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Recent Railroad Merger Activity

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U.S. DEPARTMENT OF AGRICULTURE

Growth Through Agricultural Progress

Reprinted from
The Marketing and Transportation Situation
July 1961

RECENT RAILROAD MERGER ACTIVITY 1/

> Many of the nation's railroads are striving to consolidate their operations. Efforts to merge, intensified since 1957, have been spurred by a continued decline in the rail share of total traffic and by decreases in revenues. Net operating income of railroads has declined in recent years. Through mergers railroads hope to achieve substantial operating economies. These economies, they claim, would permit them to provide better service to shippers. Some mergers may improve service by eliminating time-consuming switching at interchange points. Some shippers, however, may be adversely affected by the reduction or elimination of services where parallel routes are merged. Rate reductions also are a possible result of mergers, but these may be prevented by failure to achieve economies and protests of competing carriers.
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> In the past, regulatory bodies have sought to preserve competition between rail lines as a means of preventing discriminatory pricing practices. Merger proponents, however, contend that competition between different forms of transportation now provides sufficient competition to prevent injurious monopolistic practices. They point to economies attainable by eliminating duplicate facilities and services.
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> Unless the Interstate Commerce Commission changes its present attitude, extensive consolidation of railroads seems likely.

From 1957 to June 1961, the Interstate Commerce Commission approved 7 mergers involving 17 rail lines. As of April 1961, another 11 proposed mergers involving 30 lines were awaiting approval by either the ICC or stockholders of the companies involved, being prepared for presentation before the ICC, or undergoing preliminary study before presentation to stockholders. This degree of merger activity on the part of the railroads has not been evident since shortly after 1900.

Why this resurging interest in mergers and consolidations? What is the attitude of the national regulatory and legislative bodies toward this trend? How will mergers affect the national transportation scene? Of what importance are mergers to the nation's agricultural economy? These questions are only a few of the many that come to the fore.

In this discussion the terms consolidation and merger are used interchangeably; each is used to denote any unification of properties under single corporate management.

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Mergers and Agriculture

Railroads are an integral part of the agricultural transportation pattern. In 1959, railroads carried 1.2 billion tons of freight, about 13 percent of which was classified as products of agriculture. Much of the remaining tonnage was of indirect interest to the farmer, either as farm supplies or as materials used in producing consumer goods for the farmer.

Although their importance has declined in recent years, railroads remain the primary mover of many agricultural products. A recent study of grain transportation from midwestern country elevators showed that railroads hauled 68 percent of the grain moving from these elevators in 1958.

Available records indicate that railroads carried 70 percent of the fresh fruits and vegetables shipped by rail and truck from California and Arizona in 1959. The percentage moving by rail from these States to population centers east of the Mississippi River is even higher, more than 90 percent to some markets.

Any improvements in service resulting from mergers, with no accompanying increase in rates, would be welcomed by many shippers of agricultural products. Shippers of perishable products are especially interested in fast, dependable service. Any improvement, regardless of the enabling factors, is likely to be looked upon with favor.

In the past, shippers of bulk agricultural commodities such as grain were not so much concerned with speed of delivery; they often utilized such privileges as diversion and reconsignment to their benefit. Today grain shippers are more interested in rapid delivery, which insures quicker financial settlement and more rapid inventory turnover.

Thus, directly or indirectly, the nation's farmers have a valid interest in merger proceedings. Railroads serving the midwestern "breadbasket" have been among the most active proponents of consolidation. Mergers accomplished since 1957, along with those proposals presently before the ICC or being prepared for presentation, affect virtually every section of the nation. This means that at some stage of the journey from producer to ultimate consumer farm products are likely to move over trackage affected by merger proceedings.

Conditions Leading to Present Merger Efforts

In its annual report for the fiscal year 1958 the Interstate Commerce Commission noted that economic conditions in the railroad industry had given impetus to plans for consolidation and merger. 2/

In 1958 the operating revenues for Class I line-haul railroads totaled $9.6 billion, about 9 percent less than the revenues for 1957 and 5 percent below the average operating revenues for the period 1954-58. Railroad operating expenses were slightly lower in 1958 than in 1957, but not proportionately so. Operating expenses in 1958 equalled 78.87 percent of operating revenues, the highest ratio since 1949.

