

TESTIMONY OF ROBERT E. GALLAMORE, DEPUTY ADMINISTRATOR, FEDERAL RAILROAD ADMINISTRATION, BEFORE THE SUBCOMMITTEE ON TRANSPORTATION AND COMMERCE, HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE, NOVEMBER 1, 1979

Good morning, Mr. Chairman and members of the Committee. I am pleased to be here today to discuss railroad mergers and related transactions, both in general and with specific reference to the Administration's proposed Railroad Deregulation Act of 1979, H.R. 4570. I am particularly pleased that, as this session of Congress moves toward a close, this committee is moving forward with the intensive and provocative hearings of which this is only a part.

I sincerely hope that several reports of record profits from some of our most healthy railroads, and Conrail's improved financial reports, will not lead this Committee or the Congress to lose sight of the fact that the industry is still in bad shape financially. We have not changed our forecast of a \$13-16 billion shortfall of capital funds, excluding Conrail, for the decade ending in 1985. I re-emphasize that significant reform of the economic regulatory system is the single most important next step to recovery. We want an industry that can renew itself in the private sector, serve its shippers safely and well, employ its workers fully, and thus continue its benefits to the general public. We in the Administration are still firmly committed to railroad regulatory reform, and to the enactment of legislation to implement our proposals in this Congress.

While other areas, such as rate flexibility, have so far captured the center stage of public concern, the subject which I will discuss today -- mergers, coordinations and related transactions -- is extremely important to the future of the railroad industry.

There are two large mergers now pending at the Interstate Commerce Commission, either of which would create the nation's largest railroad, but lesser transactions are also assuming great importance right now. The conclusion of the reorganization proceedings involving the Rock Island and Milwaukee railroads will surely include the sale and transfer of parts of those systems to other carriers. The effects of such transfers on the structure of the railroad system in the Midwest and West will be significant and may generate controversy. Certainly the ongoing ICC proceeding involving the Southern Pacific's proposed purchase of the Rock Island's Tucumcari line, although not a full merger, fits this description.

It is well-known that the rail network of the Midwest contains far too many lines that are not self-supporting. Much of this redundancy can be eliminated without substantial detriment to shippers or employees through joint agreements, frequently referred to as "coordination projects," "401 projects" or, more broadly, "restructuring". Streamlining the over-extended network of poorly maintained lines will permit remaining lines to reach traffic density levels that merit continuation and upgrading. For the Midwest, "coordination" is a more useful policy than merger, because restructuring actions such as traffic consolidation, line transfers, market swaps, and related abandonments are the ingredients of streamlining, while merger only puts two corporate entities together -- with streamlining still remaining to be accomplished. Indeed, mergers may reduce opportunities for market swaps and may delay abandonments if either the company or the public believes the merger itself solves the problem of redundancy.

We base our conclusions on the discussion and findings of the Prospectus for Change in the Freight Railroad Industry, submitted to the Congress in October 1978, and I would like to submit for the record Chapter 4 of the Prospectus, entitled "Restructuring: Abandonment, Coordination, Merger, Public Ownership". Several portions of that chapter are particularly relevant to today's hearing, and I would like to cite them:

"The principal incentive for railroad companies to merge is the potential economic benefit from cost savings and marketing opportunities that may accrue to the combined system. Mergers have been categorized into two groups: parallel, where merging railroads cover essentially the same geographical area; and end-to-end, where the lines serve different territories but join at complementary interchange points. More often than not, merger proposals display both characteristics, but the categories are useful.

Mergers of companies whose systems are essentially parallel offer possibilities for reduction of capital requirements through reduction or downgrading of mainlines, yards, and terminals, and improved equipment utilization. Parallel mergers, also, are expected to reduce operating costs through the elimination of duplicate services

and through increases in labor productivity. End-to-end mergers on the other hand, are presumed to facilitate better service to customers through faster and more reliable point-to-point service in markets formerly served by interchange service. Both types of mergers have potential for reduction of corporate overhead (e.g., marketing, accounting, and executive departments); improvement in car availability; and elimination of unnecessary interchange facilities."

"End-to-end mergers, advocates believe, could create a strong intercontinental system, allowing railroad companies to focus attention on managing operations rather than on the problems of cooperating with other railroads to provide through service. End-to-end mergers could also link railroads in fast growth areas to those in slower growth areas and could aid in the balanced development of the industry. These mergers also avoid the possible anti-competitive aspects of parallel mergers."

Having cited these potential attributes of merger, I must caution that we have not seen all the prospective benefits of full-scale mergers materialize:

"Recent FRA case studies of two apparently successful mergers have found that the two mergers achieved a portion of their projected cost savings, but that availability of capital, the need to preserve certain service arrangements (in one instance at least), and the extended period of time required from the initial merger proposal to its actual execution, all diminished the effectiveness of operating changes.... The two mergers did not significantly

improve the market penetration or profitability of the merging companies. While the resulting organizations are financially successful by rail industry standards, the act of merger did not improve the intermodal competitive capability of either firm....

