Dismantling the railroads

One way to make money at the expense of the U.S. economy

In interviews with *Executive Intelligence Review*, the small group of men who control the future of the nation's rail system—at the Department of Energy, the Interstate Commerce Commission, and the New York financial community—projected a major reorganization of the nation's rail system. The system that will emerge from the coming months of political scramble, according to their planning, will include 25 percent less track, and a further reduction in size of the total system, a reduction as great as the shrinkage of the past ten years.

In the "overbuilt" Midwest, in particular, rail lines will lose between 40 and 60 percent of total track, much of it on failing carriers like the Rock Island and the Milwaukee railroads.

They have already pulled the trigger for these developments: Last month, the Rock Island effectively ceased to exist as a corporate entity. Following a month-long strike of its unionized work force, who walked out when the railroad failed to come up with cash to pay already-negotiated pay raises, the line was unable to find sufficient funds to restart operations. The attorney generals of 13 states in which the line operates closed in, demanding payment of taxes in default. The ICC has now directed the Kansas City Rail Terminal, a consortium of 12 other railroads, to operate Rock Island lines on an emergency basis. Within months, the majority of its track will be put up for auction, and much will be abandoned.

The very same week, Federal Judge McGrath granted a petition of Milwaukee Road trustee Richard Ogilvie, former Illinois governor, to "embargo" (that is, terminate service on) 6,000 miles of track, the road's long stretch to the West Coast. The outcome of the decision is unclear. Farmers' and utilities' organizations consider much of this track so essential that they have proposed an association of shippers, rail employees, and state governments to take the line over.

However, leading rail investors are not sanguine about the prospect of avoiding large-scale abandonments. "People's habits wwll have to change," said one investment bank analyst in New York. "Somebody somewhere is not going to be as well off as he used to be. Unions, businesses, and geographic areas will just not get what they're used to even though sensible people argue that there are too many railroads and too much track for the current economy to sustain. The world could do without the Milwaukee Road and the Rock Island, provided somebody gets parts of them."

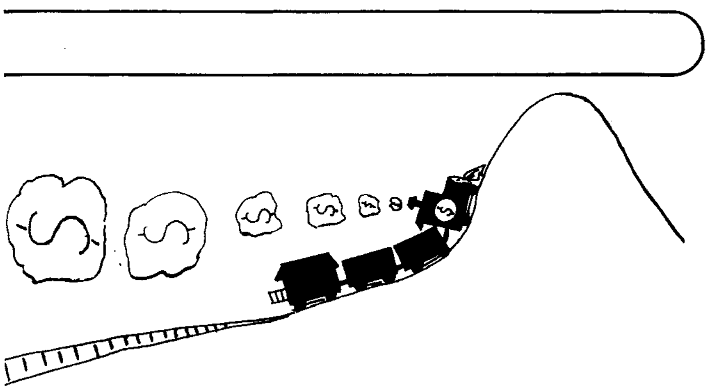
In this section

Can you make money off a bankruptcy? You can if you are a railroad investor. This week's ECONOMIC SURVEY presents the results of intensive research by Steve Parsons and Leif Johnson under the direction of our Economics Editor, David Goldman. They have produced an earth-shaking exposé of who's doing what to the American railroads—and the economy they provide essential transport services for. Wall Street investment bankers , insurance companies, real estate operators, and with essential help from government insiders, are "reorganizing" railroads out of existence, and making billions in the process. Included: the real statistics, financial and physical, on the railroads today, and a special report on the paradigmatic Penn Central: "How to make $8 billion off a bankruptcy."

Railroads overbuilt?

Exactly how and to what extent the railroads are "overbuilt" in the Midwest is a matter of contention. Certainly, they were jerry-built at the end of the last century by competing companies whose last thought was a coherent, rational rail transport system. However, according to analysts and industry officials, the shape of the future lines will not please everyone—especially not Midwestern farmers.

