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LOSS OF RAIL COMPETITION AS AN ISSUE IN THE
PROPOSED SALE OF CONRAIL TO NORFOLK SOUTHERN:
VALID CONCERN OR POLITICAL BOGEYMAN?

MARK D. PERREAULT*
NANCY S. FLEISCHMAN**

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I. INTRODUCTION

The Department of Transportation's (DOT) plan to return Consolidated Rail Corporation (Conrail) to the private sector by selling the federal government's controlling interest to Norfolk Southern Corporation (Norfolk Southern) has, not surprisingly, been the subject of a spirited debate in the transportation and political community since its announcement in February, 1985. Detractors have voiced concerns about loss of jobs, quality of service, rates, adequacy of the price, tax benefits, effects on other railroads, ports, communities, and even minority vendors.¹ Perhaps the most virulent yet poorly understood criticism has been that Norfolk Southern's acquisition of Conrail would adversely affect competition. Critics have said that the sale proposal "runs directly contrary to [antitrust] policy goals" and would have a serious, adverse effect on competition.² The proposal is a "flagrant violation of antitrust laws and would create an unconscionable monopoly."³

[T]he proposed sale of Conrail to the Norfolk Southern violates every principle of good transportation policy and destroys the competitive framework which is the key to the future health of our railroad system. . . . [The proposal] would not survive any rational scrutiny under antitrust concepts that have governed every railroad merger in this country.⁴

The purpose of this article is to examine the legal standards historically and currently applied to considering the competitive impacts of rail consolidations in conjunction with the goals of the legislation relating to Conrail. With that perspective, a viewpoint will be offered as to whether the competitive effects of the proposed sale have been addressed in a manner consistent with those standards and goals.

II. PRESERVATION OF RAIL-RAIL COMPETITION AS A CONSIDERATION IN RAIL CONSOLIDATIONS

A. *Prior to 1920*

Prior to the enactment in 1890 of the Sherman Antitrust Act, there were no federal limitations on mergers or other consolidations of compet-

¹ See Wall Street Journal, Aug. 8, 1985, at 22, col. 1.

² *Sale of Conrail: Hearings on S261-31.9 Before the Committee on Commerce, Science, and Transportation*, 99th Cong. 1st Sess. 323 (1985) (statement of Bruce B. Wilson, Vice-Pres., Law, Consolidated Rail. Corp.).

³ *Youngstown Vindicator*, Oct. 16, 1985, at 12, col. 1, (statement of Ill. Atty. Gen. Neil F. Hartigan).

⁴ *Sale of Conrail: Hearings on S261-31.9 Before the Committee on Commerce, Science, and Transportation*, 219-20 (1985) (statement of Hays T. Watkins, Bd. Chairman and Chief Exec. Officer of CSX Corp.).

ing railroads.⁵ A Jay Gould or Daniel Drew, if he worried about laws at all, could limit his concern to state corporate law and any state regulatory law which might apply to the particular transaction involved. While the enactment of the Interstate Commerce Act (Act) preceded the Sherman Act by three years, its original provisions did not address consolidations other than "pooling" between different carriers.⁶ The Act was primarily directed, from the shippers' point of view, to eliminating rebates, and, from the carriers' point of view, to achieving some modicum of rate stability in an industry then afflicted with a tremendous increase in capacity without a corresponding increase in business.⁷ The railroads had not reached the stage in their development where consolidation was viewed as the solution of choice for their problems. Rather, the railroads had looked primarily to rate agreements and, prior to 1887, the outright allocation of revenues and traffic among competing carriers, the "pool," for relief.⁸

Several years after the passage of the Act, however, a major rail consolidation movement took root. Problems such as the railroads' inability to stabilize rates at profitable levels or to slow reckless expansion of lines through provisions of the Act, rate agreements or legalized pools, as well as problems in the economy (e.g., the Depression of 1893), prompted calls for consolidation of the various lines.⁹ This movement collided with the new national policy of enhancing economic efficiency by protecting and promoting competition, which was promulgated in the Sherman Act.

The first major rail unification challenged under the Sherman Act was the attempt by the J.P. Morgan-James J. Hill-controlled Northern Securities Company to acquire the stock of the Great Northern Railway (GN) and Northern Pacific Railway (NP). This second attempt to amalgamate these competing rail lines failed when the Supreme Court affirmed a lower court decree declaring the consolidation a "combination in restraint of interstate and international commerce" and therefore

⁵ Cf. G. KOLKO, *RAILROADS AND REGULATION 1877-1916* 14 (1965).

⁶ Interstate Commerce Act of Feb. 4, 1887, ch. 104, 24 Stat. 379. Pooling, much to the chagrin of the railroads, was prohibited by the Act. *Id.* at § 5 (codified as amended at 49 U.S.C. § 11342).

⁷ G. KOLKO, *supra* note 5, at 7-44.

⁸ *Id.* at 17-19.

⁹ Aldace Walker in 1890 and Collis P. Huntington in 1891 urged rail managers to consolidate in the interest of ending anarchy. *Id.* at 64. Following the Depression of 1893 and the reorganization of many railroads, J.P. Morgan took the lead in acquiring control of, although not necessarily consolidating, a large number of carriers, including the Erie, Reading, Jersey Central, Lehigh Valley, Delaware & Hudson, Northern Pacific, Southern, and New Haven. *Id.* at 65-66. These developments did not achieve the desired result as rates declined drastically during the 1890's, from 94¢ per ton mile to 73¢ per ton mile. *Id.* at 66.

prohibited by Section 1 of the Sherman Act.¹⁰ The competitive analysis by the Court was primitive by today's standards; the Court simply found that GN and NP were "competing and substantially parallel lines from the Great Lakes and the Mississippi River to the Pacific Ocean and Puget Sound"¹¹ and that

[i]f such combination be not destroyed, all the advantages that would naturally come to the public under the operation of the general laws of competition, or between the Great Northern and Northern Pacific Railway companies, will be lost, and the entire commerce of the immense territory in the northern part of the United States between the Great Lakes and the Pacific at Puget Sound will be at the mercy of a single holding corporation. . . .¹²

A very similar case arose out of Edward Harriman's acquisition of control of the Union Pacific (UP) and Southern Pacific (SP) systems. The Court determined, again without much difficulty, that UP and SP were active competitors in that each sought, to some extent, to transport the same commerce from the East to the Pacific Coast by their lines and connecting lines, that the consolidation would end that competition; therefore, the combination must be broken up.¹³ The Court reached this conclusion despite evidence that competitive traffic was a comparatively small, although by no means negligible, part of the total traffic of UP and SP.¹⁴

Several attempts during this period by the highly competitive anthracite carriers to reduce the fierce competition between them for transpor-

¹⁰ *Northern Sec. Co. v. United States*, 193 U.S. 197 (1904). An earlier attempt by GN to purchase the bankrupt NP was forestalled by provisions of a Minnesota law prohibiting consolidation of competing railroads. *Pearsall v. Great N. Ry.*, 161 U.S. 646 (1896).

¹¹ 193 U.S. at 326.

¹² *Id.* at 327-28. The dissent of Justice Holmes is interesting from the standpoint of the history of the antitrust laws. In *Northern Securities* the Court concluded the consolidation was an unlawful "combination" under Section 1 of the Sherman Act. *Id.* at 331. Justice Holmes, in calling for strict construction of Section 1, argued that Section 1 only prohibited combinations designed to restrain the trade of others, not the union of former competitors. *Id.* at 403, 405, 406-08, 409. This position outraged President Theodore Roosevelt (i.e., "I could carve out of a banana a judge with more backbone than that"), C.D. BOWEN, *YANKEE FROM OLYMPUS* 370 (1944), and the doubts thus created about § 1 contributed to the passage of § 7 of the Clayton Act in 1914. L.B. SCHWARTZ & J.J. FLYNN, *ANTITRUST AND REGULATORY ALTERNATIVES (FREE ENTERPRISE AND ECONOMIC ORGANIZATION)* 154 (5th ed. 1977).

¹³ *United States v. Union Pac. R.R.*, 226 U.S. 61 (1912). At the time UP unlike SP did not reach California, reaching the Pacific only in Oregon. UP ownership of a steamship line operating between Portland and San Francisco and UP traffic interchanged with the S.P.-controlled Central Pacific in Utah for movement into California were, however, cited as evidence of UP competition with SP for California (and not merely Oregon) transcontinental business. *Id.* at 89-90.

¹⁴ *Id.* at 88-89.

tation of coal from the Pennsylvania fields to New York Harbor involved court action. At least two of them involved consolidations. In *United States v. Reading Co.*,¹⁵ the Court ordered the Reading Company, owner of Reading Railroad, an anthracite carrier, to divest itself of control of the Central Railroad Company of New Jersey, a parallel line for anthracite movements to New York. Similarly, in *United States v. Lehigh Valley Railroad*,¹⁶ the Lehigh's control of the Delaware, Susquehanna & Schuylhill Railroad, a collection carrier in the anthracite fields, was found to be both illegal monopolization and a combination in restraint of trade.

