APPENDIX B
REVIEW OF RECENT RAILROAD MERGER HISTORY

Creation of the Interstate Commerce Commission in 1887 *was* a general reflection of the trend toward more reliance on administrative agencies in dealing with major social problems as well as a specific response to the unfolding railroad problem. The complex and varied nature of the problem necessitated the creation of an agency with maneuverability and versatility, one whose functions would not defy too greatly the traditional "separation of powers principle.

With implementation of the Act to Regulate Interstate Commerce in 1887, the railroads and rate-setting associations were required to adjust the rate determination process and rate structures to comply with the establishment of the Commission.

The Transportation Act of 1920 instructed the Interstate Commerce Commission to prepare and adopt a plan for the consolidation of the railway properties of the United States into a limited number of systems. Following the Transportation Act of 1920, the ICC was converted from an agency devoted to facilitating private collusion to an "outright public cartel,"[1] which was vested with the power of minimum rate regulation; given control of entry into, exit from, and capital formation in the industry; and granted a variety of means for endeavoring to equalize the rate of return between the financially strong and financially weak railroads.[2] The prohibition of pooling prescribed in the original Act of 1887 was changed to allow for discretionary approvals of pooling arrange-mentsts.[3] The famous Ripley consolidation plans for equalizing disparities among

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[1] Many writers have espoused the view but none has pursued it more vigorously than George W. Hilton in 'What Went Wrong, " Trains, XXVII (January 1967), p. 42.

[2] The ICC provided a return of 5.5 percent on a fair value of investment as a target for 1920 and 1921, after which the target was 6.0 percent. If a railroad's rate of return exceeded the maximum, it was required to retain half the excess in a contingency reserve and to deposit the other half in a fund administered by the ICC for loan purposes to the weaker railroads. This provision proved un-workable, mainly because of the depression, and in 1933 the Emergency Trans-portation Act ended any effort to set a target rate of return for the industry.

[3] For an inquiry into the effects of cartel agreements on rates, tonnage shares, and profits of the major Eastern railroads in the last three decades of the

the various railroads were a result of the 1920 Act, but the stronger railroads were not interested in assisting the limping ones and had the legal right to refuse to do SO. [1]

1. Merger Criteria

The ICC published the Complete Plan of Consolidation[2] in 1929 under which any consolidation had to conform to the configuration designed in the plan and be in the public interest. None of the consolidated systems proposed under the plan was ever effected, and very few rail consolidations occurred during the period of the 1920 statute. However, the Transportation Act of 1940 repudiated the concept of a master plan for rail unifications and, instead, insisted that all proposals to purchase, lease, merge, consolidate, or otherwise acquire control of railway properties were to be examined on their own merits in the light of certain criteria as specified by Congress in Sec. 5(2)(c) of the Interstate Commerce Act of 1887. The 1940 Act redefined the criteria as follows:[3]

> (1) the effect of the proposed transaction upon adequate transportation service of the public; (2) the effect upon the public interest of the inclusion, or failure to include, other railroads in the territory involved in the proposed transaction; (3) the total fixed charges resulting from the proposed transactions; and (4) the interest of the carrier employees affected.

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nineteenth century, see Paul W. MacAvoy, The Economic Effeats of Regulation: The Trunk-Line Railroad Cartels and the Interstate Commerce Commission Before 1900. According to MacAvoy, there were four major reorganizations of the cartel, each of which was occasioned by failures from "cheating" by some of the members. Each reorganization was an attempt to provide means for detecting deviations from the agreed rates and to provide penalties for such deviations. In general, if it was possible for an individual railroad to increase its profits by being loyal to a cartel agreement rather than being disloyal, the cartel would likely be stable. However, the evasion of regulation by individual railroads and the reduction of the powers of the ICC by courts induced the eventual collapse of cartel rates.

[1] In fact, the Transportation Act of 1940 repealed the Ripley Plan for consolidations and substituted other criteria.

[2] In the Matter of Consolidation of the Railways of the United States into a Limited Number of Systems, 159 ICC 522 (1929).

[3] The Transportation Act of 1940, Sec. 5(2).