The lines that will benefit will be long-haul routes



for both grain and coal, much more, however, for coal. The Departments of Energy and Transportation are already committed to providing rate increases as required to permit the repair of coal-carrying lines. The Louisville and Nashville Road in the Southeast just received a 35 percent rate increase on its prime coal-carrying routes, under the condition that the additional revenue be ploughed back into track repairs. Burlington and Northern, likely to be the prime beneficiary of both the Rock Island and Milwaukee troubles, is the favorite rail stock among Wall Street analysts at the moment. It is already receiving rate increases from the Interstate Commerce Commission in the neighborhood of 50 percent on certain of its routes. In the case of the Milwaukee, the Department of Transportation just offered a $1,8 million subsidy to the line to prevent the closing of coal-carrying routes—the harbinger of much more to come, according to Congressional sources.

What will continue to suffer—in a dramatic acceleration of the trend of the last ten years—is short hauls to grain elevators, river and lake ports, and terminals serving agricultural routes. Ten years ago, many farms still shipped their grain via sidings that came up to individual farm silos. Now, virtually all haulage to grain elevators must be done by truck. As a result of the conversion from rail to truck, the concentration from small country elevators to larger central grain elevators, and other factors, the bottom-line cost to farmers of grain shipment has risen as much as 40 percent of the total price. The next round of abandonments, according to analysts, will force farmers to employ trucks for significant amounts of medium-haul cartage to the few long-haul rail lines remaining intact.

The cases of the Rock Island and the Milwaukee are exemplary. In both cases, the lines have pleaded bankruptcy, and put regional interests into a corner. "It's like gangrene," commented the transportation aide to the Governor of one affected state. "From what the trustee (of the bankrupt railroad—ed.) has told us, either we cut off the sick parts, or we'll lose everything."

Although state governments, utilities, and agricultural associations "suspect a hidden agenda," by and large they have accepted the claims of railway trustees like former Governor Ogilvie and his predecessor, Stanley E. Hillman, the ex-President of the Illinois Gulf Central Railroad. After all, why would a railroad lose money on purpose?

In fact, it's possible for railway investors to make a killing when railroads lose money—down to and through full-dress bankruptcy proceedings.

Currently, the Rock Island carries about 10 percent of all U.S. wheat, and a staggering 22 percent of Iowa's corn output. The line serves over 1600 grain elevators. The Milwaukee covers a similar group of shippers in Wisconsin, the Dakotas, and Montana, operating one of two Northern Tier transcontinental lines. The latter line, which is slated for closure, is not only important to Midwestern utilities, who ship Montana and Wyoming coal East for power generation. Farmers, too, are increasingly dependent on the rail lines to the Pacific ports. This has become even more the case due to bottlenecks on the main water transport routes to ocean ports. For example, the Mississippi River's biggest bottleneck, Lock and Dam 26 at Alton, Illinois, now puts an absolute limit on peak-season river transport of grain. Although methods are available to keep the waterway ice free year-round, the St. Lawrence Seaway is not available during five winter months because the investments have not been made.

The transport system presently cannot move the type of harvest that the nation's farmers now can produce, even with acreage cutbacks and federally-financed crop withholdings. Car shortages now average over 25,000 per day. Terminals and certain main-line hauls are operating at peak capacity. With agricultural products forming the single largest component of U.S. exports, the transport crunch is a basic problem for the entire national economy.

Possibly, rail lines could learn to make money by providing efficient short-hauls, terminal service, and other basic requirements of agricultural transport, rather than stripping themselves down to a few long haul routes which require little sophisticated planning. However, investors in railroad corporations can sometimes make a great deal more money through asset-stripping. The St. Louis investment bank of Sherck, Stein and Frank, which handles the personal fortune of Chicago wheeler-dealer Henry Crown, is a good case in point.

Henry Crown is a self-styled philanthropist, whose avowed goal in life is to make his net taxable worth less each year. In 1946, he acquired a block of outstanding debt issues of the Rock Island Railroad, which was then, as now, under bankruptcy reorganization. By 1948, Crown had converted most of his debt holdings to equity and emerged as the main stockholder of the Rock. Since 1962 Crown has tried to merge the Rock Island with other railroads like the Union Pacific, letting the Rock run downhill in expectation of the merger and taking all kinds of tax losses to shelter his other investments.

But the ICC blocked the attempt for 12 years. By 1974, the Rock was in such bad shape that the UP withdrew its offer. One year later, the Rock was declared bankrupt in federal court.

Since then, Crown has been trying to liquidate the Rock Island for scrap, to the consternation of railroad managers who believed the line could be revived.