The Supreme Court's 1922 decision in *United States v. Southern Pacific Co.*¹⁷ postdated the Transportation Act of 1920 but nevertheless properly belongs with the pre-1920 cases. In 1885 Southern Pacific leased the Central Pacific Railway (CP), the western portion of the original trans-continental railroad running from San Francisco Bay to Ogden, Utah, and in 1899 acquired stock control of CP. Perhaps spurred by its success in the *Union Pacific*¹⁸ case, the United States initiated an action in 1914 calling for SP to divest itself of its interests in CP. The Court's decision was a replay of its Union Pacific decision. The Court found that SP and CP were in competition for carrying freight between the East and Midwest and the Pacific Coast [(i.e., the CP over the central corridor in conjunction with connecting lines to the east, SP over its southern route)];¹⁹ therefore, this combination was in restraint of trade and SP was required to divest its interests in CP.²⁰

Thus, as of 1920, a rail consolidation could be enjoined merely by showing that there was some significant competition between the two carriers. So long as this was the law, attempted consolidation of two railroads with more than a negligible amount of parallel operations was foreclosed.

¹⁵ 253 U.S. 26 (1920). The New Jersey courts had earlier forced termination of the lease by Reading of the Central and the Lehigh Valley because such violated state antitrust laws. *Stockton, Att'y Gen'l v. Central R.R.*, 50 N.J. Eq. 52, 24 A. 964 (1892).

¹⁶ 254 U.S. 255 (1920). Lehigh was permitted to retain control of the Delaware, Susquehanna & Schuylhill by the Interstate Commerce Commission in 1924, apparently on the ground that the public interest would not be served by disentangling an already amalgamated railroad. *Control of Delaware, Susquehanna & Schuylhill R.R. by Lehigh Valley R.R.*, 86 I.C.C. 567, 569 (1924).

¹⁷ 259 U.S. 214 (1922).

¹⁸ See *supra* note 13.

¹⁹ For example, the CP over the central corridor in conjunction with connecting lines to the east, SP over its southern route.

²⁰ 259 U.S. at 229-30.

B. 1920 - 1940

The Interstate Commerce Act was amended substantially by the Transportation Act of 1920. This legislation marked the return of the railroads to the private sector after two years of federal control prompted by World War I. The new act resulted largely from the belief that the railroads required comprehensive federal regulation to attain rationalization and stability.²¹ This concern was reflected in the provisions permitting pooling²² and requiring a certificate of public convenience and necessity for construction lines,²³ and the directive to the Interstate Commerce Commission (Commission) to prepare a plan to consolidate the railroads into a limited number of systems.²⁴

There had been strong support in Congress (from the Senate especially and Senator Cummins particularly) for a bill authorizing the Commission to order compulsory consolidations.²⁵ However, this feature of the bill did not pass, either in 1920 or in subsequent years, largely because of railroad opposition.²⁶ Section 407 of the Transportation Act did permit the Commission to authorize the acquisition of control of one carrier by another when the acquisition was in the public interest. Furthermore, section 407 authorized the consolidation of two or more carriers when the consolidation was in the public interest, in harmony with and in furtherance of the Commission's plan of consolidation and when the consolidation complied with certain other restrictions. Most significantly, the section added Section 5(8) to the Act:

The carriers affected by any order made under the foregoing provisions of this section and any corporation organized to effect a consolidation approved and authorized in such order shall be, and they are hereby, relieved from the operation of the antitrust laws . . . and of all other restraints or prohibitions by law, state or federal, insofar as may be necessary to enable them to do anything authorized or required by any order made under and pursuant to the foregoing provisions of this section.²⁷

The above provisions reflected Congress' belief that the rail system was sufficiently valuable to the nation and unique in character to justify a

²¹ G. KOLKO, *supra* note 5, at 229.

²² Transportation Act of 1920, ch. 91, § 407, 41 Stat. 456, 480 (codified as amended at 49 U.S.C. § 11342).

²³ *Id.* at § 402, 41 Stat. 456, 477 (codified as amended at 49 U.S.C. § 10901).

²⁴ Section 407, 41 Stat. 456, 480 (repealed 1940).

²⁵ See R. MACVEAGH, *THE TRANSPORTATION ACT 1920* 278-82 (1923); St. Joe Paper Co. v. Atlantic Coast Line R.R., 347 U.S. 298, 316 (1954).

²⁶ 347 U.S. at 315-21.

²⁷ Transportation Act of 1920, ch. 91, § 407, 41 Stat. 456, 480 (codified as amended at 49 U.S.C. § 11341(a)).

national policy encouraging its preservation by consolidation into comparatively few systems. Advocates of the new bill reasoned that the operating costs of the carriers remaining after consolidation would be more comparable and, therefore, rail bankruptcies resulting from marginal carriers attempting to meet price competition with efficient carriers would be less common.²⁸ Also, Commission regulation could, with fewer, more rationally drawn systems, better preserve the balance between assuring reasonable rates to shippers and an adequate return to carriers.²⁹

Congress no doubt also recognized that many of the existing carriers in this balkanized industry were not viable as then structured and that the large capital costs involved in constructing new lines of railroad and the geographically fixed nature of existing lines prevented ready redeployment of capital.³⁰ These circumstances supported the adoption of a rail consolidation policy more flexible than that permitted under the antitrust laws for industries not so infected with a public interest and without such barriers to entry or exit. While Congress has modified the Interstate Commerce Act from time to time since 1920, and the transportation environment has changed dramatically, Congress has not significantly altered the national policy promoting rail consolidations reflected in the 1920 Act.

The contrast between the consolidation policy under the new law and the antitrust laws was dramatically illustrated in 1923 when the Southern Pacific obtained Commission approval for its control of the Central Pacific, only one year after the Supreme Court had ordered divestiture.³¹ The Commission stated:

We entertain no doubt that such arrangement [divestiture] would be practicable, and we are of the opinion that if the two companies entered fairly into the spirit of the Supreme Court's mandate, many of the disadvantages to which we have alluded as arising out of separation would be eliminated or mitigated. On the whole, however, we are convinced that even if everything of this nature which can be done were done, the result would be more expensive and less efficient and satisfactory service than can be rendered under unified control. The two systems would be weakened both financially and from the standpoint of service.³²

What took more time to sort out was the proper accommodation

²⁸ S. REP. NO. 304, 66th Cong., 1st Sess. (1919).

²⁹ *Id.*

³⁰ *Id.*

³¹ *Central Pac. Ry. Control*, 76 I.C.C. 508, *aff'd sub nom.* *United States v. Southern Pac. Co.*, 290 F. 443 (D. Utah 1923).

³² *Id.* at 520.

between the Act's public interest standard for consolidation and the policies of the antitrust laws. The *Central Pacific*³³ case notwithstanding, the Commission in the 1920's and early 1930's considered preservation of rail-rail competition a significant, even dispositive, factor in treating the relatively few major consolidation proposals which arose while the Commission struggled first to sell, and then scrap, its consolidation plan.³⁴ For example, in 1926 the Commission disapproved the proposed lease of the Virginian Railway by Norfolk and Western Railway solely on the ground that competition between the two lines would be eliminated.³⁵ In 1930 the Commission employed its powers under the Clayton Act³⁶ (the Commission did not at this time possess power under the Interstate Commerce Act to order an existing combination broken up³⁷) to order the Baltimore & Ohio to divest itself of its ownership of 42.8% of the stock of the competing Western Maryland Railway.³⁸ (Interestingly, the Commission permitted both of these consolidations thirty years later.³⁹)

The Supreme Court had an opportunity to provide some guidance on the accommodation between the Act and the antitrust laws in 1932 when the Court reviewed the Commission's approval of New York Central's acquisition of control of the Cleveland, Cincinnati, Chicago & St. Louis Railway and the Michigan Central Railroad.⁴⁰ The Court opted for

³³ See *supra* note 31.

³⁴ For a time the Commission was wont to disapprove consolidations for failure to complement its plan of consolidation. See, e.g., Proposed Control of Erie R.R. and Pere Marquette Ry. by Chesapeake & O. Ry., 138 I.C.C. 517 (1928); Control of Buffalo, Rochester & Pittsburgh Ry. by Delaware & Hudson Co., 131 I.C.C. 750 (1927). No doubt this had a chilling effect on rail consolidations.

³⁵ Proposed Acquisition of Control of Virginian Ry. by Norfolk & W. Ry., 117 I.C.C. 67 (1926).

