Antitrust Law or 'Public Interest' Standard?

An Analysis of the Surface Transportation Board's Approval of the Union Pacific-Southern Pacific Merger

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I. Introduction

The merger of the Union Pacific (UP) and Southern Pacific (SP) railroads in 1996 was a milestone in the history of the railroad industry. The consummation of this merger joined over 35,000 miles of track west of the Mississippi into a railroad behemoth rivaled only by the Burlington Northern-Santa Fe (BN-SF) railroad, itself a newly merged entity as of 1995.[1] This merger was approved by the Surface Transportation Board (STB), the federal agency vested with exclusive jurisdiction over the approval or disapproval of mergers in the rail industry,[2] over vehement objections from the Department of Justice (DOJ).[3]

This paper will examine the process of review which resulted in the approval of this merger, comparing the different merger analysis standards used by the DOJ and STB. Part II will lay out the doctrinal differences between the STB's 'public interest' standard and the DOJ's approach to antitrust analysis under §7 of the Clayton Act. Part III will examine how these standards were applied by the STB and DOJ in the UP-SP merger case.[4] Part IV will discuss two themes which emerge from this analysis: the fact that the two agencies are applying a similar framework of analysis to this merger, and the deferential view taken by the STB toward the applicant companies' proffered evidence. This paper will argue that neither this framework of analysis nor treatment of the evidence is a proper application of the STB's 'public interest' mandate. This paper will then conclude by discussing how the phenomenon of political capture offers an explanation as to why the STB violated its 'public interest' mandate and was so deferential to the companies' evidence in this case.

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[1] The Antitrust Revolution : Economics, Competition, and Policy 30 (John E. Kwoka & Lawrence R. White eds., 2004). (hereinafter 'Antitrust Revolution')
[2] 49 U.S.C. §11321
[3] Antitrust Revolution, *supra* note 1, at 28.
[4] I choose the UP-SP merger because it was one of the most important rail mergers of the 1990s, and engendered much debate about whether the STB was applying its 'public interest' standard properly.

II. Doctrinal differences between the mandates of the Surface Transportation Board and the Department of Justice.

The Surface Transportation Board (STB) was created in 1995 and vested with exclusive jurisdiction over rail mergers.[5] Per STB mandate, all rail mergers are to be analyzed under the 'public interest' standard, as established in 49 U.S.C. §11324. Under this standard, the STB considers five factors when evaluating whether or not to approve a railroad merger:

> **(1)** the effect of the proposed transaction on the adequacy of transportation to the public;
> **(2)** the effect on the public interest of including, or failing to include, other rail carriers in the area involved in te proposed transaction;
> **(3)** the total fixed charges that result from the proposed transaction;
> **(4)** the interest of rail carrier employees affected by the proposed transaction; and
> **(5)** whether the proposed transaction would have an adverse effect on competition among rail carriers in the affected region or in the national rail system.[6]

In addition, the STB is mandated to "accord substantial weight" to the opinion of the Attorney General when considering applications for rail mergers.[7]

This 'public interest' framework for the analysis of rail mergers is very different from the Guidelines approach applied by the DOJ when analyzing mergers under §7 of the Clayton Act. Whereas the DOJ is focused primarily on competitive harm, and whether the effect of a merger will be "substantially to lessen competition,"[8] the 'public interest' standard is considerably broader, mandating that the STB weigh a variety of issues. Most notably, competition is but one of the five factors that must be weighed by the STB: the effects of the merger on employees, other rail carriers, and adequacy of transportation must also be considered.

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[5] 49 U.S.C. §11321
[6] 49 U.S.C. §11324
[7] *Id.*
[8] 15 U.S.C. §18

III. Case Study: The Union Pacific-Southern Pacific Merger

An analysis of how the DOJ and STB applied their respective standards in the UP-SP merger case paints an interesting picture of the differences and similarities between the two approaches. While the DOJ referred to this merger the "most anticompetitive rail merger ever proposed" in testimony before the STB in 1996, the STB voted to confirm the merger.[9] Comparing the approach of the two agencies in this case explains why they came to opposite conclusions regarding this merger.[10]

To examine the approaches of the two agencies, this paper compares the opinion that the STB issued in the case with the brief submitted by the DOJ during the proceedings, concentrating on the issues which were the main focus of the opinion: competitive harms, efficiencies, and weakened competitor. For each issue, the relevant facts will be discussed, followed by a comparison of the analysis that the two agencies apply to these facts.

Two themes emerge in the course of this comparison. First, the DOJ and STB are in fact applying a very similar analytical framework, one which focuses primarily on traditional §7 'antitrust' concerns. Second, the STB is systematically deferential to the evidence offered by the UP and SP (the 'applicant companies') in support of the merger, while using every opportunity to reject or distinguish the evidence offered by the DOJ.

a. Competitive Harms

i. The Facts: 3-to-2 markets

[9] *See* Assistant Attorney General Anne K. Bingaman, Testimony before the Surface Transportation Board (July 1, 1996), *available at* http://www.usdoj.gov/atr/public/testimony/0718.htm

[10] The DOJ was not alone in opposing this merger: "a diverse group of parties rallied against the merger," including shippers, state governments, several federal agencies, and other rail companies. Salvatore Massa, *Are All Railroad Mergers in the Public Interest? An Analysis of the Union Pacific Merger with Southern Pacific*, 24 Transp. L.J. 413, 420 (1997). I focus here solely on the DOJ so as to be able to compare the merger analysis conducted by the STB and DOJ.

At the time of the proposed merger, there were but three Class I railroads west of the Mississippi: the Burlington Northern-Santa Fe (BN-SF), the UP, and the SP.[11] Because of the high concentration in the industry, a proposed merger between two of these remaining competitors raised serious concerns about competitive harms. The implications of such a merger varied regionally, but a fair number of regional markets were currently served by all three railroads and, post-merger, would be served by only two.[12] Such markets were referred to as '3-to-2' markets.

