Transportation

BNSF Rail

North American Railways—Signaling a New Urge to Merge?

A proposed merger between Burlington Northern Santa Fe Railroad (BNSF) and Canadian National Railroad (CN) would create North America's largest railroad, stretching 50,000 miles from Los Angeles to Halifax, Nova Scotia, and from the Gulf of Mexico to Vancouver, British Columbia. The new holding company, North American Railways, would surpass all other railroads in North America in revenue, miles of track, and number of employees.

The announcement on December 20, 1999, shocked nearly all rail industry observers, who generally believed that service-related problems stemming from recent railroad mergers in the U.S. had temporarily cooled the industry's merger fervor of the past 5-6 years. If the merger is approved by the U.S. and Canadian governments, the announcement may mark the beginning of a new "urge to merge" as other railroads in North America scramble to find partners.

BNSF currently operates one of the largest rail systems in North America with over 34,000 route-miles of track in 28 states and two Canadian provinces. The Canadian National Railroad (CN), the only transcontinental rail system in North America, is one of two large Canadian railroads and operates 16,000 route miles in nine Canadian provinces and 15 U.S. states. Until it was privatized in 1996, CN was owned and operated by the Canadian government. Both CN and BNSF railroads have diversified traffic bases consisting of coal, merchandise, grain, and intermodal shipments (containers or truck trailers carried on railroad flatcars). Principal interchanges between the two railroads are at Chicago, Memphis, Duluth/Superior, and Vancouver.

The international dimension of the merger promises to make it provocative among the general populace in the U.S. and Canada, based on its sheer size and potential for integrating railroad service and markets in both countries. But Canadian ownership and operation of rail lines in the U.S. is not new. Canadian Pacific acquired the Soo Line in the late 1980's, and last year Canadian National acquired Illinois Central, giving CN a direct route to the Gulf of Mexico. Three-quarters of CN's revenue is currently from U.S. operations and transborder shipments.

The proposed merger is primarily an "end-to-end" combination, which is less likely than a parallel combination to lessen competition. BNSF and CN will make this point when seeking approval over the next year. Reportedly, only 20 shipping points would see the number of direct rail competitors reduced from two to one.

The BNSF and CN assert several benefits from their proposed merger, most of which would stem from the ability to replace intercompany interchange of freight cars, and delays that result, with more efficient intracompany transfer of cars at interchange points. Thus, BNSF and CN could offer more efficient single-carrier through service to more points in the U.S. and Canada than before. Other potential benefits indicated by the carriers:

- integrated, seamless, single-rail service between Canada and the U.S. with a single invoice and a single account manager;
- enhanced intermodal service connecting eastern Canada with the U.S. Southwest and Pacific Coast points, and the Port of Halifax with the U.S. Southwest.
- more through service by avoiding crowded interchange yards such as Chicago where cars can sit for days;
- access to new markets for some BNSF-CN shippers—e.g., British Columbia forest product producers could ship via a single carrier into California and Arizona and into the lower Midwest and Southwest;
- direct, single-railroad line service to 30 states and Mexico for auto and auto parts manufacturers in Michigan and Southern Ontario, whose CN shipments have to be handed off to other western carriers at Chicago; and
- improved access for Canadian shippers into Mexico and for Mexican shippers to Canada.

Effect on Agricultural Trade

The proposed merger is likely to have little effect on total U.S. agricultural exports to Canada, the second-largest U.S. market, because most products in this trade are not transported by rail. In fact, 57 percent of the $9 billion of agricultural and

