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Short Line Railroad Creations: Terms of Sale, Impacts on Viability, and Public Policy Implications

*by Jon H. Mielke**

INTRODUCTION

"The railroad industry is in the midst of an unprecedented period of restructuring and rationalization. Over 30,000 miles of light-density branch lines, secondary main lines, and primary main lines have already been abandoned or sold to regional railroads by Class I carriers. During the next few years, an additional 20,000 to 25,000 miles might well be sold to regional operators."[1]

Rail lines sales are precipitated by one of three factors: abandonment, divestiture, or the desire to establish a low cost feeder system. Depending on the seller's motives, sales transactions may include terms, conditions, or incentives to influence subsequent operations. The objective of this study is to identify common sales provisions and to discuss the impacts that they have on new carriers.

This study relied on mail surveys, personal and telephone interviews, and secondary sources of information to determine if, when, and how sales are structured to influence the new carriers' operations. Seven of the eleven major railroads that are active in short line and regional trackage sales and 32 short line and regional carriers responded to a survey concerning sales motives and how sales agreements may be designed to influence subsequent operations. Additional primary information was gained from personal and telephone interviews and public presentations by rail industry personnel, regulatory officials, and transportation attorneys and consultants. Secondary sources of information included government publications, trade journals, and special published reports.

Before discussing actual contract terms and related incentives, this paper presents a brief historical review of short line creations and sales motives. The rationale behind a sale may influence the selling price, subsequent operations, and viability. Later sections discuss some of the conditions and incentives used by selling carriers to influence buyer operations. This discussion will consider some of the legal questions surrounding the imposition of conditions and impacts that these conditions may have on the viability of new carriers. The final section summarizes the preceding sections and presents public policy questions concerning "structured" short line sales.

HISTORICAL PERSPECTIVE, MOTIVES, AND PRICE

There has been a proliferation of short line and regional railroad creations since 1970. As Figure 1 on the following page illustrates, Federal Railroad Administration (FRA) records show that there were nearly as many short line starts in the 1970's (44) as there were in the forty years between 1930 and 1969 (49). The pace has quickened even further since then; another 157 short lines were formed between 1980 and mid-1987.[2] The ICC's estimates are even higher; they indicate that over 190 short line and regional railroads have been started in the 1980's.[3] (This paper uses the term "short line" to describe both short line and regional carriers.)

Carriers formed since 1970 currently operate over 12,000 miles of track.[4] Virtually all this track was previously owned and operated by Class I railroads and was sold to new short line and regional roads. Table 1 defines Class I carriers that sold significant amounts of track between 1970 and October 1, 1986.

As indicated in the Introduction, railroads sell track to short lines for one of three reasons: 1) the property has been or is expected to be abandoned, 2) the seller is divesting itself of rail property (i.e. bankruptcy-related sale) or 3) the seller is attempting to establish a low cost feeder system. These three scenarios will be discussed in the following subsections.

Abandonment

Abandonment-related trackage is unprofitable or marginally profitable for its owners. Economic realities force the owners to liquidate the track, traditionally via abandonment but more recently by sale to short lines. The short line alternative is more desirable to the owner since the property can be sold in its entirety without associated salvage costs and the expense of selling land parcel by parcel. In addition, the new carrier may be able to originate traffic that will be interlined with the seller, thereby generating long term operating revenues for the seller.

There appears to be a direct correlation between the propensity to sell track to short lines and the abandonment activities of Class I railroads. As Figure 2 on the following page indicates, line abandonments have declined in inverse proportion to short line start-ups since 1980. The FRA contends that short line railroads are clearly an alternative to abandonment and the permanent loss of local rail service.[5]

The dilapidated condition of most abandonment-prone track, its unprofitable nature, and the owner's desire to divest itself of the property and its related obligations may encourage a sales price close to the property's net liquidation value (i.e. $15,000 per

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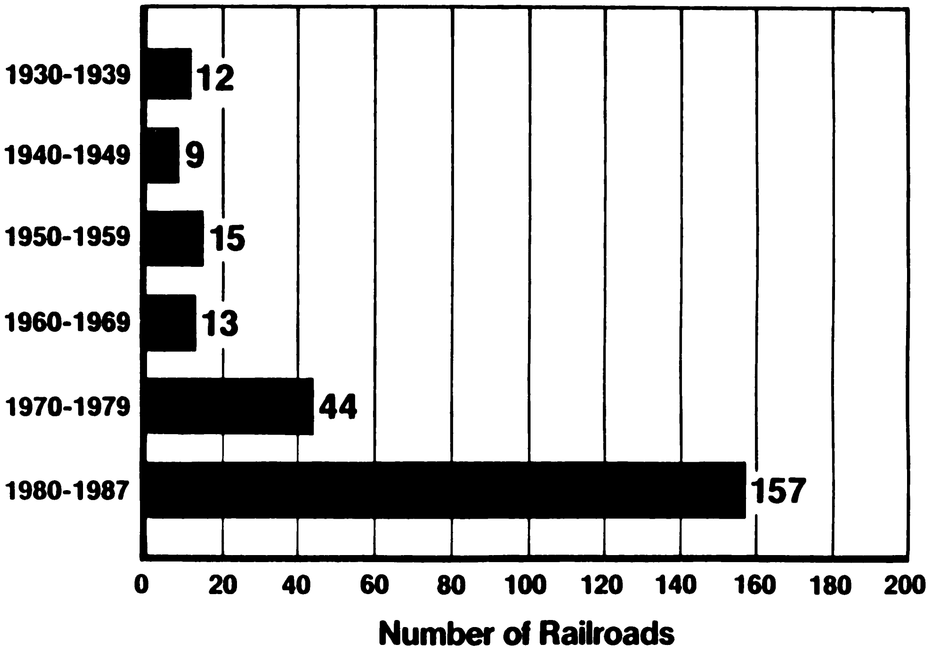
FIGURE 1