Crown is the major shareholder in another railroad, the St. Louis-San Francisco, holding over 10 percent of the stock. In the coming months, the ICC is expected to rule favorably on the proposed merger of the Frisco with the Burlington Northern. The Burlington is the Milwaukee Road's chief competitor, operating the only other northern transcontinental rail line. The merger will give Crown the largest individual block of stock in the BN—and control over the largest grain and coal carrier in the nation. The Rock Island, meanwhile, will be sold off piecemeal to various railroads at bargain-basement prices. Its routes will be drastically curtailed. A major beneficiary will be the IC Gulf Railroad. Crown turns up again as IC Gulf's biggest shipper, from his southern Illinois coal mines.

While the grain belt will just have to get by with less, Crown will get:

- a huge carry-forward tax credit from the Rock Island fire sale to shelter his gains from the BN-Frisco merger and other investments;
- hefty investment tax and related credits from the merger, as well as from sections of the Milwaukee that the BN will pick up for a song;
- a 20 percent or more increase in the value of his Frisco rail stock following the merger;
- a sharp jump in income from the BN's takeover of Milwaukee track and the higher rates it will be able to charge captive shippers. In particular, the DOE's push for coal rate increases, to be discussed below, will make the BN look terrific.

'Save the Milwaukee'

There is a "Save the Milwaukee" drive underway, under the direction of Sen. John Melcher (D-Montana). However, Melcher's operation is counting on the Department of Energy to come through with close to $50 million in rehabilitation funds for the line's dillapidated Western track to make it viable again. The DOE is expected to release a report shortly stating its position in the line. However, DOE sources say that it is unlikely that the Department will opt for saving the line to the coast—the part that Montana, Dakota and Wyoming farmers depend on. At best, the DOE will suggest saving two thousand miles of track to ship coal back East.

Ultimately, the Western interests are counting on raising the required cash through a consortium of Milwaukee Road employees, shippers, and state governments. The skeleton of such a consortium has already been formed, under the rubric of New Milwaukee Lines, Inc., a Chicago-based corporation.

However, the other shoe has not yet dropped. Fuel allocations—which helped push the Milwaukee and the Rock under during last summer's gasoline shortage—will hit the transportation sector hard this winter, according to industry analysts and Department of Energy sources. The unraveling of the rail grid will then accelerate—under the ddrection of Energy Secretary Charles Duncan.

Airlines will create a precedent for the entire transportation sector, one analyst predicted. "When deregulation came out," he said, "it was said that small communities would be hit. That didn't happen. The commuter lines took over the service. But wait until you get dollar a gallon aviation fuel. Then the Midwest is going to be absolutely raped. Service to the mid-sized cities, like Cincinnati, Dayton, Toledo, and Milwaukee, is going to be cut back drastically."

The expected early winter fuel shortage will give Duncan the pretext that he (and the airlines) want, the analyst continued. Farmers this year will require between 25 and 30 percent more diesel fuel than last, due to ground and weather conditions. Much of that fuel will not be available, especially when colder weather hits and farmers must switch to less available, lighter grade fuels. Farmers will demand more fuel, and Duncan may give it to them by imposing mandatory fuel allocations on transport. "The airlines will love this, particularly since profits are now on the downward curve since airline deregulation. They need to get rid of unprofitable routes." More fuel allocations will possibly enable farmers to complete the harvest—but inhibit trucks and rail lines from shipping harvested grain. And the entire exercise will spark the national debate over railroad and trucking deregulation.

"It's easier to go after the airlines first," said one analyst. "Theri rights of way are just a scrap of paper. If you go after the railroads, you run into a guy whose got two grain elevators and a steel mill on a section of track. But if the airlines go, other transport modes will follow."

The Federal Railway Administration appears to be thinking along these lines. The FRA is ignoring shippers' charges that rail deregulation would entail widespread service cutbacks and rationalizations that would lead to huge rate increases. Says Deputy Administrator Robert Gallamore: "We at FRA believe that deregulation is a good idea whose time has come.... [There] must be greater efforts to rationalize excess or redundant facilities.... We recognize this means more abandonment. We also recognize that the prospect of losing local rail service is very disturbing to shippers and communities served by those lines."

—David Goldman and Stephen Parsons