1. How the two agencies treated the facts

a. Department of Justice

Due to the high level of concentration in a 3-to-2 post-merger market, the DOJ was very concerned with the potential for higher prices and collusion. The DOJ pointed out the increased risk of such a concentrated market in its brief. "The change in concentration is as extreme as it gets short of monopoly—merger to duopoly with no relief from intermodal, source, or product competition and no prospect for new entry."[13] They argued that the merger would likely result in both unilateral and coordinated effects in these 3-to-2 markets, as it would be in the interest of the post-merger duopoly to raise prices for shippers.[14] To demonstrate the likelihood of increased prices, DOJ presented numerous empirical studies conducted on the rail industry throughout the 1980s and 90s which concluded unanimously that higher concentration in the rail industry would lead to higher prices and collusion.[15] These studies were unchallenged by any

[11] "Class I railroads refer to those above a specific size criterion set by the ICC…as of 1996, [a Class I railroad had to have a minimum revenue] of $255 million." Antitrust Revolution, *supra* note 1, at 29.
[12] *See* Brief submitted by the Department of Justice, Antitrust Division, to the Surface Transportation Board (June 3, 1996), at 9. (hereinafter "DOJ Brief")
[13] *Id.* at 11
[14] *Id.* at 11-14
[15] *Id.* at 17-18.

other published work with the exception of the studies specifically commissioned by the applicant companies when applying for this merger.[16]

In addition to their myriad empirical studies, the DOJ presented a classic, Guidelines-approach economic analysis of collusion to the STB, testifying that the merger will "increase the similarity between the two [remaining] western railroads," thereby making it much easier for them to cooperate with each other on price criteria.[17] Such a collusive agreement between the UP-SP and BN-SF need not be complex; agreements between competitors can be "as simple and intuitive as, 'you keep your customers and I'll keep mine' " and still have a dramatic price effect on the market.[18] The DOJ further explained that a cartel with only two members is much easier to monitor and punish when deviations occur: if one of the members loses a customer, there is no mystery as to where that customer has now turned for rail service.[19]

b. Surface Transportation Board

The STB also analyzed the possibility of higher prices and collusion in a post-merger two-player market, but the agency concluded their analysis by dismissing most of the DOJ's concerns regarding these issues as "overstated."[20]

The STB largely rejected the DOJ's guidelines theory and testimony as inconclusive. They cited testimony from the Department of Transportation (DOT): "As DOT explains, "the competitive outcome of duopoly is indeterminate. In principle, competition can lead to a wide range of outcomes from prices that maximize the joint profits of the duopolists to a competitive equilibrium."[21] Essentially, the STB accepted the DOT's testimony that the outcome of a 3-to-2

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[16] *Id.* at 18-19
[17] *Id.* at 15.
[18] *Id.*
[19] *Id.*
[20] Union Pacific Corporation—Control and Merger—Southern Pacific Railroad Corporation, 1 STB 233 (1996), at 87. (hereinafter "STB Opinion")
[21] *Id.* at 91.

merger is speculative; they were not convinced by any of the specific evidence which had been proffered by the DOJ that the outcome of *this* merger would indeed be collusive, or lead to higher prices. One reason the STB was unimpressed with much of the DOJ's proffered evidence was because most of it was not "railroad-specific."[22] The agency had requested railroad-specific evidence from the DOJ during oral argument and lambasted the DOJ when they were unable to provide this data.[23]

> Opponents' positions on the instant merger are drawn from theory and models of firm behavior that lack empirical support. They support their statements with reference to a body of literature on industrial organization, showing that concentration at some point leads to higher prices. However, only a very few of these studies address the railroad industry, and their credibility has been seriously challenged.[24]

As for those DOJ studies which *did* focus on the rail industry, the STB rejected them based on the methodology used or because they were too specific. First, the railroad-specific studies offered by the DOJ used a static context when calculating projected increases in rail rates after the merger. The STB viewed this as highly problematic because the studies did not take into account what the STB called the "key dynamic element of this merger, the dramatic cost reductions it will make possible."[25] As a result, these studies "fail to acknowledge that any limited ability this merger creates to raise rates over costs will be offset to the extent that the merger results in significant reductions in applicants' costs."[26] In a sense, therefore, while the STB recognized the fact that the railroads might indeed be able to raise rates somewhat, they dismissed this as unimportant as a result of the fact that, on the whole, prices were still projected to *go down* as a result of increased efficiencies after the merger. Second, the STB dismissed the DOJ's studies because they focused on particular categories of shippers in the rail industry, such

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[22] *Id.* at 99-100.
[23] *Id.*
[24] *Id. at* 101.
[25] *Id.*.
[26] *Id.*

as grain shippers. "We do not think it is valid to apply rate projections based on grain traffic to other categories of 3-to-2 traffic that have markedly different transportation characteristics."[27]

To further support the proposition that two-player rail markets would not necessarily be collusive, the STB stated that "previous experience with rail mergers since 1980 indicates that carriers have not colluded in two-railroad markets."[28] They pointed out several regions, such as the Wyoming Powder River Basin, that are currently only served by two railroads yet show signs of "vigorous" competition and increasingly lowered prices for shippers.[29] From this example, the agency inferred that other dual player railroad markets could also be competitive.

In addition, the STB questioned the veracity of DOJ's claim that 'three' player markets currently existed at all in the western railroad industry. The SP, with limited access to capital and an inferior infrastructure, was struggling to maintain its current service levels.[30] Because of the SP's poor financial condition, it is "constrained, not a full competitor, with limited impact on the pricing actions of other western carriers."[31] A loss of such a weakened competitor would have minimal if any effect on competition between the two remaining competitors. "For all of these reasons, we believe that protestants have overstated harm in 3-to-2 markets and that corrective action in 3-to-2 markets is not required."[32]

The agency concluded that, "based on our experience with railroad mergers, and the lack of railroad-specific evidence presented by DOJ in support of its position, we find DOJ's arguments [regarding collusion in a 3-to-2 market] to be unconvincing."[33]

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[27] *Id.*
[28] *Id.* at 91.
[29] *Id.* at 99.
[30] *Id.* at 102.
[31] *Id.*
[32] *Id.*
[33] *Id.* at 100.

