Downside of Open Gateway Requirements

Vertical merger enforcement is a challenge for regulatory and competition authorities. As vertical mergers substitute intrafirm transactions for market transactions, they have the potential to reduce costs – whether through the elimination of "double marginalization" or through other forms of economies and efficiencies emphasized by scholars as eminent as Ronald Coase and Oliver Williamson.[32] On the other hand, vertical mergers also have the potential to harm competition by creating a vertically integrated firm with the ability to disadvantage its non-integrated rivals, either upstream or downstream.[33] It is the task of the regulator or competition authority to differentiate between the two as likely merger outcomes and, often in practice, to seek to allow the merger and enjoy the efficiencies while imposing conditions to minimize the competitive harm.[34] It is a danger for the regulator or competition authority that the imposition of conditions designed to protect non-merging competitors may compromise or even destroy the very efficiencies otherwise created by the merger.

In the context of the end-to-end rail mergers that lead to debates about traffic diversion and open gateways, this tradeoff began to be recognized fairly early on at the ICC. In one of the rare railroad merger proposals in the decade following World War II, the Chicago, Burlington & Quincy Railroad and the Santa Fe proposed jointly to acquire the Kansas City, Chicago & St. Louis Railroad. The acquisition promised to shorten the Burlington's route between Kansas City and St. Louis as well as to provide the Santa Fe with entry into St. Louis. However, competing southwestern railroads argued that the merger would divert so much of their traffic to the Santa Fe that they might be forced to abandon certain lines, and the ICC prohibited the acquisition.[35]

Commissioner Charles Mahaffie filed a blistering dissent, arguing that the protection of the complaining lines would deny shippers the benefits of shorter and more efficient routing:

> Of course if the line is greatly improved and traffic can be handled over it more economically and efficiently than over existing lines there will be, and there should be,

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[30] *Ibid.,* citing Applicants' Reply to UP's Motion to Compel.
[31] *KCS v. U.S.*, 288 F. Supp. 742, 746 (1968).
[32] Classic sources include A.A. Cournot, RECHERCHES SUR LES PRINCIPES MATHEMATIQUES DE LA THEORIE DES RICHESS (1838); J.J. Spengler, *Vertical Integration and Antitrust Policy*, 50 J. POL. ECON. 347 (1950); R.H. Coase, *The Nature of the Firm*, 4 ECONOMICA 386 (1937); and Oliver Williamson, *The Vertical Integration of Production: Market Failure Considerations*, 61 AM. ECON. REV. 112 (1971).
[33] See, for example, S. Salop and D. Scheffman, *Raising Rivals' Costs*, 73 AMER. ECON. REV. 267 (1983); Salop and Scheffman, *Cost-Raising Strategies*, 36 J. IND. ECON. 19 (1987); and Carl Shapiro, *Vertical Mergers and Input Foreclosure: Lessons from the AT&T/Time Warner Case*, 59 REV. IND. ORG. 303 (2021).
[34] Klass and Salinger, *op. cit.*; Langenfeld, *op. cit*.
[35] *Chicago, Burlington & Quincy Railroad Co.*, 271 I.C.C. 63 (1948).

> some diversion of traffic.... The reasoning of the report, if applied generally, would pretty much freeze the railroad plant. If it had been applied to all transportation as of, say, 1920 it would have prevented the entry of motor carriers and perhaps of air carriers into the transportation field. It is not, as I see it, in accord with the principles of the act, which ... are intended to promote adequacy and efficiency of transportation service for the benefit of the public.[36]

In 1960, the Commission itself, while imposing the DT&I conditions on the Erie Lackawanna merger, noted the limits on what it intended in that regard:

> In connection with transactions such as this, it is not practicable, nor would it be in the public interest, to impose conditions calculated to freeze the flow of traffic into a preexisting pattern or to protect competing and connecting carriers against all possible adverse effects which might follow from the unification and resulting improvements in service by the surviving corporation. Such action would prevent, to a substantial extent, the effectuation of service improvements to which the shipping public is entitled, and would unduly restrict the unified company in its solicitation and routing of traffic and the development of a strong competitive system.[37]

In 1962, a staff study by the ICC's Bureau of Transport Economics and Statistics analyzed the history of Commission merger enforcement between 1948 and 1960 and, without criticizing the DT&I conditions by name, acknowledged that "conditions attached to a merger approval which preserve joint routes or interchange arrangements may prevent the attainment of a degree of efficiency which otherwise would have been possible through more economical alternate routes."[38]

From 1962 through 1967, the ICC wrestled with the proposal of the New York Central and Pennsylvania Railroads to merge into one company – the Penn Central.[39] Amid multiple ICC proceedings and court decisions that culminated in the final consummation of the merger in 1968, the Commission sought to approve the merger but worried about its impact on three small regional railroads whose ownership status and independence were facing uncertainties – the Erie-Lackawanna, Delaware & Hudson, and Boston & Maine. While noting that strict conditions seeking to minimize diversion from these three railroads "would ... deny to applicants and some shippers, for the time being, some of the merger benefits," the Commission issued a temporary order that "the merged company shall not publish or provide for any new or changed routing practice and/or freight rates or services, either locally or jointly with other carriers, which would divert or tend to