Class I and II companies reported a net railroad operating income of $772.9 million in 1958. This income was 17 percent less than for 1957 and 20 percent under the average net operating income for the 5 years ending in 1958. Railroad income from other sources rose slightly above the previous year's total, but increased capital investment, fixed charges and other deductions brought the net in-

2/ Interstate Commerce Commission, 72nd Annual Report, p. 53.

come for Class I and II companies down to $630 million, about 18 percent less than the net income for 1957 and 21 percent under the average net income for the years 1954-58.

By 1960, the financial plight of the railroads was even more pronounced, particularly for those in the eastern United States. The continuing passenger service deficit poses a serious financial problem for these railroads; many have a large volume of commuter traffic. Net operating income for Class I railroads was $584 million in 1960, down 22 percent from 1959 and 29 percent below the average for the 5 years 1956-60. For each of the years 1957-59 the ratio of debt to capital for intercity railroads and their lesser subsidiaries was 54 percent or more, higher than for any year since 1941.

In order to improve their position the railroads needed to increase their revenue to meet rising costs or decrease their costs to gain more net income. The increased competition from other modes of transportation made it unlikely that the railroads could raise their revenues by increasing rates. Their decreased revenues were traceable, in part, to their failure to share proportionately in the overall growth of the transportation industry. Each year competitive transport modes were hauling a greater share of the total volume of goods moved. Any increase in rates would only accentuate this trend. The railroads turned to mergers as a means of achieving operating economies and reducing overhead expenses, thus improving their economic position.

During the decade ending in 1958, the national volume of freight moving in intercity traffic increased 38 percent, from a volume of 882.9 billion ton-miles in 1949 to 1.2 trillion ton-miles in 1958. For the same period, the railroads intercity ton-mileage rose only 5 percent. Their share of the national total fell from about 60 percent in 1949 to 46 percent in 1958. Trucks hauled 21 percent of the traffic in 1958, compared with 11 percent in 1949. The volume hauled by trucks in 1958 was 163 percent greater than in 1949.

Differentials in rate of growth have become even more pronounced since 1958. The nation's interstate highway system has undergone extensive improvement, thus offering faster and more direct highway routing. Older water routes have been improved and new water routes have been opened.

An ICC study, "Fluctuations in Railroad Freight Traffic Compared with Production," shows that rail tonnage at the end of the 1947-57 decade was only 74.3 percent of the "potential." Potential tonnage is defined as the volume which would have been carried if the railroads had maintained their relative 1947 position as carriers of freight originating from production in this country. In 1957 they moved 28.5 percent of the total tonnage produced, compared with 42.5 percent in 1947. The report indicated that in 1957 the railroads hauled 75.2 percent of their potential traffic in products of agriculture.

Advantages and Disadvantages--Railroads and Public

Rail lines do not enter into merger proceedings unless they are confident they will benefit. Thus, careful studies of proposed mergers are made before any definite action is taken. (Indeed, one road conducted a study to see if a merger study should be made.)

There are two general types of consolidation. Parellel mergers join lines serving basically the same territories, often with common terminal and junction points. End-to-end mergers join roads with few common operating points other than at or near their extremities.

Of the two types, parallel consolidation offers more immediate advantages to the carriers. This type of merger affords a choice of routes and terminal facilities, of which the most efficient may be retained. Duplicate services, lines, and facilities may be discontinued or de-emphasized. End-to-end mergers offer less opportunity for savings of this nature; any savings effected are most likely to be derived from reduction of personnel through economies of scale. Other savings may be achieved by more efficient and economical use of motive power and equipment over the longer through routings made possible by consolidations.

In either type of consolidation, advantages may accrue from the economy of large-scale operation. Management, supervisory, maintenance, and sales forces may be consolidated and eventually reduced. Repair and maintenance facilities may be centralized. Traffic and accounting activities may be combined.