2. Comparison of how the two agencies treated the facts

Two interesting themes emerge from the two agencies' analysis of 3-to-2 markets. One theme is the fact that, despite their differing statutory mandates, the STB and DOJ applied the *same framework of analysis* to this issue of anticompetitive harms. Both agencies recognized the same issue (the potential for anticompetitive harms such as collusion and rising prices) as key to this merger analysis, and the reality that these competitive harms could well result from a 3-to-2 market structure. The two agencies were therefore asking the *same questions* in their analysis. The difference came in how they evaluated the evidence proffered to *answer* these questions.

This is the second theme which emerges: the differing treatment of the evidence between the two agencies. The STB's treatment of the evidence was seriously skewed: the agency systematically deferred to the evidence proffered by the applicant companies, while dismissing the DOJ's empirical studies and economic theory.

This unequal treatment of the evidence is evident in several ways. First, the STB devoted ample verbiage in their opinion toward deconstructing the various studies proffered by the DOJ: they were either too general and therefore not applicable to the rail industry, too specific within the rail industry (for example, because they only focus on the grain industry, as discussed above), or the methodology used failed to account for all the relevant variables (see the static context claim, above). Such a Goldilocks-style of rejection leaves one wondering what type of evidence DOJ could have offered that *would* have been accepted by the STB.

Second, the STB accepted evidence which applied to specific rail regions or industries as convincing when offered by the *applicant companies,* while finding unpersuasive the industry-specific rail studies offered by the *DOJ.* Compare the STB's treatment of the DOJ's grain shipper studies with the evidence proffered by the applicant companies on the Wyoming Powder

River Basin. The STB stated that the DOJ's evidence on grain transport was unconvincing because the grain industry is different from most other rail customers. The competitive two-player market in the Wyoming Powder River Basin, however, was accepted as a relevant example of a competitive rail market despite the fact that the Powder River Basin is an exclusively coal mining area with specific transportation requirements. The STB accepted this data on the competitive nature of the Wyoming Powder Basin as evidence that two player rail markets can be competitive without extrapolating as to whether that situation was genuinely analogous to the vast swaths of rail markets which will be changed as a result of this merger. This demonstrates that, even when the DOJ *attempted to provide* rail-specific studies, they were not the *right type* of rail specific studies according to the STB. The rail companies do not appear to have run into this problem.

Third, the STB rejected most of the DOJ's evidence despite the overwhelming asymmetries in the *amount* of evidence offered by the DOJ versus that offered by the applicant companies. Although the quantity of evidence presented is certainly not dispositive of the strength of a case, here the DOJ presented myriad unchallenged empirical studies as well as a theoretical analysis to support their contention that the risks of collusion were especially high in this case. This portfolio of evidence did not appear to impress the STB, however: irrespective of the fact that the applicant companies offered little evidence in rebuttal of the DOJ's collusion studies, the STB still found their position more convincing. The DOT's testimony that the outcome of 3-to-2 mergers is "speculative" was apparently sufficient to rebut the full force of the DOJ's claim that, in most industries and in most contexts, both economic theory and practice have shown that collusion is a very real danger in situations similar to the present case.

What emerges is the sense that, despite the fact that the two agencies analyze the same *issues* surrounding the merger, it is the STB's skewed treatment of the *evidence* that led to the different conclusions between the agencies on this issue of competitive harm.

ii. The Facts: '2-to-1' markets, and the trackage rights solution.

In a number of regions, especially along the Gulf Coast and in the Central Corridor region, the pre-merger rail market was only served by two players: the UP and the SP. Consequently, the UP-SP would have a monopoly in these areas after the merger. To ameliorate this monopoly situation, the applicant companies proposed a trackage rights agreement: in markets where the UP-SP would be in a monopoly position post-merger, the UP-SP would lease rights to its track to its remaining competitor, the BN-SF. Essentially, the UP-SP would be bringing the BN-SF back into the market as a 'second competitor,' thus recreating the pre-merger situation where two rail companies competed for traffic in those markets.[34]

1. How the two agencies treated the facts

a. *Department of Justice*

The DOJ pointed out the obvious: this merger will give the applicant companies a monopoly in numerous markets along the Gulf Coast and Central Corridor.[35] This market carries rail traffic worth between $900 million and $2 billion, and even the "applicants admit that the merger will give UP-SP…the undisputed power to raise price and reduce service" in these markets.[36]

[34] Antitrust Revolution, *supra* note 1, at 38-39.
[35] DOJ Brief, *supra* note 12, at 8-9.
[36] *Id.* at 9.

The DOJ rejected the applicants' proposed solution of offering trackage rights to the BN-SF, finding this solution to be "wholly inadequate."[37] Most importantly, such trackage rights would put the BN-SF at an inherent disadvantage as a tenant railroad leasing from the landlord UP-SP.

> A trackage rights tenant can never be put in the same position as an independent railroad. Landlord railroads inevitably have the incentive and opportunity to favor their own trains and to discriminate against competing tenants who operate trains over their track. In addition, there are inherent difficulties involved in providing the tenant with access to necessary facilities and in setting a compensation rate that will allow the tenant to compete.[38]

Such an unequal situation could not result in genuine competition between the two players in any of these 2-to-1 markets.[39]

To solve the problem of these monopoly markets, the DOJ recommended (1) denial of the merger application, or, in the alternative, (2) divestiture of substantial amounts of track where the monopoly markets would otherwise occur.[40] With regards to divestiture, the DOJ pointed out that four railroads who do *not* pose anticompetitive concerns had already offered billions for the SP track in the Central Corridor and Gulf Coast regions.[41]

b. Surface Transportation Board

The STB, on the other hand, supported the trackage rights solution offered by the applicant companies. They admitted up front that the agreement raised a number of concerns, including discrimination against the tenant railroad, whether or not the BN-SF will have sufficient traffic density along the route to make it an efficient competitor, and the fact that BN-SF was offered an inferior route in these markets.[42] These concerns, however, were assuaged by

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[37] *Id.* at 19-20.
[38] *Id.* at 23.
[39] *Id.* at 25.
[40] *Id.* at 3-4.
[41] *Id.* at 24.
[42] STB Opinion, *supra* note 20, at 112-14.