³⁶ Section 11 of the Clayton Act authorized the Interstate Commerce Commission to enforce compliance with Section 7 of that act where applicable to common carriers subject to the Interstate Commerce Act. 15 U.S.C. § 21. That power has apparently not been used since the Interstate Commerce Act was amended in 1933, see *supra* note 37, to prohibit consolidation of two or more carriers other than in accordance with the Interstate Commerce Act. See Seaboard Air Line R.R.—Merger—Atlantic Coast Line R.R., 320 I.C.C. 122, 132 (1963), *vacated sub nom.* Florida East Coast Ry. v. United States, 242 F. Supp. 14 (N.D. Fla.), *vacated and remanded*, 382 U.S. 154 (1965). That rail consolidations were not to be governed by the Clayton Act but rather by the Interstate Commerce Act was further driven home by the 1950 amendment to the Clayton Act exempting Commission approved transactions from coverage. See 15 U.S.C. § 18.

³⁷ Section 202 of the Act of June 16, 1933 added a provision making unlawful the continuance of control or management of two or more carriers other than in accordance with the Act. Act June 16, 1933, ch. 91, Title II, § 702, 48 Stat. 217 (codified as amended at 49 U.S.C. § 11343(b)).

³⁸ Interstate Commerce Comm'n v. Baltimore & O. R.R., 160 I.C.C. 785 (1930).

³⁹ See Chesapeake & O. Ry.—Control—Western Md. Ry., 328 I.C.C. 684 (1967); Norfolk & W. Ry.—Merger—Virginian Ry., 307 I.C.C. 401 (1959).

⁴⁰ New York Cent. Sec. Corp. v. United States, 287 U.S. 12 (1932).

leaving the Commission considerable leeway without offering meaningful guidance:

The fact that carriers' lines are parallel and competing cannot be deemed to affect the validity of the authority conferred upon the Commission. . . . The question whether the acquisition of control in case of competing carriers will aid in preventing an injurious waste and in serving more efficient transportation service is thus committed to the judgment of the administrative agency⁴¹

By the time the Supreme Court considered the accommodation issue in depth again it was some years later and concerned not railroads but their up-and-coming nemesis, the trucking industry.

C. 1940 - 1980

With the enactment of the Transportation Act of 1940 came belated congressional recognition that the dream of a Commission inspired consolidation program would not come to fruition. Instead, Congress reemphasized the goal of rationalizing the rail system while freeing the carriers from the requirement that rail consolidations be consistent with the Commission's consolidation plan.⁴² "[T]he power to initiate mergers and consolidations was left completely in the hands of the carriers."⁴³ The 1940 Act also specified the four considerations which must, among others, be given weight in determining whether a rail consolidation, merger or acquisition is in the public interest.⁴⁴ Preservation of competition was not then specifically listed.⁴⁵ Shortly thereafter the Supreme Court finally addressed in some detail the proper accommodation between the Act and the antitrust laws in a consolidation proceeding before the Commission. Although the decision, *McLean Trucking Co. v. United States*,⁴⁶ involved the consolidation of motor carriers, the statutes interpreted applied equally to rail carriers.

The Commission had authorized the consolidation of seven large motor carriers into a new company, Associated Transport, Inc. The new company would be the only single ownership truckline operating from New England to Florida and would become the largest motor carrier in the United States. McLean Trucking Company, a competing carrier, sued to set aside Commission approval of the transaction. The Department of Justice (DOJ) entered the case in support of McLean.⁴⁷

⁴¹ *Id.* at 25-26.

⁴² See Transportation Act of 1940, ch. 722, Title I, § 7, 54 Stat. 898, 905 (1940).

⁴³ *St. Joe Paper*, 347 U.S. at 319.

⁴⁴ See 54 Stat. 898, 905 (codified as amended at 49 U.S.C. § 11344(b)).

⁴⁵ *Id.*

⁴⁶ 321 U.S. 67 (1944).

⁴⁷ *Id.* at 68-72.

In reaching its decision, the Court stated "there can be little doubt that the Commission is not to measure proposals for all-rail or all-motor consolidations by the standards of the anti-trust laws."⁴⁸ Neither, however, has Congress "authorized the Commission in passing on a merger to ignore their policy."⁴⁹ The Court cited provisions of the national transportation policy "promoting economical service and fostering sound economic conditions in transportation and among the several carriers" and "encourag[ing] the establishment and maintenance of reasonable charges for transportation services, without unjust discriminations" as the statutory source for consideration of competition.⁵⁰

In short, the Commission must estimate the scope and appraise the effects of the curtailment of competition which will result from the proposed consolidation and consider them along with the advantages of improved service, safer operation, lower costs, etc., to determine whether the consolidation will assist in effectuating the overall transportation policy.⁵¹

In this case, the Court went on to decide that the Commission had not exceeded its discretion in finding that the proposed consolidation would result in improved transportation service, greater efficiency of operation and substantial operating economies. It further stated that ample competition would remain and concluded that the transaction was in the public interest.⁵²

World War II, post-war prosperity and the economies obtained in the changeover from steam to diesel motive power delayed for a time a large scale rail consolidation movement. By the end of the 1950's, however, construction of a national highway system and the corresponding development of a highly competitive motor carrier industry, as well as the growth of inland water carriers and pipelines, forced the railroads to consider again the advantages of consolidation.⁵³

The *McLean*⁵⁴ decision was applied to a rail merger in *Minneapolis & St. Louis Ry. v. United States*.⁵⁵ This case concerned Commission ap-

⁴⁸ *Id.* at 84-85.

⁴⁹ *Id.* at 86.

⁵⁰ *Id.* at 86-87.

⁵¹ *Id.* at 87.

⁵² *Id.* at 88-90.

⁵³ Revenue carloadings of major railroads had dropped from 52,817,915 in 1929 to 37,636,031 in 1955, and dropped further to 27,160,247 in 1970. RAILROAD FACTS 24 (1984). The railroads' market share, by revenue freight ton-miles, dropped from 74.9% in 1929, to 56.2% in 1950 and 39.8% in 1970, while the motor carriers' share over the same years rose from 3.3% to 16.3% and then 21.3%. *Id.* at 32. The market share of water carriers on rivers and canals, and of pipelines, rose markedly in those years also. *Id.*

⁵⁴ See *supra* note 46.

⁵⁵ 361 U.S. 173 (1959).

proval of a joint application by the Atchison, Topeka & Santa Fe Railway and the Pennsylvania Railroad to acquire control of the Toledo, Peoria & Western Railroad (TP&W), a bridge carrier operating principally between a connection with the Santa Fe at Lomax, Illinois and the Pennsylvania at Effner, Indiana. The Commission had found that both Santa Fe and Pennsylvania were, to some extent, competitors of the TP&W since interchanging with TP&W at Lomax or Effner resulted in short hauling themselves (i.e. both Santa Fe and Pennsylvania had lines parallel to TP&W lines and normally carriers prefer, for revenue reasons, to get their longest possible haul rather than interchange to another carrier short of the long haul interchange). Nonetheless the Commission had approved the control application and the Court affirmed, relying on *McLean*.⁵⁶

There followed a long line of rail consolidations which were, in almost all instances, approved as consistent with the public interest. Some of these involved lines which competed extensively with each other. One of the most fiercely contested was the merger of the Seaboard Air Line and Atlantic Coast Line Railroads.⁵⁷ The Seaboard Air Line and Atlantic Coast Line were major competitors of each other in a six state area and together owned 81% of the rail mileage in the state of Florida.⁵⁸ Of their combined tonnage, 33.4% was found to be competitive as between the two lines,⁵⁹ and both carriers were profitable with every prospect of remaining so for the immediate future.⁶⁰ Nonetheless, the Commission approved the merger and, after reversal of the Commission's decision by a federal district court on competition grounds, the Supreme Court, in remanding the matter to the district court, strongly indicated its concurrence with the Commission's decision. The Court concluded that the district court had failed to properly apply *McLean* and *Minneapolis & St. Louis Railway*:

[The Commission] recognized that the merger would eliminate competition and create a rail monopoly in parts of Florida. But it found that the merged lines carried only a small part of the total traffic in the area involved; that ample rail competition would remain therein; and that the reduction in competition would 'have no appreciably injurious effect upon shippers and

⁵⁶ *Id.* at 238-39

⁵⁷ The U.S. Department of Justice, the Georgia Public Service Commission, various railroads, and a good number of shippers and communities in the Southeast were opposed to the merger Seaboard Air Line R.R.—Merger—Atl. Coast Line R.R., 320 I.C.C. 122, 124, 161-62 (1963), *vacated sub. nom.*, Fla. East Coast Ry. v. United States, 242 F. Supp. 14 (N.D. Fla.), *vacated and remanded*, 382 U.S. 154 (1965).

⁵⁸ 320 I.C.C. at 163.

⁵⁹ *Id.* at 164.

⁶⁰ *Id.* at 146-53.

communities'. . . . In addition, the Commission noted that the need to preserve intramodal rail competition had diminished due to the fact that railroads were increasingly losing traffic to truck, water and other modes of competition.⁶¹

The merger was ultimately consummated by creation of the Seaboard Coast Line Railroad, which today as Seaboard System Railroad is an important constituent of the CSX system.