In a report to a Senate Transportation Study Group, railroad interests pointed out the following advantages as likely to benefit the public: "(1) Shorter and more direct railroad routes; (2) simplified and more efficient terminal operations; (3) faster and more dependable service; (4) greater availability and utilization of motive power and freight cars; and (5) a sound railroad industry which will perform its part in preserving a national transportation system . . ." 3/ In order for the public to receive these advantages, the railroads will have to attain corresponding benefits from any merger.

Disadvantages to be evaluated in any such merger proposal include such items as: (a) Actual expense of accomplishing the merger; (b) cost of labor protection under the terms of Section 5(2) of the Interstate Commerce Act; and (c) opposition from labor groups, individuals, industries, or communities that believe they will suffer because of the merger.

A primary obstacle to mergers is the uncertainty of obtaining the benefits propounded by merger advocates. Initial expenses are a certainty, whereas the expected savings are problematical. If a weak line joins a strong line the cost of improving facilities and service may absorb most or all of the potential economies.

Other railroads often oppose merger proposals, largely to prevent the loss of interchange traffic but also to limit the flexibility and strength of their competition. Opposing roads may either try to join the merger or limit it if they cannot prevent it.

Advocates of consolidation cite eventual rate reduction as a possible benefit to shippers. However, competing carriers often object to and may prevent these reductions. Some 5,900 protests were filed against 5,600 rate adjustments proposed during the fiscal year 1959 by six classes of carriers responsible to the ICC. Of the adjustments proposed, 5,331 represented reductions and of the protests, over 99 percent came from carriers--type against type and within type, carrier against carrier. 4/ Only two-thirds of the 1,174 rail rate adjustments proposed in 1959 became effective. For the fiscal years 1956-60 more than 4,000 rail rate adjustments were proposed, of which less than 65 percent were put into effect. Thus, one out of every three proposed reductions failed to become effective. In an instance where a merger involved directly competitive lines the combination could conceivably eliminate some of these protests; however, other lines serving the same area might be even more prone to protest any reduction.

As previously mentioned, railroad interests have cited merger benefits likely

3/ Association of American Railroads, Consolidation and Merger in the Transportation Industry, report to the Transportation Study Group under S. Res. 29., Feb. 1960.

4/ Boyd, Richard M., The Users' Need for Effective Transportation, Speech before National Transport Institute, Chicago, Illinois, Jan. 18, 1961.

to accrue to the public. Along with these specifics, they have indicated that the shipping public could benefit from any savings realized by component lines of a merger. Such savings would enable greater capital expenditures for better service, and these expenditures would be made necessary by the intense competition of other forms of transportation.

Most shippers stand to gain more from end-to-end consolidation than from merger of parallel and competitive carriers. Longer through routings would eliminate the time-consuming switching at interchange points and give the shipper faster, more dependable service.

Labor-force reduction, relocation of some maintenance and terminal facilities, and elimination of other maintenance and terminal facilities are byproducts of a successful merger which will necessarily harm segments of the general public. It is likely that traffic would be concentrated along the most efficient and economical routes, resulting in better, more economical service. However, this could lead to poorer service being offered along the more inefficient routes. Problems of this nature must be weighed by the ICC in their decisions as to what best protects the interest of the public.

Historical Background

The railroad consolidation movement began almost immediately after the formation of the first railroad companies but was most active during the period after the Civil War and prior to the economic depression of 1893.

Legislative bodies and the general public felt that such consolidations could lead only to eventual elimination of competition, the protector of the public from ruinous monopoly. The Interstate Commerce Act of 1887 incorporated these views. Section 5, apparently drawn up to help preserve competition, prohibited pooling agreements between rail carriers. This slowed the merger pace. The application of the Sherman Anti-trust Act to railroad combinations virtually halted consolidation after the early 1900's. 5/

In 1920, the legislative attitude toward consolidation was seemingly reversed. The Transportation Act of 1920 amended the ICC Act of 1887 and instructed the Commission to ". . .prepare and adopt a plan for the consolidation of the railway properties of the continental United States into a limited number of systems. . .competition shall be preserved as fully as possible and wherever practicable the existing routes and channels of trade and commerce shall be maintained. . ." 6/

These systems were to be established so that, insofar as possible, costs, property values, and rates of return on each system would be equitable.