assurances from the BN-SF and UP-SP as to the fairness of the agreement and evidence which demonstrated that voluntary trackage rights agreements have worked in the past. Because "[a]pplicants and BN-SF…have agreed upon a detailed written trackage rights protocol that should ensure equal treatment of all trains without regard to ownership," the STB accepted that the agreement would in fact provide equal opportunities for competition between the two players.[43]

To ensure that the BN-SF would compete effectively along the leased track, the STB imposed a number of conditions on the merger. These conditions included a "common carrier obligation" on the BN-SF to compete vigorously in these markets as soon as possible, and a reporting obligation, whereby the BN-SF must report quarterly on their progress in maintaining effective routes along these tracks.[44] As a result of these monitoring obligations and the predicted effectiveness of the trackage rights agreements, the STB decided that competitive "[h]arm to 2-to-1 shippers from the merger as conditioned will be negligible."[45]

2. Comparison of how the two agencies treated the facts.

The themes which emerged above in the discussion of 3-to-2 markets are again apparent in the STB's writings on 2-to-1 markets: the two agencies were applying a similar framework of analysis to the issues in this case, and the STB exhibited considerable deference to the evidence offered by the applicant companies.

Similar to what was seen in the 3-to-2 market analysis, the two agencies examined potential harms in the 2-to-1 markets through the same analytical framework. Both agencies found 2-to-1 markets to be a key *issue* in this merger analysis, and both saw the same *potential*

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[43] *Id.* at 112.
[44] *Id.* at 114.
[45] *Id.* at 87.

harm (monopoly power) arising from this situation. Both agencies also recognized the potential for trackage rights agreements as a *solution* to this problem.

Where the agencies diverged was again with regard to the evidence: does the evidence prove that these trackage rights agreements will in fact be a solution to the 2-to-1 market problem? The STB accepted the testimony of the companies: their evidence that trackage rights agreements have worked in the past and their good faith that the UP-SP trackage rights agreement would be 'fair.'[46] They were dismissive of the DOJ's portfolio of studies detailing the inequalities between competitors which typically result from such agreements. Without really examining the DOJ's concerns in the context of this case, the STB stated that these issues would be resolved by their monitoring conditions and the fact that the applicant companies have stated that the agreement will be 'fair.'[47] Such treatment of the evidence provides an additional example of the deference which the STB accorded to the evidence offered by the applicant companies.

b. Efficiencies

i. The Facts: Efficiencies

The applicant companies provided a litany of efficiencies which were predicted to result from the proposed merger, including savings on labor costs, operations, and shipper logistics. They claimed that efficiencies from the first year alone would save $290 million, and these cost savings would ramp up to the point where, five years after the merger, the parties would be saving $750 million annually in operating costs.[48]

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[46] *Id.* at 112.
[47] *Id.*
[48] Antitrust Revolution, *supra* note 1, at 36.

ii. How the two agencies treated the facts

1. Department of Justice

The DOJ attacked the applicant companies' claims of efficiencies in several ways. Their primary bone of contention was that the merging parties' proposed efficiencies were non-merger specific.[49] The DOJ offered a plethora of well-respected studies and the testimony of Dr. Laurits Christensen to support their case.[50] Examining industry productivity trends, the agency claimed that the railroads would achieve $564 million in cost savings in the year after the merger "merely by keeping pace with projected productivity gains for the industry."[51] These non-merger specific productivity savings would account for 75% of the cost savings projected by the applicants.[52] Their evidence uniformly concluded that these massive productivity gains were a continuing result of the deregulation of the railroads which took place in the 1980s, *not* as a result of previous rail mergers, as the applicant companies contended.[53] The DOJ pointed out that there was no evidence presented which proved that the predicted efficiencies were merger specific: "the Board [STB] has no basis for distinguishing between any operating efficiencies that could be obtained only by merging and the efficiencies that could be obtained by less anticompetitive means."[54]

The DOJ made two further claims: that the efficiencies claimed by the applicant companies were overstated, and that these efficiencies were achievable by less anticompetitive means. First, the DOJ attacked several dubious categories of savings which were claimed by the applicant companies as efficiencies, the most notable of which was the trackage rights fees that

[49] DOJ Brief, *supra* note 12, at 43.
[50] *See* Statement of Dr. Laurits R. Christensen, taken April 9, 1996.
[51] DOJ Brief, *supra* note 12, at 43-44.
[52] *Id.* at 44.
[53] *Id.*
[54] *Id.* at 48.

the BN-SF would pay the UP-SP to obtain use of their track in the 2-to-1 markets.[55] Such fees were simply transfer funds from one competitor to another, not 'efficiencies' gained through the merger. Second, DOJ testified that the benefits claimed by the applicants could be achieved through less anticompetitive means. For example, the UP could "enter…into a trackage rights agreement with SP or other forms of voluntary cooperation short of a merger."[56] The DOJ rejected applicants' argument that none of the efficiencies claimed by the merger could be achieved through such voluntary agreements, and pointed to applicants' own evidence on trackage agreements, which proved that these agreements can be very successful when properly executed.[57]

2. Surface Transportation Board

The STB accepted almost all of the efficiencies proposed by the applicant companies. They stated that the merger would result in new operating efficiencies, shorter, more efficient routing between cities, and efficiencies in administration and traffic handling, among other benefits.[58]

The STB rejected the testimony of the DOJ's expert Dr. Christensen, who claimed that these efficiencies were not merger-specific, but would rather be "the result of ongoing, favorable industry productivity trends brought about by Staggers Act deregulation" in the rail industry.[59] The STB stated that the applicant companies had effectively rebutted Christensen's studies on efficiencies because they had shown that several large rail mergers had occurred during the period in which his studies focused. Therefore, "Christensen's rail productivity study necessarily

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[55] *Id.* at 45.
[56] *Id.* at 46.
[57] *Id.* at 47.
[58] STB Opinion, *supra* note 20, at 92-93.
[59] *Id.* at 94. The Staggers Act was passed in 1980, and led to the deregulation of the rail industry.

includes, rather than excludes, merger-related productivity gains."[60] Even DOJ studies that concentrated on years in which no mergers had occurred were rejected by the STB, as the agency reasoned that "firms who experienced a merger earlier still accrue benefits in later years."[61] This analysis plainly failed to "factor out" the effects of mergers on productivity gains.[62]

