State of the Rail Industry

Testimony to:
Subcommittee on Surface Transportation and Merchant Marine of the U.S. Senate Committee on Commerce, Science, and Transportation

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by:
James J. Valentine, CFA, Morgan Stanley

My name is James J. Valentine and I am a Managing Director at Morgan Stanley, a New York-based investment banking firm, responsible for the firm's equity research effort pertaining to railroads, trucking and air freight. I have been researching the freight transportation sector on Wall Street for approximately 10 years. We take freight transportation very seriously at Morgan Stanley which may explain why our firm has been ranked by third-party constituents as number one or two each year for its equity research and investment banking in this area. My time is evenly split between interviewing industry sources, including company management, and discussing my conclusions with institutional investors. The work conducted by my team on freight transportation is regularly quoted by the major business news sources such as the Dow Jones' and Bloomberg's news wires, *The Wall Street Journal* as well as freight transportation periodicals such as *Traffic World* and *Transport Topics*. I received a masters degree in finance from the University of Iowa and hold the Chartered Financial Analyst (CFA) designation.

Testimony

The stock market value of U.S. railroads as a percentage of the 500 largest companies traded in U.S. equity markets (S&P 500 index) is one fifth the size it was in 1980,[1] demonstrating that capital has exited the railroads at a time when it has flowed into other sectors of corporate America (see Exhibit 1). In my testimony, I will attempt to explain why there has been such a decline in interest for railroad stocks by the public equity markets. We believe that any student of the railroad industry understands that passage of the Staggers Rail Act of 1980 was a watershed event, as it removed archaic regulations that had burdened the railroads for decades. Since passage of the Act, the industry has witnessed improvements to profitability brought about in part by the industry's newfound ability to exit unprofitable markets. Furthermore, major labor reform in the early 1990s allowed railroads to reduce 5-man crews to 2-man crews, thus accelerating the trend of an already declining workforce (see Exhibit 2) and resulting in substantial improvements to overall railroad productivity. The problem from the perspective of Wall Street investors with all of this success is that the railroads have given much of the savings back to customers instead of the shareholders, as evidenced by the fact that the industry still does not earn its cost of capital (see Exhibit 3) at a time when customer rates continue to decline (see Exhibit 4).[2] In my opinion, the equity markets are slowly losing patience with railroads as an investment as they continue to wait for the promised land of adequate returns, and may eventually turn their backs on the industry, leaving the government to bail it out similar to what we saw with the creation of Amtrak for passenger service in 1970.

I do not mean to imply that the industry is on its last leg because it clearly is not, but I believe if we do not make structural changes to the business model, the slow downward trend is unlikely to reverse itself. Since this is an industry that has taken over a century to build, any analysis about its well-being or future prospects should be done over an extended period of time. If we look at the period since 1980, we see that railroads have lost market share to the trucks in every year (see Exhibit 5).[3] Furthermore, on an inflation-adjusted basis, railroad industry freight revenues in 2000 were 28% below those of 1980 (see Exhibit 6). For any industry, declining revenues is not a sign of health and in fact, usually leads to bleak consequences. Investors bought railroad stocks throughout the 1980s on the idea that once the benefits of Staggers could be realized, these companies would earn their cost of capital. By the early 1990s, investors were becoming frustrated by the lack of progress although they became pacified when PEB 219 reduced crew sizes from 5-man to 2-man, resulting in better margins and thus better returns for the industry, but still not enough to earn the cost of capital. A few years later, after it was clear that even with 2-man crews the industry would not earn its cost of capital, investors began to lose faith at which point the industry leaders initiated a major round of mergers, with the prospects of reducing costs and capital needs through consolidation. But now, six years after this round of mergers began, we still have an industry with inadequate returns. Furthermore, it appears that the industry's largest area of savings in the past, namely labor productivity, is slowing as headcount reductions have decelerated (see Exhibit 2) and unlikely to result in additional savings unless there is a major change in work rules by the unions. Making matters worse, we are witnessing a long-term trend in freight patterns towards faster, smaller, lighter and more frequent movements of freight which puts railroads at an inherent disadvantage to trucks and air freight.[4]

