The Rail Industry's "Chicken Little" Routine Doesn't Fly

Letter to the Wall Street Journal, April 10, 2000

Holman Jenkin's analysis of what's happening in the rail industry ("Shareholders Catch a Slow Train to the 21st Century," March 15, 2000) perpetuates the myth that the "sky will fall" if competition is introduced into railroad monopoly markets. Mr. Jenkin's thesis largely centers on his assertion that the railroad industry "has spent a century not earning back its cost of capital." An inspection of the concept of "capital need" hardly supports the notion of a long-term, capital-deficient railroad industry.

1. Capital need is a concept applicable to individual companies -- not to complete industries. In competitive industries, some companies fail, some are acquired, some merge, and some prosper. When good and poor performances are combined to calculate an average industry statistic, the result can be misleading. The rationalization of the railroad plant was a natural market phenomenon in which some railroads remained financially strong and had no difficulty in attracting capital.

2. The four dominant railroads have no history of capital shortfalls. When the Staggers Rail Act was passed in 1980, the current four dominant railroads had relatively sound earnings as reflected in the following rates of return on equity: NS (16.1%), CSX (12.5%), BN (10.2%) and UP (10.2%). These railroads remained strong throughout the 1980s and most of the 1990s, as illustrated by their 1996 returns: UP (16.6%), NS (13.7%), CSX (11.7%), and BNSF (11.4%). Collectively, they spent about $20 billion to acquire other railroads. Clearly, there were no capital shortfalls for these railroads over the past two decades.

3. Capital need and depressed stock-market prices are not synonymous. Railroad stock prices are depressed in the same manner as other companies in the "old economy." Many non-railroad companies, who enjoy adequate earnings, strong financial structures, and an abundance of capital, have seen their stock prices tumble. Furthermore, railroads have pushed much of the equipment investment to others (including, customers), and plant investment is largely funded through internal funds and debt.

4. It is natural for investors to suffer when expectations of merger benefits are not realized. When railroads pay premium prices to acquire other railroads on the basis of prospective benefits that do not materialize, investors should suffer the consequences. After all, it is the investors who took both the upside and downside risk associated with railroad pre-acquisition claims. Unlike customers who depend on single-railroad service, investors have alternative opportunities.

5. There is no credible evidence that railroads are capital deficient. BNSF continues to be a thriving railroad (14.8% return on equity in 1998 and a strong 1999 performance), while the other three dominant railroads are in post-acquisition, transitional periods. Still, they have been able to fund their newly acquired debt and make substantial capital investments. For example, the March 1, 2000 edition of U.S. Rail News reported that in 1999 CSX invested $1.4 billion and NS $2.8 billion respectively, in new plants and expansions along their lines.

While railroads must have the prospects of earning adequate profits to attract capital, such prospects should not emanate from insufficient service and monopoly pricing. Rail customers do not propose to "re-regulate" railroads as regulation can never simulate the efficiencies of open markets. Furthermore, railroad-customer confrontation, costly and lengthy regulatory proceedings, and a maze of complex regulations are not in the interest of either railroads or their customers. Quite simply, railroad customers want what other customers already have -- choice. The introduction of competition to highly capitalized industries has improved performance and earnings, despite prior claims to the contrary. There is no reason to expect railroads to fare any differently. Using shareholders' disappointments in rail earnings as a reason to endorse the railroads' version of "Chicken Little" is not in the public interest and is bad economics.

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