The only itemized efficiencies claimed by the applicants that were rejected by the STB were the trackage rights fees the merged entity would receive from the BN-SF and the money the merged entity would save from traffic diversions along the combined rails.[63]

iii. Comparison between how the two agencies treat the facts

Yet again, both agencies applied a similar framework of analysis to this merger. Despite the fact that the STB labeled efficiencies as "public benefits" in its opinion, the agency analyzed efficiencies in a manner very similar to the methods used by the DOJ when applying §7: as a potential counterbalance to the anticompetitive harms of a merger.[64] The agency stated as much at the beginning of their opinion, where they wrote that "our statutory mandate…requires us to balance efficiency gains against competitive harm."[65] The difference between the DOJ and STB in this case is therefore not the *framework* through which they analyze these efficiencies, or the *weight* accorded to efficiencies in their analyses, but rather which efficiencies they find to be legitimate based on their evaluation of the evidence.

The STB's treatment of the evidence of efficiencies proffered by the companies was much less rigorous than the DOJ's approach. While the DOJ wanted the parties to *prove* their claimed efficiencies (that they will indeed materialize, and that they are merger-specific), the

[60] *Id.*
[61] Massa, *supra* note 10, at 438-39.
[62] *Id.* at 439.
[63] STB Opinion, *supra* note 20, at 92.
[64] *Id.* at 92-93.
[65] *Id.* at 86.

STB had a presumption of sorts that the merging parties' proposal *will* result in the claimed efficiencies. The STB found it anathema that the DOJ wanted to shift a burden toward the applicant companies to demonstrate that their efficiencies *were* merger-specific.

> Indeed, DOJ has even gone so far as to suggest that applicants have the burden of proving the negative proposition that the merger benefits cannot be obtained through any means short of merger…DOJ's approach goes against the grain of our statute, which assumes that carriers will take the initiative in proposing rail consolidations that permit railroads to…operate more efficiently."[66]

Such an assumption that the companies' proposed efficiencies *will* be merger-specific indicates an extreme deference to the evidence proposed by the companies.

The STB's deference here is particularly interesting because the DOJ offered a veritable portfolio of evidence proving that the claimed efficiencies in fact would be a result of deregulation, *not* the proposed merger. The applicant companies countered such evidence by saying that the DOJ's studies encompassed efficiencies which were a result of both mergers and deregulation. Even if the companies' claim that *some* of these efficiencies resulted from prior rail mergers was true, it seems clear that both factors, rail mergers and deregulation, must have played a role. The STB, however, was not concerned with disaggregating the two causes: they simply accepted the companies' evidence that, after this merger occurs, the proffered efficiencies will follow.

The agencies' disagreement over trackage rights agreements provides yet another example of how the STB treated the evidence offered by the DOJ and the applicant companies differently. The STB completely rejected the DOJ's argument that, absent the merger, voluntary trackage rights agreements between the UP and SP could result in the same type of efficiency savings that the parties were claiming would result from the merger. This is one of the more blatant examples of the STB's inconsistent treatment of the evidence, as the STB accepted these

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[66] *Id.* at 94.

same arguments about the benefits of voluntary trackage agreements when they were offered by the applicant companies *in favor of* the trackage rights solution to the 2-to-1 market concentration problem.[67] Somehow, when offered by the DOJ *against* the merging parties, the STB found cause to reject these same studies.

The deference of the STB to the applicant companies is not absolute, however, as the agency opens the door but a crack to the DOJ over efficiencies and agreed that some categories of claimed efficiencies (such as the transfer funds from the trackage rights agreement) were indeed not legitimate, as DOJ claimed.

c. *Weak Competitor*

i. The Facts: Weak Competitor

The Southern Pacific (SP) had been struggling financially for about a decade before the proposed merger in 1995. Among its woes were an outdated infrastructure, delayed service, and insufficient funds to fix these problems.[68] By the beginning of the 1990s, however, there were signs the company had begun to improve. SP raised $2 billion between 1992-95 through stock sales and real estate, and the company had invested this money to improve operations and on new equipment.[69] Operations had improved dramatically since 1994, and revenues were up: the company was in fact the only western railroad to report increased revenues in the first quarter of 1996.[70]

ii. How the two agencies treated the facts

1. Department of Justice

[67] Massa, *supra* note 10, at 441. See above discussion in Part III(a)(ii).
[68] Antitrust Revolution, *supra* note 1, at 37.
[69] DOJ Brief, *supra* note 12, at 35.
[70] *Id.* at 36.

The DOJ rejected the applicant companies' claim that the SP was a weak competitor, presenting a panoply of evidence in support of this position. First, they cited the fact that the SP had raised capital and improved its operations in recent years, and presented an expert who concluded that the company would continue to be able to generate significant capital absent the merger.[71] Second, they interviewed a variety of shippers from various industries and regions who stated that the SP was a significant competitor who "restrained the prices of other railroads—notably UP."[72] Looking at information from these shippers as well as the evidence presented by the applicant companies, they pointed out that even "applicants' own evidence shows that SP is currently the first choice of [redacted]% of shippers in many markets, and undoubtedly the second choice of many more."[73] SP could clearly not be discounted as a competitive force if it beat out the competition from both the UP and the BN-SF in a certain percentage of rail markets. Third, the DOJ analyzed internal UP documents, which stated that the management of UP regarded the SP as an effective competitor.[74] Such internal documents belied the claim the applicant companies made to the STB that the SP was not, in fact, a competitive force in the industry.