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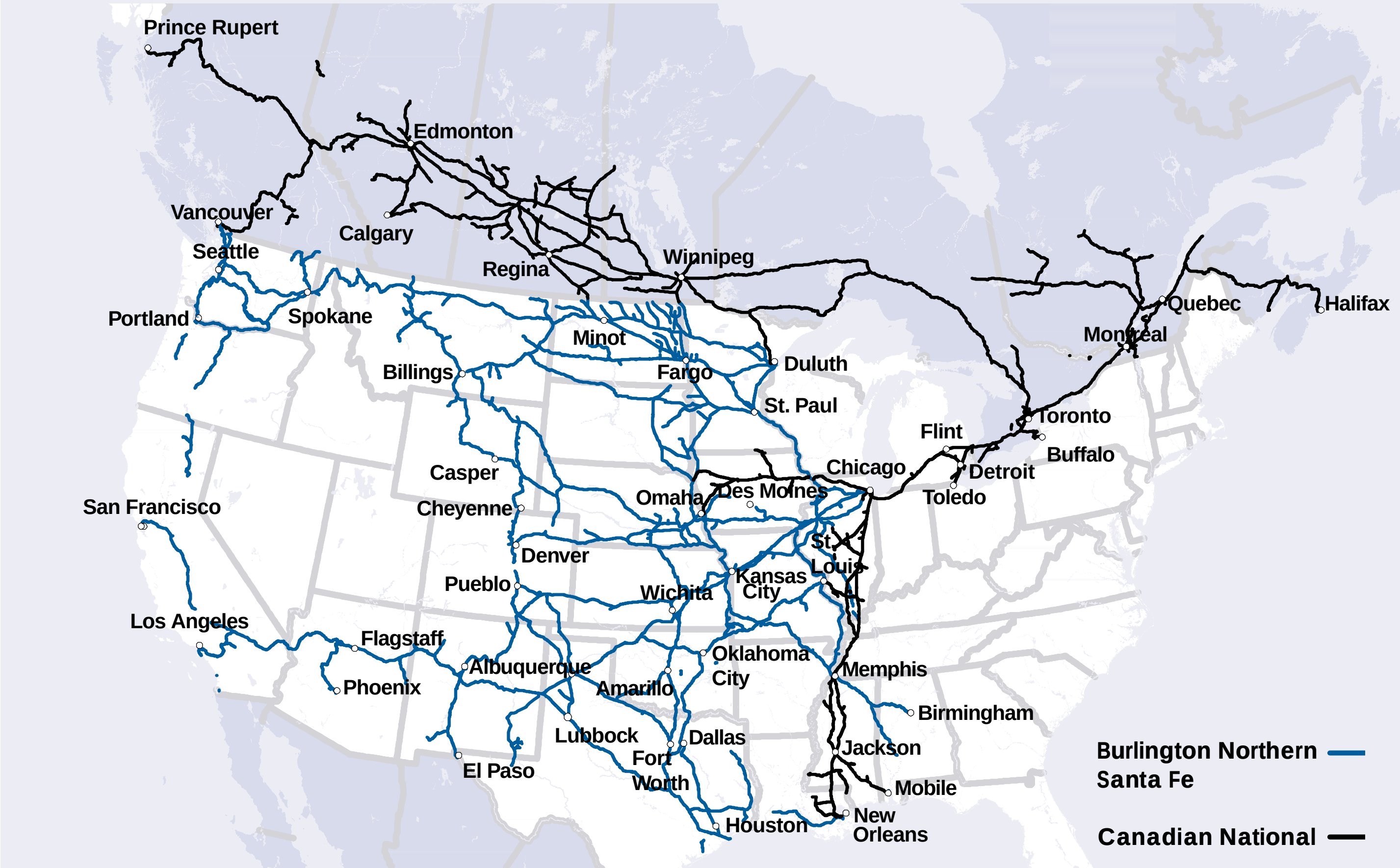