The Commission similarly approved the consolidation of such competitive carriers as the Louisville & Nashville and Nashville, Chattanooga & St. Louis,⁶² the Virginian and Norfolk and Western,⁶³ the Erie and the Delaware, Lackawanna and Western,⁶⁴ the Baltimore & Ohio and Chesapeake & Ohio⁶⁵ (and later the Western Maryland),⁶⁶ the Illinois Central Gulf and the Gulf, Mobile & Ohio,⁶⁷ and the Pennsylvania and New York Central.⁶⁸ It was only in the case of a consolidation where the efficiencies to be realized were relatively small and the loss of intramodal competition deemed relatively significant that the Commission disapproved an application on grounds of loss of competition. This was the case in the proposed acquisition of the Western Pacific by the Southern Pacific.⁶⁹ These carriers had parallel lines in the central corridor between Utah and Northern California, an area of the country in which the Commission found intramodal competition of greater significance than other areas of the country because of the distances involved.⁷⁰ Both

⁶¹ 382 U.S. at 154.

⁶² Louisville & N. R.R. Merger, 295 I.C.C. 457 (1957), *aff'd sub nom.* Louisville & N. R.R. v. United States, 244 F. Supp. 337 (W.D. Ky. 1965). The City of Nashville objected, unsuccessfully, on the ground that the merger would reduce the number of competing trunk line carriers in Nashville from two to one (or three to two, if the Tennessee Central, connecting elsewhere with the Illinois Central and Southern, was considered).

⁶³ Norfolk & W. Ry.—Merger—Virginian Ry., 307 I.C.C. 401 (1959).

⁶⁴ Erie R.R.—Merger—Delaware, Lackawanna & W. R.R., 312 I.C.C. 185, *appeal dismissed sub nom.* Brotherhood of Maint. of Way Empl. v. United States, 189 F. Supp. 942 (E.D. Mich. 1960), *aff'd*, 366 U.S. 174 (1961).

⁶⁵ Chesapeake & O. Ry.—Control—Baltimore & O. R.R., 317 I.C.C. 216 (1962).

⁶⁶ Chesapeake & O. Ry.—Control—Western Md. Ry., 328 I.C.C. 684 (1967), *appeal dismissed sub. nom.* Pittsburgh & L.E. R.R. v. United States, 294 F. Supp. 86 (W.D. Pa. 1968).

⁶⁷ Illinois Cent. Gulf R.R.—Acquisition—Gulf, Mobile & O. R.R., 338 I.C.C. 805 (1971), *appeal dismissed sub nom.* Missouri P. R.R. v. United States, 346 F. Supp. 1193 (E.D. Mo. 1972), *aff'd*, 409 U.S. 1094 (1973). The Department of Justice opposed the Gulf, Mobile & Ohio acquisition because it believed a substantial loss of competition would result from consolidation of the parallel Central and Gulf systems.

⁶⁸ Pennsylvania R.R.—Merger—New York Cent. R.R., 327 I.C.C. 475 (1966), *aff'd sub nom.* Erie-Lackawanna R.R. v. United States, 279 F. Supp. 316 (S.D. N.Y. 1967), *aff'd*, 389 U.S. 486 (1968).

⁶⁹ Southern Pac. Co.—Control—Western Pac. R.R., 327 I.C.C. 387 (1965).

⁷⁰ *Id.* at 400.

carriers were profitable and the efficiencies and other benefits of the acquisition were largely limited to some operational consolidations.

If there remained any doubt that preservation of intramodal competition was only one factor to be considered in approving or disapproving a rail consolidation, that doubt was eliminated in *United States v. Interstate Commerce Commission (Northern Lines Merger Cases)*.⁷¹ The consolidation between Great Northern and Northern Pacific struck down by the Supreme Court in 1904 was approved by the Court in 1971. The Court affirmed Commission approval of the merger citing projected public benefits of \$40 million per year. These benefits resulted largely from more efficient routing of traffic, elimination of redundant facilities and a reduced need for new employees on the consolidated system, such improvements as improved car supply and tracing, wider routing and better claims service, and the presence of the strengthened Milwaukee Road as a northern tier competitor (the extension of Milwaukee to the Pacific Coast had occurred since 1904).⁷²

D. 1980 - Present

The Staggers Rail Act of 1980 represented a major overhaul of the Interstate Commerce Act designed to promote the rehabilitation and financial viability of the railroads by reforming federal regulatory policy to better balance the needs of carriers, shippers and the public. Congress specifically recognized that railroads historically were the essential factors in the national transportation system but that today most transportation in the United States is competitive, that nearly two-thirds of the nation's intercity freight was transported by modes other than rail, and that the earnings of the rail carriers were insufficient to generate funds for necessary capital improvements.⁷³ The Act substantially liberalized regulation of rail rates in the interest of alleviating this capital shortfall and the general decline of the rail industry.⁷⁴

Perhaps because the public interest standard for approval of rail consolidations was thought to be sufficiently flexible already, the Staggers Act did not overhaul the existing scheme for permitting rail consolidations. Congress did, however, indicate its approval of consolidation as a means of promoting the health of the rail industry by limiting the Commission's discretion to *disapprove* a rail consolidation not involv-

⁷¹ 396 U.S. 491 (1970).

⁷² *Id.* at 505-16. Court approval came over the vigorous opposition of the Department of Justice.

⁷³ Staggers Rail Act of 1980, Pub.L. No. 96-448, §§ 2, 3, 94 Stat. 1897 (1980).

⁷⁴ *See, e.g.*, § 201(a) (codified at 49 U.S.C. § 10701a) of the Act which provides a rail rate need be reasonable only if a rail carrier has market dominance over the transportation to which a particular rate applies. Formerly, all rail rates had to be "reasonable" as determined by the Commission. *See* 49 U.S.C. § 1(5) (repealed).

ing the merger or control of at least two Class I railroads.⁷⁵ The Act also added to the four factors the Commission must consider in determining whether to approve the merger or control of at least two Class I railroads “whether the proposed transaction would have an adverse effect on competition among rail carriers in the affected region.”⁷⁶ This factor was not deemed a substantive addition to the Act, however, but merely a codification of the existing *McLean* rule.⁷⁷

The combining of regional railroads into larger systems accelerated in the 1980's. Recent consolidations have involved the creation of large systems better able to compete with motor carriers by offering single line service over great distances.⁷⁸ Most have been end-to-end consolidations but even these have had some competitive impact.

*CSX Corporation — Control — Chessie System, Inc. and Seaboard Coast Line Industries, Inc.*⁷⁹ involved the consolidation of a predominately midwestern and northeastern carrier (Chessie) with a predominately southeastern carrier (Seaboard). Chessie and Seaboard did, however, have some significant overlapping operations; both carriers operated lines between Chicago and the Ohio River for movements beyond, to and from the Southeast. “The competition between Family Lines [Seaboard] and Chessie in this market may be described as parallel.”⁸⁰ Nonetheless, the Commission concluded that the elimination of one rail competitor in a market in which several other carriers would remain was outweighed by the procompetitive effects of the single-system service created by the transaction.⁸¹ Single-system service would permit CSX to develop new traffic currently moved by other modes of transportation.

Both carriers were also originators of significant amounts of coal used by utilities in the Southeast and there was concern about elimination of this source of competition.⁸² The Commission acknowledged there might be some diminishment of source competition, however, it found this com-

⁷⁵ Pub.L. No. 96-448, § 228(b), 94 Stat. 1931. A Class I railroad as of 1984 was one with annual operating revenues of \$87.3 million or more. RAILROAD FACTS 2 (1984).

⁷⁶ Pub.L. No. 96-448, § 228(a), 94 Stat. 1931.

⁷⁷ See *Norfolk S. Corp.—Control—Norfolk and W. Ry. and S. Ry.*, 366 I.C.C. 171 (1982).

⁷⁸ In addition to those cases cited in footnotes 75 and 81, see *Guilford Transp. Indus., Inc.—Control—Delaware & Hudson Ry.*, 366 I.C.C. 396, *aff'd in part and remanded in part sub nom. Central Vermont Ry. v. Interstate Commerce Comm'n*, 711 F.2d 331 (D.C. Cir. 1983); *Guilford Transp. Indus., Inc.—Control—Boston & Maine R.R.*, 366 I.C.C. 294 (1982), *aff'd in relevant part sub nom. Lamoille Valley R.R. v. Interstate Commerce Comm'n*, 711 F.2d 295 (D.C. Cir. 1983); *Norfolk S. Corp.—Control—Norfolk & W. Ry. and S. Ry.*, 366 I.C.C. 171 (1982); *Burlington N.—Control and Merger—St. Louis—San Francisco Ry.*, 360 I.C.C. 788 (1980).

⁷⁹ 363 I.C.C. 518 (1980), *aff'd sub nom. Brotherhood of Maintenance of Way Employees v. Interstate Commerce Comm'n*, 698 F.2d 315 (7th Cir. 1983).

⁸⁰ 363 I.C.C. at 565.

⁸¹ *Id.* at 566, 574.

