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INSIGHT

Canadian Railroads Competing to Acquire Major U.S. Freight Line

Updated September 2, 2021

Canadian Pacific Railway (CP) and Kansas City Southern (KCS), two of the seven Class I companies that handle long-distance U.S. rail traffic, announced a merger agreement in March. In April, another Class I carrier, Canadian National (CN), submitted what it termed a "superior proposal" to acquire KCS, which was accepted in May.

Either deal, if approved by shareholders and federal regulators, would be the largest consolidation of major railroads in several decades, and would create the first railroad network to serve Canada, the United States, and Mexico under a single corporate owner. While this could lead to better service for some shippers, it could also have adverse consequences for competition in freight transportation. Any transaction is likely to undergo lengthy review by the Surface Transportation Board (STB). On August 31, all five STB commissioners voted to deny CN's request to create a "voting trust" to hold shares of KCS, an arrangement that would have allowed CN to acquire shares while the merger is still pending before the Board. The decision follows President Biden's July executive order encouraging federal agencies to take steps to preserve competition throughout the economy. While STB's decision may or may not reflect the merger's prospects, it signals that regulators are considering the potential implications closely.

Background

CP and CN, both based in Canada, are among the survivors of the extended consolidation in the U.S. railroad industry, along with Union Pacific and BNSF in the western United States, CSX and Norfolk Southern in the East, and KCS running north-south through the middle of the country and into Mexico. Since the 1990s, only smaller carriers have changed hands. Potential mergers among Class I carriers—for example, CP explored a merger with CSX in 2014 and with Norfolk Southern in 2020—have triggered vociferous objections and have not come to fruition.

CP and CN both serve Canada from coast to coast, but also own railroads and trackage rights in the United States (**Figure 1**). Both carry significant traffic between U.S. points and Canadian ports. CN also controls a north-south freight corridor connecting Chicago to New Orleans, which it acquired in 1998. In approving that transaction, STB pointed to the importance of having KCS as a competitor in the same markets. KCS, meanwhile, controls around 6,700 miles of track in the United States and Mexico,

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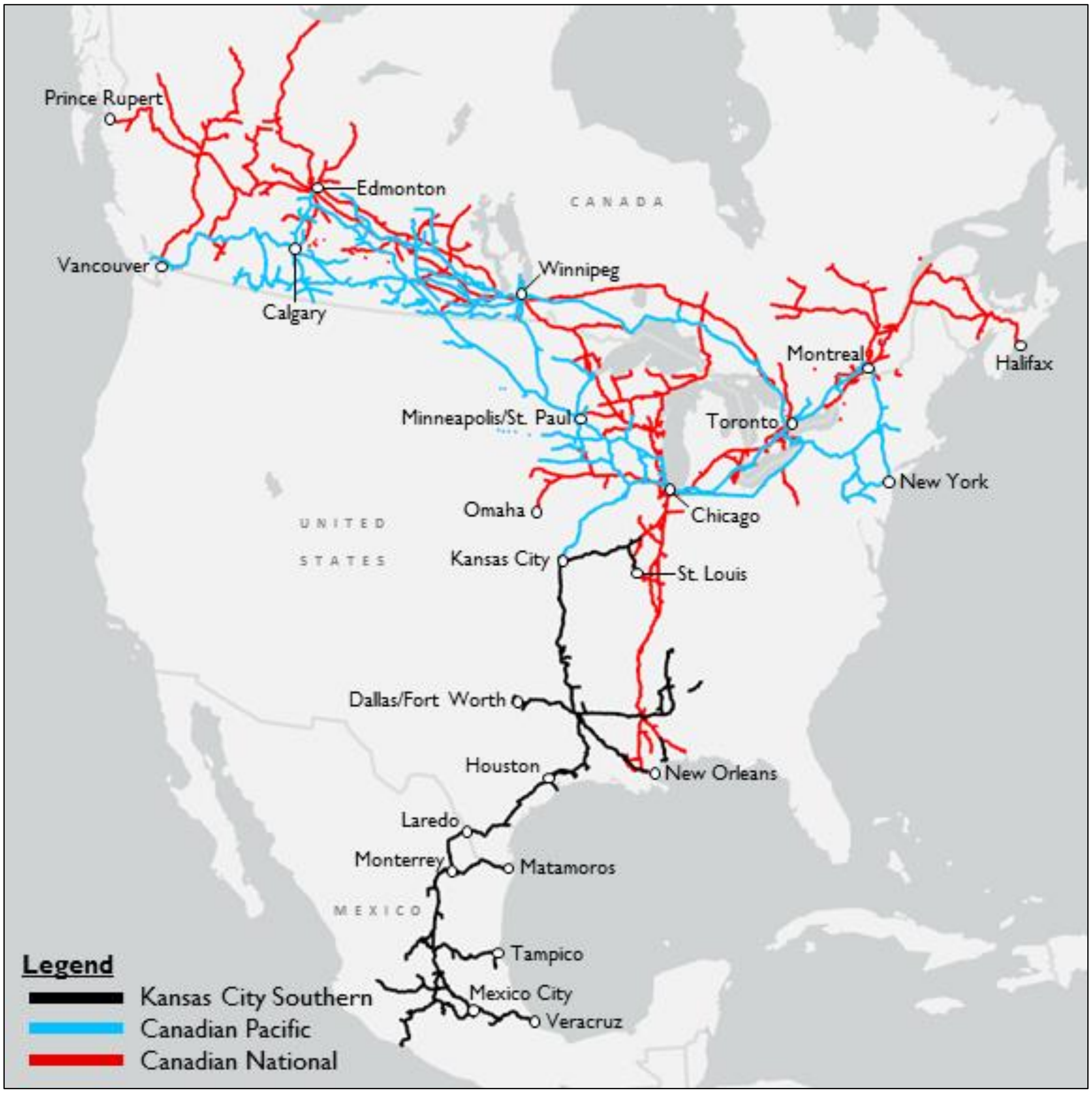
IN11671