Local and Regional Railroads
(By Year Started)



Source: Presentation by John H. Riley, Administrator, Federal Railroad Administration, before the Senate Committee on Commerce, Science, & Transportation, Washington, DC, October 20, 1987.

mile).[6] All the Conrail sales reflected in Table 1 were abandonment-related[7] The Northeast Rail Service Act of 1981 even requiers Conrail to make some sales at 75 percent of the property's net liquidation value.[8]

Divestment

Not all short line sales involve abandonment-related track. There is a growing trend for Class I railroads to sell lines that are profitable and in good repair.

There are two motives for selling profitable lines; either the seller is divesting itself of its rail interests or it is attempting to establish a feeder system that is more profitable than the current operation. Divestiture will be discussed in this subsection; feeder lines will be discussed in the next.

Divestiture may be either forced or voluntary. The liquidation sales of the Rock Island and the Milwaukee Road in the 1970's and early 80's are prime examples of forced divestitures. As Table 1 indicated, these two bankrupt carriers sold over 2850 miles of track to short line operators between 1970 and 1986. Even though these carriers were bankrupt, certain line segments within their systems may have been profitable and excellent candidates for short line operations.

TABLE 1

Trackage Sold to Short Line Carriers
1970—October 1, 1986

Carrier	Miles Sold
Illinois Central Gulf (ICG)	4,309
Conrail	2,211
Rock Island	2,028
CSX	1,258
Chicago & North Western	1,258
Milwaukee Road	848
Southern Pacific	543
Burlington Northern	517
TOTAL	12,972

Source: Due, John F. *Update as of October 1986 on New Railroads Formed to Take Over Lines Abanadoned or Spun Off by Major Railroads*. Working Paper Number 18. University of Illinois at Urbana-Champaign, 1986, pp. 16–17.

Table 1 also showed that the Illinois Central Gulf was the most active seller of rail lines between 1970 and 1986. The ICG is not in bankruptcy but many of its line sales have involved high density and pre-

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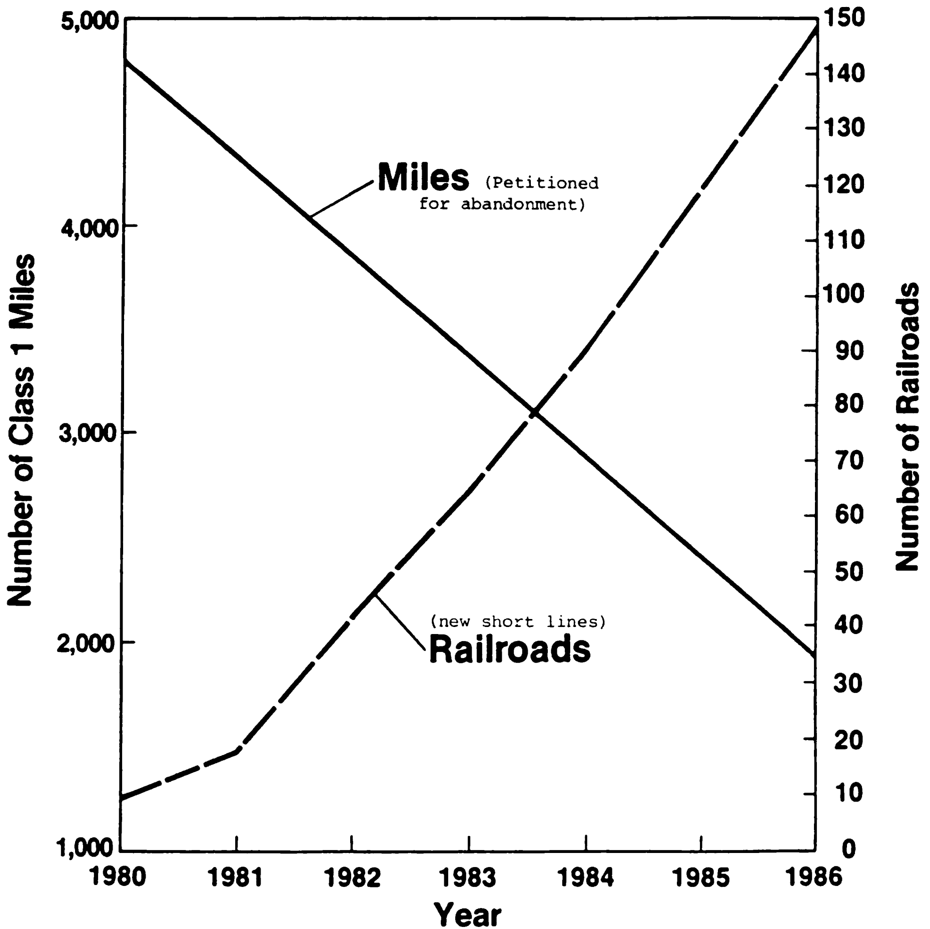
sumably profitable track. Lines that generate over 100 carloads of freight per mile are likely to be sucessful as short lines.[9] Five recent ICG sales involved lines that collectively averaged nearly 445 carloads of freight per mile.[10]