⁸² *Id.* at 567-70.

petition insignificant in light of the fact that most utilities were served by only one railroad and the few that were served by two railroads would have continued access to alternate sources of coal.⁸³ The Commission clearly believed that consolidations permitting rail carriers to compete more effectively with other modes of transportation were in the public interest, even if some reduction in rail-rail competition would occur.⁸⁴

In *Union Pacific Corp.—Control—Missouri Pacific Corp.*,⁸⁵ the Commission concluded that a substantial reduction in rail-rail competition would occur in two instances. The elimination of Missouri Pacific (MP) as an independent competitor of UP in the central transcontinental corridor east of Denver was deemed significant and, accordingly, the transaction was conditioned upon UP granting trackage rights to Denver & Rio Grande Western and Southern Pacific to replace MP as a competitor in this corridor.⁸⁶ The elimination of MP as an independent competitor of UP between Kansas City and Omaha/Council Bluffs was similarly deemed significant and, accordingly, the transaction was also conditioned upon UP granting trackage rights to the Missouri-Kansas-Texas Railroad (M-K-T) between Kansas City and Omaha/Council Bluffs.⁸⁷ The Commission was also concerned about possible vertical foreclosure between Kansas City and the Gulf grain export ports resulting from the combination of UP and MP. UP originated considerable grain in Nebraska and Kansas and MP and M-K-T were two of the rail carriers operating between Kansas City and the Gulf ports. Since M-K-T depended heavily on UP for interchange of traffic at Kansas City and would likely lose much of this traffic to MP upon consolidation, the transaction was conditioned upon UP/MP granting M-K-T trackage rights to several grain originating points in Nebraska and Kansas in order to preserve M-K-T as an effective competitor south of Kansas City.⁸⁸ It is notable that the Commission protected intramodal competition only in geographical areas (i.e., longhaul transcontinental corridor) or with commodities (i.e., grain) where intramodal competition was not thought to be effective.

The Commission has adopted a policy statement applicable to the merger or control of two Class I railroads.⁸⁹ The Commission notes there are two potential results from consolidation which "would ill serve the public—reduction of competition and harm to essential services."⁹⁰ The Commission states therein:

⁸³ *Id.* at 571-73.

⁸⁴ *See id.* at 574.

⁸⁵ 366 I.C.C. 459 (1982), *aff'd sub nom.* Southern Pac. Transp. Co. v. Interstate Commerce Comm'n, 736 F.2d 708 (D.C. Cir. 1984), *cert. denied*, 105 S.Ct. 1172 (1985).

⁸⁶ 736 F.2d at 726.

⁸⁷ *Id.* at 720.

⁸⁸ *Id.*

⁸⁹ 49 C.F.R. § 1180.1 (1985).

⁹⁰ 49 C.F.R. § 1180.1(c) (2).

The Commission recognizes that rail carriers face not only intramodal competition, but also intermodal competition from motor and water carriers. The Commission's competitive analysis depends on the relevant markets. In some markets the Commission's focus will be on the preservation of effective intermodal competition, while in other markets (such as long-haul movements of bulk commodities) effective intramodal competition may also be important.⁹¹

The emphasis on intermodal competition indicates how far the competitive analysis of rail consolidations has come since the *Northern Securities*⁹² case.

The bankruptcy of Penn Central and certain other railroads, the formation of Conrail and the subsequent determination to sell Conrail has a statutory history of its own. Preservation of rail-rail competition is only one of many goals, but by no means the overriding goal, Congress has pursued in railroad legislation.

III. PRESERVATION OF RAIL-RAIL COMPETITION AS A CONSIDERATION IN THE FORMATION OF CONRAIL AND SUBSEQUENT DETERMINATION TO SELL CONRAIL

A. 1970's Congressional Response to the Penn Central and Other Railroad Bankruptcies

On June 21, 1979, the Penn Central Transportation Company filed a petition for voluntary reorganization under the bankruptcy laws in the United States District Court for the Eastern District of Pennsylvania.⁹³ The Penn Central collapse was the largest bankruptcy in American history up to that time.⁹⁴ It was accompanied by the failure of most of the other railroads serving the Northeastern United States: the Reading, Central of New Jersey, Lehigh Valley, Erie Lackawanna, and smaller lines.⁹⁵

At the time the principal tool for accomplishing a railroad reorganization was Section 77 of the Bankruptcy Act.⁹⁶ Enacted during the 1930's, Section 77 was designed primarily to facilitate the restructuring of capital, which was perceived as the predominant cause of rail failures at that time, and less so, with the restructuring of rail systems and facilities. Recognizing that Section 77 was entirely inadequate for the structural problems of railroads in the Northeast, Congress enacted the

⁹¹ 49 C.F.R. § 1180.1(c)(2)(i).

⁹² *Northern Sec. Co. v. United States*, 193 U.S. 197 (1904).

⁹³ J. R. DAUGHAN AND P. BINZEN, *THE WRECK OF THE PENN CENTRAL* 306-07 (1971).

⁹⁴ *Id.* at Inside Front Cover.

⁹⁵ E. F. P. STRIPLIN, *THE NORFOLK AND WESTERN: A HISTORY* 356-57 (1981).

⁹⁶ See 11 U.S.C. § 205 (1951) (repealed).

Regional Rail Reorganization Act of 1973 (3-R Act) to provide a more permanent answer to the Northeastern railroad bankruptcies.⁹⁷ The declaration of Congressional policy firmly established that the focus remained upon "essential rail service"⁹⁸ and "identification of a rail service system in the midwest and northeast which is adequate to meet the needs and service requirements of this region and of the national rail transportation system."⁹⁹ Preservation and enhancement of rail-rail competition were not among the stated Congressional findings and purposes of the 3-R Act.¹⁰⁰

Among other things, the 3-R Act provided for the creation of Conrail pursuant to a Final System Plan formulated by the United States Railway Association (USRA).¹⁰¹ Consistent with the overall purposes of the 3-R Act, the principal goal of the Final System Plan was "a financially self-sustaining . . . rail service system adequate to meet the rail transportation needs and service requirements of the [Northeast]."¹⁰² Competition was farther down the list of eight Final System Plan goals.¹⁰³

Congress' priorities were not accidental or ill-considered. Rather, they sprang from a crisis-generated grasp of competitive realities in the Northeast. The Senate Commerce Committee's lengthy study of Penn Central had recognized the increasing importance of truck and other intermodal competition.¹⁰⁴ To provide a better understanding of the place of rail service, Congress in the 3-R Act required the Secretary of Transportation to issue a report recommending the geographic zones in which and between which continued rail service should be provided.¹⁰⁵ The required report was issued on February 1, 1974, as *Rail Service in the Midwest and Northeast Region (Rail Service)*, which in turn provided a starting point for the USRA's *Preliminary System Plan (PSP)* of February 26, 1975.

B. Foundation of Initial Congressional Policy

Rail Service and *PSP* give a clear statement of the rationale for both Conrail's structure and the subsequent legislation.

The current rail system was built in economic times and under economic conditions very different from those prevailing in the 1970's.

⁹⁷ See 45 U.S.C. §§ 701-748 (1974).

⁹⁸ 45 U.S.C. § 701(a)(1), (2) (1974).

⁹⁹ 45 U.S.C. § 701(b)(1) (1974).

¹⁰⁰ See 45 U.S.C. § 701 (1974).

¹⁰¹ See 45 U.S.C. § 716 (1974).

¹⁰² 45 U.S.C. § 716(a)(1), (2) (1974).

¹⁰³ See 45 U.S.C. § 716(a)(5) (1974).

¹⁰⁴ SENATE COMM. ON COMMERCE, *THE PENN CENTRAL AND OTHER RAILROADS*, 92d Cong., 2d Sess. 304-06 (1972).

¹⁰⁵ See 45 U.S.C. § 714.

The system was constructed to meet local transportation and political needs, at a time when other modes offered few alternatives and little competition and with little thought given to national or even regional needs.¹⁰⁶ Even as competition from other modes developed and prospered and track miles gradually shrank, system tonnage capacity grew as freight cars became larger, locomotives became more powerful, yards were automated and improved traffic control systems were installed.¹⁰⁷

While the physical capacity of the freight system was increasing, the rail share of total freight traffic and the need for the increased capacity was declining. As a result, railroads included many duplicate main lines with very low average density as compared with capacity,¹⁰⁸ thousands of miles of local service lines generating insufficient traffic and revenue to return the cost of operation,¹⁰⁹ and more than one railroad serving markets which generated sufficient rail traffic to support only one railroad.¹¹⁰

In the railroad industry excess capacity often caused excess competition among competitors unwilling or unable to leave the market. Too much competition in the rail industry was one of the causes of infrequent service, poor plant and equipment utilization, high unit costs, and high rail rates; a combination of these factors exacerbated the financial instability of the industry.¹¹¹

In order to assure the public of competitive rates and services, DOT recommended that only within and between high volume, long haul markets was rail-rail competition to be considered.¹¹² Total rail traffic volume, not market share or other factors, was to be the principal determinant in preserving rail-rail competition. Direct rail-rail competition would be preserved only where traffic volumes and flows would permit two railroads to provide service with acceptable operating efficiency.¹¹³

DOT suggested certain characteristics for markets within which or between which rail-rail competition should be preserved: (1) traffic must have a length-of-haul of at least 200 miles; (2) traffic volume must be sufficient to be handled in efficiently sized trains (i.e., 30 loaded cars for merchandise trains and 75 loaded cars for bulk commodities); (3) cars in the efficiently sized trains must all be moving in the same general direction to minimize out of route movement and intermediate switching;

¹⁰⁶ *PSP* at 2.

