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Report of Special Committee of American Bankers Association on Railroad Consolidation

American Bankers Association

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Railroad Consolidation

REPORT

of

American bankers association. SPECIAL COMMITTEE
of Commerce and Marine Commission

Appointed by

American Bankers Association



Fifty-Second Annual Convention

Los Angeles, Calif.,

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REPORT OF SPECIAL COMMITTEE
of the
AMERICAN BANKERS ASSOCIATION
on
RAILROAD CONSOLIDATION



To the American Bankers Association:

SINCE the history of American progress parallels that of transportation, and in order to maintain the pace of this wondrous age, the *railroads must be placed in better shape to attract capital.*

This committee, realizing that the railroads are the greatest single industry in the United States, has approached the problem of rail consolidation, or unification, as an economic rather than a political question . . .

because the ownership of the bonds or underlying securities of the railroad systems is largely in the hands of savings banks, and insurance companies, who in turn represent a legion of many millions of policy holders, depositors and small investors; and *because* the distribution of the channels of commerce anticipated in rail consolidation is a mighty responsibility wherein one section of the nation should not gain at the disadvantage of another, but for the general national betterment.

Rail Evolution

National transportation, now approaching the three-quarter century mark, is entering upon a new era. First, it was fostered

in an epoch of public encouragement during which time governmental grants and subsidies were many; then came consolidations that gave birth to the great systems of today, a process arrested by anti-trust legislation. Next came the period of regulation through the Interstate Commerce Commission, which, despite many grievances, bore some beneficial results. This control was followed by an interval of careful management, returning public confidence, and better service. Now comes the time when the railroads must resume their processes of logical enlargement, that the nation may keep step with its heritage of progress. Let us call it the era of justifiable consolidation, or the adaptation to our common carriers of America's effective principle of massed production; or, more correctly, transportation is in evolution toward massed distribution to care for the tremendous production developed by the unified industrial growth of this still young nation.

Physical Adjustment Lengthy

It is most apparent that logical consolidations are not necessarily a grouping by mere geographical lines, connecting dots on a map, or even coordinating sections without regard to whether these particular groups would harmonize and make a living. Bringing large properties together is a slow and difficult process. After the financial and legal phases have been accomplished, the physical adjustments are perhaps the most difficult. There are the rights of local communities; the interest of labor; consideration for things dear to precedent. In England many of these stumbling blocks have appeared and, in order to eliminate them without needless friction, it is taking a long time for the real economies to assert themselves.

Based on Natural Traffic

Nature and her products seem to be the real key to the situation; affiliation of routes endowed with a balanced proportion of raw materials and manufactured products, or any

balanced exchange that supplies both-ways traffic; the coordination of lines of reciprocal rather than identical needs, minimizing, through a diversity of traffic, the hazards of sectional or crop blights.

Consolidation, then, should be considered from the standpoint of the natural flow of traffic, because no one railroad, nor any single railroad system in existence at this time, can prosper on the traffic which both originates and ends on the rails of that system. Each system should be made so strong and self-reliant as to be able to withstand the vicissitudes resulting from all forms of depression.

Unification brooks no disregard of economic laws, so that merging should be a deliberate, though delicate task. Any railroad gerrymandering would interfere decidedly with our common prosperity.

Public Pays for Mistakes

Any one-sided relationship, or the unwise assumption by the strong roads of the burdens of the weak, only leads to the breakdowns of credit in which the public must eventually foot the bill. In this connection it is estimated that there are some sixty to seventy thousand miles of railroad in the United States that cannot make a living. How much of this would enter into the unification plan is at the discretion of the Interstate Commerce Commission. However, it is not hard to realize the natural reluctance of profitable railroads to tie up with unprofitable lines. Apply the same theory to any other business enterprise and the application hits close to home. Besides, the time when the abandonment of the truly unprofitable mileage of this country would be a community calamity has passed with the coming of the motor truck, and it is just as unwise and unsound for losing railroads to be maintained by the public, as for any form of business to be publically subsidized.

Community Interests Important

Yet, this committee is deeply mindful of the fact that consolidation must be done in a way to be beneficial, at least not detrimental, to the communities served by the railroads; and if, in the process of voluntary consolidation, important units are not included, then provision must be made to care for the worthy ones.

But it is wrong alike with railroads, banks, grocery stores or shoe shops, or any business, to saddle a strong unit with an undeniably weak one. If it is fully established that the road is a weak property, one of two things must eventually happen: if not able to earn operating expenses and taxes, it should be placed in the "observation ward," with the view that it might be necessary to have it taken up and abandoned; or, if not able to earn something over expenses, its capital obligation should be reasonably adjusted to its earning capacity.