The ICG sales were not motivated by abandonment or bankruptcy. The ICG's parent company has expressed a voluntary desire to divest itself of all its rail holdings. Its approach has been a streamline its system via short line sales to create a core system of lines between Chicago and New Orleans. This system is being sought to make the ICG an attractive acquisition for some other railroad. The parent company is seeking total divestiture; the sale of profitable lines is one of the results.

Divestiture-related sales often result in selling prices based on the going concern value of the property.[11] Sellers are attempting to maximize their economic return on the property; the property's ability to generate revenue may warrant a price higher than its net liquidation value. Whereas net liquidation values may be $20,000 per mile or less on some lines, many short line sales have resulted in selling prices of over $100,000 per mile; the ICG recently sold 413 miles of track to the Mid South Railroad for over $295,000 per mile.[12] Lines that command these high prices are generally in fair condition and have traffic bases in excess of 100 cars per mile. They bring higher prices because of their ability to generate revenue and service debt.

FIGURE 2

Mileage Contained in Abandonment Petitions versus Number of New Short Line/Regional Railroads



Source: Presentation by John H. Riley, Administrator, Federal Railroad Administration, before the Senate Committee on Commerce, Science, & Transportation, Washington, DC, October 20, 1987.

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Feeder Lines

Unlike the ICG or bankrupt carriers such as the Rock Island or the Milwaukee Road, some railroads sell profitable lines for reasons other than a depature from the rail industry; they are attempting to establish feeder carriers. They are motivated by a desire to 1) eliminate the burdens of ownership (high operating and maintenance costs, etc.), 2) recover some economic value from theline (sales price), and 3) preserve the benefits associated with ownership (access to traffic originated or terminated on the lines).[13]

There are eleven Class I railroads that have been active or may become active in short line and regional trackage sales.[14] The most active in terms of feeder line sales is Burlington Northern (BN). Between October 1986 and December 1987 BN sold nearly 2000 miles of track to seven different entities; all these sales were designed to feed and enhance BN's remaining rail operations.[15] Other carriers are watching BN closely and may adopt a similar strategy if it proves successful.[16]

As is the case with divestiture-related sales, feeder line sales are motivated by an attempt by the seller to realize a maximum economic return from the property. Unlike divestitures, however, feeder line sellers attempt to maximize their economic return on a long-term basis rather than strictly through a one-time influx of cash. The seller may be more concerned with the short line's ability to generate and interchange traffic with the seller than it is with the selling price. Sales prices for feeder line track may therefore be less than the property's true going concern value. The seller may be willing to sell for less in exchange for a sales agreement that enhances the likelihood that the new carrier will interchange future traffic with the seller rather than some other railroad. Mechanisms used to encourage this relationship are the subject of the following section.

TERMS OF SALE: CONDITIONS AND INCENTIVES IN FEEDER LINE SALES

"Where a seller anticipates a continued opportunity to participate in traffic to and from the feeder line, conditions regarding future operations . . . are likely to occur."[17]

The seller's ability to attract short line traffic to its lines is determined by physical factors and/or relationships established as a part of the formal sales agreement or via subsequent business practices. The following subsections discuss variables that influence short line interchange decisions.

When discussing these variables it is important to remember that everything is negotiable in a sales contract and that every transaction is unique. Carriers sometimes hesitate to discuss specific tactics because of pending or future short line sales. Some of the procedures discussed in the following subsections may therefore be commonplace while others may be rare, rumored, or totally hypothetical. Except for certain legal considerations to be discussed later, anything is possible in short line sales agreements.

Physical Factors

The physical configuration of the property being sold may make a "structured" sale unnecessary. If the line involved is a stub-end branchline or for some other reason has interchange capabilities with only the seller, there is no need to design the sale to influence the short line's flow of traffic. Figure 3 illustrates a situation where a new short line would have natural interchange capabilities with only one carrier—the seller.