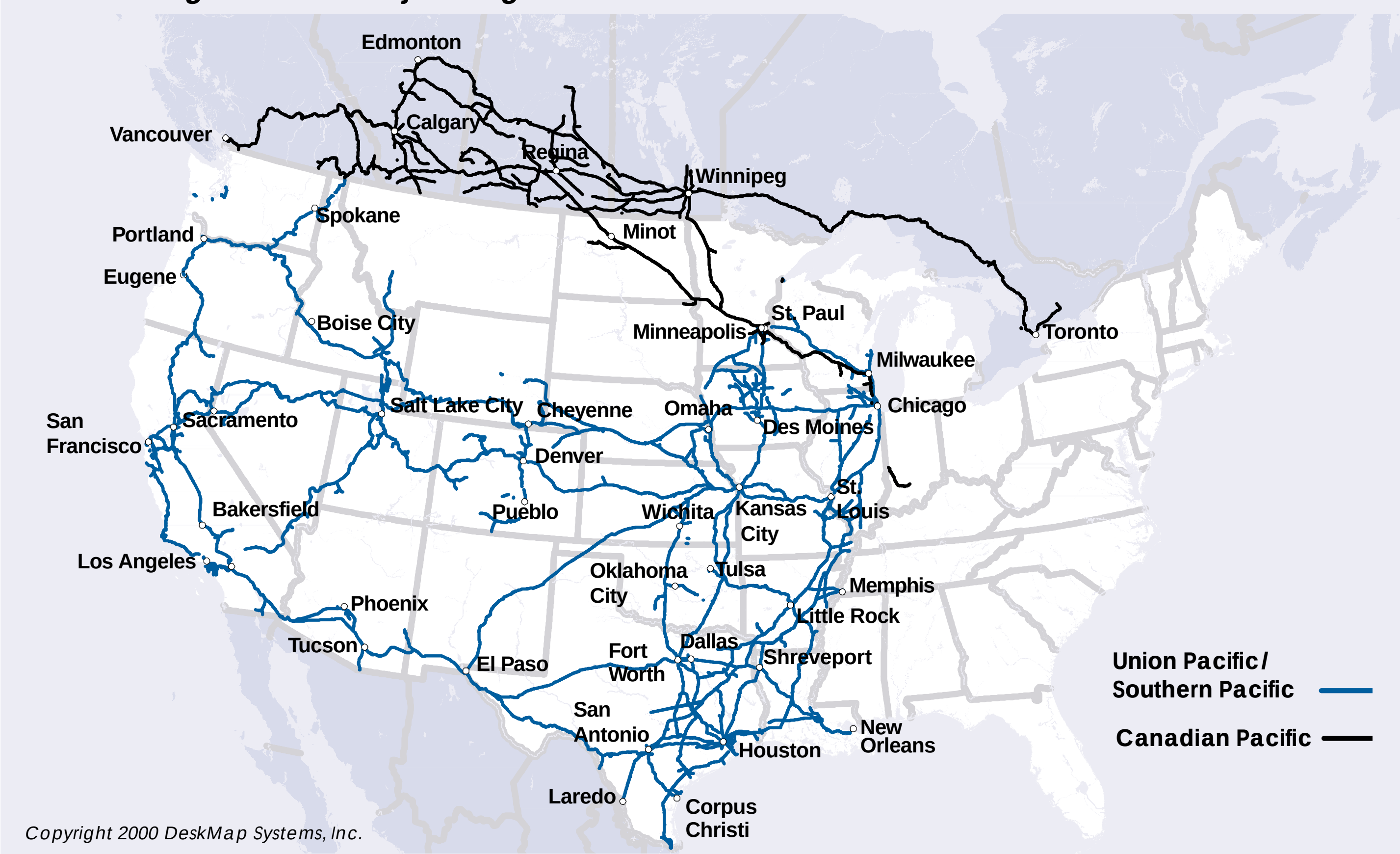
Proposed Merger Would Create North America's Largest Railroad . . .