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[36] Ibid. at 166-167, cited in Michael Conant, *Railroad Consolidations and the Antitrust Laws*, 14 STAN. L. REV. 489 (1961-62) and James Johnson and Terry Whiteside, *Professor Ripley Revisited: A Current Analysis of Railroad Mergers*, 42 ICC PRACTITIONERS J. 419 (1975).
[37] *Erie R. Co. Merger*, 312 I.C.C. 185, 191 (1960).
[38] RAILROAD CONSOLIDATIONS AND THE PUBLIC INTEREST, *op. cit*., cited in Michael Crum, *A Critique of and Recommendations for the ICC's Evaluation of Proposed Railroad Mergers*, 51 ICC PRACTITIONERS J. 368 (1984).
[39] The broader case has been widely analyzed and discussed. See, for example, Joseph Daughen and Peter Binzen, THE WRECK OF THE PENN CENTRAL (1971); Stephen Salsbury, NO WAY TO RUN A RAILROAD (1982); and George Drury, *Penn Central Co.*, in William Middleton, George Smerk, and Roberta Diehl, ENCYCLOPEDIA OF NORTH AMERICAN RAILROADS (2007).

divert traffic from routes in which the E-L, D&H or B&M, now participates."[40] (It also – unusually for the Commission – crafted a system of indemnities to be paid by the merged firm if the three lines suffered diversion. We shall discuss indemnities below.)

During the same period that the Commission was backing away from strict enforcement of the DT&I conditions, it was also gradually warming to the idea of flexibility, innovation, and experimentation in rate setting: from a grudging acceptance of volume-based rates under strict conditions (*Grain by Rent-A-Train, IFA Territory to Gulf Ports*, 335 I.C.C. 111 [1969]), to a positive reference to "innovative ratemaking" (*Investigation of Railroad Freight Service*, 345 I.C.C. 1223 [1976]), to, with a nod to the 4R Act of 1976, a full-throated endorsement of "innovative ratemaking" with examples of "unit-train rates, annual volume rates -- provided no destructive competition is involved -- multiple car rates, and rent-a-train agreements" (*Standards and Expeditious Procedures for Establishing Railroad Rates Based on Seasonal, Regional, or Peak-Period Demand for Rail Service*, 355 I.C.C. 522 [1977]). In 1978 the Commission even announced its intention "to issue a general policy statement permitting the filing in tariff form of railroad contract rates" (*Proposed Change of Policy: Railroad Contract Rates*, 43 F.R. 22148).

In 1977, another ICC staff study – this one by the Rail Services Planning Office – noted that over the years the rationale for its imposition of the DT&I conditions – discussed above, and here summarized as "preventing a controlling road 'from practices that will unduly prejudice a smaller road's relations with other railroads'" – had expanded to include the protection from diversion of large and financially sound railroads, and stated specifically that "strict enforcement [of the DT&I non-discrimination conditions] could … impede the initiation of improved service by the merged carrier."[41]

The Commission cited this staff study in beginning a major retreat from routine imposition of the DT&I conditions in its opinion in *Seaboard Coast Line R. Co. – Investigation of Control and Modification of Traffic Conditions* in 1979.[42] First, the opinion notes that "the effect of the DT&I conditions has been to keep railroad rates artificially high. A railroad subject to these conditions cannot offer lower rates to obtain the long haul, because of the traditional Commission approach that a reduced rate on a restricted routing is a commercial closing." The Commission expressed its agreement with the statement of the Administrative Law Judge (ALJ) for the case that "this traditional approach is unsuited to today's environment."

The opinion proceeded to announce a broad policy reconsideration:

> We take this opportunity to clarify that changed conditions require that we reassess our view of the DT&I conditions…. We are now further considering whether the standard routing and traffic conditions should be imposed routinely, and if imposed, whether they should be used only to provide limited protection for a limited period of time.

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[40] *Pennsylvania R. Co. – Merger – New York Central R. Co.*, 327 I.C.C. 475 (1966). See also Gilbert Schroeder, *Anti-Trust – Railroad Mergers – A Matter of Public Interest*, 18 DE PAUL L. REV. 272 (1968), and Carl Helmetag, *Railroad Mergers: The Accommodation of the Interstate Commerce Act and Antitrust Policies, op. cit.*
[41] Rail Services Planning Office, IMPACTS ON OTHER CARRIERS, *op. cit.*
[42] 360 I.C.C. 582 (1979).