The same result is possible for sales involving multiple lines and several hundred miles of track. Figure IV illustrates such a situation. The short line depicted in Figure 4 has multiple interchange points; both are, however, with the seller. Except for trarffic that both originates and terminates at short line stations, all traffic would be interchanged with the seller.

In situations where interchange capabilities would exist with other carriers, the seller may choose to sell the property in a manner that establishes artificial barriers to interchange. These artificial barriers are established through the use of trackage rights.

Trackage rights are a permit for a non-owning carrier to operate over the owner's tracks; they are a

FIGURE 3

Stub-end Branchline
Single Interchange Possibility

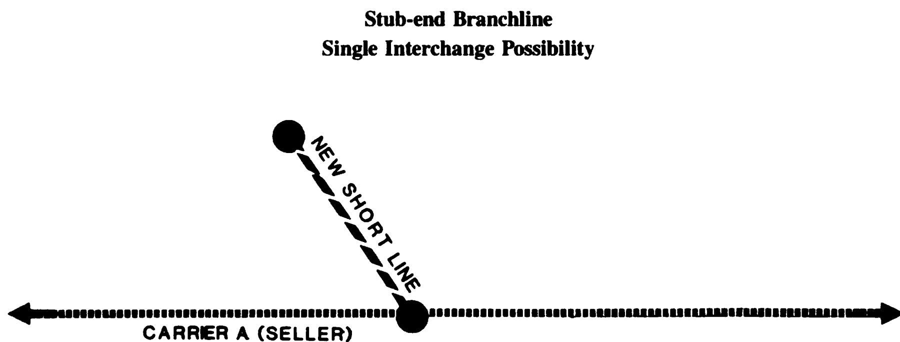

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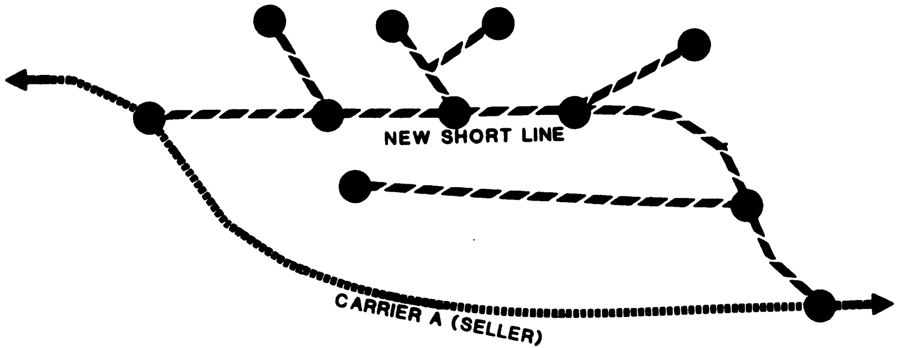
FIGURE 4

Regional Carrier
Single Interchange Possibility



right of passage. The granting carrier continues to own the track and specifies, through a contractual agreement, how the grantee may use it. The user may or may not be allowed to serve shippers on the line. Similarly, the owner can specify if the operator can interchange with other carriers that intersect the line; the owner continues to control switching points. If the owner wants to restrict the ability to interchange with other carriers it simply denies the practice.

Figure 5 illustrates how a seller can use trackage rights to structure a short line sale to insure that a short line's interline traffic will be interchanged with the seller.

In Figure 5 the new short line may be serving shippers on the trackage rights segment but ownership and control of the interchange point remain with the seller. Despite the appearance of multiple interchange possibilities, the new short line may be precluded from interchanging traffic with anyone but the seller. The seller therefore retains an interest in the operations of the short line and enjoys ongoing operating revenues from all interline traffic originated and terminated by the short line.

Trackage rights do not necessarily have to occur at what appears to be at the end of the short line and at a point of interchange with the seller. As Figure 6 illustrates, they can also be used at points within the short line's system to control interchange.

In this situation, the seller may not have any post-sale rail operations for hundreds of miles from the potential interchange point. Trackage rights may, however, allow it to continue to control switching practices and to influence the interchange of traffic between the new short line and another carrier.

Influence via trackage rights continues even after all the terms of the sales agreement are satisfied. The short line can gain additional interchange capabilities only by negotiating a new interchange agreement with the seller or by establishing new inter-