Investors, again becoming aggravated by poor returns, are now pressuring railroad management to cut back on capital expenditures. And for good reason, we think, when we see that the railroads have spent in excess of $50 billion on capital expenditures over the past 10 years and generated only $30 billion of net operating income (see Exhibit 7).[5] For now, these cutbacks are in areas marked for growth, but if this trend continues we could see deeper cuts by the railroads which would very likely hurt service levels. Unfortunately, here we sit in 2001 with the railroads having no more cards to play to win back the shareholders. I'm quite concerned that without some structural change we are going to see Wall Street continue to lose interest in the industry, and thus run the risk of a government bail-out of the freight railroads sometime in our lifetime. And don't let the recent rally in railroad stocks suggest that the long-term investors have a newfound hope for the industry, as we believe much of the rally can be explained as simply short-term momentum investors returning to industrial stocks in advance of an expected upturn in the economy. If history repeats itself, after this economic recovery is underway, the railroads will once again be valued by the long-term investors, who traditionally look for adequate returns as a prerequisite before investing.

I'd like to dispel the misperception that railroads are taking advantage of their market position by charging excessive rates. Let's start with the fact that the U.S. has not witnessed a major new rail line built in at least 20 years. And yet, during the past 20 years, we've seen billions of dollars poured into new industries (including the dot-coms) because the *prospects* of good returns have been there, even if the actual returns haven't materialized. If the railroads were "gouging" their customers to the benefit of the shareholders it would seem that some of this entrepreneurial capital would have been deployed into the railroad sector similar to the manner in which AT&T has been under attack by new competition since its 1984 split-up. To illustrate this point, in 1999 there were over 700 long-distance companies in the U.S. up from just a handful prior to 1984, driven by the prospects of extracting the former AT&T monopoly rents and generating returns that exceed each of their respective costs of capital. With investors having deployed enough capital to add 120,000 route miles of telecommunication fiber to non-AT&T networks over the past 10 years, why can't we get enough capital to build just one new 100-mile rail line in the U.S.? The answer, in our view, is that railroads don't have the *prospects* of earning a good return on their investments and so they can't attract new capital. When customers complain that they are being unduly charged by the carriers I think it's completely missed that there is no law in the U.S. that says a new rail line can't be built. If the railroads were charging rates that were truly excessive, we would see entrepreneurs pouring capital into new build-outs to get these customers competitive access to another carrier, similar to what we see in the long-distance telephone market -- and yet, we can find less than 20 such rail build-outs in the past decade. Customers need to be careful about what they wish for, as their efforts to drive rates lower will likely only cause more capital to leave the industry and service to deteriorate, continuing this downward cycle that has occurred for the past 50 years.

Here are some of the issues that we think Washington might consider addressing to help the railroads achieve the basic principles of any healthy industry, namely revenue growth equal to or better than the rate of inflation and a return on capital better than the cost of capital.

- Put the railroads on an even playing field with long-haul trucks and barges in terms of Federal subsidies.[6] By any account, the long-haul trucking and barge industries receive substantial Federal dollars to help maintain their rights of way, whereas the railroad industry gets none.
- Remove rate caps and other onerous restrictions that prevent the industry from pricing its product in a manner to obtain a proper return. As we discussed earlier, in this day and age of free-flowing capital for good investments, customers can force competition onto the incumbent rail carrier in almost every instance where they would claim excessive pricing.
- Remove disincentives for conducting mergers. The existing and pending railroad merger rules require too much of the economic benefits of a merger be returned to customers and labor. This is evident in the fact that despite all of the industry consolidation over the past six years, the industry's returns are no better (see Exhibit 3).
- Create incentives for railroads to conduct expansion in places where the highways have too much congestion. The $2.4 billion Alameda Corridor in southern California would never have been built without public funding. When completed in 2002, it will allow for more trade to move through