¹⁰⁷ *Rail Service* at 5-6.

¹⁰⁸ *Id.* at 8.

¹⁰⁹ *Id.* at 10.

¹¹⁰ *Id.* at 12.

¹¹¹ *PSP* at 108.

¹¹² *Rail Service* at 14, 23.

¹¹³ *Id.* at 30.

and (4) traffic volume and directional flow must support frequent train service (i.e., eight trainloads daily inbound or outbound in the same general direction).¹¹⁴ Applying the numerical criteria it had developed, *Rail Service* identified only 17 zones, plus certain major gateways, at which and between which rail-rail competition should be maintained.¹¹⁵

DOT concluded that "required improvements in rail operating efficiency cannot be achieved without making some significant reductions in interrailroad competition."¹¹⁶ Recognizing that intermodal competition was a significant market force and an adequate alternative to rail-rail competition, DOT recommended that in low-volume, short-haul markets only intermodal competition be promoted.¹¹⁷

Defining "workable competition" for purposes of the *PSP*, USRA also focused upon the size of the market in terms of rail traffic volume.¹¹⁸ USRA accepted the goal of preserving interrailroad competition in major markets, but recognizing the conflict with other goals,¹¹⁹ recommended service by only two railroads in major eastern seaboard markets.¹²⁰ USRA was concerned about eliminating the high costs of excessive interrailroad competition and achieving the benefits of economies of density.¹²¹

USRA looked carefully at the growth and effectiveness of intermodal competition; even before restructuring direct rail-rail competition at the customer site had become rare.¹²² The conclusions USRA reached in the *PSP* were that intermodal competition was an adequate substitute to meet the public needs in many markets, that indirect rail competition could produce many of the same benefits as direct rail-rail competition and that increasingly efficient intermodal competition would continue to reduce the benefits derived solely from interrailroad competition.¹²³ On this basis, USRA decided that, if necessary, indirect rail and intermodal competition could meet the competitive goals of the 3-R Act.

¹¹⁴ *Id.*

¹¹⁵ *Id.* at 31-35.

¹¹⁶ *Id.* at 12.

¹¹⁷ *Id.* at 14.

¹¹⁸ *PSP* at 109.

¹¹⁹ *Id.* at 12.

¹²⁰ *Id.* at 39.

¹²¹ *Id.* at 107-09. Norfolk Southern's purchase of Conrail will achieve USRA's goal of preserving competition in major markets (e.g., Cleveland, Toledo, Canton-Massillon, Ohio, etc.) while achieving economies of density (e.g., consolidating Norfolk Southern, Conrail Ohio—St. Louis traffic on Conrail's Muncie, In - St. Louis line). See generally STUDY OF THE ESTIMATED TRAFFIC DIVERSION AND VIABILITY OF THE DIVESTITURE PROPOSALS RESULTING FROM THE ACQUISITION OF THE CONSOLIDATED RAIL CORPORATION BY NORFOLK SOUTHERN CORPORATION (Verified Statement of Louis M. Newton) (filed with Interstate Commerce Comm'n, May 24, 1985).

¹²² *PSP* at 111.

¹²³ *Id.* at 121-22.

C. Implementing the Policy

The *Final System Plan* implemented these conclusions. Congress approved the *Final System Plan* through express enactment.¹²⁴ Accordingly, Conrail's creation reflected a carefully articulated policy favoring an efficient railroad as a better competitive instrument than multiple, traffic-starved railroads.

The 3-R Act restructuring was consummated on April 1, 1976, when thousands of miles of line were actually deeded to Conrail. USRA proposed making major transfers to Chessie, but the breakdown of labor negotiations frustrated this undertaking.¹²⁵ Similarly, a USRA proposal to transfer a line into the Wilmington, Delaware, area to Southern Railway failed because of labor problems.¹²⁶ Norfolk and Western Railway did acquire an approximately 100-mile route making its access from Cincinnati to Chicago and St. Louis less circuitous¹²⁷ and Delaware and Hudson Railway acquired trackage rights to Buffalo, Washington, northern New Jersey, and Philadelphia.¹²⁸ On the whole, however, participation of solvent, privately owned carriers in the restructuring was limited. Aside from labor issues and the emphasis upon creating an efficient railroad, the problems facing Conrail were simply too overwhelming for such participation to be attractive to other railroads.

Several subsequent reports on the future of Conrail emphasized greater concern for retaining adequate rail service than assuring continued rail-rail competition.¹²⁹ Conrail confirmed that trucks, not other railroads, were and would continue to be its major source of competition.¹³⁰ As the rail market share continued to fall, it had become apparent that some major rail markets served by Conrail no longer had the traffic mix

¹²⁴ See 45 U.S.C. § 718(d) (1).

¹²⁵ See United States Railway Ass'n, *Final System Plan* 18, 28-29 (1975); Norfolk & W. Ry. and New York, C. & St. Louis R.R.—Merger, 363 I.C.C. 270, 279 (1980).

¹²⁶ See *FINAL SYSTEM PLAN* at 26-28.

¹²⁷ See *id.* at 19.

¹²⁸ 363 I.C.C. at 279. Delaware & Hudson's rights were a last minute response to Chessie System's decision not to purchase major parts of the Erie Lackawanna and Reading systems. *Id.*

¹²⁹ These reports, issued in response to a Staggers Act directive, were: UNITED STATES RAILWAY ASS'N, *FEDERAL FUNDING OF CONRAIL: RAIL SERVICE OBJECTIVES AND ECONOMIC REALITIES* [hereinafter cited as *USRA I*] December, 1980; UNITED STATES RAILWAY ASS'N, *CONRAIL AT THE CROSSROADS: THE FUTURE OF RAIL SERVICE IN THE NORTHEAST* [hereinafter cited as *USRA II*], April, 1981; U.S. DEPT. OF TRANSPORTATION, *RECOMMENDATIONS FOR NORTHEAST RAIL SERVICE*, March 31, 1981; and CONSOLIDATED RAIL CORPORATION, *OPTIONS FOR CONRAIL* [hereinafter cited as *OPTIONS*], April 1, 1981.

¹³⁰ *OPTIONS* at 2-19. Conrail has continued to emphasize this point. Its 1984 Annual Report states that "railroads are no longer an inevitable part of the American industrial machine" because Conrail faces "competition from trucks in every market we serve." Annual Report at 11.

and volume to support two-railroad service.¹³¹ Given that the goal of competition is economic efficiency, it was concluded that rail-rail competition should not be subsidized in markets where it is not economically justified.¹³² Rail-rail competition provided by the private sector required comparable justification.

Notwithstanding the emphasis placed on creating an efficient railroad and despite several billion dollars of government investment, Conrail showed a net operating loss of \$2 billion between 1976 and 1981.¹³³ Rail freight traffic kept falling as trucks increased their market share in the well-highwayed Northeast. At intermittent evaluations, the government declared the bottom had been reached, but it never was.

D. The Decision to Sell Conrail

Finally, in 1981, the prospect of not just continued federal ownership but continued federal liability for Conrail losses inspired a serious effort to return the railroad to the private sector. The Northeast Rail Service Act (NRSA)¹³⁴ made several reforms designed to make Conrail more attractive. It also directed that Conrail be sold, as a whole, if possible, but in pieces if necessary. Preservation or enhancement of intramodal competition was not a stated concern of the legislation.

IV. THE DEPARTMENT OF TRANSPORTATION'S DECISION TO SELL CONRAIL TO NORFOLK SOUTHERN AND SUBSEQUENT EVENTS

A. The Bidding Process and Selection of Norfolk Southern

With the assistance of such provisions of NERSA as relief from state and local taxes, expedited abandonment of surplus lines and federal funding for employee reductions, Conrail's performance improved and enabled Conrail to meet the requirements for sale as an entity.¹³⁵ The Department of Transportation began to seek a buyer. It employed the investment banking firm of Goldman, Sachs to advise it during the process. Goldman, Sachs approached more than one hundred potential purchasers.¹³⁶

Interest appeared to be slight. The only concrete result through 1983 was a leveraged offer of \$500 million plus wage concessions by labor organizations representing Conrail employees.¹³⁷

¹³¹ USRA II at 75.

¹³² *Id.* at 76.