Chairman Darius Gaskins issued a short concurring opinion, noting first that "In my view, the public interest is served by permitting the Family Lines to pass through the cost savings available from single-line operations in the form of lower rates. Shippers throughout the South will now be able to decide how to route their traffic on the basis of the lowest price available as well as the best service", and then querying whether the DT&I conditions were in fact inconsistent with the recently enacted 4R Act and the resulting amendments to the Interstate Commerce Act, both emphasizing the procompetitive benefits of cost and rate reductions.

The Commission had already, just a month earlier, declined to follow an ALJ's recommendation to impose the DT&I conditions in its complicated decision to allow the purchase of the Detroit, Toledo & Ironton Railroad by the Grand Trunk Railroad over the objections of the Norfolk & Western and Baltimore & Ohio Railroads, which had jointly sought to purchase the DT&I themselves.[43] The Commission noted in its decision that "Diversions that may occur could lead to a loss of revenue, but it is not our responsibility to insulate carriers from competition. Harm to a particular carrier becomes relevant only if there is a corresponding impact on the public interest by impairing a carrier's ability to provide essential service" – which the Commission judged not to be the case here.[44] Furthermore:

> To foster rail competition unencumbered by artificial restraints or burdensome regulations we have determined not to impose traffic protective conditions here. This *change in policy* will allow rail carriers to compete more freely in the marketplace with other railroads and other modes of transportation....
>
> In the future, it should be clear that the standard DTI traffic conditions will be imposed only where it is shown that harm may befall shippers and carriers who are not adequately protected by other provisions of title 49, subtitle IV. These traffic conditions may also be imposed upon a clear showing by (1) a carrier that the consolidation will cause traffic diversions sufficiently serious to harm its ability to provide essential rail services to the public, or (2) a shipper that the result of the consolidation will be to deprive if of adequate transportation service.[45]

Shortly thereafter, in 1982, the Commission issued a decision in its *Rulemaking Concerning Traffic Protective Conditions in Railroad Consolidation Proceedings* in which it completed its renunciation of the automatic imposition of the DT&I conditions in rail merger proceedings, and in particular any version of these or other conditions "requiring rate equalization".[46]

As it noted in the decision, the related Notice of Proposed Rulemaking had "set forth the following arguments for elimination of the DT&I Conditions":

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[43] *Norfolk & Western Railway C. and Baltimore & Ohio Railroad C. – Control – Detroit, Toledo & Ironton Railroad C.*, 360 I.C.C. 498 (1979).
[44] Mark Burton points out that one reason a carrier's service might be considered "essential" has to do with network effects: the competitive role of the carrier in other routes might be weakened or eliminated by a weakening or elimination of the carrier in the route that is affected by the merger.
[45] *Ibid.*; emphasis added.
[46] 366 I.C.C. 112 (1982).

1. The Conditions are contrary to the congressional policy expressed in the Railroad Revitalization and Regulatory Reform Act of 1976 (Public Law 94-210) (4R Act) of fostering intramodal rail competition;

2. The Conditions remove incentives for efficient operations by keeping carriers from pricing more efficient routes at lower rates;

3. The Conditions encourage unnecessary utilization of resources as carriers are forced to offer specialized services, instead of lower prices, to attract new business;

4. The Conditions hamper carrier efforts to rationalize their systems by freezing existing junctions and interchanges;

5. The Conditions stifle the ability of rail carriers to meet motor and water competition by allowing connecting rail carriers to block rate reductions; and

6. Existing statutory authority provides sufficient protection against the type of abuse the conditions are intended to preclude.

With that setup in the RFP, the outcome of the decision was likely not a surprise. The decision stated clearly that "We no longer think that a mere rate disparity constitutes a commercial closing." On the contrary: "Because of the need for carriers to make rate adjustments in response to competitive pressures [both intramodal and intermodal], we believe it is appropriate to presume that a rate reduction is lawful unless a protestant makes a prima facie case that there has been a route closing which is not in the public interest." In sum: "The Commission finds that the 'DT&I' traffic protection conditions are anticompetitive and contrary to the public interest."[47]

The Commission and its successor agency reiterated these points in two subsequent merger decisions.

In approving the acquisition of the Missouri Pacific Railroad by the Union Pacific, the Commission responded to requests by intervening railroads for DT&I-like conditions as follows:

> Open gateway conditions to railroad consolidations are not generally in the public interest. The provisions of 49 U.S.C. 10705 provide statutory protection against anticompetitive cancellations of through routes and joint rates. A condition that would require a level of protection for the maintenance of a gateway that is higher than is provided by statute might tend to preserve inefficient routings and to have a chilling effect on rate and service innovations by the new consolidated system.[48]

Sixteen years later, the new Surface Transportation Board, in the course of a major decision approving the application of CSX and Norfolk Southern to acquire and divide up most of the assets of Conrail, responded similarly to intervenor requests for conditions to protect against diversion:

> The ICC carefully examined and rejected arguments similar to those made here in Traffic Protective Conditions, 366 I.C.C. 112 (1982), aff'd in relevant part Detroit, T. & I.R.R. v. United States, 725 F.2d 47 (6th Cir. 1984) (DT&I). As the ICC found there, the freezing of

[47] *Ibid.*

[48] *Union Pacific Railroad – Control – Missouri Pacific Railroad*, 366 I.C.C. 459 (1982).

