Midwest Railroads and Northeast Lessons

John W. Barnum

IN THE EARLY 1970s when the Penn Central and seven other Northeast railroads went bankrupt, the federal government stepped in with new laws, a new agency to plan a way out of the crisis, and billions of dollars in grants and loans. More recently two railroads in the Midwest have gone bankrupt and there is mounting concern about the several carriers in the region that are still solvent. Congress and the Carter administration are under pressure to ensure continued freight service in the Midwest as was done in the Northeast, and if history is any guide, massive government intervention is again a possibility.

My purpose here is to ask and, I hope, answer two questions. What lessons did we learn—or should we have learned—from the reorganization of the bankrupt railroads in the Northeast? How should we apply those lessons to the railroad problems in the Midwest?

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I believe that six principal lessons were learned in the course of the Northeast bankruptcies and the establishment of Conrail (the corporation formed by Congress to consolidate the viable properties of the bankrupt lines).[1] Most of these lessons are not new, but rather serve to remind us of what we already knew or should have known.

The Six Lessons

The first lesson is that Section 77 of the Bankruptcy Act does not meet the present problems of railroad bankruptcy. Section 77 was designed originally to refloat a railroad that had been sunk by excessive debt but that could, with less debt, operate at a profit. In other words, it was designed for the circumstances of railroad bankruptcy in the 1930s. It did not provide a solution for the railroads in the Northeast that went bankrupt in the 1970s, when the Penn Central, for example, was losing $1 million a day on operations, even without paying local taxes or servicing debt.

Section 77 is not a satisfactory mechanism for reorganizing even one such railroad, let alone for reorganizing a number of them collectively. Its principal shortcoming is that it divides authority between the Interstate Commerce Commission (ICC) and the federal court presiding over the reorganization, making each king of its own domain but neither capable of bringing about a reorganization on its own. Section 77 also makes it virtually impossible for a railroad that is in reorganization to abandon or transfer properties until a reorganization plan has ICC and court approval, and it gives the shareholders of the bankrupt railroad the power to block any merger (including one that might make more sense than a self-contained reorganization from the viewpoint of transportation efficiency or public interest).

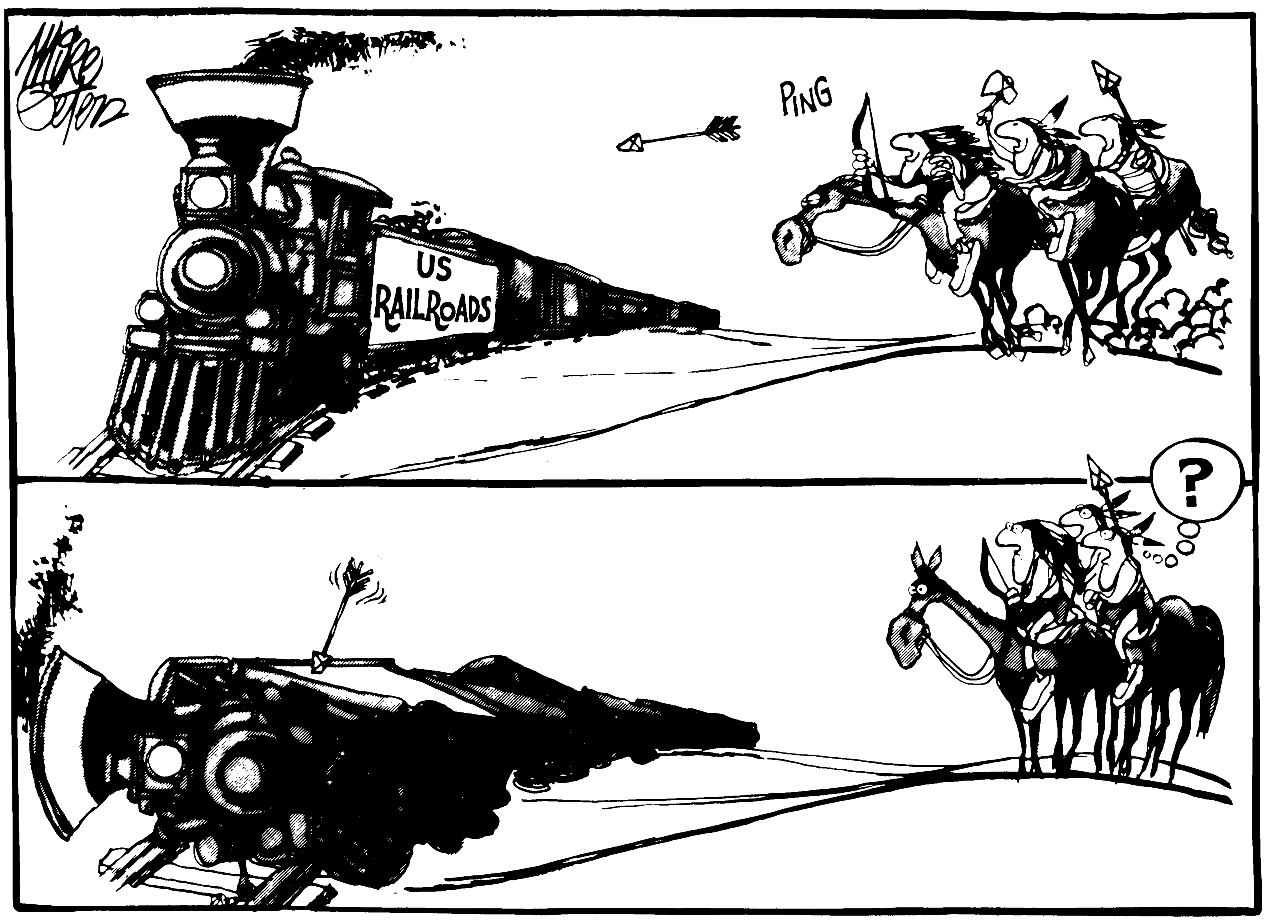
By late 1972, two years after the Penn Central had filed for reorganization, we at the Department of Transportation had drafted a complete revision of Section 77. We did not