2. Surface Transportation Board

The STB declared the SP a "weak competitor" and stated that "[a] major benefit of the merger is that it would permit the financially weak SP to become a part of a large, healthy rail system."[75] The agency accepted the evidence presented by the merging parties that SP had insufficient capital to invest in its infrastructure and that its "position will continue to decline

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[71] *Id.* at 35-38.
[72] *Id.* at 36.
[73] *Id.* at 13.
[74] *Id.*
[75] STB Opinion, *supra* note 20, at 97.

over time."[76] The STB found the DOJ's expert testimony about the currently improving state of the SP wholly unconvincing when compared with the historical evidence offered by the applicants, which showed that "[o]ther than in one unrepresentative year, 1994, SP has historically been financially weak and unprofitable, relying heavily on large real estate sales to generate necessary cash flows."[77] The agency concluded that these one-off real estate sales in the mid-1990s would not be able to generate capital effectively in the future, especially as the supply of saleable real estate owned by the SP was declining.[78]

The STB recognized the fact that the SP was not in danger of imminent failure, but still held that its weakness would preclude it from being an effective market player:

> [a]lthough SP could remain in operation as an independent carrier for some time absent the merger, its inability to generate adequate cash flow from operations, and limitations on its ability to borrow or to sell stock, will preclude it from being a strong competitor to UP or BNSF. The level of service now offered by SP is below that offered by its competitors, and declining; it is essentially a single-track, low-density, high-cost railroad.[79]

Furthermore, the STB was concerned about the dominance of the newly-merged BN-SF on the western rail industry. The agency stated that both "UP and SP face increasing pressure from a newly merged, more efficient BN-SF, which has been investing substantial capital into improving its service."[80] Consequently, it would be in the interests of both railroads to merge, because it would put the merged entity "in a much improved position to compete aggressively with BNSF to provide better, more efficient service to shippers in the West."[81]

iii. Comparison of how the two agencies treated the facts

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[76] *Id.* at 98.
[77] *Id.* at 97.
[78] *Id.*
[79] *Id.*
[80] *Id.* at 88.
[81] *Id.*

The two agencies apply a somewhat differing framework of analysis when examining the SP as a weakened competitor. While both agencies agreed that a weakened or failing competitor is a *relevant factor* in merger analysis, they disagreed on what *degree of 'weakness'* makes a firm fall into this category. The STB stated that a weak firm provides little competitive value to the market at all, even if this competitor is not failing *per se*. The DOJ's paradigm of the 'failing firm defense' is much stricter than that of the STB: a firm is failing, and therefore relevant for anticompetitive purposes, only if "absent the acquisition, the assets of the failing firm would exit the relevant market."[82] Weakened competitors are still competitors.

Irrespective of the fact that their thresholds for what defines a weak competitor were somewhat different, the agencies again disagreed on the facts regarding whether or not the SP *is in fact* a weak or failing firm. The STB was willing to accept the applicant companies' evidence that the SP's decline was a foregone conclusion. They did not address the DOJ's evidence that a certain percentage of shippers currently chose the SP as their first or second choice, that the UP itself considered the SP to be a viable competitor, or evidence that SP had been improving in recent years. Instead, they focused on historical evidence offered by the applicant companies which stated that SP had been a weaker competitor over much of the past decade. This reliance on historical evidence rather than current industry conditions seems to be a direct flip from how the STB weighed the evidence of competitive harms. In that context, as discussed above, the STB lambasted the DOJ for not providing evidence which was either current or specific to the UP-SP merger. Here, they rejected the DOJ's both current *and* specific evidence about the SP's improving finances in favor of historical evidence offered by the merging parties that the SP 'has been' in decline over the past decade.[83] Such inconsistent treatment of the evidence provides

[82] U.S. Dep't of Justice & Fed. Trade Comm'n, Horizontal Merger Guidelines (rev. 1997), at 33.
[83] STB Opinion, *supra* note 20, at 98.

further proof of the skewed manner in which the STB evaluates the evidence offered by the two parties.

IV. Analysis of the DOJ's and STB's approach to the UP-SP merger

Two main themes emerge from the above comparison: the similar legal analysis applied to this merger by both the DOJ and STB, and the agencies' disparate treatment of the evidence. This paper will address each in turn, focusing on whether or not the STB's framework of analysis and treatment of the evidence in this case are consistent with their Congressional mandate to apply a 'public interest' standard.

Section A will address the STB's legal analysis, and discuss whether the STB is correctly applying a 'public interest' *framework of analysis* in this case. Concluding that it is not, Section B will discuss whether or not the 'public interest' standard instead plays a different, more subtle role in the agency's analysis: can it explain the STB's deferential *view of the evidence*? Again, the answer is no. Part IV will conclude by offering an alternate explanation as to why the STB was so deferential to the companies' evidence: political capture.

a. The DOJ and STB applied very similar legal standards in this case.

The first theme which is apparent from the UP-SP decision is that the two agencies are applying a very similar framework of analysis to the merger at issue. Throughout the STB's opinion it becomes clear that both the STB and the DOJ are considering the *same factors*, such as competition, efficiencies, and weakened competitors, and are *analyzing these factors in primarily the same way*: by weighing empirical studies, the testimony of experts, and historical evidence.

It is puzzling to see the two agencies applying such a similar framework of analysis, considering that their statutory mandates are very different. The question is then this: is the STB really applying the public interest standard in this case?

i. Is the STB following its 'public interest' legal mandate?

1. The 'public interest' framework that Congress created for the STB

Congress created the STB with the explicit mandate that mergers in the rail industry be analyzed under an alternative 'public interest' framework, *not* §7 of the Clayton Act. As stated in Part II of this paper, this standard has five factors, directing the STB to consider "public benefits," competitive harms, and the interests of rail employees, among other considerations.[84]

2. The legal framework the STB applied in the UP-SP case

Despite Congress' efforts, the STB has applied an 'antitrust-like' framework of analysis to this merger which is similar to the approach used by the DOJ to analyze mergers under §7. Rather than examining all five factors of the 'public interest' standard, the STB instead chose to focus on the first and fifth factors of their mandate in the UP-SP decision.[85] They interpreted the first factor to refer to the "public benefits" which may result from the merger, and consequently construed these "public benefits" as "any efficiency gains a railroad may derive from the merger."[86] The fifth factor squarely focuses on the potential anticompetitive effects of the merger. The agency ignored or minimized the remaining three factors. In the end, the five factors of the 'public interest' test boil down to a balancing test, as the STB plainly states at the outset of the UP-SP decision: "our statutory mandate…requires us to balance efficiency gains against competitive harm."[87]

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[84] 49 U.S.C. § 11324. See Part II, which lists the five factors.
[85] Massa, *supra* note 10, at 418.
[86] *Id.*
[87] STB Opinion, *supra* note 20, at 86.