> gateways and routes through regulatory decree has extremely anticompetitive consequences by precluding carriers from making efficiency and service improving routing changes and related rate reductions. We continue to believe that carriers involved in mergers and consolidations such as this one should be allowed the flexibility to determine what gateways and routings are most efficient given their newly restructured systems. Although not all connecting carriers benefit from this shifting of traffic, shippers do benefit from this process....
>
> We continue to believe that conditions of this [DT&I] type are inefficient, anticompetitive, and contrary to the public interest.[49]

In summary: in decisions from 1979 through 1998, the ICC and then the STB made it clear that they had heard, understood, and finally accepted arguments that at least the full imposition of the DT&I conditions – which, recall, included effective prohibitions of post-merger rate cutting by the merged railroad for its new single-line hauls – what we might term the "strong" form of the DT&I conditions – were contrary to the public interest, and probably directly contrary to the 4R Act and Staggers Act as well. Statements in the UP/MP (1982) and Conrail (1998) decisions could seemingly be interpreted as throwing shade on the requirement of the preservation of "open gateways" as well – though these could be interpreted as begging the question, since one definition of closed gateways had previously been the charging of lower rates for single-line service.

And yet, in its almost-300-page decision of 2001 titled *Major Rail Consolidation Procedures*, the Board made clear a continuing favoring of what it termed (but declined to define) open gateway conditions:

> We will require applicants to submit a service assurance plan with their initial application and operating plan. Applicants also will be expected to include measures for preserving competition wherever feasible, *including effective plans to keep open major existing gateways*....
>
> Numerous parties, including NITL [the National Industrial Traffic League] and American Chemistry Council (ACC), stress that gateways must be kept open not just physically but economically. Although we agree, *we will not go so far as to resurrect the long-discredited commercial closing doctrine, under which any rate differential was deemed to close a gateway.* As the ICC explained in Traffic Protective Conditions, 366 I.C.C. 112 (1982), such a rate equalization policy destroys the ability of the merged carrier to reduce rates to reflect its new efficiencies, inhibits competition, and thereby harms both shippers and carriers. At this juncture, we do not believe it would be appropriate to impose any of the several across-the-board rules that have been suggested by various parties for determining when a gateway would be deemed economically closed. Rather, we believe such issues are best addressed on a case-by-case basis.[50]

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[49] *CSX Corporation and Norfolk Southern Railway – Control – Conrail*, 1998 STB LEXIS 1559.
[50] *Major Rail Consolidation Procedures*, 2001 STB LEXIS 546; emphasis added.

In at least six merger decisions issued since the publication of the *Major Rail Consolidation Procedures*, the Board has conditioned its merger approval on some variant of keeping "all existing active gateways ... open on commercially reasonable terms." These have included the following:

- *Canadian National Railway – Control – Duluth, Missabe & Iron Range Railway*, 2004 STB LEXIS 230): "Applicants must adhere to their representation that they will keep all existing active gateways affected by the CN/GLT Transaction open on commercially reasonable terms."
- *Kansas City Southern – Control – Texas Mexican Railway*, 2004 STB LEXIS 777: A narrower focus on the merged firm keeping the all-important "Laredo gateway open on commercially reasonable terms."
- *Canadian Pacific Railway – Control – Dakota, Minnesota & Eastern Railroad*, 2008 STB LEXIS 549: "We are also requiring that applicants adhere to the representations they made on the record in this proceeding, including the pledge to keep open on commercially reasonable terms all gateways affected by the proposed transaction." In this matter, the Department of Transportation filing noted that "Generally, conditions to preserve interchanges or gateways are disfavored."
- *Canadian National Railway – Control – Elgin, Joliet & Eastern Railroad Company*, STB Finance Docket 35087 (2008): "Applicants must adhere to their representation that they will keep all existing active gateways affected by the CN/EJ&E transaction open on commercially reasonable terms."
- *CSX Corporation – Control and Merger – Pan Am Systems*, STB Finance Docket 36472 (2022): CSX will "keep all existing active gateways affected by the Proposed Transaction open on commercially reasonable terms."
- Canadian Pacific Railway – Control – Kansas City Southern, STB Finance Docket 36500 (2023):

  Applicants ... state that "CP/KCS will continue to maintain efficient operations serving existing gateways *wherever traffic levels warrant* – in terms of both the through train services to and from the gateways as well as the operational capabilities and infrastructure necessary to carry out efficient interchange." (Id. (emphasis added).) The Board clarifies that the condition to keep gateways open on commercially reasonable terms applies both financially and operationally (physically).... But ... Applicants are not the judge of whether traffic levels do, or do not, warrant application of their commitment to keep a gateway open financially or operationally on commercially reasonable terms.... Rather, in any dispute regarding commercial reasonableness—like with arguments regarding limited past use of an interline routing option—CPKC remains free to assert that traffic levels are a factor that should be considered in evaluating the "commercial reasonableness" of challenged conduct and, in any formal proceeding, to present evidence and argument to support its position. If an argument based on traffic levels is made by Applicants in any formal proceeding, they will be required to demonstrate that such levels justify the actions complained-of that had been taken at the gateway.

