Why the Government shouldn’t bail out freight railroads

By Henry Posner III

Historically, Class 1 railroads opposed almost any type of government subsidy or partnership—passenger trains being the outstanding exception. Taxpayer money, railroads feared, would lead to the government dictating what, where, and how they operated freight trains. Now some Class 1 carriers have begun to accept—and even request—government money to add capacity to compete with truckers. This may actually be bad for the railroad industry.

To wit: Norfolk Southern thinks the State of Virginia invest $1.2 billion to double-track its former Norfolk & Western Shenandoah Corridor paralleling Interstate Highway 81, instead of the state spending $3.3 billion to widen that highway.

Other Class 1’s are watching intently, for this would set a precedent for them to similarly seek government money for their infrastructure. There’s a potential competitive threat, too, if other railroads get government money and they don’t. And it raises the possibility that once governments start investing in Class 1’s, they might feel they have the right to insist on access for passenger service and even competing freight carriers.

Historically, government funding has been most common for short lines, primarily to preserve lines that would “otherwise be abandoned.” For justification, the government entity (usually a state), often cites its desire to take trucks off the highway, or its desire to preserve essential infrastructure.

In the case of railroads that actually would otherwise have been abandoned—as many branch lines could have been characterized in the 1980’s—both goals were achieved. An excellent example is the network in central Pennsylvania operated by Dick Robey, which includes the Juniata Valley, Lycoming Valley, and Stourbridge Railroad. In this case a local government agency bought lines that were abandonment candidates, upgraded them to minimum operating condition, and hired a contract operator to provide service.

This rationale for government subsidy was turned inside out in the 1990’s when fundamentally profitable lines that were not abandonment candidates, such as Canadian National’s Central Vermont, were auctioned off to the highest bidder. The circumstances under which many of these transactions occurred were at least partially obscured by the following:

• The mantra that a railroad’s principal competition is trucks when the competitions at hand were among bidders
• The misunderstanding that protection of rail investors is the same thing as preserving rail infrastructure
When bidders drive a property’s purchase price too high, the property’s revenue can no longer pay for operating and maintenance costs as well as the purchase price itself. Since the bank has to be paid or the railroad will face foreclosure, and most operating costs (even wages) have a certain irreducible minimum, the only place for savings is infrastructure maintenance.

Eventually, the track can deteriorate no further if minimum service is to continue. The short line must then either abandon service and salvage anything of value to repay investors, enter bankruptcy so that service can continue, or seek taxpayer funds to repair its track. The net result, in the case of the overpriced property, is the railroad becomes a conduit from government treasuries to Class 1 stockholders; little is gained by the short line itself.

Bidders who overpaid for rail properties have in effect been protected from the consequences of their bad investment decisions by state governments that believe they are preserving essential rail service. Several short lines, after absorbing large amounts of government money have ultimately abandoned their track anyway, because there was insufficient traffic to support the line’s operating and finance expenses.

Here’s the point: government bail-outs cannot preserve railroad service unless there’s traffic to support the service, and infrastructure in the case of the Iowa Interstate, there was a meaningful role for the state government to play. The Iowa Railway Finance Authority, a state agency, had a crucial role in preserving and reopening the former Rock Island main line as a through route. The private sector provided substantial risk equity capital and commercial debt, with the authority providing the balance of the funding through low-interest loans secured by the net liquidation value of the track material and real estate. The Iowa Interstate Railroad was not the subject of an auction and was not just a railroad that “would otherwise be abandoned”—for four years over several segments it actually was a abandoned.—HENRY POSNER III
without traffic isn’t essential to anyone. Where there’s traffic, however, the marketplace figures out a way to preserve railroad service. Consider the Rock Island main line from Chicago to Council Bluffs, Iowa. While through service ceased after the Rock Island was liquidated in 1980 (see above), pockets of traffic attracted branch line service. Eventually, traffic potential drove the restoration of through Chicago-Council Bluffs service.

All of this is useful when considering the revelation recently experienced by some Class 1 railroads that government investment in railroad infrastructure will provide the “level playing field,” or fair competition between railroads and trucks, that railroads have long sought.

It’s a new tactic. Railroads may have conceded their battle to raise highway use taxes, as truckers have generally managed to couple tax increases to increases in their size and weight restrictions. And, it’s usually easier to pry money from the government than get governments to undo entrenched policies, especially those backed by campaign contributions.

It’s probably not coincidental that some Class 1’s, having been caught in the same trap as short lines and regionals in the 1990’s—overpaying for their merger acquisitions—find themselves standing in the same line for government investment. And in some respects, they wish to go to the head of the line. However, governments so far have done little to distinguish between lines that are abandonment candidates and those which were the subject of an auction.

In general, a behavior rewarded is a behavior perpetuated. Subsidizing railroad infrastructure maintenance and improvement might not have been too costly for taxpayers on a short line scale, but on a Class 1 scale, it’s real money. Government investment or the expectation of government investment will likely only further the ability of prospective railroad owners and merger partners to pay acquisition premiums.

Make no mistake: the effect of government distorting a sound private-sector business serves only to continue the lack of financial discipline increasingly pervasive in the railroad business. Despite any unfairness of subsidized highway competition, railroads will continue to be viable whenever and wherever there is traffic to haul.

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