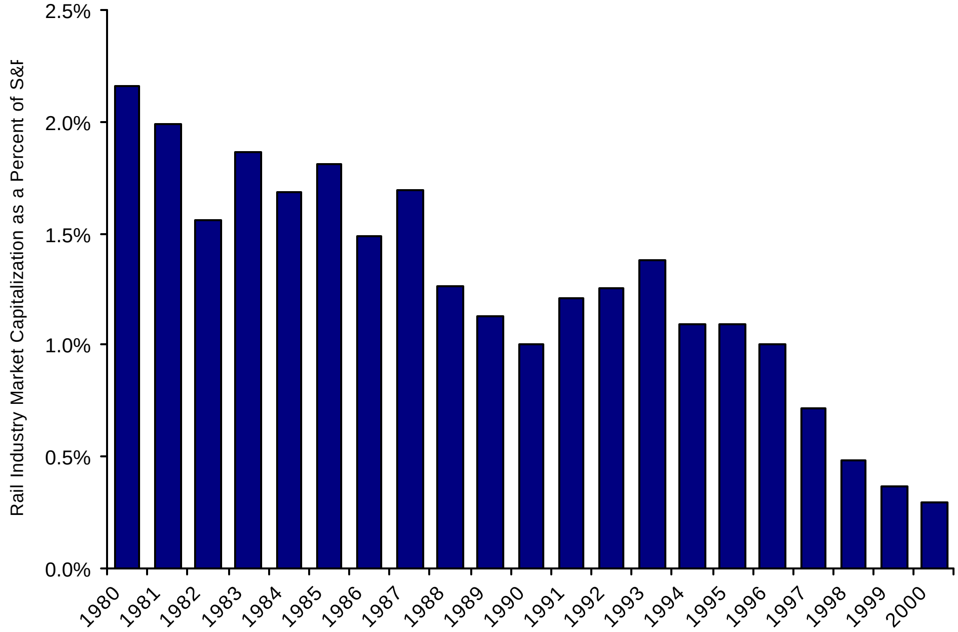
southern California while taking trucks off of the local roads, thus allowing for economic growth in an environmentally-friendly manner. We need more creative solutions such as this in order to help the railroads and the Nation's transportation system support economic growth in congested places.

- Reform FELA, as it creates too much of a cost for the railroads and too much of a gamble for employees who become injured. The other modes of freight transportation are not burdened by FELA, which puts the railroads at a competitive disadvantage.
- Reform Railroad Retirement by allowing the unions or railroads to manage their retirement programs and presumably lower the associated costs. Similar to FELA, the other modes of freight transportation are not burdened with this regulation, and thus the railroads are at a competitive disadvantage.
- Eliminate the 4.3-cent per gallon deficit reduction tax as it is no longer needed.

Some of my suggested reforms may seem controversial, but if we keep conducting business the way we have in the past, we believe we are destined to get the same poor financial results and eventually put the entire industry into jeopardy of collapse. I've been researching the railroad industry for ten years and have come to the conclusion that I will not be researching this industry ten years hence, unless there is major change, because it is unlikely to be an industry that investors will want to own. If we assume that the trends that have taken place over the past 50 years continue into the future, we see that this industry is headed for trouble. Unfortunately, the railroad industry has not had enough influence in getting the aforementioned reforms accomplished and unless someone steps in to help save the hand that feeds many of us, we expect that all of us in the rail industry will have to find new industries in which to work.