We are seemingly left with a stated mandate of the STB that merging railroads commit to a future policy of the maintenance open gateways, but – with the removal of a clear older definition of

closed gateways as the definitional result of rate reductions by the merged railroad – an absence of clear guidance as to exactly what that requirement means. One may be reminded of the famous concurring opinion of Supreme Court Justice Potter Stewart in *Jacobellis v. Ohio*:

> Under the First and Fourteenth Amendments criminal laws in this area are constitutionally limited to hard-core pornography. I shall not today attempt further to define the kinds of material I understand to be embraced within that shorthand description; and perhaps I could never succeed in intelligibly doing so. But I know it when I see it.[51]

2.3 Indemnities and Other Specific Remedy Proposals

As noted above, while giving its approval to the merger of the Pennsylvania Railroad and the New York Central Railroad into the Penn Central, the ICC was concerned about the fate of three smaller northeastern railroads whose status was at the time subject to some uncertainty: the Erie-Lackawanna, the Delaware & Hudson, and the Boston & Maine.[52] The Commission imposed strong (though temporary) non-discrimination terms vis-à-vis these three smaller lines on the merged firm: "the temporary preservation of present practices and patterns (as to both routes of movement and volume) on traffic for which E-L, D&H and B&M competes with applicants and other railroads making up the proposed system."

However, in this case it went a step further and, apparently for the first time in its history, ordered "the payment of an indemnity by the [merged firm] to E-L, D&H and/or B&M whenever, in a given year, the revenues of E-L, D&H and B&M are, as to each of them, proportionally less than the combined revenues of each protected carrier and the [merged firm], as computed on the basis of the relationship existing between such revenues for the year 1964." These conditions were to apply "during the protective period", i.e. "pending final determination" of the status of the three smaller railroads.

Specifically:

- The "base revenue ratio" would be calculated as the protected carrier's freight revenues divided by the sum of that carrier's freight revenues plus those of the Pennsylvania and New York Central Railroads in 1964. This ratio was 13.1% for the E-L, 3.3% for the D&H, and 4.3% for the B&M.
- For any given year going forward, the sum of the protected carrier's freight revenues and those of the merged firm would be calculated and then multiplied by the "base revenue ratio" to yield the "standard revenue".
- If in that year the revenues of the protected carrier are less than the standard revenue, the difference is the "indemnification base".
- The protected carrier's average freight operating ratio (operating costs as a percentage of revenues) for the year's 1962-65 would be subtracted from 100% to

[51] 378 U.S. 184 (1964); footnote omitted.
[52] *Pennsylvania R. Co. – Merger – New York Central R. Co*, 327 I.C.C. 475 (1966). See also Gilbert Schroeder, *Antitrust – Railroad Mergers, op. cit.*, and Carl Helmetag, *Railroad Mergers, op. cit.*

yield the “indemnification factor”. The indemnification factors were 20.76 for the E-L, 25.27 for the D&H, and 26.64 for the B&M.
- The dollar amount of that year’s indemnity would then by the indemnification base multiplied by the indemnification factor.

The decision then helpfully provides an example:

> To avoid questions regarding the use of this unique, but simple, indemnification provision, the following example is provided as a guide to its application:

1964 Freight revenues, E-L ($)	176,512,915
1964 Freight revenues, PRR-NYC	+1,171,256,031
Total freight revenues 1964	1,347,767,946
Base revenue ratio, E-L, 1964	13.0967 percent
y year freight revenues, E-L ($)	200,000,000
y year freight revenues, Transp. Co.	+1,330,000,000
Total freight revenues, y year	1,530,000,000
Standard revenue = $1.53 billion x .130967 =	200,379,510
Less earned revenue	-200,000,000
Indemnification base	379,510
Indemnification factor (100 - 79.24[a])	x .2076
Amount of indemnification to E-L, y year	78,786.28

> [a] E-L's average freight operating ratio, 1962-65, expressed as a percentage of 100.

In a subsequent proceeding, the Commission responded to concerns about cost recovery from the three protected carriers by increasing the indemnification factor from 100 minus the earlier operating ratio to a flat 50 percent.[53]

Anyone versed in microeconomics or the debates regarding rate-of-return regulation will recognize the problematic incentives created by this indemnity regime: in any given year, each of the protected railroads could increase its indemnity payment by lowering its revenues. Correspondingly, in any given year, the merged firm could lower its indemnity payment also by lowering its revenues. To its credit, the Commission recognized this problem (or at least the first half of it):

> In imposing the conditions we anticipate that the petitioners will not relax their own solicitation efforts nor permit the quality of their service to decline upon the expectation

[53] *Pennsylvania Railroad Company – Merger – New York Central Railroad Company*, 330 I.C.C. 328 (1967).