"Similar conclusions were reached in other merger analyses. A DOT staff study in 1969 reported: "The conclusion of the economic evidence is that the cost-savings arguments for large railroad mergers have to be very largely discounted and must be applied to individual cases with very great circumspection." The Task Force on Railroad Productivity concluded: "...there (does not) appear to be any evidence that rail service has generally improved as a result of merger" and "...anticipated cost savings may not be realized because they are based on anticipations of economies of scale or density which either do not exist or are offset by diseconomies of scale." An MIT study said that: "...as a form of rationalization, mergers have proven only moderately successful...." Finally, the Rail Services Planning Office recent Rail Merger Study concludes:

....economies stemming from parallel mergers have been difficult to realize. Merger savings typically are a relatively small proportion of system revenue. Capital expenditures for new or rehabilitated yards, track connections and facilities, and delays in securing abandonment approvals tend to minimize increased cash flow and return on investment.

Our activities over the last several years, as participants and on-lookers in formal merger and related proceedings before the ICC, as catalysts of restructuring through use of our authority under Section 5 of the DOT Act, and as participants in ongoing reorganization proceedings, have convinced us that there are two major problems with the existing procedures in these areas. First, the standards that the ICC must apply in deciding whether to approve a transaction are murky, conflicting, and complex. And second, in part because of the standards problem, and in part because the ICC has not yet developed an expedited procedure for small transactions (although a proposal for such a procedure is expected to be issued shortly), proceedings of all degrees of importance and complexity take much too long. The procedural reforms of the Railroad Revitalization and Regulatory Reform Act of 1976 (the 4R Act) have helped, but it is clear that simply continuing to pressure the ICC to do the same thing in less time can have limited benefits. Perhaps improvements could be made in the 4R Act's new procedures in section 403 and regulations under that section to expedite restructuring.

Merger Standards are Overly Complex and Lead to Lengthy Proceedings

A simple, literal reading of section 11344 of the Interstate Commerce Act, the section dealing with rail mergers and transfers, would lead one to conclude that the Commission need consider only four issues in deciding such cases: adequacy of transportation, effect on the public interest of including or excluding other carriers, total fixed costs resulting from the transaction, and the interests of the employees. Unfortunately, the simple reading belies the complexity of the problem. First, the ICC has determined that the nine additional issues listed in section 11350,

regarding the expedited merger procedure, are applicable in all cases. These include consideration of environmental impacts, the comparative costs of the proposed transaction with the costs of other alternatives, the effect on communities, and the effect on rationalization of the rail system.

That's not all. The courts, applying traditional antitrust law, have added additional criteria, including the six goals set out in the National Transportation Policy, section 10101 of the Interstate Commerce Act. Finally, in 1978, the Commission added and clarified criteria. According to the ICC's Rail Consolidation Procedures, the Commission must consider the following in any merger case: maintenance of essential rail services, operating efficiencies, reduction of redundant facilities, financial viability of the consolidated company, and maintenance of intra- and intermodal competition "whenever economic realities make it possible."

The number, and sometimes contradictory nature, of the existing standards do not lead to a consistent transportation policy with respect to mergers. Additional complexities result from the ICC's ability and historical willingness to add conditions to mergers it approves, usually to mitigate the impact of changes in traditional routing patterns on connecting carriers. The Prospectus for Change report concludes that these protective conditions have the effect of diluting the prospective benefits of merger.

By comparison, the Airline Deregulation Act of 1978 altered airline merger standards, which also had become too complex, to focus on two major issues -- the effect of the proposal on competition and the projected transportation benefits. This standard, together with statutory labor protection, takes into account the only issues that we believe the government should be deciding with respect to transportation mergers -- whether the public will suffer from a loss of competitive pressure to control costs, provide innovative and reliable services, and price final output at efficient and sustainable levels, or whether the public will benefit directly from increased competition, service, and operating economies attributable to the merger. The Administration's bill, H.R. 4570, adopts an amended version of this standard for use in railroad coordination transactions, such as the granting of joint trackage rights. We urge the Committee to consider whether these modified standards might not also be a way out of the legal and procedural morass of full-scale railroad merger proceedings.

Transactions Short of Merger May Yield a Healthier Rail System

While we believe that merger standards and procedures must be improved, it is transactions of a more limited nature that are more common and, we believe, more likely to have a beneficial effect on the rail system. As we discussed earlier in citing the Prospectus for Change report, "mergers are a less promising technique to improve the railroad industry than other approaches to restructuring . . . [such as] line transfers, joint use agreements, and abandonments."