Exhibit 1

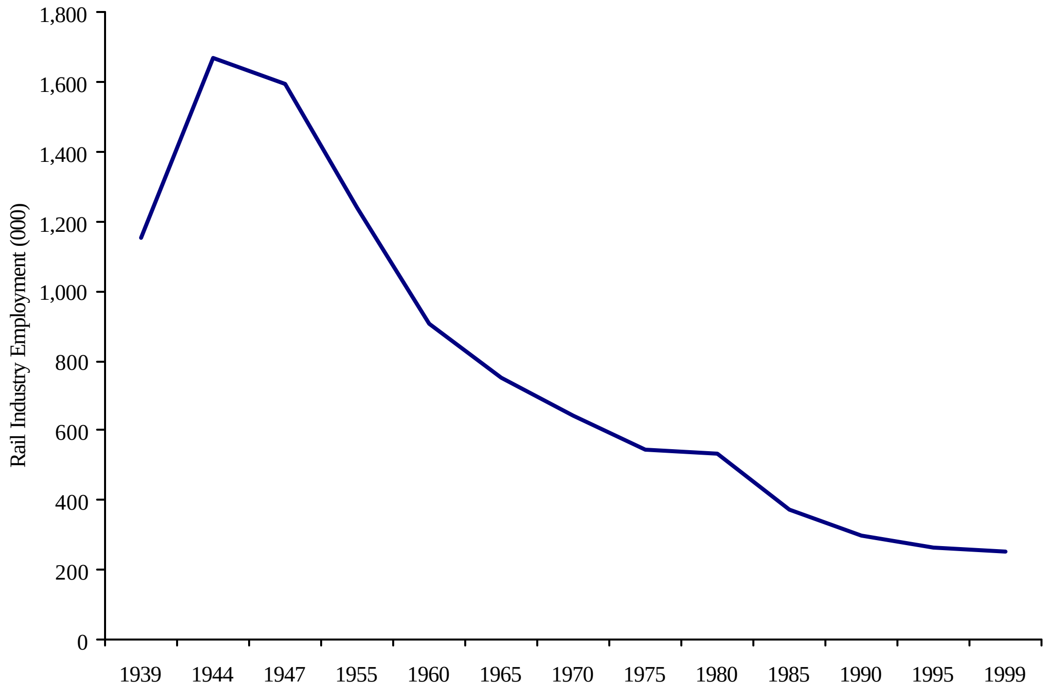
U.S. Railroad Market Capitalization as a Percentage of S&P 500 Capitalization



Source: Standard & Poors

Exhibit 2

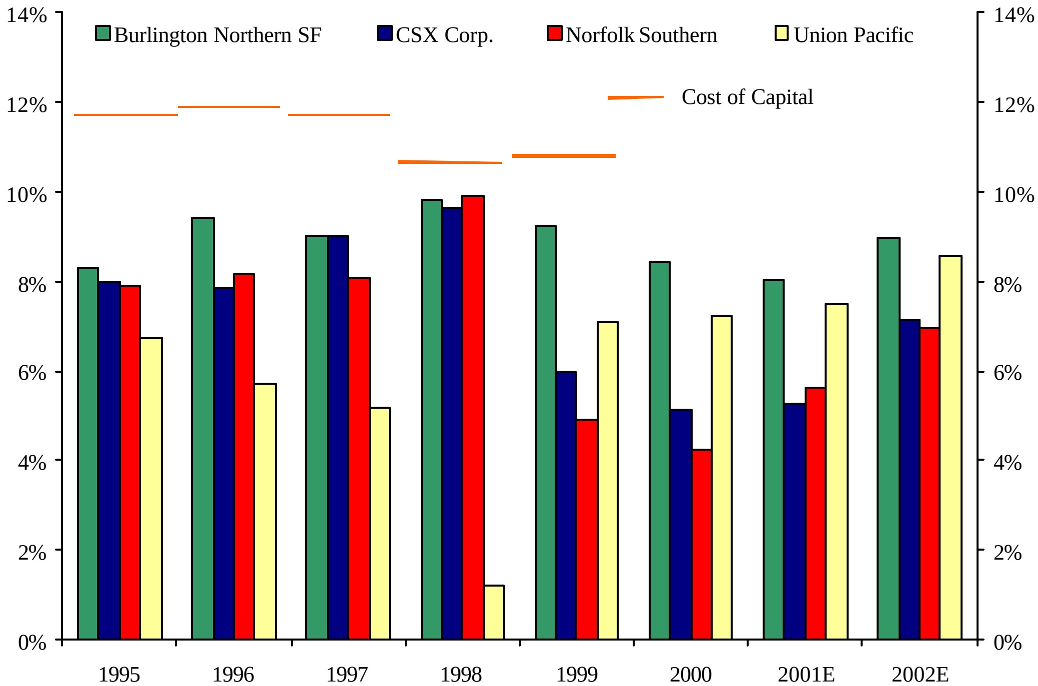
U.S. Railroad Industry Employment, 1939-1999