This analytical framework mirrors the very same antitrust considerations which are examined by the DOJ as part of every §7 analysis: efficiencies and anticompetitive harms. Despite the fact that the STB cloaks its discussion of these 'antitrust' factors with the label of "public interest," the factors considered by the STB are the same issues weighed by the DOJ in every stock §7 merger analysis.[88] The bulk of the STB's opinion focuses on these issues of competitive harms and efficiencies, comparing the evidence of the applicant companies to the analysis offered by the DOJ and other opposing parties.[89] Essentially, the agency is focusing on the 'antitrust' factors of their mandate, while minimizing the remaining three factors, which deal with the interest of rail employees and other regional rail carriers.

ii. This 'antitrust' version of the STB's mandate is not in fact 'public interest.'

What the STB has done is essentially whittled its 'public interest' mandate down to an 'antitrust'-like legal standard which is very similar to the legal analysis applied by the DOJ under §7. Such an adulterated application plainly contradicts the purpose of their 'public interest' mandate. As stated above, the primary purpose of the 'public interest' framework was to place mergers in the rail industry under an alternative merger review standard *instead of* the traditional §7 merger framework applied by the DOJ. The STB's manipulation of their standard to the point where they end up applying the *very same framework of analysis* as the DOJ would under §7 therefore squarely ignores the primary purpose of the 'public interest' mandate in the first place. If Congress had wanted the STB to apply §7, it could have left the railroads under the jurisdiction of the DOJ or granted the STB explicit instructions to apply §7 to rail mergers.

[88] *Id.* at 92-93.
[89] It is true that the agencies' treatment of 'failing firm' is different. As the bulk of their opinion concentrates on efficiencies and competitive harms, however, this does not change the basic premise of this paper that the two agencies are applying a very similar (overall) framework of analysis.

Accordingly, it is clear that the STB has failed to apply the *legal framework of analysis* established by public interest mandate in this case. The question is then this: does the public interest mandate do any work in this case? While the STB has clearly not applied the public interest *legal standard*, does the 'public interest' standard play a role in any other part of the agency's analysis, such as their deferential *treatment of the evidence*?

b. The STB gave deferential treatment to the evidence of the applicant companies in the UP-SP merger case.

The second main theme which emerges from the above comparison of the two agencies' analyses is their disparate treatment of the proffered evidence. As is discussed above, despite the fact that the STB is applying a framework of analysis similar to that of the DOJ, the two agencies come out with different results due to the STB's deferential treatment of the evidence. One need only look at the treatment of the trackage rights evidence[90] or the way the STB rejected the DOJ's evidence of collusion[91] to get a sense of the skewed way in which the STB treated the evidence. This differing treatment of the evidence explains why the two agencies come to opposite conclusions as to whether this merger should be approved.

Did the 'public interest' standard affect the way the STB weighed the evidence in this case? Although the STB did not apply the legal framework of their public interest standard, the standard may have had broader, more subtle effects in the agency's analysis: for example, by creating a presumption that the STB should be deferential to the applicant companies' evidence.

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[90] See Part III(b)(iii) above, pgs 10-11.
[91] See Part III(a)(i)(2) above, pg 5.

i. Can the ‘public interest’ standard explain why the STB was deferential to the evidence proffered by the applicant companies in this case?

There are two main reasons why the ‘public interest’ standard does not in fact justify the STB’s deferential view of the evidence: because ‘public interest’ is a legal standard, not an evidentiary one; and such deference would directly contradict the policies underlying Congress’ creation of the STB.

1. ‘Public interest’ is a legal standard, not an evidentiary one.

First and foremost, the ‘public interest’ standard is a legal standard; it is not about the facts. As a legal standard, ‘public interest’ provides a *framework of analysis* for the STB, establishing *which* criteria the parties must prove in order to meet the standard. It says nothing, however, about *how* the pieces of evidence offered to prove these criteria should be weighed.

The only way in which the public interest standard could justify the STB’s deferential treatment of the evidence would be if the standard itself established a *legal presumption* in favor of the case made by the applicant companies. No such presumption in favor of the companies can be found in the ‘public interest’ mandate.[92] Accordingly, as a matter of logic, the ‘public interest’ standard should have no effect on how the STB weighs the evidence offered by the opposing parties in this case.

2. Such deferential treatment of the evidence would directly contradict the policies underlying Congress’ creation of the STB.

The last possibility is that the underlying policy rationale behind the ‘public interest’ standard implies that the STB should accord more deference to the companies’ evidence.

[92] In fact, if anything, Congress wanted the STB to accord more deference to the evidence proffered by the *DOJ*. 49 U.S.C. §11324 states that the STB is to “accord substantial deference to any recommendations of the Attorney General.”[92] Although this statement does not specifically state that the DOJ’s *evidence* is to be given more weight in the analysis, Congress clearly is signaling that the *opinions and analysis* of the DOJ are to be weighed seriously in the STB’s deliberations.

Such deferential treatment of the evidence, however, does not make sense in light of the policy reasons behind the creation of the STB and the 'public interest' standard. As discussed above, when Congress created the STB in 1995, it made a legislative judgment that mergers in the railroad industry should be approved *only if* they are in the 'public interest.' Implicit in this judgment is the fact that *not all* proposed rail mergers *will be* in the public interest. The STB was created to review these mergers, acting as a screening mechanism of sorts to figure out which rail mergers are in the public interest, and which are not.

It would be illogical under these policy goals for the STB to have a strong presumption in favor of the evidence offered by the rail companies. According the companies' evidence deference would inherently be in tension with the STB's mandate to analyze and evaluate rail mergers, as it would slant the agency toward the very entities it was supposed to be 'screening.' A screening mechanism which is but a rubber stamp for the companies' merger proposals would be no screening mechanism at all. The STB's deference to the companies' evidence, therefore, is inconsistent with their 'public interest' mandate.

The 'public interest' standard, therefore, appears to have done little work in this case. The STB has not applied the framework of analysis mandated by the standard, and they have evaluated the proffered evidence in a manner which contradicts the basic purpose behind the creation of the 'public interest' review process.