[1] Conrail (Consolidated Rail Corporation) is a freight railroad, but it also operates intercity passenger trains for the account of Amtrak (National Railroad Passenger Corporation), which was established by Congress in 1970 to assume the passenger operations of any railroad that chose to get out of that business. Conrail also operates commuter services for the account of local transit agencies.

send it to the Congress, however, because it was already apparent that the problem in the Northeast was not to reorganize one railroad under any form of Section 77, but rather to reorganize several railroads simultaneously. Section 77 would not have permitted us or anyone to bring all the parties and issues together in a single forum, and even a revised Section 77 would have meant endless litigation during which critical elements of the national transportation system would have continued to deteriorate. So, instead of revising Section 77, the administration and the Congress developed the Regional Rail Reorganization Act of 1973—called the 3-R Act. The old Section 77, with its record of decade-long reorganizations, remains on the books.

The second lesson we learned—or relearned—is that railroad labor can and will call its own tune. The process that led to the 3-R Act was triggered by a one-day strike on February 8, 1973—a strike in response to the Penn Central's posting of some work-rule changes—and the labor protective provisions set forth in Title V of the act were pretty much written by railroad labor. Negotiators for the railroad brotherhoods did make certain concessions (such as granting management the right to relocate employees), but they held fast on the requirement that whatever new entity emerged from the reorganization process must start out with the labor contracts of the bankrupt lines.

The Penn Central's contracts were already more favorable for labor than most in the industry, largely because that was the price paid for labor's acquiescence to the 1968 merger of the Pennsylvania and the New York Central. It would be neither accurate nor fair, however, to suggest that labor costs were the sole cause of the Penn Central's insolvency. In their prescription for a successful reorganization, the reorganization trustees had identified two additional ailments—continued passenger service losses and unnecessary trackage—and had called for federal funds as the cure. (To complete the picture, we may note that other ob-



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servers included management as part of the problem.)

Title V did authorize federal financial assistance for displaced railroad employees. But so far only $180 million of the $250 million authorized in the 3-R Act have been committed for this purpose and Conrail has only 5,000 fewer employees than the 100,000-plus who worked on the bankrupt properties that Conrail acquired. Thus—as part of our second lesson—we learned that the problem of reducing labor costs is far more difficult than anticipated.

Even should Conrail now be able to consolidate and renegotiate those contracts (failing which it will never become profitable), clearly the requirement that Conrail assume the existing labor contracts sounded the death knell for any transfer of all but the smallest pieces of the bankrupt lines to solvent carriers. Since the 3-R Act assured the employees of the bankrupts that they would enjoy the benefits of their existing contracts or receive federal payments if displaced, their unions refused to accept any less favorable contracts with another railroad, even though the individual workers' jobs and existing pay scales would have been protected. Thus the requirement frustrated the Chessie System's acquisition of the Erie Lackawanna and the Southern Railway's acquisition of the Delmarva Peninsula properties of the Penn Central.