> that their traffic or revenues are guaranteed by the [merged firm]. Any evidence of such practices brought to our attention may be considered a prima facie reason for reopening these proceedings to consider revision or deletion of the conditions.[54]

In 1974, the Commission expressed a more direct rationale for its requirement of indemnities as a condition of merger approval in the second -- and apparently only other – instance of its application, the C&NW merger with the Rock Island:

> Traditionally, the Commission has imposed traffic protective conditions to reduce the shock of a merger on competitors of the merged carrier. Typically, such conditions have proved to be difficult to enforce, at times requiring protracted proceedings before the I.C.C. during which period the protection sought to be afforded has ordinarily been lost. In an effort to improve the effectiveness of traffic protective conditions by making them easily enforceable while at the same time providing a greater measure of sanctioned flexibility, the Commission has [in this matter] employed an indemnification mechanism as a part of the conditions.[55]

This decision set up a system of indemnities to be paid by the merging firm for "decreases in the normal amount of traffic" at particular gateways to the North Western, Milwaukee, Frisco, Kansas City Southern, and Katy Railroads. The indemnity mechanism granted was broadly similar to that in the Penn Central decision, with indemnities based on reductions in freight interchanged as compared with the pre-merger pattern, and with account taken of operating ratios (though in this case a regional average rather than railroad-specific).

> The basic question to be resolved in each case is the same as in the usual traffic protective conditions, to wit, what amount of traffic shall be protected? For each car which the indemnifying carrier fails to deliver at the designated gateway below the amount protected, such carrier shall compensate the protected carrier in an amount equal to the average net revenue per car interchanged. This will be computed as follows: (As an example we use the UP and the Milwaukee. All statistics are fictional, used for illustration purposes only.)
>
> 1. Determine the average number of loaded cars per year (based on the average of the 5 years previous to the year in which the merger was consummated) delivered by the indemnifying carrier to the protected carrier at the designated gateways. (In this instance assume that UP had delivered an average of 40,000 loaded cars per year to the Milwaukee at the Omaha and Council Bluffs gateways.)
>
> 2. Determine the average gross revenue per car, to the protected carrier, on the traffic it received from the indemnifying railroad during the year preceding that in which the merger was consummated. (Assume that Milwaukee had an average gross revenue per car on its UP traffic of $500.)
>
> 3. Multiply the average number of cars received by the average gross revenue per car to derive the gross revenue which the protected carrier would normally derive from traffic

[54] *Ibid.*

[55] *Chicago & North Western R. C. – Control – Chicago, Rock Island & Pacific R. C.*, 347 I.C.C. 556 (1974).

delivered by the indemnifying carrier. (40,000 loaded cars per year x $500 gross revenue per car = $20 million, which Milwaukee would normally derive from traffic received from UP.)

4. If the number of cars delivered by the indemnifying railroad, at the designated gateways during the year for which protection is provided, falls below the average number of loaded cars determined in step 1, the indemnifying railroad shall indemnify the protected carrier for its lost net revenue on the deficiency. Payment would be determined by subtracting the protected railroad's gross revenue on traffic actually received from the indemnifying railroad at the designated gateways, from the gross revenue which the protected carrier normally would have derived from such traffic as determined in step 3; and then multiplying this figure by 100 percent minus the average operating ratio of all western district rail carriers for the 5-year period preceding the year in which the merger was consummated. [If UP delivered only 30,000 cars during the year, and Milwaukee's gross revenue from such traffic was $15 million, UP would be required to indemnify Milwaukee for its net revenue on the $5 million diverted gross revenue ($20 million normal gross revenue minus $15 million actual revenue = $5 million gross revenue deficit). Assuming an average operation ratio of .80 for western district carriers, actual payment would be $5 million x (1.00 minus .80), or $5 million x .20 = $1 million.]

5. If the average operating ratio of western district railroads is above .90, the indemnifying carrier shall pay the protected carrier no less than 10 percent of the protected carrier's diverted gross revenue. [Thus, if, in our example, the average operating ratio were .95, UP would be required to pay Milwaukee $5 million x .10 = $500,000, not $5 million x (1.00 minus .95) = $250,000.]