This latter course is especially advisable where unification of the strong with the weak seems imperative to prevent hardships to dependent communities. It would be unwise for such consolidations, undertaken to avoid abandonment, to be effected on a basis of making good the improvident or unfortunate investments in the weaker road.

The really profitable and logical small lines have a natural protection in a consolidation program, in that many of these short lines, with limited physical value, show substantial net incomes by reason of a profitable division of the through rate. Present law forbids duplication of facilities, so that, in the event of unification, the owners of the small lines are apt to receive favorable attention based on their incomes.

Improve Rail Financing

Desirable groupings of this sort would adjust the inequalities of earnings among carriers, simplifying immeasurably the

now vexing problem of short-line financing. For, while under the Transportation Act these dependents can borrow from the government surplus fund, the requirements are such that they could as well and as easily get the money from their bankers.

The question of financial significance of consolidation is one that has naturally received much attention from this committee. Frankly, we have encountered from the public no general opposition to or demand for consolidation. In its present form, it is properly a matter of moment to rail executives, stockholders, forward-looking business men, economists, statesmen and financiers. The shippers are not voicing their concern if they have any, for the practical ones can see no immediate rate amelioration, and rail service is admittedly of such standard now as to cause them little anxiety.

But, this deduction of supreme importance is patent: A more complete transportation system is necessary for the prosperity that is to be, and to this end capital must be attracted to railroad investment.

Restore Railroad Progress

One economist has pointed out that in 1923 there were 14,400,000 corporate stockholders in the United States, as compared with 4,400,000 in 1900. But this increased public ownership did not go into the vital industry of railroading, for the holders of such stock ten years ago were 500,000 as compared with 800,000 Class 1 road security holders today. A pitiful increase by comparison to other utilities.

It seems essential that the greatly improved credit of the railroads at present, so largely the result of efficient and economical operation, should not be impaired, but still further strengthened by the financial methods to be employed in effecting consolidations. In general, we believe that the Government, exercising such minute control of our common carriers, cannot

escape—though no such tendency is noted—the responsibility of affording to the owners of rail property the legitimate expectation of every commercial proposition—a fair return on its value; and if the moderate return of 5.75 per cent permitted but not guaranteed, which few roads have reached, is wholly inadequate to attract capital to the enterprise of transportation, adjustments should be made on the average of five-year instead of one-year periods. This, with the patent influence of consolidation diffusing the earnings in such a way as to make a more even distribution of the revenue paid by the public for transportation, should restore much of the attractiveness of rail securities.

Railroad executives and the Interstate Commerce Commission may be relied upon to protect the growing confidence of the investing public by not increasing the ratio of debt to equity by sanctioning any unwise combination of ill-assorted elements.

Clear Financial Basis

All proposed natural consolidations so far have clearly and properly laid out the terms and financial arrangements upon which the consolidation was to be effected. Every such plan has provided for the issuance of capital securities (stocks or bonds) and the exchange of the new securities for the stocks and some or all of the bonds of the corporations to be merged. For the protection of the investing public, no other plan should be considered, for there cannot be a genuine plan of consolidation if the properties do not indicate the common denominator to which new securities are to be reduced and the ratios on which the old and new securities are to be exchanged.

The Certain Benefits

The benefit most certainly to be counted upon is that of improved and more efficient transportation service. The ad-

vantages of coordination in train schedules, car supply, etc.; or substitution of one-line hauls for two-line or three-line hauls; of the better distribution of fuel supply; of the more complete utilization of equipment, of terminals; elimination of switching; standardization of materials and concentration of purchases; are obvious. There will undoubtedly be some substantial economies in the elimination of inter-line accounting, doing away with the wasteful forms of competition; in undesirable duplication of capital expenditures, and so on. But, inasmuch as the great bulk of a railroad's expense is the wages of labor and cost of materials and supplies, and knowing that rates must suffice to yield a fair return on the value of the property devoted to transportation—factors which cannot be materially changed by consolidation—this committee deprecates urging, as a reason for unification, that a material reduction of rates will follow.

There may be—although the promise seems remote—a better basis for a new national rate policy in a country of fewer but larger rail units. Custom and precedent seem to have given us our rate fabric and its attendant conflict for advantage of section against section, industry against industry. Only through a fundamental revision would unification aid, because, as now practiced, a much larger percentage of the tonnage is shipped on the commodity rates established for the development of various industries and sections than on the so-called classification rate basis.