In 1929 the Commission published the "Complete Plan of Consolidation" (159 I.C.C 522). Under this plan any consolidation effected had to: (1) Conform to the system outlined in the plan, and (2) be in the public interest. Rail lines could not be forced to consolidate, but any proposed consolidation had to adhere to the provisions of the Transportation Act of 1920.

The Commission's ruling that any true consolidation could not be authorized until after publication of its complete plan limited the number of mergers effected during the 1920's and 30's. 7/ Only four actual mergers or consolidations involving 17 railroads were accomplished under the Transportation Act of 1920. 8/

5/ U. S. v. Trans.-Missouri Freight Association, 166 U. S. 290 (1897) and 171 U. S. 505 (1898); Northern Securities Case, 193 U. S. 197 (1904).

6/ Interstate Commerce Act, Section 5(4). (Feb. 28, 1920, c. 91, sec. 407, 41 Stat. 481.)

7/ Control of the Big Four by New York Central, 72 I.C.C. 96 (1922).

8/ Leonard, W. N., Railroad Consolidation Under the Transportation Act of 1920, (New York, Columbia University Press, 1946), chapter VIII.

The Emergency Transportation Act of 1933 (48 Stat. 211) placed significant emphasis upon consolidation. While the Act of 1920 was designed mainly to equalize the rate of return for all systems and preserve the weak lines, the Emergency Act sought to reduce costs and increase the efficiency of service. A Federal Coordinator of Transportation was appointed and granted authority to investigate and recommend action to prevent wasteful duplication in service. 9/ The Emergency Act amended the Interstate Commerce Act to the effect that any form of combination was held to be legal when approved by the Commission, such approval to be premised on the combination agreeing with the plan for consolidation and promoting the public interest. 10/

The Transportation Act of 1940 (54 Stat. 898) was enacted as a result of hearings instituted by Congress to examine the position of other transportation media in the national transportation scene. This Act relieved the Commission of its obligation to formulate and effect a plan of consolidation and established the statutory provisions which now control merger and consolidation. For the first time, a national transportation policy was stated and incorporated as part of the Interstate Commerce Act. 11/ The aim, "to promote safe, adequate, economical, and efficient service and foster sound economic conditions in transportation . . ." has proved an important factor in later merger and consolidation developments.

Present Statutory Provisions

As amended by the Transportation Act of 1940, the Interstate Commerce Act leaves initiation of merger proceedings up to the rail lines concerned. The Interstate Commerce Commission has authority to approve or disapprove any proposal, in accordance with the criteria outlined below after hearing all interested parties, including protestants.

Part I, Section 5 of the Interstate Commerce Act regulates any joining together of railroads in any form of pooling arrangement; consolidation or merger of properties into one corporation; joint purchase, lease, or contract agreement, or acquisition of control through stock ownership. Section 5(c) states: "In passing upon any proposed transaction... the Commission shall give weight to the following considerations, among others (1) the effect of the proposed transaction upon adequate transportation service to the public; (2) the effect upon the public interest of the inclusion of, or failure to include, other railroads in the territory involved in the proposed transaction; (3) the total fixed charges resulting from the proposed transaction; and (4) the interest of the carrier employees affected."

Section 5 includes two other provisions which often have direct bearing on whether or not a merger proposal is approved. Section 5(2) grants the Commission authority " . . . to require upon equitable terms the inclusion of another railroad or other railroads in the territory involved, upon petition by such railroad or railroads requesting such inclusion and upon a finding that such inclusion is consistent with the public interest." Section 5(2) (c) further provides: "No transaction shall be approved which will result in an increase

9/ The Coordinator's recommendations might include enforced consolidations. However, he could not issue any orders which would reduce the number of employees in service, or adversely affect employees' compensation (48 Stat. 212, 48 Stat. 214, and 48 Stat. 216).