connecting Mexico's Pacific coast with ports in Texas and Louisiana, and destinations as far inland as Kansas City and St. Louis. Some traffic from Mexico is handed off to railroads other than KCS for part of its journey in the United States.

Figure 1. CN, CP, and KCS Systems



Source: CRS, using data from U.S. Department of Transportation Bureau of Transportation Statistics.

Note: Includes certain trackage and haulage rights.

One reason for interest in KCS is the uncertain future for pipeline projects linking Canadian oil and gas fields with Gulf Coast refineries and ports. With new pipeline projects stalled, railroads may assume a greater role in transporting oil and gas for refining and export. Concerns over trains carrying hazardous materials have yet to generate notable opposition to the merger, but could come to light during the environmental analysis phase of the STB evaluation process.

STB Merger Rules

Any merger involving more than one Class I railroad is automatically considered a “major” transaction subject to the highest level of STB scrutiny. KCS and CP had targeted mid-2022 for completion of their merger, and it is unlikely CN would be able to complete a deal with KCS any faster. However, when STB adopted stricter merger regulations in 2001, it granted KCS—the smallest of the Class I railroads—a waiver that allows it to meet pre-2001 standards in the event of a merger. The reasoning at the time was that KCS was small enough that its involvement in a merger would present fewer anticompetitive effects than a merger between two larger railroads. As a result, KCS and its proposed merger partner must demonstrate to STB that the level of competition would remain unchanged following the transaction, whereas mergers among other Class I carriers will be approved only if they can demonstrate that competition would be *enhanced* as a result.

On April 23, STB affirmed that it would allow KCS and CP to invoke this waiver, noting that the combined system would still be the smallest Class I railroad based on U.S. operating revenue. The end-to-end, as opposed to overlapping, nature of the merger also influenced the board’s decision. However, the potential overlap in the north-south market factored into STB’s May 17 decision to apply the newer set of rules in CN’s case. (A combined KCS-CN system would become the third-largest Class I railroad.)

Potential Economic and Competitive Implications

KCS is one of the two largest railroads in Mexico and the only one that connects to all other Class I railroads. (KCS-owned tracks in Mexico and the United States are noncontiguous, separated by a short segment owned by Union Pacific and used by KCS under a trackage rights agreement.) Its network allows KCS to play an important role linking Mexican manufacturers—notably in the automotive sector—with customers anywhere in North America. If either CP or CN were to gain control of KCS, it could result in unequal terms for competing railroads seeking to preserve access to Mexican markets and manufacturers.

A combined CP-KCS railroad system would have a T shape on the North American map, similar to CN. If CN were to acquire KCS, it would effectively eliminate a competitor for north-south shipping between the Midwest and Gulf Coast. These connections are especially important for grain producers in the upper plains states and the fossil fuel refineries on the Gulf. Groups representing many customers in these industries have voiced their support of a merger with CP in letters submitted to STB; a merger with CN has received many letters of support as well.

The merger is not likely to affect passenger service to as noticeable an extent, as KCS is not a major host of Amtrak traffic.

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