Consolidations should not be of such magnitude as to make it difficult for the system to be developed and operated by a single management. That roads can reach a point where size does not increase efficiency and economy of operation is shown by the general figures for 1922. As the size of the system increases, the ratio of expense of the central organization appears to decrease until the ratio of 2.50 per cent is reached. Past this point, regardless of the size, the reduction ceases.

ending

The limit of mileage successfully directed by one management may differ with the density of traffic, but experts generally point out that the units of consolidation should be large enough to effect economies possible in supervision and yet small enough to avoid over-centralization, loss of personality in management, and inefficient forms of bureaucratic control.

Compulsion Un-American

Our conclusions against any form of compulsory consolidation can be easily substantiated. No one is more conscious than the railroads, themselves, of the fact that they owe their corporate existence as public utilities to the service rendered the public.

Congress and legislatures admittedly have certain lawful control over them, but only so far and to such degree as they do not destroy or lessen the value of such individual properties. In other words, they should not have the right to regulate these public utilities to the degree that they confiscate the property either in whole or in part. If such a condition can be forced upon railroads, then no other properties are exempt.

Inasmuch, therefore, as the Interstate Commerce Commission, after years of effort, have announced their inability to formulate a general plan of compulsory consolidation, and the entire scheme of forcing business men to do something with their own capital that may be against their own best judgment has been accepted as un-American, the repeal of this portion of the Transportation Act seems a popular and desirable course.

Provide Adequate Machinery

New enabling legislation is essential to correct and supply a substitute for the demonstrated defects and shortcomings of the consolidation provisions of the Transportation Act of 1920. Another oversight is the failure to provide adequate machinery

and to confer clearly corporate power upon the railroad corporations to carry out any authorized consolidation, or to carry on after effecting such consolidation. The charters of few railroad companies confer the necessary corporate power to consolidate.

It is doubtful whether the linking of consolidation to federal valuation is feasible. The provision of the present act is that the capitalization of the company formed by consolidation must not exceed the aggregate federal valuation of the combined properties. Thus, consolidations will be delayed pending the valuation. In effect, it compels the railroads to pay for the privilege of consolidation a price they are reluctant to pay, namely, the acceptance for all time of the correctness of the Government's valuation.

It seems advisable that Congress give some thought to a removal of these restrictions, providing a legal approach to unification by corporate consolidations, through acquisition by one carrier of the physical properties of the other, or control of carriers through purchase of stock.

Resume Natural Enlargement

Consolidation is not a new thing. The present large railway systems are made up by reason of the consolidation of numerous smaller companies. In 1890, legal restraint arrested this development which too broadly extended and emphasized the principles of competition. This natural process of consolidation should be permitted to go forward, subject to supervisory jurisdiction of the Interstate Commerce Commission, to the extent of maintaining competition and preserving so far as possible the present channels of trade. If this process had not been arrested some years ago by prohibitory legislation, the nation's natural railroad evolution would have automatically disposed of this question of consolidation.

Consolidation by loose associations, different boards, etc., is a problematical course. With the removal, however, of present legal obstacles and the granting of clear corporate powers to both effect and operate consolidated properties when approved by the Interstate Commerce Commission, the present so-called consolidations would become real mergers and whatever natural tendencies existed among other lines would develop. In other words, if present legislative restrictions are removed and consolidations permitted, subject only to the supervisory power of the Commission, they will take place gradually and effectively in the future as they did in the past, but along sound economic lines that will preserve the integrity of investments.

Cannot Thwart Evolution

We cannot turn back the wheels of progress. Adjustments of transportation to new conditions are even now in the transitory period, equalizing the opportunities for business and placing the railroads once more in the vanguard of national development.

Knowing that the successful systems of today are but the logical and natural outgrowth of consolidations, we believe that the further legalized grouping of the railroads of the country into a limited number of strong and efficient systems, which will, as far as practicable, maintain existing routes and channels of trade and commerce, and preserve as between themselves the advantages of effective competition, is a highly desirable course to common prosperity.

As the Interstate Commerce Commission has amply demonstrated its ability to rule upon railroad questions, this committee believes their competency and specialized knowledge equip them to protect fully the public interests under a series of authorized voluntary rail consolidations, which should be encouraged, but not hastened, for one thing is most apparent: It

will take the attrition of time to wear down and smooth over the difficulties of consolidation without serious disruption to our economic course.

It is doubtful whether sufficient economies will result from consolidation to warrant any general reduction in freight or passenger rates; but natural alliances, if wholesome competition is preserved, will be beneficial to the country in providing a more adequate service, which is generally regarded more important to its welfare than rates.

Weighing each case thus on its merits, the development of a uniformly stronger rail system, coordinated because of traffic relations and not for speculative purposes, will insure a progressive, competent and competitive transportation service at rates which will produce the maximum net results to the shipper and carrier, and the greatest expedition consistent with the comfort, convenience and the paramount requisite of all, dispatch—with safety to the public.

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