Source: Association of American Railroads

Exhibit 3

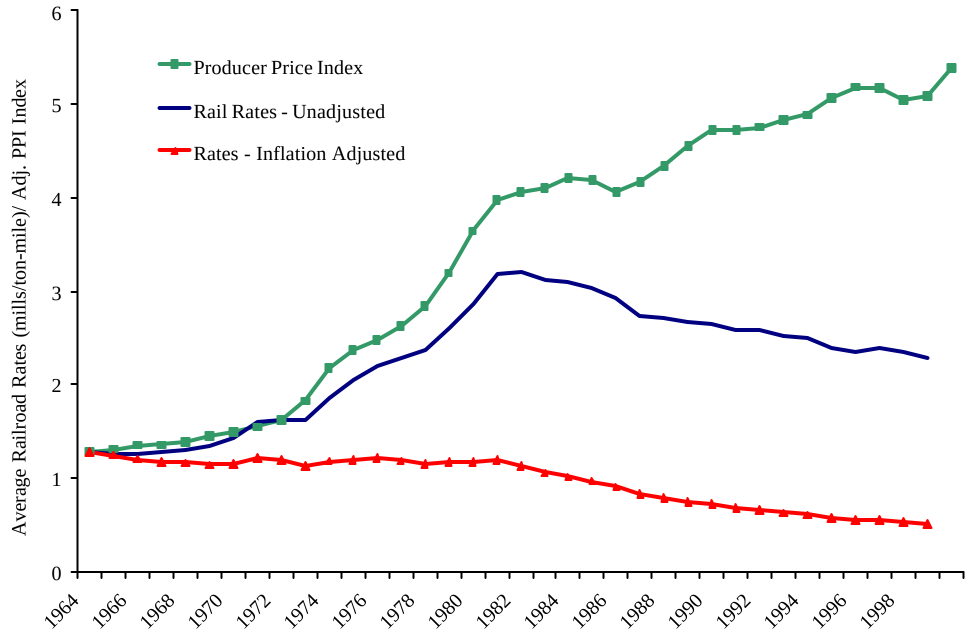
Return on Capital and Cost of Capital, for Major U.S. Railroads 1995 - 2002E



Source: Association of American Railroads (cost of capital), Morgan Stanley Research (return on capital calculations)