FIGURE 5

Track Rights to Influence Interchange

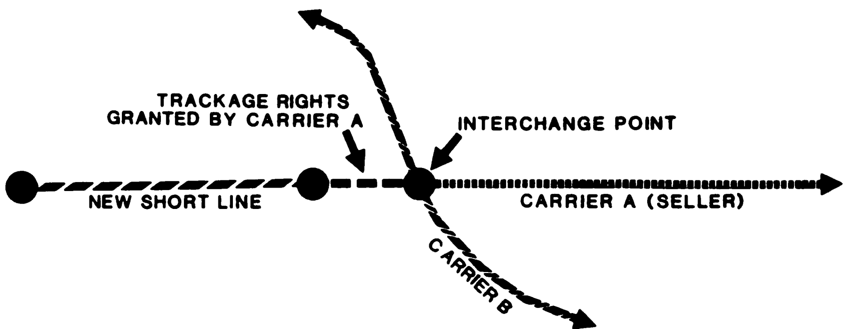


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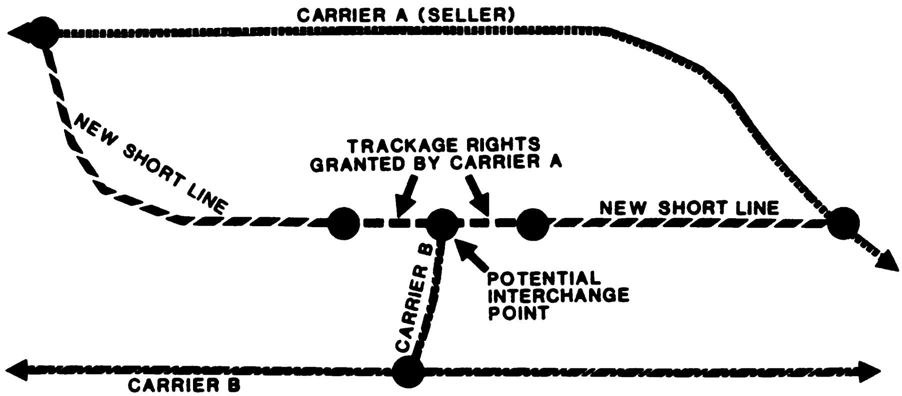
FIGURE 6

Intermediate Trackage Rights To Influence Interchange



change points through the construction or purchase of track.

Contractual Limitations

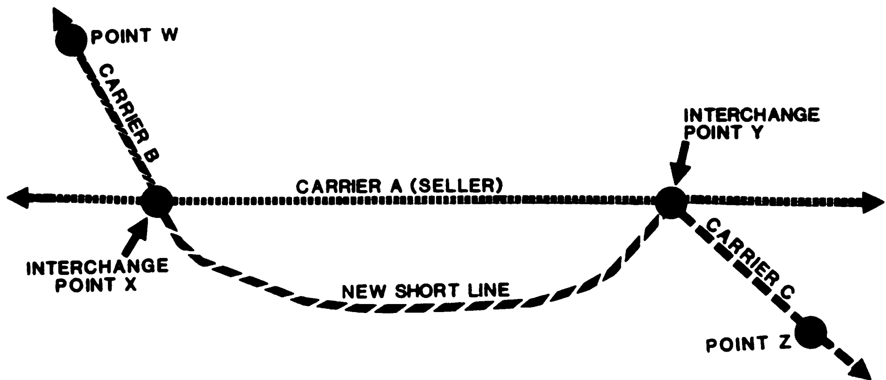
Selling carriers may attempt to influence subsequent short line operations through the use of the sales contract. The agreement may include terms that require the short line to interchange with the seller or that restrict the short line in a manner that prevents the new carrier from competing with the seller. Figure 7 on the following page illustrates such a situation.

In this example, Carrier A sold track to a short line. After the sale both carriers serve interchange Points X and Y. An unfettered sale would have resulted in the introduction of a new competitor into the "bridge traffic" market. (An example of bridge traffic, as illustrated by Figure 7, would be freight that originates at Point W and is destined for Point Z; the portion of the movement between Points X and Y is "bridge traffic" since the carrier involved neither originates or delivers the shipment.)

The seller (Carrier A) in this real example did not want to introduce a new carrier into a market that it was serving. It therefore stipulated in the sales agreement that the new short line could handle only single line traffic or traffic that either originated or terminated at a point served by the new carrier. The agreement kept the new short line from competing with the seller for bridge traffic.

FIGURE 7

Bridge Traffic Prohibition



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Some carriers question the legality of this type approach to influence post-sale short line operations (concerns such as these will be discussed later). There are, however, other ways to encourage short line traffic to gravitate toward the seller's system. This is the topic of the next subsection.

Contractual Incentives

There are means other than physical dislocation and contractual prohibitions that can be used to encourage a new short line to interchange traffic with the seller. These means of encouragement may be established by the sales agreement or otherwise and take the form of economic incentives or disincentives.

Rail traffic normally flows along the route that is most economical. To encourage a short line to interchange with the previous owner, the seller may draft a sales agreement that makes traffic voluntarily flow to the seller rather than some other interchange possibility. In this situation, a short line operator may have the physical ability to interline with carriers other than the seller but it would not be in its best interest to do so; mutual benefits result from ongoing cooperative interchange between the buyer and the seller.

The following paragraphs discuss some contractual incentives/disincentives that may influence freight movements.

Financing—Perhaps the biggest opportunity to influence the interchange of traffic arises when the seller is financing the sale (i.e. contract for deed). This occurrence provides the buyer with numerous opportunities to influence traffice flows.

