DIVERSIFICATION AS A MEANS OF FINANCIAL SUPPORT FOR SURFACE TRANSPORTATION UTILITIES

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> The collapse of the $6-billion Penn Central empire did more than bring down the mightiest of the railroad conglomerates. The shock wave it created brought new demands on Capitol Hill and from the Interstate Commerce Commission for legislation that would prohibit future railroad diversification.

Those statements are from an article in Business Week of March 11, 1972. They contain a number of factual errors. But more important, they draw a wholly erroneous conclusion from the legislative proposal made by the Interstate Commerce Commission regarding conglomerates and diversification. In a few moments, I shall comment on our legislative proposal.

As to whether conglomerate diversification was the cause of Penn Central's difficulties, I am in no position at this time, to state flatly one way or the other. The matter is pending before the Commission on a formal investigation docket. It is being looked into by others as well, including committees of Congress. But I can state unequivocally that a large part of Penn Central's problem is an outgrowth and a manifestation of a basic malady affecting railroad operation throughout the northeast quadrant of the nation.

Today, seven[1] major northeastern railroads are in reorganization under section 77 of the Bankruptcy Act. None of the other six is distinguished for diversification. On the other hand, New England's Bangor & Aroostook Railroad, said by some to have been victimized by a conglomerate, is not in bankruptcy. Nor are the Missouri-Kansas-Texas (The Katy Line), the Kansas City Southern, the L&N, the Union Pacific, the Santa Fe, Southern Pacific, Illinois Central, and numerous other railroads which are conglomerate affiliates, some having been actively diversified for more than 100 years.

These comments on Penn Central are intended to bring out two key points:

* The Interstate Commerce Commission has not concluded that diversification was the cause of Penn Central's fall.

* Commissioner, Interstate Commerce Commission, LL.D. Union College, 1947. A.B., Univ. of Ky., 1926.

1. Penn Central, New Haven, B&M, Erie Lackawanna, Lehigh Valley, Reading, and Central of New Jersey.

* Today's Commission has not determined that diversification is necessarily bad for transportation companies, or inconsistent with the public interest in transportation.

Before drawing any conclusion, we should examine the facts. First, what is a conglomerate? Generally speaking, it is a group of affiliated corporations, each engaged in a different and normally unrelated business pursuit.

Control of the group may lie in either a dominant operating company or a non-operating holding company.

A carrier may create a non-carrier holding company to which its stock would be transferred in exchange for the holding company's stock. The holding company would then diversify.

Regulated carriers have become "diversified" in another way—being acquired by an existing non-transportation conglomerate.

There are various reasons why regulated carriers become affiliated with conglomerates. Some railroad men have candidly stated their chief reason—to escape regulation. With motor carriers, it is not quite the same. In fact, it appears that certain non-carriers acquiring truck lines quite willingly submit to I.C.C. regulation. Assuming that all conglomerates are seeking to maximize returns for their stockholders, why the difference?

The major rail systems traditionally have engaged in nonrail businesses, primarily land-oriented. Their industrial development departments foster growth of industrial parks and other business at locations adjacent to the rail line, and for this purpose, the railroads would have the land available.

The western rail systems obtained vast acreage from the Federal Government as an inducement to construct their lines in the first place. That was all part of the national program in the last century to promote settlement of the West. Part of that acreage was sold to obtain construction funds. But much of it has been held, and today produces income from minerals, lumber, agriculture and other non-rail activities.

Through the conglomerate structure, those lands and other rail assets can be released from certain governmental restraints, thereby facilitating their use in enterprises promising more attractive returns. History shows that assets frozen into a railroad produce the traditionally low rail rate of return. They might even be consumed in public service wholly without recompense—as appears to have been the case with certain properties of the New Haven and the Jersey Central (two railroads now in reorganization).

Some railroads lie—nailed to the ground—in economically depressed areas, where the sustaining industries of bygone days have moved away

or have irretrievably lost market position. Examples are the textile industry of New England and the anthracite coal industry of Pennsylvania. Certain rail resources, fixed in place to meet the needs and aspirations of the last century, today stand unused, and worse than that, have little prospect of productive employment in the foreseeable future.

This is not to say they cannot be used for railroad purposes. The point is that their use is not likely to produce an adequate return to the owners.

Diversification by railroads is also fostered by tax considerations generated through use of the consolidated tax return. To a railroad with a seemingly endless parade of deficit years, tax loss carryovers and investment credits are meaningless. But the conglomerate, like magic, makes the tax benefits materialize.

Diversification reflects, undoubtedly, a coming of age of railroad managers. The economic realities of the computer era have weaned them away from the 19th Century notion of monopoly power. They understand the cyclical nature of their industry; they acknowledge the existence of formidable competition in other modes of transport; they perceive a future of frustration in the capital markets, vying for acceptance against nonregulated competitors.