6. The indemnity requirement shall be reduced, as indicated below, whenever the Commission determines that the reduction in interchange volume is due to crop failure, general economic recession, or other similar cause. When on the relevant portion of an indemnifying carrier's system, the number of loaded cars handled by the indemnifying carrier, during a year for which protection is provided, falls 10 percent or more below the average number of cars handled by the indemnifying carrier on that portion of its system during the 5-year period preceding the year in which the merger was consummated, the number of loaded cars required to be delivered to the protected carrier at the related interchange point would be reduced by the same percentage. [Assume that UP had normally handled 2 million cars per year and that during the year in question it handled only 1,700,000, a 15-percent reduction. The number of cars it would be required to deliver to Milwaukee would also be reduced by 15 percent. Thus, 40,000 cars minus 15 percent equals 34,000 cars for which Milwaukee would be entitled revenue protection. Milwaukee should, thus, have a gross revenue protection of $500 x 34,000 equaling $17 million. So, if the actual gross revenue from traffic received from UP was $15 million, UP would be required to indemnify Milwaukee by $400,000, for its diverted net revenue on $2 million or ($17 million minus $15 million x .20 = $400,000.)][56]

[56] *Ibid.*; footnotes omitted.

In this matter also the Commission expressed concern regarding the incentive properties of indemnity regimes:

> We recognize that objections may be raised to conditions of this nature on the grounds that they are somewhat inflexible; that the protected carriers may feel relieved of an incentive to provide good service; and that the carrier providing the protection is deprived of some of the benefits of the transaction and possibly some of its incentive to consummate the proposed merger. These conditions are thus imposed reluctantly, and only because we find that they are absolutely essential to assure the continued ability of North Western and Milwaukee to serve the general public.[57]

Two 1980 merger decisions that firmly rejected proposals from non-merging railroads for indemnities may have convinced potential claimants in future mergers that that door was shut.

In the Burlington/Frisco merger, both the Milwaukee and the MKT requested indemnification for diverted traffic both past and future. The Commission was having none of it:

> Our imposition of indemnification in the past has been to allow a carrier to continue to provide service while a more permanent solution was being finalized. We no longer require that corporate entities be preserved; rather, we are concerned about essential services. In this climate a provision of indemnity seems highly anticompetitive. Indemnity may well induce a carrier to become less aggressive and provide less than optimum service. Indemnity also may be viewed as a reward for being unable to compete in the marketplace. This transfer of funds would, in effect, be a massive cross-subsidization not only of commodities, but of inefficient operations of another railroad, merely to preserve the existence of the other railroad. Hence, *we do not see indemnity as a viable condition under any circumstances*.[58]

The Commission reiterated these views later in the year in the proposed SSW/Rock Island merger:

> We consider the indemnification of competitors unsound for policy reasons. First, the carrier receiving indemnification may be less likely to provide optimum prices or services, since it will be automatically compensated for any loss of net revenues experienced. Since indemnification is calculated on the difference between 1977 net revenues and those of subsequent years, the payment is triggered by poor financial performance. It therefore can be viewed as a reward for inefficiency or inability to compete.
>
> Indemnification also may result in cross-subsidization by a healthy railroad of the less efficient operations of another carrier. Since a portion of the financial rewards to the acquiring carrier are siphoned off, the benefits to that carrier are reduced. At the same time, the condition creates a disincentive for the acquiring carrier to maximize competition with

[57] *Ibid*.
[58] *Burlington Northern – Control and Merger – St. Louis San Francisco R.*, 360 I.C.C. 788 (1980).

> the lines it is indemnifying, since the latter must be reimbursed for its losses. As a result, shippers served by both carriers would be disadvantaged by an indemnity requirement.[59]

3. Supplementing "open gateway" conditions?

The STB will apparently continue to condition its merger approvals on the post-merger maintenance of "all existing active gateways affected by the Proposed Transaction open on commercially reasonable terms" (CSX/Pan Am decision). This is despite the fuzziness that remains in defining this condition – though we know now that it does not mean rate equalization. The Board has apparently quickly abandoned its experiment with using indemnities paid to former connecting railroads by the merged railroad as a supplement to an open gateways condition. However, other supplemental mechanisms have been tried, and the Board in its CP/KCS decision may have hit upon the best available.

In its application to acquire the Wisconsin Central in 2001, CN included a rate protection agreement signed with the National Industrial Transportation League (NITL), a large and influential organization of shippers. In addition to contract provisions protecting service quality and agreeing to arbitration in case of disputes, the agreement limited any increases in the rates charged by the merged railroad as part of a joint-line rate to a relevant measure of inflation:

> CN/WC's portion of ... existing common carrier through rates may be increased by no more than the change, if any, in the Unadjusted Rail Cost Adjustment Factor (RCAF-U), or, if CN/WC so chooses, the change in the RCAF-U minus any fuel cost element of the RCAF-U plus any cost-based fuel surcharge applied by CN/WC.