10/ The Emergency Transportation Act of June 16, 1933, c. 91, Title II, secs. 201 and 202.

11/ 54 Stat. 899 (Sept. 18, 1940).

of total fixed charges, except on a specific finding by the Commission that such increase would not be contrary to the public interest."

It should be noted that the public interest is a vital factor to be considered in any ICC decision regarding consolidation. The protection of the public has been a part of railroad legislation since the Granger Laws were enacted. Changes in legislative policy over the years have paralleled changes in legislative and regulatory viewpoints as to what best protects the public interest.

Regulatory Attitude and Future Prospects

In the mid-1950's, legislative and regulatory bodies became more conscious of the changed competitive situation in transportation. The Secretary of Commerce described the situation in 1954 thus: ". . . the monopoly element which once characterized our public transportation and which prompted much of our present transportation policy has been replaced for all practical purposes by a highly competitive system." 12/ In 1955, a presidential advisory committee said in its report: "The net result is a competitive system of transportation that . . . has eliminated the monopoly element which characterized this segment of our economy some thirty years ago." 13/

The Commission indicated a changing attitude in its report on a merger case in 1957. 14/ The report stated: "With the construction of new highways, referred to by some as 'expressways' and others as 'freightways', the competition of the railroads from motor carriers will be enhanced. Without doubt, the possibility of faster truckline schedules will disadvantageously affect the ability of the railroads to compete with them, particularly with respect to the more lucrative traffic.

"The foregoing reflects how imperative it is for the railroads to do everything in their power to enhance their competitive situation through all possible economies and efficient operations. The proposed merger is designed to accomplish that result."

Later in the same report, the Commission, noting that the effect of the transaction upon competition was an important aspect to be considered and recognizing that the proposed merger would reduce competition throughout the affected area, stated that this fact did not preclude its approval of the merger. The report designated the Commission's task to be "to estimate the scope and appraise the effects of the curtailment of competition which will result . . . 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."

It is possible that the recognition by railroad management of this change of attitude by regulatory bodies contributed almost as much to the intensified merger activity since 1957 as did the economic status of the railroads.

From recent consolidation hearings and decisions, it may be seen that the ICC has come to think more and more along the

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12/ The Honorable Sinclair Weeks, Statement before a Subcommittee of the Committee on Interstate and Foreign Commerce of the House of Representatives, Sept. 19, 1955.

13/ Revision of Federal Transportation Policy, A report to the President prepared by the Presidential Advisory Committee on Transport Policy and Organization, April 1955.

14/ Louisville and Nashville Merger case, 295 I.C.C. 457 (1957) p. 468.

lines first expressed in the Louisville and Nashville Merger case of 1957. An ICC decision approving a 1959 consolidation of eastern railroads indicates that public interest is no longer considered to be as adversely affected by reduction of competition among railroads as before, since other forms of transport are likely to provide strong competition. 15/

For western railroads, however, barge competition is not present and their typical movement is of such length that they have an inherent advantage over motor carriers. Thus, they are affected less by motor carrier competition than eastern railroads.

In pointing out that the merger would result in a larger, stronger company, better able to meet the challenges faced by the railroad industry, the decision stated, ". . . the position of the railroad has deteriorated steadily in recent years with the accelerating transportation revolution."

It is of particular interest to note that this decision is a reversal of the Commission's decision on an application for combined operation of the same railroads 34 years previously. In 1926 the Commission refused the application on the grounds that competition would be lessened and an injurious monopolistic situation would be created. 16/

In each of three mergers approved late in 1960, 17/ the Commission's statements were strikingly similar in one respect: In each instance it was noted that the merger in question would provide improved service to shippers served by each of the railroads involved. This would seem to indicate that the "public interest" is now considered to be best provided for by improved service and other tangible benefits, rather than by preservation of competition.