A third lesson we learned—or were reminded of — is that, in this arena, politics touches everything, usually with economically unsound results. Political pressures dictated aborting the strike in 1973, and political pressures dictated the size of the Conrail system. That system is larger than it should be (and is being kept larger than it should be) for political reasons. It is, in fact, too large to be viable. One of the main arguments for giving Conrail the entire $1.3 billion it is now requesting is to relieve the pressure on Conrail management to satisfy political interest groups. This has the marks of an ironical argument, or at least of adopting the "theory of the second best" with a vengeance. But undoubtedly it *is* better to give Conrail so large a sum than to give it less, which would leave it more vulnerable to continued political pressure and risk what it is given being improperly allocated for political reasons.

There has also been political pressure to assist railroads elsewhere in the country, and —given the need to obtain congressional support for spending billions of dollars on the railroads in the Northeast—it has not been possible to deny financial assistance to the Rock Island and the Missouri-Kansas-Texas. Thus, financing Conrail has necessarily meant supporting excess capacity elsewhere in the country.

Fourth—and here, for a change, is some good news—the reorganizations in the Northeast and the formation of Conrail proved that the courts can use a modernized bankruptcy law to reorganize railroads, and that they can do so expertly and within the short time limits set by such a law. One of the more fortunate occurrences in the Northeast rail reorganizations was the presence of John Fullam as the reorganization judge for the Penn Central and the selection of particularly qualified members for the Special Court (the new federal court established by the 3-R Act to oversee the formation of Conrail). But the fact that they are especially capable does not undercut—it may even support—the basic proposition that, given a workable statute, the federal judiciary is an invaluable mechanism for bringing order out of conflicting interests in a crisis of this sort.

Fifth, and this should not come as any surprise, we have again seen that government planning is less than perfect. Although the United States Railway Association (USRA, created by the 3-R Act to plan a solution to the problem of the eight bankrupt railroads in the Northeast) did an outstanding job, in my opinion, and although other government agencies (like the ICC and its Office of Public Counsel) made significant contributions, the fact remains that USRA's final system plan for Conrail was based on a number of assumptions about increased productivity and rehabilitation costs that have proven to be unrealistic. In other words, it has been demonstrated once again that government planning is not an especially satisfactory substitute for the decisions that emerge from the marketplace.

Sixth and last, we have been reminded that railroading is a precarious undertaking, with narrow—if any—margins of profitability. In recent times, the capabilities of highway and waterway freight and their federally provided advantages have jeopardized the viability of a national rail freight system, bringing to mind the story of how automobiles and airlines first jeopardized, then obliterated, the profitability of railway passenger service. Perhaps this points up the need for careful examination of federal financial assistance to the various modes of transport, as well as the need for some hard decisions to redress imbalances. In addition, we have recently seen—again—how vulnerable railroads are to the weather, to industry strikes, and to the state of the economy. And we have learned that catching up with maintenance and equipment problems is costly and difficult to budget accurately. Moreover, notwithstanding the efforts at regulatory reform culminating in the Railroad Revitalization and Regulatory Reform Act of 1976 (called the 4-R Act), we have observed the reluctance of both the ICC and the Congress to relax the heavy hand of regulation that has so often frustrated innovation and the efforts of managements to run their railroads profitably. Of course, as noted, we have also learned, or been reminded, that labor costs continue to be a significant barrier to profitable operation.

Caveats

Along with identifying the lessons we learned (or had confirmed) during the Northeast reorganizations, we should also take note of two important premises of the Northeast reorganizations. These premises were not so conclusively established by the results in the Northeast as to warrant calling them lessons, and they are, indeed, likely to be challenged as we come to deal with the Midwest.

We must recognize, for one thing, that the debates in 1973 and 1974 on how to solve the problem of the bankrupt railroads in the Northeast did *not* end for all time the specter of railroad nationalization. Because it was possible to reorganize most of the Northeast railroads into a new and more or less private-sector company,[2] the clamor for nationalization never rose above the annoyance level. The railroad brotherhoods' position was significant if not critical here. Among other things, the brotherhoods had studied the problems that nationalization had caused rail labor in the United Kingdom and were satisfied they could do better under reorganization than working for the government.