The question is then this: what explains the STB's abrogation of its 'public interest' mandate? Legal explanations appear to have done no work here, so this paper will now explore the possibility that political capture of the agency has played a role.

ii. Does political capture explain why the STB accorded such deference to the applicant companies' evidence?

Political capture is a phenomenon which occurs when concentrated, powerful interest groups mobilize and use their clout to influence political players or outcomes. As a concentrated, organized industry with a well-defined set of interests, the rail industry is a classic case of an industry in prime condition to engage in political capture.

Unsurprisingly, the rail industry has had a powerful role in helping to reshape the regulatory agencies and laws which govern the nation's railroads since the beginning of railroad deregulation in the 1980s.[93] Such a phenomenon is referred to more specifically as "regulatory capture"—the idea that regulatory agencies tend to become the captives of the industries they are purporting to regulate."[94] The railroad deregulation regime was in fact "hammered out in a negotiated compromise between established interest groups much in the way the interest group theory of politics would predict."[95] The influence of rail interest groups also had an effect on the continuing regulatory changes which led to the creation of the STB in 1995.[96]

Accusations about the regulatory capture of the STB have been flying since the creation of the agency in 1995. Shippers, politicians, and unions have repeatedly testified to the severe bias exhibited by the STB toward the rail industry's merger proposals. As stated by a union official in the NYT, "it's the worst case of an agency that has been captured by the industry it regulates."[97]

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[93] Joseph D. Kearney & Thomas W. Merrill, *The Great Transformation of Regulated Industries Law*, 98 Colum. L. Rev. 1323, 1394 (1998).
[94] Richard D. Cudahy, *Whither Deregulation: A Look at the Portents*, 58 N.Y.U. Ann. Surv. Am. L. 155, 161 (2001).
[95] Kearney & Merrill, *supra* note 93.
[96] Joseph D. Kearney, *Will the FCC Go the Way of the ICC?,* 71 U. Colo. L. Rev. 1153, 1194 (2000).
[97] Allen R. Myerson, *Transportation Board Ponders Planned Conrail Takeover*, N.Y. Times, June 3, 1998, at D8. (quoting an officer of the AFL-CIO).

There are several ways in which the rail industry can be said to have 'captured' the STB. First, the STB is a political body, so the rail companies have the potential to influence those who control the STB itself. The STB's three Board Members are appointed to five-year terms by the President and confirmed by the Senate, and are generally individuals with long experience in transportation policy, lobbying, and industry.[98] Such appointees are not immune from the political winds of the current administration or the influence of rail lobbying groups on Congress.

In addition, the rail companies have attempted to curry favor with politicians who have influence over the STB. Many politicians represent constituencies who are greatly affected by changes in the rail industry; for example, politicians from the Midwest, who represent large coalitions of farmers that rely upon the railroads to ship their goods. The rail industry has made great efforts to influence these politicians. For example, as the UP-SP merger was being considered by the STB, the UP contributed large sums of money to politicians who, based on the interests of their constituents, were projected to take a strong stance *against* the merger. One of these politicians, Bob Dole from Kansas, explicitly refused to take a position against the merger in front of the STB despite the fact that it was projected to hit some of his key constituents, Kansas grain farmers, particularly hard.[99]

Although it is difficult to *prove* the political capture of an agency, the signs are all there: a long history of political power for rail companies, large contributions to important politicians who have influence over the STB, and the fact that the agency itself is run by political actors

[98] *See* website of the Surface Transportation Board, *at* http://www.stb.dot.gov/stb/about/board.html.
[99] Richard W. Stevenson & Douglas Frantz, *POLITICS: THE CONTRIBUTORS; Kansas Opponents of Big Rail Merger Say Dole Ignored Them*, N.Y. Times, Sept. 23, 1996, at A13.

who have experience working in or with the rail industry. It is clear that the rail industry has the tools to capture the industry, and has made great efforts to do so over the past several decades.

These signs of political capture provide an explanation as to why, despite applying a legal standard which was similar to that of the DOJ, the STB was in fact biased toward the evidence offered by the rail companies during this merger proceeding. Their skewed treatment of the evidence had nothing to do with the standard the agency was supposed to apply: instead, the political power of a powerful rail lobby who wanted this merger passed might very well have influenced the STB's view of the evidence.

V. Conclusion

The above examination of the UP-SP merger reveals two main themes in the STB's analysis: the agency applies an 'antitrust-like' standard to mergers rather than the 'public interest' mandate assigned it by Congress, and it is deferential to the evidence proffered by the rail companies. This paper has concluded that neither this 'antitrust-like' analysis nor the deferential treatment of the companies' evidence is justified under the agency's Congressional mandate to apply a 'public interest' standard. Accordingly, the STB has violated their 'public interest' mandate, basically applying an antitrust-like analysis cloaked in the phraseology of the 'public interest' standard to the UP-SP merger.

As a result, the STB has essentially taken rail mergers out of the 'public interest' framework and placed them back in a more §7-like framework. The effect of this altered standard on the outcome of rail mergers is unclear, especially considering the skewed view of the evidence exhibited by the agency. What is clear is that, whatever the STB is doing, it is not what Congress intended for them to do when they established the agency in 1995.

In response to the STB's deviation from their mandate, Congress has several choices: it can change the 'public interest' standard, tightening it up so the STB is forced to weigh the five factors as established; it can disband the STB's merger division and place the railroads under §7 merger analysis; or it can do nothing. Since the approval of the UP-SP merger, Congress has largely chosen to follow the latter course of action.[100] Whether this inaction is a result of disinterest, lack of resources to consider this problem, or approval of the STB's final results is uncertain.

What is certain is that, regardless of the legal standard the agency applies, the STB itself may not have much work to do before long in the merger realm. Due to the spate of merger activity which followed the deregulation of the 1980s, there remain but two Class I railroads west of the Mississippi, and two to the East. What merging remains to be done in such a highly concentrated industry, if any, is therefore limited. In the end, this 'problem' may be solved because it, in effect, goes away.

[100] There has been some recent action in Congress on this issue, however. In 2005, Representative Green of Wisconsin presented a draft bill which proposed an amendment to the Clayton Act "to restore the application of the antitrust laws to rail carriers." H.R. 3318, 109th Cong. (2005).