Unlike mergers, where companies seem to come together on their own, there has been a reluctance for companies to come together to discuss the mutual benefits of lesser transactions. In part this may be due to fear of violating the antitrust laws; in part it is due to a failure to foresee and appreciate the benefits of these lesser transactions. We are fond of quoting a statistic that two-thirds of the rail traffic today moves over twenty percent of the rail system. To some extent, simple abandonments are the most cost (and energy) efficient solution to this problem. However, in many other cases, a package of restructuring transactions can reduce unnecessary trackage and related costs, with significantly smaller adverse impact on service.

The 4R Act contains an extremely important tool to assist in the restructuring process. Under section 5 of the DOT Act, as amended by the 4R Act, (usually called "the 401 process"), the Secretary of Transportation or his delegate may convene meetings of carriers and other interested parties to discuss "unification or coordination projects." Participants are not subject to prosecution under the antitrust laws for discussions on unification and coordination at these sessions. Using this authority, last year we were able to obtain the first "401 agreement" on four transactions that would, together, have led to the reduction of 329 miles of the rail system with minimal impact on shippers. These agreements included a coordination agreement in which carriers running largely parallel services agreed to use one set of tracks, and "market swaps" or "coordinated abandonments" in which two carriers, each losing money serving the same points, agreed that only one (designating which one) should serve the cities. We had also reached a landmark agreement for joint use of a major section of mainline track in Iowa that is being

upgraded with 4R Act preference shares funding. As is apparent, careful balancing of competitive and transportation benefits is essential in developing these proposals. The Prospectus I referred to earlier defines these concepts or strategies in greater detail.

Unfortunately, the transactions announced last year have not been finally implemented because of intervening difficulties on the Milwaukee Railroad, with which you are all quite familiar. We do believe that the 401 process will be very important in the final reorganization of the Milwaukee and is the cornerstone of our policy toward the Rock Island. We have already held a series of conferences in Iowa regarding the lines that the Milwaukee intends to transfer to others, and we have begun meeting with railroads and States interested in service over lines of the Rock Island. Aside from these major negotiations, we also have underway six other 401 sessions involving 21 railroads and 10 States. These actions hold promise of achieving real operating efficiencies and cost savings, while protecting major shippers and employees.

Our activities involving railroads both in and out of reorganization have convinced us that while the 401 process is a useful tool, it has not been as useful as it could be. In such a

proceeding, the fact that the project has been approved by the Secretary carries no weight before the Commission, although it is fair to say that if the Secretary has done his job properly, there should be fewer protests.

We think that there can be improvements in the process. With respect to transactions involving a railroad in reorganization, we believe that the existing procedure should be streamlined by giving the court full authority over transfers. We are examining what the role of DOT and ICC should be. A step in this direction was taken last year in the bankruptcy act revisions, but there are several deficiencies in handling these transactions:

- 1) there is no provision for the court or the ICC to grant interim operating rights to a carrier whose application to purchase is pending before the court and the ICC;
- 2) the statute does not clearly authorize the court to approve a transaction that the Commission has rejected, which could lead to the type of ping-pong between the court and the Commission that previously characterized rail bankruptcies;
- 3) there is no presumption in favor of a proposal that has been developed by DOT through the 401 process; and
- 4) if interim operating rights were approved and another carrier were willing to provide service without subsidy, it would still be risky for that carrier to undertake necessary rehabilitation work until it had permanent ownership approval.

It is our hope that we will be able to devote more of our resources to the problems of railroads not in reorganization, and here too the 401 process could be improved. Our bill, H.R. 4570, does this in several ways. First, the standard for approval of all coordination transactions has been simplified as discussed above. The ICC will be required only to consider whether the transportation benefits of the transaction outweigh any anti-competitive effects on the surface transportation industry in the affected region. Second, time limits are shortened to 365 days for transactions of general transportation significance and 120 days for others.

The bill also provides that, with respect to an abandonment or a coordination transaction, the opinion of the Secretary is entitled to "substantial weight." Where an abandonment is part of a coordination agreement reached under the 401 process, the Commission must consider the transaction as a whole and may only disapprove the abandonment if its negative effects outweigh the benefits of the transaction as a whole. We believe that these changes are important and should be part of any regulatory reform bill.

Finally, we urge you to act favorably on Title II of H.R. 4570, the Railroad Restructuring Assistance Act. That legislation would tie use of our low cost assistance funds more closely to railroads' efforts at necessary restructuring that would occur as a result of regulatory reform. This we think is a more proper and efficient use of Federal funds than we can achieve under current law, which puts the premium on "overcoming deferred maintenance." That is, we would rather be in the business of helping the railroads and their shippers prepare for the future than simply re-establishing what proved to be uncompetitive in the past.

In summary, we believe mergers and related transactions are important parts of the railroad environment, and that significant reform is needed in both the standards and procedures under which they are approved. Our proposed legislation would accomplish that reform. That concludes my prepared statement. I will be happy to try to answer your questions.