In addition to the statutory requirements, the ICC seems to have adopted a set of ad hoc criteria as a result of its being left to adjudicate each case "on its own merits. At various times these criteria appear in merger cases presented to the ICC. The ad hoc criteria involve (i) speed of delivery; (ii) economy and frequency of service; and (iii) the appropriate provision and most efficient use of general and specialized transport facilities.[1] These criteria have actually evolved as an attempt to clarify the ambiguities of the term "public interest," which is specified in the statutory criteria, and to maintain some degree of intramodal, competitive traffic flow. They represent factors which are important determinants influencing traffic on given routes and which have a direct bearing on a shipper's choice of routes. Because mergers bring about structural changes, the protection of public and private interests with respect to routes and traffic volume are frequently evaluated in terms of these ad hoc criteria.

In an actual merger case, the applicants resort to demonstrating the beneficial impacts of what has been described above as the ad hoc "set." The ICC then attempts to evaluate this deluge of favorable data with evidence presented by protectors and interveners. It is assumed that the applicants will carry out their promised and planned operating changes. **Only occasionally does** the ICC subsequently spot-check a unified railroad for confirmation purposes. This "surveillance" is one area where the regulatory agency (and not only in the railroad industry) needs to improve its efforts.

The most recent upward trend in rail mergers dates from 1957 when the Interstate Commerce Commission approved the consolidation of the Louisville and Nashville Railroad with the Nashville, Chattanooga, and St. Louis Railway. Since that time the trend of rail mergers has accelerated until, at present, a large proportion of the major carriers has either actively considered consolidation or has submitted formal merger proposals for ICC approval. Recent cases vary in complexity, from relatively simple proceedings involving acquisition of stock control in order to simplify corporate structures, to highly complex cases involving several large competing railroads. In the case of certain Eastern railroads, the trend toward consolidation signifies resort to a means of preserving the profitability of rail lines under private operation. In contrast, the issues in the applications of some Western railroads, which have generally been more profitable than those in the East, have shown a more direct concern with the question of competition versus regulated monopoly, first in railroad services over certain routes and, second, between railroads and their alternative transportation modes.

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[1] For a discussion of these criteria, see James T. Keafsey, The Economics of the Transportation Firm (Lexington, Massachusetts, D. C. Heath and Company, 1974), pp. 68-69.

It is alleged that most merger proceedings tend to be handled uniquely without much attention being devoted to the ways in which each merger affects the overall operational and geographical structure of the industry.

Another commonly raised issue related to mergers is the fact that the process of adjudicating mergers has been unduly slow. Seemingly endless rounds of legal maneuvering and regulatory deliberations have created an impression of wheel-spinning, the costs of which some people feel are barely offset by the post-merger savings. For example, one of the simplest combinations to effectuate--consolidation of the Chicago Great Western into the Chicago and North Western--was proposed in early 1964, approved by the ICC in 1967, but sent back to the ICC in January 1968 because of federal court litigation. Similarly, the Burlington Northern merger scheme was conceived in 1957, reviewed by the ICC for several years, rejected in 1966, reconsidered and approved in 1967, contested in 1968, and finally implemented in 1969.

The railroads have been confronted with both the intensification of external competition from other modes of transportation and increased operational costs from within the industry itself--problems for which only soundly conceived mergers were hoped to offer solution. If the case discussed below is representative of all mergers in the industry, it is important to assess the impact of mergers on the performance characteristics and resource allocation decisions of railroad companies.

2. A Brief History of Railroad Negotiations Behind the Penn Central Merger

The merger of the Pennsylvania Railroad Company (PRR) and the New York Central Railroad Company (NYC) was originally proposed in January 1957. At this same time studies relating to the proposed merger were authorized. These studies were completed in substance by January 1959, when the NYC discontinued its merger plans on the grounds that its officials believed that as long as the PRR controlled the Norfolk and Western Railway Company (N&W) a merger would create an "unbalanced competitive situation'? in the East and perhaps ultimately result in nationalization of the independent railroads. At that time consideration was given to the fact that the N&W was in the process of purchasing the Virginian Railroad Company. After its merger discussions with the PRR were terminated, the NYC began to purchase capital stock in the Baltimore and Ohio (B&O). Shortly after February 1959, the NYC entered into negotiations with the Chesapeake and Ohio Railway Company (C&O) and the B&O, looking toward the possibility of a so-called two-party railroad system in the East composed of the NYC, C&O, and B&O on the one hand, and the PRR and its satellites (including the N&W) on the other. The NYC's action in pursuing the C&O and B&O arrangement was largely founded on the consummation of the

N&W - Virginian merger, [1] which it had not opposed other than seeking limited conditions.