But if Conrail fails, the nationalization debate will resume. Moreover, if the railroad unions were to anticipate that a private-sector solution in the Midwest would differ substantially from the one in the Northeast—with adverse results for them—they might change their minds about nationalization, or at least show more interest in the idea during the political debate.

No more than it killed the nationalization idea did the Northeast reorganization kill for all time the idea of having the government take over the railroad rights-of-way. There has already been renewed discussion of this concept, especially in New England, where there is noticeable support for a regional transportation authority's doing just that—if not for taking over the railroads in their entirety.

It is easy to see why some of the railroads there and elsewhere in the country would be attracted to such a scheme. A railroad that has on its books several hundred million dollars in rights-of-way, on which it is earning a minimal return (if any), would be delighted—even ecstatic—to exchange that asset for a like amount of negotiable federal notes. Indeed, the railroad might even be better off financially than it is now if it sold the property at a discount (though management and the mortgagees would understandably start negotiations by asking at the least for the book value of the assets or even for their replacement and assemblage values). As a part of the same scheme, management might seek to improve its operating statements by contracting with the government to maintain the rights-of-way on a cost-plus basis. The government would then be underwriting something that the railroad should be doing now anyway, but often does not have the money to do.

In my opinion, the government's taking over the rights-of-way would be most unfortunate. It would saddle taxpayers with enormous acquisition and maintenance costs, frustrate any further improvement in the productivity of the national system by rationalization

[2] Conrail is a Pennsylvania corporation whose common stock is owned by the estates of the bankrupt railroads in proportion to the relative value of the assets they transferred to Conrail. The federal government's investment is reflected by debentures and preferred stock. The goal is to have Conrail retire the government debt and preferred stock out of earnings.

and reduction of labor costs (there no longer being a profit motive in that aspect of the operation), and put the government into competition with other private-sector transportation —including other railroads if it acquired only the rights-of-way of the bankrupt lines. There would also be the problem of compensating local governments for the railroad properties taken off the local tax rolls. But Conrail's failure, or even an effort on Conrail's part to abandon unprofitable lines, would be likely to rekindle the interest in government ownership of the roadbeds—"just like the highways. . . ."

The Midwest Is Different

Before we try to apply in the Midwest what we have learned in the Northeast, we should look briefly at the principal differences between the two situations. I see four.

In the Midwest there is substantially more duplication of mainline capacity and probably an even larger percentage of surplus trackage (or trackage "available for subsidy," to use the USRA euphemism) than was the case in the Northeast. In the language of the economists, the opportunities for disinvestment are greater. And, perhaps more significant, there will be less justification in the Midwest for pressure from politicians to retain every inch of track inasmuch as there should be less loss of service per mile of disinvestment, whether through abandonment or through downgrading of mainlines to branch lines. (By this apparently naive comment, I do not mean that the political pressure will be any lower, only that its justification is less.)

In addition, none of the railroads in the Midwest is essential to a national system, as the Penn Central might have been said to be. Indeed there does not appear to be a compelling need to preserve any of the individual companies in the Midwest as independent entities.

Moreover, there is enough local and "bridge" traffic throughout the Midwest to make railroading profitable for a system burdened by less duplication. This statement assumes, of course, that a national railroad system is itself viable. Even if it is not, the Midwest still differs from the Northeast, where there was (and still is) some feeling that it is simply not possible to operate a railroad profitably east of Pittsburgh (or east of the Hudson, depending on one's expert).

Last, because of the potential profit, there undoubtedly are willing buyers for the viable segments of the Midwest lines, which was not the case for lines in the Northeast. When former Secretary of Transportation William Coleman attempted to solve the problem in the Northeast by inviting the Chessie and the Norfolk & Western each to take half of the properties of the bankrupt lines, the two managements asked for substantial federal financial assistance and even indemnification against losses as conditions for the takeover. Part of their reluctance was attributable to the enormity of the undertaking, which Conrail's experience now proves was a justifiable concern. But the basic problem was uncertain profitability. Even the relatively small acquisitions which the Chessie and the Southern sought to negotiate were only marginally attractive, and their attractiveness was dissipated by the unions' insistence on preserving their rights under the Erie Lackawanna and Penn Central contracts. In contrast, there should be in the Midwest a number of profitable bite-size consolidations available to well-heeled carriers interested in market extensions.