For example, the buyer and seller may negotiate what is considered a competitive division of revenue on cars interchanged. The division will provide the short line with revenues to finance operations, maintenance, debt retirement, etc. To give itself a competitive advantage over other interchange possibilities, the seller may offer the new short line a $50 credit towards its contract for deed for every car interchanged. To qualify for the credit the short line may have to satisfy some form of volume commitment, i.e. 90 percent of all the short line's loadings must be interchanged with the seller. The economic incentive will encourage traffic to move to the seller's lines.

Car Supply—To minimize start-up costs and to discourage excess car supply, the seller may offer to fill the short line's ongoing need for cars. Car orders are taken from shippers by either the buyer or the seller and are filled by the seller. The cars are then turned over to the short line for delivery to shippers.

The seller may base this car supply arrangement on the understanding that cars consigned to the short line will be loaded and returned to the seller. Failure to work with the seller could jeopardize the short line's access to cars and relatedly to operate revenue. Car supply may also be tied to a volume commitment as described in the preceding subsection.

Reclaim on Car Hire—The cost of owning and operating rail cars is computed on a per mile and per day basis. A covered hopper car, for example, costs approximately $15 per day to own and 5 per mile to operate. When cars are owned by one carrier and used by another, per diem and mileage charges result.

Class I carriers may make per diem allowances to short line operators to encourage them to interchange with the cars' owner. For example, the Class I may tell a short line that it will provide cars with two "free" days. If the short line can get cars delivered, loaded, and returned to the Class I carrier in two days it will, in effect, increase its revenues on those loadings by #30 per car by avoiding all per diem charges. This "reclaim on car hire" agreement will encourage the traffic to flow toward the Class I's system.

Indirect Incentives

There is probably no one contractual term or economic factor that will insure that a short line's traffic will gravitate to the seller's system. If, however, the intent of the sale is to establish a feeder short line, the seller will attempt to structure the contract and develop a relationship that, in effect, establishes a long-term partnership between the two parties. Accepting the offerings of the Class I may be in the best interest of the short line; guaranteeing the future of the relationship may be accomplished only by reciprocating via the interchange of traffic. The following subsections discuss some indirect incentives that may be used by selling carriers to build a partnership that results in an interchange of traffic.

Accounting Services—Class I carriers typically have elaborate, computerized accounting systems for tracing cars, billing shippers, etc. Conversely, short lines are relatively small businesses which, without outside help, would accomplish similar tasks with less sophisticated and more costly methods.

The cost of providing these services to a new short line are minimal for a Class I railroad. The seller may, therefore, offer these services to the new carrier at cost. This cost may be well below what it would cost the short line to perform these tasks itself or to contract the work elsewhere. The relationship creates a dependence that indirectly encourages the interlining of freight.

Bridge Traffic—Just as selling carriers may attempt to structure short line sales to attract interline freight, they may offer the short line business to encourage reciprocity.

Figure 8 illustrates a situation where a Class I Carrier (Carrier A) has an option of handling freight itself or using a short line as a "bridge" carrier.

In this example, if freight originates at Point V and is destined for Point Z, Carrier A has the option of delivering it direct via Point X or interlining it with the short line at Point W and again at Point Y. Carrier A's net revenue may be the same regardless of the route used. A decision to interline with the short line may, in turn, encourage the short line to work closely with Carrier A versus Carrier B at Point Y on other interline shipments.

Equipment Maintenance—Class I railroads have streamlined their systems in recent years via abandonment and short line sales. This process has left them with excess capacities in many areas, one of which is equipment maintenance.

Short line sellers may use this capacity in sales agreements by offering, for example, car and loco-

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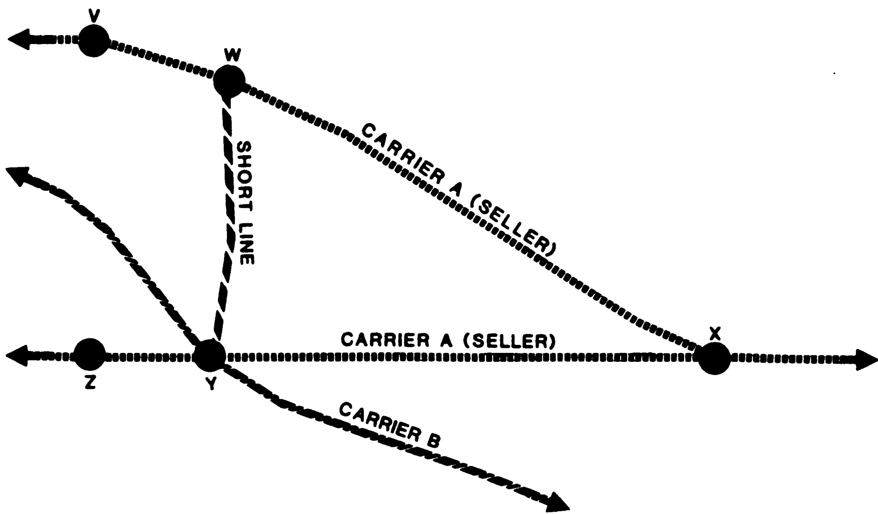
FIGURE 8

Bridge Traffic to Encourage Interchange



motive maintenance services to new short lines; the approach allows the seller to eliminate some of its excess capacity problems while covering its out-of-pocket expenses. Conversely, the short line avoids related start-up costs and satisfies its maintenance needs at a cost level below what it would cost to contract to have the work done elsewhere or to do it in-house.