¹³³ Bus. Wk., April 16, 1984, at 80.

¹³⁴ 45 U.S.C. §§ 761-767c, §§ 1101-1116.

¹³⁵ See The N.Y. Times, July 4, 1983, at D-27, col. 3.

¹³⁶ Bus. Wk., *supra* note 133, at 74.

¹³⁷ *Cf. supra* note 135.

Norfolk Southern was aware from the beginning that Conrail was for sale. Its constituent railroads, Norfolk and Western and Southern, had considered possibilities in the Northeast under the 3-R Act prior to 1976. They had correctly foreseen the continuing decline of rail business in the Northeast; they reacted to NERSA with caution. Nevertheless, in early 1984, a full-scale study of the prospects of a Norfolk Southern-Conrail consolidation was undertaken.

The study produced paradoxical results. Standing alone, Conrail was a bad investment. It would not produce a satisfactory return, and, in fact, over time the railroad would encounter cash flow problems. Yet, in combination with Norfolk Southern, the results were different. The combined systems could attract more traffic. At the same time, it could reduce operation expenses by \$140 million a year through consolidation of duplicative lines and facilities.¹³⁸ Finally, under existing tax laws, even after giving up Conrail's \$1.8 billion net operating loss carryforward and \$305 million in investment tax credits, there would be some benefit from Conrail's depreciation deductions. If Conrail did well, the tax benefit would be less significant because Conrail's own income would offset it, but if Conrail did poorly, the available depreciation deductions would make the losses less catastrophic.

Meanwhile, Conrail's 1983 results suggested that the 1981 reforms and Conrail's own drastic cutbacks were producing results. Net income was \$313 million.¹³⁹ There was still no rush of bidders, but on April 10, 1984, Allegheny Corporation publicly announced a \$1 billion offer for the government's stock.¹⁴⁰

The Department of Transportation, relieved to have reasonable offer, announced that it would accept bids only through June 18, 1984.¹⁴¹ Norfolk Southern made an offer of \$1 billion on that date.¹⁴² Thirteen other companies also submitted bids, some frivolous, a few plausible.¹⁴³

DOT began what turned out to be a lengthy bid evaluation process. In the course of the summer of 1984, with Conrail having its best-ever year, DOT managed to get the Norfolk Southern bid increased to \$1.2 billion.¹⁴⁴ In August, DOT named 6 "finalists," reduced to 3 in September: Norfolk Southern, Allegheny Corporation and the Marriott Group.¹⁴⁵ At

¹³⁸ Cf. Letter from J. Paul McGrath to Elizabeth H. Dole (January 29, 1985) (reprinted in *Sale of Conrail: Hearings on S261-31.9 Before the Committee on Commerce, Science, and Transportation, 99th Cong., 1st Sess. 49 (1985)*) [hereinafter McGrath Letter].

¹³⁹ See *BUS. WK.*, *supra* note 128, at 76.

¹⁴⁰ Cf. *TRAFFIC WORLD*, May 7, 1984, at 18-19.

¹⁴¹ *Id.*

¹⁴² *Roanoke Times & World News*, June 19, 1984, at A1, col. 1.

¹⁴³ See *The New York Times*, September 20, 1984, at D-4 col. 6.

¹⁴⁴ See *id.*

¹⁴⁵ See *id.*

that time DOT referred the Norfolk Southern bid to the Departments of Justice and Treasury for antitrust and tax evaluation, and also negotiated forms of contracts with the finalists. Finally, on February 5, 1985, DOT accepted the Norfolk Southern offer, subject to enactment of necessary legislation.¹⁴⁶

B. Department of Justice Evaluation of Norfolk Southern-Conrail Consolidation

The Department of Justice (DOJ) evaluation lacked any direct precedent. In the first place, NERSA had no provision for any DOJ involvement if Conrail was sold as a whole and provided only for DOJ comments if Conrail was sold in pieces.¹⁴⁷ Secondly, it was clear from the beginning that any sale to Norfolk Southern would (as all railroad sales have since 1920) take place under a statutory exemption from the antitrust laws. In the absence of any direct precedent, it would have been logical for DOJ to analyze the impact on competition using the balancing approach found in ICC merger decisions.

Norfolk Southern, however, did not know and was not told what approach DOJ would take. Throughout the fall of 1984, it furnished large amounts of traffic data and other information at DOJ's request. Later in 1984 and early in 1985, it furnished additional information on particular stations and commodities identified by DOJ.

DOJ analyzed the combination as if it were in fact subject to the Clayton Act. Substantively, its study followed the pattern of recent DOJ studies submitted in ICC merger proceedings.¹⁴⁸ But there was an important procedural difference. In an ICC proceeding, DOJ's role has been to explain the anti-competitive impact of a transaction. The Commission has weighed that impact against other public interest considerations in reaching a decision. In the Norfolk Southern-Conrail referral, DOJ was not only the advocate of competition, but the judge of what should be done to preserve it.

On January 29, 1985, Assistant Attorney General for Antitrust J. Paul McGrath reported to Secretary of Transportation Elizabeth Dole that the Norfolk Southern-Conrail combination was acceptable, subject to divestitures.¹⁴⁹ The divestitures were required to be sufficient to add a railroad

¹⁴⁶ See The United States of America Norfolk Southern Corporation Memorandum of Intent of February 8, 1985.

¹⁴⁷ 45 U.S.C. § 767(a).

¹⁴⁸ Testimony of Acting Asst. Att'y Gen. Charles F. Rule, House Commerce Transportation and Tourism Subcommittee, April 30, 1985.

¹⁴⁹ See *supra* note 138.

competitor to enumerated markets, and to link those markets to the major eastern and western interchange points, or "gateways."¹⁵⁰

Negotiating the DOJ-required divestitures and agreeing on a sales price proved difficult. Finally, on April 19 and June 5, 1985, Norfolk Southern entered agreements with the Pittsburgh and Lake Erie Railroad (P & LE) and Guilford Transportation Industries for the transfer of approximately 1400 miles of line (including leased lines) for a consideration of \$18 million and \$50 million, respectively. In addition, the agreements provided over 200 miles of trackage rights to connect the systems where no suitable line was available for sale.

In the fall of 1985, in response to criticism of the condition and competitiveness of the line to St. Louis that Guilford was to purchase, Norfolk Southern and Guilford modified their agreement to substitute trackage rights over the Conrail main line. The Justice Department also required other changes, including direct access to Detroit for Guilford. Finally, on November 20, the Justice Department announced that the structure of the divestiture satisfied its concerns.¹⁵¹

With these changes, the divestitures will result in the transfer of 1094 miles of line (including leased lines) and 1167 miles of trackage rights. The price to P&LE and Guilford is \$21.8 million and \$35 million, respectively.

V. A VIEWPOINT ON RAIL-RAIL COMPETITION AND THE NORFOLK SOUTHERN-CONRAIL AFFILIATION

A. *DOJ Underestimated the Pervasiveness of Intermodal Competition in Conrail's Market*

Although Norfolk Southern negotiated and signed the required divestiture agreements, it consistently took the position that the remedy was excessive. To some extent it disagreed with DOJ's analysis of markets. More fundamentally, Norfolk Southern's view rested on a sense of where the railroad industry was going. Particularly in Conrail territory, Norfolk Southern saw a railroad industry with less and less heavy freight on which to rely, and so with greater and greater dependence on general merchandise and trailer-on-flatcar, container-on-flatcar business. That business, however, was precisely the business for which trucks could effectively compete, particularly for the short distances in Conrail's region of operations. In fact, Norfolk Southern itself was experiencing

¹⁵⁰ Specifically DOJ found that Conrail/Norfolk Southern must divest to an independent acquirer rail assets along an east-west corridor between Buffalo and Pittsburgh on the east to Chicago and St. Louis on the west. See *supra* note 138. The acquirers were to have access to serve certain shippers in eight counties in New York, Ohio, and Indiana and a direct connection with third party railroads in Buffalo, East St. Louis, Toledo, and Chicago. *Id.*

¹⁵¹ Roanoke Times & World-News, November 22, 1985 at A8, col. 2.

losses to trucks in some of the very markets identified by DOJ as potentially subject to rail market power.¹⁵²

A number of features of the DOJ study caused it to understate the truck competition which was Norfolk Southern's dominant concern. First of these features was the study's underlying data base, the 1977 Census of Transportation.¹⁵³ Although DOJ tried to account for subsequent developments,¹⁵⁴ the computerized selection of problem markets on the basis of traffic shares did not reflect the growing role of trucks.

Second, in an effort to be conservative, DOJ insisted on looking at markets in terms of very highly defined commodities, specifically, five-digit Standard Transportation Commodity Codes (STCC).¹⁵⁵ A large percentage of truck volumes are not broken down that far in the records, so even if the identical five-digit STCC is moving preponderantly by truck, it may be recorded as, say, a three-digit commodity and never enter the data base at the level of detail DOJ used. Furthermore, the ultimate issue is the substitutability of truck carriage for rail carriage, and in many instances the differences between the characteristics of commodities at the five-digit level are so small that trucks can carry one as effectively as another.