On June 14, 1960, the C&O filed an application with the Commission under Section 5 of the Interstate Commerce Act for authority to control the B&O. Even though the C&O was opposed to inclusion of the NYC in this proposed transaction, negotiations continued between the NYC and the B&O. The discussions were halted abruptly when the C&O, through ownership and stock exchange assents, acquired more than 50 percent of the B&O's outstanding capital stock. The reaction of the NYC was to file an application under Section 5 for authority to control the B&O jointly with the C&O. These matters were heard on a consolidated record. During the pendancy of these transactions, the ICC approved the merger of the Delaware, Lackawanna, and Western Railroad Company into the Erie Railroad Company. [2] The NYC did not Oppose this merger despite the fact that its officials felt that it would lose substantial traffic as a result. The PRR also supported this merger despite its estimates of loss of traffic.

On March 17, 1961, the N&W filed applications under Section 5 of the Act to merge, purchase, control, and/or lease the properties of the New York, Chicago, and St. Louis Railroad Company (Nickel Plate); Wabash Railroad Company (Wabash); and the so-called Sandusky line of the Connecting Railway Company, a PRR subsidiary. The NYC intervened in these proceedings prior to hearing and filed a petition seeking inclusion under Section 5(2)(d) of the Act. In October 1961, after the C&O had contracted to purchase approximately 61 percent of B&O stock, and after the NYC determined that it had little, if any, chance of obtaining joint control of the B&O with the C&O, or of effectuating an NYC - C&O - B&O merger, the NYC advised the PRR that it was ready to resume negotiations leading to merger. It was the belief of the president of the NYC that if the transactions embracing the N&W, Nickel Plate, and Wabash, and the control of the B&O by the C&O, were consummated, the NYC could not compete with these two systems independently. While the action of the NYC in seeking merger with the PRR was in large measure defensive, the former believed that a PRR/NYC System divorced from the N&W and competing with an expanded N&W System and a C&O/B&O System would offer the Eastern section of the United States a competitively balanced railroad system. As a result of negotiations with the PRR, the NYC withdrew its application in the C&O/B&O proceedings and its petition for inclusion in the N&W proceeding.

Negotiations between the PRR and the NYC were conducted during the latter part of 1961. The merger agreement was signed on January 12, 1962,

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[1] Finance Docket? No. 20599.

[2] Finance Docket. No. 20707.

with the approval of both boards of directors and with subsequent approvals by the respective shareholders. Although the outcome was not apparent for several years, the merger application was finally effectuated in April 1968. The Pem Central case was a merger that was completely different from any previous one because it involved the combination of two large-size companies into what is presently the largest railroad system. Of course, the declaration of bankruptcy by the Penn Central in June 1970 is a well-documented topic.

The net effect of the complications resulting from current merger proceedings is the raising of pertinent, more aggregative questions of public policy. For example, the president of the Chicago and Eastern Illinois has stated the following: [1]

> Any merger proposal involving two or more railroads has advantages and disadvantages irrespective of whether the railroads are operating in the 'black' or in the 'red. ' The effect of the merger on the railroads involved, on their employees, competing railroads, individual shippers, and others must be subordinated to what is considered to be in the best interest of the public. The Interstate Commerce Act attempts to safeguard the rights of those who may have conflicting interests in a merger proceeding by providing for participation of interested parties in public hearings, for the issuance of reports, and for the filing of petitions for rehearing, reconsideration, etc. Finally, after administrative remedies are exhausted, provision is made in the Interstate Commerce Act for review of the Commission's order in the courts. Carriers operating in the 'black' who can successfully meet the requirements of the statute relating to railroad mergers are more likely to strengthen the overall U. S. transportation system than those operating in the 'red' who are permitted to merge in the hope that the merged company can achieve results one or more of the railroads parties to the merger could not achieve while operating as a separate entity. We cannot have a strong transportation system without strong healthy railroads.

Despite the piecemeal efforts to achieve mergers in the West, the ICC has been reluctant to approve any of them unless some type of overall plan is first developed which will meet national transportation policy requirements and the nebulous (public interest) criterion. Even without an overall plan, however, a prevailing and important empirical issue continues to be investigation of the impacts of mergers on which public policy considerations for restructuring can be developed.

[1] Statement by Kenneth C. Davis, Trains, XXVII (January 1967), p. 42.