Applying the Lessons

How then do we apply what we have learned in the Northeast to this Midwest situation? I suggest the following conclusions.

First, a Conrail solution is not the right answer. Although several railroad officials have recommended consolidation with government assistance—"Farmrail" is one such scheme—I believe that we should avoid undertaking another government planning process and bringing about another collective reorganization, calculated to raise out of the ashes a brand new phoenix financed with federal funds. Such a process is less efficient than the marketplace, more vulnerable to political pressures, and unnecessarily expensive. Moreover, consolidating the viable elements of the Midwest railroads into a *single* new entity would both eliminate desirable competition and block the possibility of hooking the useful parts of the Midwest railroads to solvent railroads operating in other regions.

Second, the federal government must resist pressures to bolster the bankrupt lines unless the bolstering will accelerate rationalizing the railroad structure in the Midwest. Existing federal financial assistance programs are intended for catching up on maintenance and otherwise improving those parts of the system that would be essential in any restructuring—for preserving and improving the national system as a whole as well as for aiding a particular railroad. But when the property belongs to a bankrupt line, the infusion of funds is likely merely to prolong the reorganization process and delay rationalization. The federal financial assistance provisions of the 4-R Act—the authority to guarantee loans and even for the federal government to purchase preferred (but subordinated) stock of the railroads—should be used in the Midwest as incentives for private-sector restructuring of the system. This does not mean shotgun marriages of insolvent or faltering railroads; it means preserving potentially viable pieces of a railroad for a while, lest they lose their attractiveness to solvent railroads.

Third, Section 77 must be replaced with a bankruptcy statute that will permit the courts to achieve reasonably rapid results, a statute that does not divide the critical authority between the ICC and the federal courts. There is a need for simplification and clarification of the court's authority and, ideally, for specific time limits in the statute. The courts should be able to authorize transfer or abandonment of property more easily than they now can. For example, they should have more leeway to permit property transfers before a plan is finally approved, rather than have to wait until the reorganization process is completed. At present such transfers can be frustrated by the argument that the property could be important to the surviving company. And certainly the option of merging with other railroads must be made more feasible than it is under Section 77. The revision of the Bankruptcy Act passed by the House of Representatives early in 1978 (H.R. 8200) would be a significant improvement over Section 77.

Last—and, in fact, part of the previous point but sufficiently important to note separately—some provision must be made, either in the Bankruptcy Act or in a companion statute, for federal financial assistance to railroad employees who lose their jobs or are relocated as a result of a reorganization. Subsection 77(n) of the Bankruptcy Act now continues existing collective bargaining agreements, and Section 1167 of H.R. 8200 would prevent the trustees and court from meddling with existing labor agreements except in accordance with Section 6 of the Railway Labor Act. Unless we have a statute similar to the labor protective provisions of the 3-R Act to cushion the impact of a reorganization on labor, it is unreasonable to expect that the spaghetti in the Midwest can be rationalized and sufficient disinvestment achieved.

Some of the nation's stronger railroads have been able to keep their systems lean and profitable by making substantial cash settlements to employees displaced by abandonments. But the bankrupt railroads in the Midwest are not in any position to do that, and the solvent railroads that might be tempted to acquire some of the bankrupts' properties could lose interest if they had to assume excessive labor costs, or even labor agreements inconsistent with their own. The same forces that kept the Chessie and the Southern from making any substantial contribution to the solution in the Northeast would deter the strong and solvent railroads of the West and the South from playing the role in the Midwest that would best serve the needs of the national transportation system.

The federal government would actually save money if it could handle the excess labor problem directly rather than indirectly. If the government cannot directly compensate workers who would be displaced, it will end up either financing the marginal or bankrupt railroads so that they can hobble along and fix up unneeded properties, or compensating the solvent railroads for the unnecessary labor costs involved in acquiring properties from the estate of a bankrupt railroad—or both.

Each of these four suggestions has been stimulated by the lessons that I for one learned from the Northeast reorganization. If those are indeed the lessons we should have learned, the principal issue is whether the administration and the Congress will have the political courage to apply them—to let the marketplace do the planning and to use federal funds to achieve a viable national system whose capacity (and therefore maintenance cost) is commensurate with the demand for rail service. ■