To them, diversification offers the stability of a broader base, the glamor of product variety, the attractiveness of growth, and a freedom for enterprise. The picture is one of enhanced profits and investor acceptance.

They have tried other paths to rejuvenation but have fallen short of the mark. Some of the railroad mergers were launched too late, or were too long in consummation, or too slow in bearing fruit.

The multi-modal transportation department store concept ran afoul of ancient taboos. Revenue input and rate competition are attenuated by regulatory strictures.

Abandonment of deficit operations evokes hostile political and public response. Nationalization could no longer be dismissed as nonsense. Seemingly there was no way up and no way out.

To the railroads, the non-carrier holding company and its potential for diversification offered economic salvation.

With motor carriers the story is not quite the same. This industry has had enormous growth, obviously flourishing in a regulatory climate. To its benefit is the ever-increasing highway orientation of our society, with its planned 48,000-mile interstate throughway, its ubiquitous network of all-weather roads, and its emphasis on speed and flexibility. In recent years, some of the larger motor carriers have had returns on capital ranging from 8 to 25 percent. Opportunities for growth and profit seem to arise wherever the trackless truck can travel.

As a result, the urge to diversify has not yet captivated the motor

carriers. They have integrated horizontally (with equipment leasing companies, maintenance firms, terminal operators and warehouses), but with the entire corporate structure geared to the performance of transportation service.

The invasion by non-carrier conglomerates is beginning to make a dramatic change, however. Some of the truck lines have been annexed into affiliation with such diverse businesses[2] as baseball, chemicals, clothing, television, mutual funds, oil drilling and others.

Probably the chief qualifications of the motor carrier are: attractive cash flow, high return on investment, relatively low capital requirements, and growth potential. These attributes would tend to enhance the quality of the acquiring conglomerate's securities, and, at the same time, offer a source of funds and profit.

Let us look briefly at what diversification under a conglomerate structure has done for some carriers. The Union Pacific Railroad was diversified almost from its inception. But in 1969, it formed a holding company with several nontransportation subsidiaries, and spun off to them various properties which historically "belonged" to the railroad.

In the preceding four years, when the railroad was the parent, U.P. had an average annual income of $105 million. In the next two years, as a subsidiary within the conglomerate, the railroad had incomes averaging $116 million.[3]

With Southern Pacific, Illinois Central and others, the story is the same. As a parent railroad, they enjoyed profits; but as subsidiaries in conglomerates, their profits increased.[4]

Recognizing that long-range trends are not yet visible, and that income statements do not tell the whole story, these successes should not be ignored.

Let me cite two examples on the motor carrier side:

International Utilities, a diversified conglomerate, acquired Ryder Truck Lines in 1970, and Pacific Intermountain Express in 1971. With Ryder, there was a dramatic turnaround from prior years when it was plagued with problems and deficits. With P.I.E., profits remained strong while service was extended so that the Ryder-P.I.E. system can provide

2. Admiral—Texas Rangers; Commercial Motor Freight—Vanner Industries; Interstate Motor Freight—Fuqua Industries; Jones Motor—Alleghany Corp.; Terminal Transport—Texas Gas Transmission Co.

3. Not including an extraordinary charge of $77 million in 1971, reflecting Amtrak's takeover of passenger service.

4. Not including extraordinary charges in 1971, reflecting Amtrak's takeover of passenger service.

single-line service between major population centers throughout the country.

Greyhound presents a unique chapter. Until 1963, it was content to be a bus line, and in many respects it was No. 1. But then, it formed a holding company and began to diversify. In 1969, it took over a giant conglomerate already in being. That was Armour-Dial. With annual sales of $2 billion, it was the second largest meat packer in the country.

Some of the motivational factors governing Greyhound in this almost explosive expansion seem apparent. First, the jet plane and the 2-car family, stunted the growth of bus patronage.

In 1963, Greyhound had liquid assets and balance sheet strength sufficient to commit perhaps 30 percent of its total assets to diversified opportunities. Today it holds investments with a net worth listed at three quarters of a billion dollars, of which the bus lines make up less than one-third.

These success examples do not tell the whole story.

There is another side for which I will use two brief examples. The Chicago & North Western Railroad created a holding company, using railroad funds for diverse investments. First a chemical company was acquired. It was an immediate success. That was followed by another chemical company, then by fabrics, steel and diverse other lines. Naturally, the railroad's resources and substantial tax credits gave the project a big boost.

But in 8 years, management became disillusioned with the long-term prospects of the railroad industry, and this year sold their railroad. As a parting shot, the conglomerate management was reported as saying that the sale of the railroad will improve the earnings quality of the holding company by eliminating from the conglomerate's picture the unpredictability of the railroad's earnings.