The Board declined to impose this rate increase ceiling as a merger condition, based on its finding of no significant competitive harm from the merger that required correcting. Somewhat ambiguously, however, the Board noted that "we will, however, hold applicants to representations they have made in this record about the meaning and reach of the NITL/CN Agreement", using as an example the agreement's definition of a "shipper".[60]

Three years later, KCS similarly offered a rate protection agreement signed with NITL in its application to purchase the Tex Mex Railroad. In this case, though the railroad and the shippers' organization again agreed on terms for maintaining service quality and on the use of arbitration for dispute resolution, the rates provision of the agreement required only "commercially reasonable contract or common carrier rates and charges over any existing interchange" – there was no more specific formula limiting rate increases.

Once again, the STB's decision referred to this agreement and noted the Board's assumption that the merged railroad would be obliged to honor it, but declined to make the agreement a condition of its approval of the merger (as NITL had urged, but KCS had resisted).[61]

In the CP/KCS merger proceeding, the UP and NITL, joined this time by the BNSF, the American Chemistry Council, and the Fertilizer Institute, proposed a variant on the CN/NITL rate

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[59] *St. Louis Southwestern Railway – Purchase – Chicago, Rock Island & Pacific Railroad*, 363 I.C.C. 323 (1980).
[60] *Canadian National – Control – Wisconsin Central*, 2001 STB LEXIS 711 (2001).
[61] *KCS – Control – Texas Mexican Railway*, 2004 STB LEXIS 777 (2004).

protection provision of 2001.[62] Their proposed condition involved the "Rule 11" rates proposed by the merged firm – that is, the rates charged by the merged firm for its portion of joint rates. In particular:

> Where a CPKC route competes with an interline route that includes a former-CP, -KCS, or -KCSM segment, CPKC must, at a shipper's request, provide the shipper a confidential Rule 11 rate calculated as a mileage-based prorate of the CPKC rate that the shipper can use to create a competitive interline alternative.[63]

There was some debate in the proceedings regarding the appropriateness of using mileage as the basis for the division of the joint-line rate, but the Board based its decision to reject this mechanism on the more fundamental incentive argument that it would impose a cost on – that is, provide a disincentive to – rate reductions for single-line hauls by the merged firm. It could also, claimed the merging parties and the Board, "have the effect of subsidizing rival carriers—by enabling them to reap the benefits of cost efficiencies generated by the newly combined carrier."[64]

However, the Board did not in this case rely solely on the "open gateways on commercially reasonable terms" condition and commitment. Rather it imposed its own supplemental condition, one that arguably avoids the incentive problems of that proposed by UP and the Joint Associations, and that in addition will be enforced for an apparently unprecedented seven-year oversight period:

> To facilitate Applicants' adherence to the gateway commitment and the Board's enforcement, the Board will require during the oversight period that Applicants provide to a shipper, upon request, a written justification for rate increases above the rate of inflation for interline movements subject to the open gateway obligation.

Furthermore,

> This condition will help ensure that shippers have information needed to assess whether a price increase is warranted or whether it may be the result of potential foreclosure that warrants a request for Board enforcement, use of Applicants' proposed arbitration process, or other alternative dispute resolution procedures.

Finally, and in line with the 2001 NITL proposal,

> For purposes of the conditions imposed in this decision, the applicable rates of inflation will be determined by reference to the rail cost adjustment factor (unadjusted) published by the Board in EP 290 (Sub-No. 5), Quarterly Rail Cost Adjustment Factor, or, in the case of a rate that contains a fuel surcharge provision, the All-Inclusive Index Less Fuel (AII-LF) Index published by the Association of American Railroads.[65]

This mechanism allows the merged railroad to enjoy and share the fruits of its new single-line efficiency – no rate equalization requirements! – while seeking to insure, in case of attempts at

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[62] In this proceeding, the NITL, American Chemistry Council, and Fertilizer Institute filed collectively as the "Joint Associations".
[63] UP Final Brief at 17-18. See also Steven Salop Verified Statement at 44-46.
[64] CP/KCS decision at 58-60.
[65] CP/KCS decision at 68, 78.

anticompetitive behavior – and subject to the effectiveness of STB enforcement and/or arbitration – no real – i.e. inflation-adjusted – rate increases for the merged firm's portion of joint-line rates for seven years. Shipper protection does not come at the expense of the poor incentives of either rate equalization or for single-line rate setting.

This mechanism is consistent with one recommended over a decade ago based on a purely theoretical model (and with no inflation):

> When the two [end-to-end] railroads are being merged, the task of the regulator becomes almost trivially simple. As shown above, the merged company would lower the combined inter-regional rate anyway. All the regulator would have to do to make no party worse off is to require that no intra-regional rate be raised above its pre-merger level.[66]

After a century of iteration, perhaps the STB has solved the open-gateways conundrum. One might expect to see this type of condition imposed to supplement open-gateway requirements going forward. As Winston Churchill did not quite say, you can always count on American regulators to do the right thing – after they have tried everything else.

[66] Michael Braulke and Jörg Schimmelpfennig, *Vertical Rail Mergers: Welfare Effects and Regulation Issues*, INTL. J. STRATEGIC DECISION SCIENCES 1 (2010) 88, 91.