. . . Dwarfing Two Other Major Merger Candidates



forest products shipped from the U.S. to Canada in 1998 consisted of items that almost always move by truck—fresh and processed fruits and vegetables, meats, dairy products, snacks, and other consumer-ready foods. Other commodities bring the "non-rail" market share to at least 75 percent. Only 6 percent of the value of U.S. agricultural exports to Canada consists of commodities that typically move long distances by rail (e.g., grain and forest products). Consequently, unless new markets develop as a result of the BNSF-CN merger, it should have no appreciable effect on U.S. agricultural exports to Canada.

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In contrast, products generally shipped long distances by rail dominate Canadian exports to the U.S. Because the proposed merger extends single-line rail service into Canadian production areas for forest and bulk agricultural products, it will likely increase these types of Canadian agricultural exports to the U.S. Forest products account for more than half of Canadian agricultural exports to the U.S. ($18.8 billion total in 1998), and bulk exports account for another 6 percent. Only 23 percent of the total were commodities shipped mostly by truck—fresh and processed fruits and vegetables, meats, dairy products, snacks and other consumer-ready foods.

Would the merger encourage the use of Canadian ports for exporting U.S. grain? Probably not, because the CN east-west route across western Canada is circuitous relative both to the more southern Canadian Pacific line and to the BNSF route to U.S. Pacific Northwest ports. Moreover, the BNSF currently has most westbound export movements from U.S. northern tier states locked up, and would be unlikely to compete against itself by promoting the routing of grain through Canada on the CN. Other factors mitigating the likelihood of U.S. grain moving to export via the CN are that Canadian grain handling costs are higher, capacity problems at the Canadian west coast have at times limited the quantity of exports, and grain exports at Vancouver are periodically disrupted by labor disputes.

The merger should also not significantly affect offshore Canadian grain exports, as long as Canadian export rail rates remain capped. Canadian grain for export is usually shipped at statutorily set railroad rates, not available to U.S. shippers, which are capped at just above variable cost. In contrast, railroads in the U.S. price in a more commercial environment at what the traffic will bear. As a result of these two radically different pricing environments, Canadian rail rates for grain movements to West Coast export positions are currently only 50-60 percent of U.S. rail rates for comparable movements out of the Pacific Northwest. Still, Canadian grain has occasionally moved through U.S. ports for export when logistical problems have arisen in Canada. Southbound movement of Canadian grain through the U.S. grain transportation system would be much more likely if railroads in Canada were ever allowed the pricing freedom of railroads in the U.S.

Finally, although grains and oilseeds comprise only 2 percent of the value of U.S.-Canada bilateral trade in agricultural and forest products, the merger should increase trade of these commodities by improving the efficiency of the rail linkages between Canada and the U.S., thereby lowering shipping costs. The largest single merger-related effect on U.S.-Canadian agricultural trade is likely to be on exports of Canadian forest products to the U.S., because of the magnitude of trade in this commodity and the importance of rail to its cross-border movement.

Potential Impacts On Trade Relations

As merits of the merger are debated over the next year, a number of implications are likely to concern U.S. agricultural interests. The merger, for example, could affect the relative trade advantage of U.S. and Canadian grain producers.

Specifically, U.S. producers and exporters are likely to perceive that the merger could heighten the ability of the Canadian Wheat Board (CWB), which has single-desk selling authority for wheat exports, to use its size and affiliation with the Canadian government to negotiate preferential rate and service packages with the BNSF-CN system to move Canadian grain into the U.S. While the historic involvement of the CWB in transportation is currently under review in Canada, a merged BN-CN system will certainly allow all Canadian grain shippers much greater and lower cost access to U.S. markets than before.

Examples of preferential rate/service packages negotiated for Canadian grain shipments into the U.S. are currently coming to light. Research by the Upper Great Plains Transportation Institute and other industry organizations indicate that Canadian Pacific rail rates from points in Canada to Minneapolis are currently as much as 20 percent or 18 cents per bushel lower than for similar or shorter distances on the CP from North Dakota to Minneapolis. Industry contacts indicate that these CP rate discounts for movement of Canadian wheat to Minneapolis were put in place by the CP in response to a similar rate package negotiated with Canadian National by the CWB. While the Wheat Board's actual involvement cannot be verified, this issue is certain to be raised in debate on the proposed merger.

U.S. agricultural shippers are also likely to be concerned about the timing of the proposed merger, as the U.S. rail industry and its customers are still recovering from a series of mergers that disrupted rail service. Rail service problems in the western and eastern U.S. that followed recent mergers, such as the Union Pacific/Southern Pacific merger (*AO* March 1998, December 1998) and the split of Conrail, have raised awareness among railroads, shippers, receivers, and government regulators of the potential for major service disruptions when two large railroads merge.