In the other example, the Bangor & Aroostook Railroad put itself into a conglomerate. Railroad assets and tax credits were consumed, and after a few years, the railroad was spun off. The new owners have challenged some of conglomerate's dealings with the railroad as its subsidiary, and have filed a suit for recovery of damages.

I believe it is conceded that diversification often offers financial stability, especially to industries sensitive to economic fluctuations. The conglomerate can utilize the tax laws in dimensions not otherwise available; it can achieve economies of scale in management and administration; it can obtain credit on preferential terms and gain favor with investors; it has easier access to cash and capital.

In turn, the conglomerate can provide ready financing at low interest to its affiliates—for equipment, maintenance, capital improvements, and upgrading of service.

This would enable the carrier affiliates to reduce expenses; to expand, innovate and improve as warranted by the business; to establish long-range programs, and make their moves at the most opportune times.

These significant advantages should be available to carriers, no less than to other industries with which transportation utilities must compete in the capital markets. To deny these advantages to transportation would be inequitable and short-sighted.

However, an obvious purpose of the conglomerate is to invest where the returns are greates; and if the carrier lags behind or loses promise, it can be jettisoned like the C&NW and the Bangor & Aroostook.

Conglomerates have been known to strip assets from carriers, by directing the payment of large dividends, by upstream loans and advances that never really get paid back, by heavy assessment of management fees for perfunctory services, etc.

If, in fact, a carrier has over-capacity and excessive reserves, disinvestment or diversion of resources to more profitable activities may not be inconsistent with the public interest. A rational plant reduction and realignment of corporate resources, without adverse effect effect upon essential service could be economically sound. But, as we have seen, conglomerate manipulations are not always advantageous to the carrier, or in turn, the public it serves.

The duty of a public official in transport regulation is to serve the public, to the end of providing a transportation system adequate to the ever-evolving needs of the nation and its commerce. With that as the objective, we must be concerned about the conomic soundness and earnings capacity of transportation companies. That concern is, in fact, a matter of statute.

By statute, it is unlawful for carriers to issue securities, or incur certain obligations without I.C.C. approval.[5] That approval is contingent upon the carrier's continued ability to serve the public.

By statute, the Commission prescribes reports and a uniform system of accounts,[6] and may approve the consolidation of carrier properties subject to reasonable conditions.[7]

This entire statutory plan can be circumvented and even be subverted, by skillful employment of the conglomerate device. The holding company and the non-carrier affiliates, outside the I.C.C.'s jurisdiction, can issue securities, incur obligations and engage in intercorporate transactions which can draw upon the carrier subsidiary and encumber its ability to

5. Sections 20a and 214, ICA (49 U.S.C. 20a and 214).
6. Section 20 ICA (49 U.S.C. 20).
7. Section 5(2) ICA (49 U.S.C. 5(2)).

serve just as much as if the carrier itself were doing these things.

If a carrier advances cash to finance an affiliate's project, or for the same purpose, is forced to open a line of credit, or pay out a dividend, or make an upstream loan, the effects upon the carrier are no less serious than if the carrier issued securities of its own in the same amount.

The important question, however, is not how much a conglomerate takes out of a carrier, but rather, how much is left in. And, to pass judgment upon the latter, we should consider:

* What has been the effect upon the carrier's ability to serve the public?
* What resources are needed to meet the reasonable capital requirements of its transportation business?
* What service and capital obligations can the public reasonably impose upon the carrier?

Based on these and other policy considerations, and recognizing that the larger carriers are turning up the conglomerate road, the I.C.C. has proposed legislation to maintain the integrity of transport regulation.

Obviously, a national transportation policy setting standards for the industry would be futile, if the major transportation producers could evade it. To close the gap, the Commission's bill would extend regulation over conglomerates on three basic points:

* First, when a non-carrier obtains control of a carrier. (The present law is addressed to situations involving two or more carriers.)
* Second, when a non-carrier issues securities affecting a carrier subsidiary.
* Third, when remedial steps are needed to correct conglomerate abuses likely to impair a transportation affiliate.

In dealing with non-carriers now subject to I.C.C. jurisdiction, the Commission has generally refrained from extending its regulation outside areas of its own expertise. Our new proposal would continue that policy.

The proposed legislation, in the manner of a sanction, would in itself, be a deterrent against transactions inconsistent with the specified standards.

In order to employ the remedial jurisdiction, the Commission would first have to find an existing or threatened harm and identify the cause. Thereupon, it could issue a cease and desist order, and could place under its cognizance all the carrier's intercorporate transactions, until the situation is corrected.

If diversification is a lawful and advantageous way of doing business, its availability should not be denied the transportation industry, which

must compete with non-regulated industries for financial and investor support. But since the Nation and its entire economy are heavily dependent upon the regulated surface transportation utilities, safeguards against abuse are warranted. Employment of the conglomerate technique in the carrier business must be placed under such reasonable restraints as are necessary to protect the public interest in transportation.