Also, the DOJ required a very high truck share of the market, more than 50%, to rebut the inference of rail market power.¹⁵⁶ In reality much smaller truck shares may show that trucks are capable of capturing more traffic even if railroad raises rates.

For all these reasons, DOJ tended to find competitive problems with the Norfolk Southern-Conrail combination where problems were not likely to exist.

B. DOJ Placed Emphasis Unprecedented in Recent History on Preserving Rail-Rail Competition in the Divestitures

The addition of another rail carrier between Buffalo and Chicago to replace Norfolk Southern as an independent rail competitor for Conrail in that corridor is understandable, if not ultimately in the public interest.¹⁵⁷ Norfolk Southern and Conrail do have, more or less, parallel lines

¹⁵² Just between 1980 and 1984, the rail share of the U.S. freight bill dropped from 13% to 11% and trucks captured more and more merchandise business. L. M. SCHNEIDER, RAILROAD STRATEGIES FOR THE 1980'S AND 1990'S (Railway Finance Law Group, October 4, 1985).

¹⁵³ See McGrath Letter, *supra* note 138, at 4 (January 29, 1985).

¹⁵⁴ DOJ supplemented the 1977 data with survey and interviews with shippers. *See id.*

¹⁵⁵ *See id.* at 3 n.3.

¹⁵⁶ *See generally id.* at 3-4.

¹⁵⁷ Guilford has agreed to purchase Norfolk Southern/Conrail lines between these two cities pursuant to DOJ's divestiture requirements. *See id.* at Attachment A.

between those cities¹⁵⁸ (although Norfolk Southern has been increasingly unable to compete with Conrail in this corridor given the significantly greater volume of traffic on Conrail and the better service Conrail can therefore provide). Similarly, understandable is DOJ's insistence that the independent competitor be given the right to access industry at major rail shipping centers currently served by both Conrail and Norfolk Southern on or reasonably adjacent to this corridor (e.g. Cleveland, Toledo, Ft. Wayne, steels mills in Lorain, Canton and Massillon, Ohio).¹⁵⁹ DOJ's concern for preserving rail-rail competition at the expense of fragmenting traffic in the relatively shorthaul, truck-dominated Buffalo-Chicago corridor is less compelling than the Commission's concern for preserving rail-rail competition in the long haul transcontinental corridor in the UP-MP consolidation,¹⁶⁰ but it is at least understandable.

What is more difficult to understand is DOJ's decision to require independent rail competitors be given access to Pittsburgh, St. Louis and a myriad of minor rail markets in between.¹⁶¹ Norfolk Southern is a minor player in the rapidly declining Pittsburgh rail market, running four trains per day at most, into or through the area, and the future of its line into Pittsburgh, without regard to Conrail, is not bright, given the level of business and the cost of maintaining the line. And Norfolk Southern's lack of access to industries in the Northeast has hurt its position for much of the business moving over the St. Louis gateway.

The divestitures have now gone so far as to provide the independent rail competitors (i.e. Guilford and P&LE) access to relatively small shipping points located off the St. Louis corridor, such as Wabash, Hartford City, and Kokomo, Indiana, to establish rail-rail competition between the independents and Norfolk Southern-Conrail *beyond that* which now exists by opening all Norfolk Southern-Conrail Indianapolis area industries to Guilford on a competitive basis (and granting Guilford the right to take over switching of all such industries from Conrail), and to actually increase, not simply maintain, the number of competing rail carriers in Toledo and Ft. Wayne. Guilford is even granted the right to perform the switching on major portions of Conrail's St. Louis line, not only for its own account but also for Conrail's, all in the interest of preserving rail-rail competition.

¹⁵⁸ The Official Railway Guide (Nov/Dec 1985). As a matter of historical interest, the Norfolk Southern Buffalo-Chicago line was built in 1880-82 principally in order to turn a quick profit by selling it to the then owner of Conrail's Buffalo-Chicago line, the Lake Shore & Michigan Southern. E. F. P. STRIPLIN, *supra* note 90, at 275. Under pressure from DOJ, Lake Shore's successor, New York Central, spun off the Norfolk Southern line to independent owners in 1916. *Id.* at 278.

¹⁵⁹ See McGrath Letter, *supra* note 138, at Attachment A.

¹⁶⁰ See *supra* notes 85-88 and accompanying text.

¹⁶¹ See *id.*

*C. DOJ's Attention to Rail-Rail Competition Goes Far Beyond
What Is Required Under Transportation Law
or the National Transportation Policy*

DOJ has had the opportunity in the Norfolk Southern-Conrail transaction to impose its view on the role rail-rail competition should play in a rail affiliation. It is important, however, that it be understood that DOJ's position is at odds with the views of Congress, the courts, and the Commission as evidenced by their actions in establishing or interpreting the Interstate Commerce Act and national transportation policy over the last 65 years. And, DOJ has repeatedly attempted to persuade the courts and the Commission to adopt its views but has failed.¹⁶² DOJ's views also find no support in the legislation creating, and determining to sell, Conrail.¹⁶³ Preservation of rail service in the Northeast has been the aim, and excessive rail-rail competition has been viewed as detracting from that goal.

DOJ is frank in admitting that the proposed acquisition of Conrail "was analyzed . . . according to the same standards and principles . . . [applied] to mergers generally."¹⁶⁴ What DOJ ignores, and has always ignored in rail consolidations, is that, rightly or wrongly, there is a national transportation policy which encourages consolidation of rail carriers in order to preserve, with minimal disruption and human cost, a national rail transportation system.

It is possible the shipping public would have been better off today if Congress had decided to use Section 7 of the Clayton Act as the standard for rail consolidations.¹⁶⁵ Perhaps if the Seaboard Air Line and Atlantic Coast Line, or Great Northern and Northern Pacific, had not been permitted to merge in the 1960's and 1970's, the pressures of truck competition and the inability to consolidate facilities and personnel would have forced those roads to take the drastic steps Florida East Coast Railway has taken to survive [i.e., take a long term strike (with its disruption and human costs) and eventually become a non-union, low cost carrier.]¹⁶⁶ Perhaps, however, such efforts by one or all of these roads, and

¹⁶² See *supra* text accompanying notes 47, 57, 67 & 72.

¹⁶³ See *supra* notes 93-134 and accompanying text.

¹⁶⁴ See McGrath Letter, *supra* note 138, at 3.

¹⁶⁵ Indeed, DOJ believes the Clayton Act standard and Interstate Commerce Act standards are "substantially the same." *Id.* at 2 n.2.

¹⁶⁶ The Florida East Coast Railway had been a marginal carrier for years while operating under the burdens of the national collective bargaining agreements. In 1963 it accepted a strike rather than acquiesce in the national agreement, (see *Brotherhood of Ry. & S.S. Clerks v. Florida E. Coast Ry.*, 384 U.S. 239 (1966)), and eventually prevailed. In

others, would have failed and they would have by now entered the bankruptcy courts. And even that result might not, in DOJ's view, be unacceptable: the freedom to compete is the freedom to fail and if a large part of the rail industry has become redundant, so be it. The answer to DOJ, at least for now, however, is that Congress continues to believe that maintaining a healthy rail industry by means of consolidation, for the various reasons discussed previously, *is* in the national interest.

Be that as it may, DOJ's views have carried the day, Norfolk Southern has committed to the unprecedented divestitures establishing two new competitors to Norfolk Southern-Conrail, and the matter is before Congress. What Norfolk Southern has the right to ask at this stage is for acknowledgement by responsible participants in the Conrail sale process that the rail-rail competition issue has, by virtue of the divestitures, been at least adequately addressed and is now a non-issue. Informed opponents of the Norfolk Southern acquisition who raise the spectre of monopolies and antitrust are, at this stage, merely attempting to buttress a position they have chosen to take for other reasons.

Author's Note

On February 4, 1986, the U.S. Senate approved by a vote of 54-39, legislation sponsored by DOT providing for Conrail to be sold to Norfolk Southern. The legislation provided that DOT was authorized to proceed with the sale in conjunction with the divestitures required by DOJ. In the face of the announced opposition to the sale by the Chairman of the House Energy and Commerce Committee, and at the request of DOT, on May 9, 1986, Norfolk Southern increased its cash offer to the government for Conrail to \$1.9 billion (and, for the first time, agreed to Interstate Commerce Commission review, on an expedited basis between enactment of the sale legislation and consummation of the sale, or any competitive issues raised by the sale). Nonetheless, the legislation did not advance in the House and, ultimately, on August 21, 1986, Norfolk Southern withdrew its offer to purchase Conrail. The preceding article was written prior to these developments. The consideration given to the issues analyzed in this article will remain relevant as alternative dispositions of Conrail are contemplated by the government.

recent years Florida East Coast has been consistently profitable in a geographically limited market with strong truck competition.