Competition is no longer the sole criterion for evaluating consolidation. Current national and industry needs call for maximum efficiency in the performance of the transportation function. Recommendations have called for elimination, in the long run, of redundant capacity in any form of transport. The need for more rapid progress in the economic upgrading of the railroad system has been cited. 18/

Today, a primary criterion for evaluation of any merger proposal with respect to the public interest appears to be the contribution it can make toward concentration of capital investment upon such routes to accomplish major improvements and subsequent elimination of unnecessary trackage and facilities.

More recently, the "Doyle Report" 19/ has called for major revisions in the present national transportation policy toward consolidation. The removal of

15/ ICC Fin. No. 20599, Norfolk and Western Railway Co.--Merger, Etc.--Virginian Railway Co.

16/ Control of Virginian Railway, 177 ICC 67.

17/ ICC Fin. No. 20707, Erie Railroad Co.--Merger, Etc.--Delaware, Lackawanna, and Western Railroad; ICC Fin. No. 2115, Chicago, and Northwestern Railway Co.,--Purchase Etc.--Minneapolis and St. Louis Railway Co.; ICC Fin. No. 21108, Duluth South Shore and Atlantic Railroad Co.--Merger--Minneapolis, St. Paul and Sault Ste. Marie Railroad Co. and Wisconsin Central Railroad Co., Issuance of Securities, Etc.

18/ Williams, Ernest W. and Bluestone, David W., Rationale of Federal Transportation Policy. U. S. Department of Commerce, Wash., D. C., April 1960, pp. 3 and 69.

19/ U. S. Congress, National Transportation Policy, Preliminary draft of a report prepared for the Committee on Interstate and Foreign Commerce, 87th Congress, 1st Session, January 3, 1961.

legislative obstacles, so far as possible, is cited as the first consideration of national policy: "Such concepts as preserving competition as far as possible or avoiding a substantial lessening of competition and the preservation of existing trade routes must be abandoned in the light of intensive competition of other modes and a national need for revamping the traffic flow along the direct main routes." The report further states: "Rail monopoly should result in areas where rail traffic will not support intramodal competition."

Since early 1961, more national attention has been focused on the merger issue than at any time since the revocation of the Transportation Act of 1920. Congressional leaders have pointed with alarm to the possibility that areas of the nation will be left with inadequate rail service. Labor groups are speaking out more strongly against the current surge of consolidations, citing that 200,000 railroad jobs will be lost if mergers now pending are approved by the Commission. Railroads with no present merger prospects are demanding to be included.

Resolutions to slow down the merger trend have been introduced in both houses of Congress. The resolution pending in the House of Representatives would suspend the authority of the ICC to approve any merger for 20 months. During this time the ICC would study which railroads should be merged.

The Senate resolution does not put any restriction on merger approvals, but it does urge the Commission to act with caution and deliberation on merger approvals.

In an effort to answer this tide of criticisms, real and implied, the ICC is beginning a study to gauge the impact of mergers on the nation's economy, on the shipping public and on the railroads economic structure. The results of this study may well plot the future course of the railroads.

The Department of Justice has declared an interest in all merger proceeding which would result in elimination of rail competition. It is investigating to determine if such consolidations would lead to a monopolistic stituation harmful to the public interest. As previously indicated, the ICC has stated its belief that competition from other transport modes limits the inherent dangers of a one-line monopoly of rail transportation.

It appears that the merger movement is just now getting fully underway. In the coming years, there promises to be an extensive realignment of railroad organization and management as we know it today. Unless the studies now underway and the protests directed to the ICC cause the Commission to change its present position, there will be fewer railroad systems in the future.

Mergers are not the sole answer to the many problems and questions facing the railroad industry. At least two broad categories of problems will remain: (1) The rate of adoption of technological innovations in the future will affect the ability of railroads to compete with trucks and water carriers. Mergers may or may not alter the institutional framework for adopting innovations. (2) The trend toward regional self sufficiency within the United States in production and distribution of some products and goods will tend to reduce the average length of freight haul and railroads have their greatest comparative advantage in long-haul freight traffic.