The control and influence such a large company would have over North American wheat exports is another area of concern among agricultural interests. Industry sources indicate that BNSF

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already controls over half of wheat movements in the U.S., and its share of high-protein hard red winter and spring wheat exports is even higher. CN is one of only two railroads in Canada moving Canadian wheat to export position, and has a 51- percent market share of all Canadian grain movements. When railroads service "captive" shippers, it is the railroad that determines when those shippers can participate in markets. U.S. agricultural interests will be watching how a combined BNSF-CN system would ration capacity among competing U.S. and Canadian grain shippers when demand for rail service exceeds supply.

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Finally, many shippers in the U.S. are likely to be concerned about the North American railroad structure following the BNSF-CN merger. Just five Class I railroads would remain in North America (Class I railroads have operating revenue of at least $259.4 million and together account for 71 percent of U.S. mileage operated, 89 percent of railroad employees, and 91 percent of freight revenue.) Other possible railroad mergers could be on the horizon. A followup combination between carriers such as Union Pacific-Southern Pacific and Canadian Pacific is not only likely but probable if the proposed BNSF-CN merger is approved.

The Next Steps

The proposed merger must be approved by stockholders of each company, by the U.S. Surface Transportation Board (STB), and by a Canadian court regarding compliance with Canadian regulatory requirements. In the U.S., both the BNSF and the CN are expected to file their formal merger application with the STB in March 2000. The STB has up to 30 days after the filing to issue a procedural schedule—a timeline that will guide participation of all parties in the proceedings. Under current law, STB review and evaluation of the merger can take up to 22 months after application, or a shorter period of time if merger participants petition for an expedited review. The BNSF and the CN have already petitioned the STB for a ruling one year after they file their merger application.

Because of likely followup mergers in the North American rail system in the wake of a BNSF-CN merger, the STB is reexamining its long-held policy of evaluating the proposed railroad merger at hand without considering the impact of other railroad mergers that would likely result. As a first step, STB has announced that it will hold a public hearing on March 8 on the subject of major railroad consolidations and the present and future structure of the North American railroad industry.

The proposed merger has cast renewed attention in the U.S. Congress on reauthorization of the STB as the U.S. regulatory body responsible for railroad oversight and on whether or not to increase STB legal authority to regulate railroads. Some members of Congress favor transferring regulatory oversight over railroad mergers to the U.S. Department of Justice, which adjudicates the merits of mergers, acquisitions, and consolidations under antitrust law for most other U.S. industries.

The issues in the proposed merger illustrate how business consolidations across national borders in key service sectors such as transportation can complicate trading relationships among countries. U.S. agricultural interests are likely to be hesitant about supporting the proposed combination for several reasons. Service problems stemming from past U.S. railroad mergers are fresh memories, and the net benefits to U.S. agriculture from the merger are likely to be small. Other concerns revolve around the interplay between the new railroad and the Canadian Wheat Board, and other North American railroad mergers that may follow if this merger is approved.

The proposed merger and potential followup mergers in North America are likely to make transnational ownership and operation of North American railroads a major transportation issue in both the U.S. and Canada over the next few years. AO

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March Releases—USDA's Agricultural Statistics Board

The following reports are issued electronically at 3 p.m. (ET) unless otherwise indicated.

March

1 Broiler Hatchery
2 Dairy Products
3 Dairy Products Prices (8:30 am)
Egg Products
Livestock Slaughter - Ann.
Poultry Slaughter
8 Broiler Hatchery
10 Crop Production (8:30 am)
Dairy Products Prices (8:30 am)
13 Turkey Hatchery
14 Potato Stocks
15 Ag Chemical Usage - Postharvest Applic.
Broiler Hatchery
16 Milk Production
17 Dairy Products Prices (8:30 am)
Cattle on Feed
20 Cold Storage
21 Chickens & Eggs
22 Broiler Hatchery
23 Agricultural Land Values
Catfish Processing
Hop Stocks
NASS Facts Newsletter (4 pm)
24 Cotton Ginnings (8:30 am)
Dairy Products Prices (8:30 am)
Hogs and Pigs
Livestock Slaughter
29 Broiler Hatchery
30 Agricultural Prices
Peanut Stocks & Proc.
31 Dairy Products Prices (8:30 am)
Grain Stocks (8:30 am)
Prospective Plantings (8:30 am)
Rice Stocks (8:30 am)