Equipment Supply—Being relatively small businesses, short line carriers typically purchase only the equipment that is essential for day-to-day operations. This occurrence may result in difficulties when service demands are heavy or when circumstances require specialized equipment. For example, heavy car movements may leave the carrier short of locomotive power or a derailment may create a need for a heavy duty crane. The selling road can encourage a long-term working relationship with the short line by supplying necessary equipment on an "as needed" basis. The cost to the seller is small; significant savings may result for the new short line.

Procurement—Class I railroads generally buy in volume lots and achieve lower per unit costs than smaller carriers. They may purchase diesel fuel for 70 cents rather than 95 cents per gallon; ties may be bought for $20 instead of $25. Short line sellers may use this capacity to their advantage by offering to serve as a supplier for a new short line. The short line can price needed supplies both from the Class I seller and on the open market. If the Class I is willing and able to purchase the necessary supplies and make them available to the short line at or near cost, the short line will save money and the partnership will be strengthened.

Tariff Publication—As is the case with accounting services, publishing tariffs may be complicated and costly for a new short line. The seller may view this fact as yet another opportunity to develop an interdependence between itself and the new short line. The Class I may offer to continue to publish rates from short line points in its tariffs, thereby relieving the short line of many of its ratemaking and tariff publication obligations. Cost savings result for the short line; the incremental cost to the Class I is small.

Voluntary Coordination Agreements (VCA's)—Many Class I carriers have entered into agreements with other Class I railroads to permit each party to sell transportation services to points served by the other party. These standing agreements greatly enhance the marketing capabilities of each carrier by providing ready access to off-system markets.

Similar agreements may be negotiated between Class I's and short lines. These agreements are especially desirable for short lines because short lines, by their very nature, serve small geographic areas and few, if any, major markets. VCA's provide short lines and their shippers with access to distant off-system markets. Sellers may use this access to forge an interdependence between themselves and the new short line. A mutually beneficial interchange of traffic is the result.

LEGAL CONSIDERATIONS

There are legal limits to what a selling carrier can do to encourage a short line to interchange traffic with the seller or to inhibit the ability of the new carrier to compete with the seller. Feeder short lines with multiple interchange possibilities are, however, a fairly recent arrival on the short line scene and there appears to be a lack of statutory and case law to specifically define what is or is not legal. Ap-

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proaches taken by some sellers to influence subsequent traffic flows are questioned by others; there is no clear consensus as to what the legal limits are.

The ability to structure sales to influence future operations appears to be tempered by questions surrounding restraint of trade and anti-trust law. These considerations apparently keep sellers from pointedly requiring new operators to interchange exclusively with the seller. They have encouraged some carriers to sell strictly on a "cash and carry—no strings attached" basis. Other carriers avoid potential problems by selling only lines that have natural physical barriers to multiple interchange (i.e. stub-end branchlines.) Still other sellers consider the use of incentives to be a legal method of influencing subsequent interchange.

As discussed earlier, some carriers use trackage rights to control post-sale short line operations. Some concerns exist, however, regarding the use of trackage rights to control interchange. Questions also arise regarding the legality of contractural limitations that inhibit competition (i.e. the previous example where the buyer is limited to handling only that traffic that either originates or terminates on its system).

Structured sales may be going largely unnoticed by the public because of the ICC's decision to exempt most sales from administrative and public review. Conditions, if any, may be known only to the parties to the sales agreement.

The ICC is currently reconsidering its rules which exempt short line sales from administrative review.[18] It may eventually modify these rules to provide for increased scrutiny of proposed sales. Congress is similarly considering action that would expand public participation of line sales. Either occurrence could result in more public awareness of structured sales. If the shipping public perceives that short line sales are being constructed in a manner contrary to its interests, it may pursue even further administrative, legislative, or judicial action.

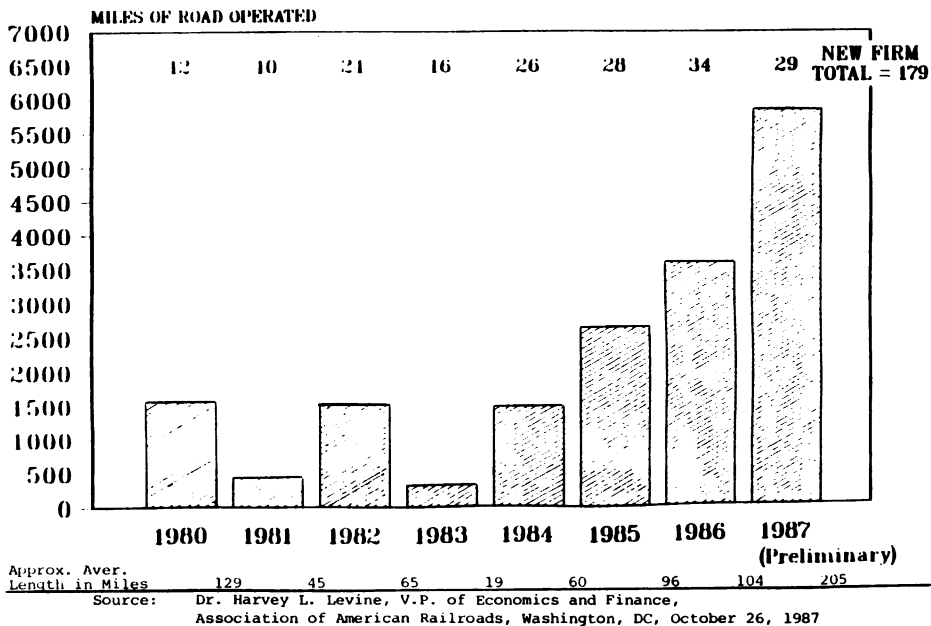
For the time being it appears that if a sale were challenged before the courts because of provisions that influence subsequent operations, it might be reviewed based upon the impacts that the conditions have on comeptition. If the sale was structured to reduce competition in the transportation marketplace it might be of questionable legality. If, however, the sale merely replaced one carrier with another and maintained the competitive "status quo," it would probably be found legal.[19]

SUMMARY

The trend to establish short line railroads has intensified in recent years. As discussed in the introduction and summarized in Figure 9 on the following page, this trend has involved not only the establishment of more lines each year but also in a growing tendency to sell larger parcels of track. From 1980-83 the average sale involved approximately 60 miles of track; the average sale in the 1984-87 period involved nearly 120 miles of line. The trend towards more and larger sales can be ex-

FIGURE 9

Short Line Creations by Year and Length



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pected to continue unless situations change to eliminate some of the economic incentives to form short lines (i.e. labor concessions) or action is taken by Congress, the courts, or the Interstate Commerce Commission to directly or indirectly discourage such sales.

The line sale phenomenon of the 1970's and 80's was sparked by the sale of lines that were authorized for abandonment. The trend later broadened to include sales of larger and more viable line segments; often as a result of bankruptcies or attempts by carriers such as the Illinois Central Gulf to down-size their systems. These transactions have, however, been generally straightforward cash sales with no attempts made to influence subsequent short line operations.

A more recent offshoot of the short line trend is the structuring of sales to encourage a continuing working relationship between the buyer and the seller. The primary goals of the seller in these cases are to eliminate operating and ownership costs and realize continuing revenues from traffic associated with the property. Generating immediate cash from the sale is a secondary goal.

Short line sellers are therefore driven by one of two motives; either they are disinvesting in the rail industry (abandonment or divestiture) or they are disposing of property while trying to establish an ongoing relationship with the buyer.

Shippers may favor situations where a new carrier functions independently of the previous owner, especially if the new carrier has interchange possibilities with several carriers and thereby gives shippers increased access to various markets. It's important to note, however, that this occurrence is usually synonymous with a high purchase price and the problems that go along with it (cash flow, etc.). In some instances a continuing relationship between the buyer and the seller may be beneficial or even critical to the long term success of the buyer and relatedly to the interests of affected shippers.

From the public perspective the desirability and even the acceptability of structured sales depends on whether they force or merely encourage an ongoing relationship. Unforced relationships are likely to be a result of economic incentives that benefit both the buyer and the seller. These incentives will enhance the profitability and viability of the carriers and facilitate the long term provision of rail service to affected shippers; they may also broaden the ratemaking capabilities of the carriers to the benefit of the shippers.

Forced relationships may also benefit a new carrier since they are likely to be accompanied by allowances that ease start-up and early operations (lower sales price, car supply, etc.). In the long run, however, a forced relationship may be of diminishing value to the short line and the shipping public. Shippers may be deprived of many of the inherent advantages that a more independent short line might have to offer.

Structuring sales to influence subsequent short line operations is a relatively new innovation and is directly related to the evolving trend to establish feeder short lines. The success or failure of recent sales will dictate whether or not Class I carriers intensify their efforts to "spin-off" more and larger portions of their systems.

Opinions vary within the railroad industry concerning the advisability and even the legality of some of the methods used to influence post-sale short line operations. Carrier actions and future administrative, legislative, and judicial actions concerning structured sales may contribute to the ultimate determination of whether the current trend to create feeder short lines is in its infancy or its waning days.

ENDNOTES

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Copies of the instruments used to survey Class I and short line carriers are available upon request.

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