Exhibit 4

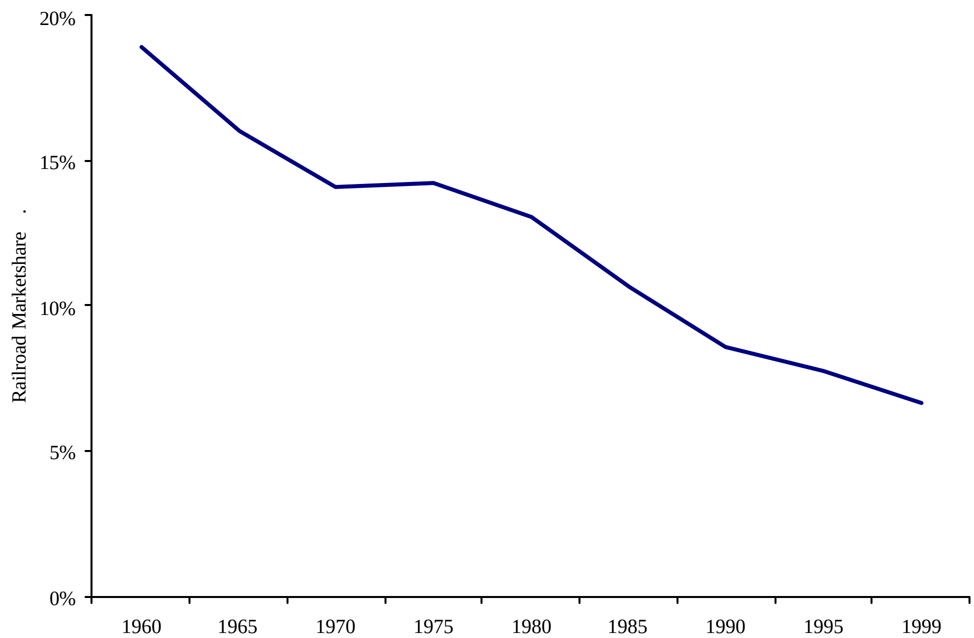
Average Annual Railroad Customer Rates and Producer Price Index, 1964-1999



Producer Price Index, indexed to 1964 = 1.284. Source: Association of American Railroads, FactSet

Exhibit 5

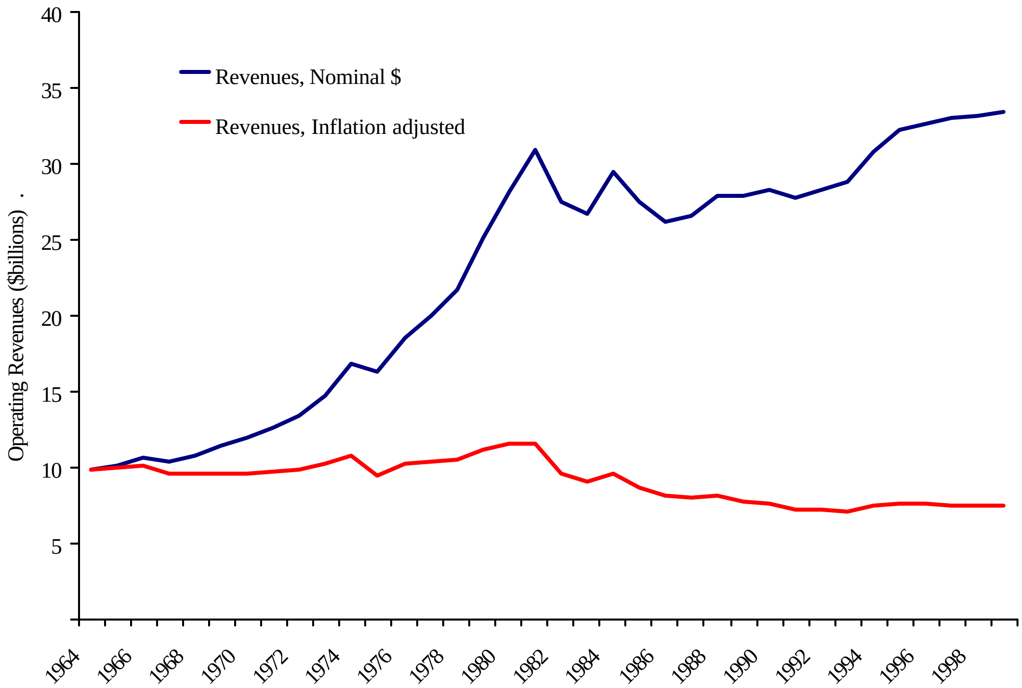
Railroad Market Share of Total Nation's Freight Bill, 1960-1999



Source: Transportation in America report, Eno Foundation

Exhibit 6

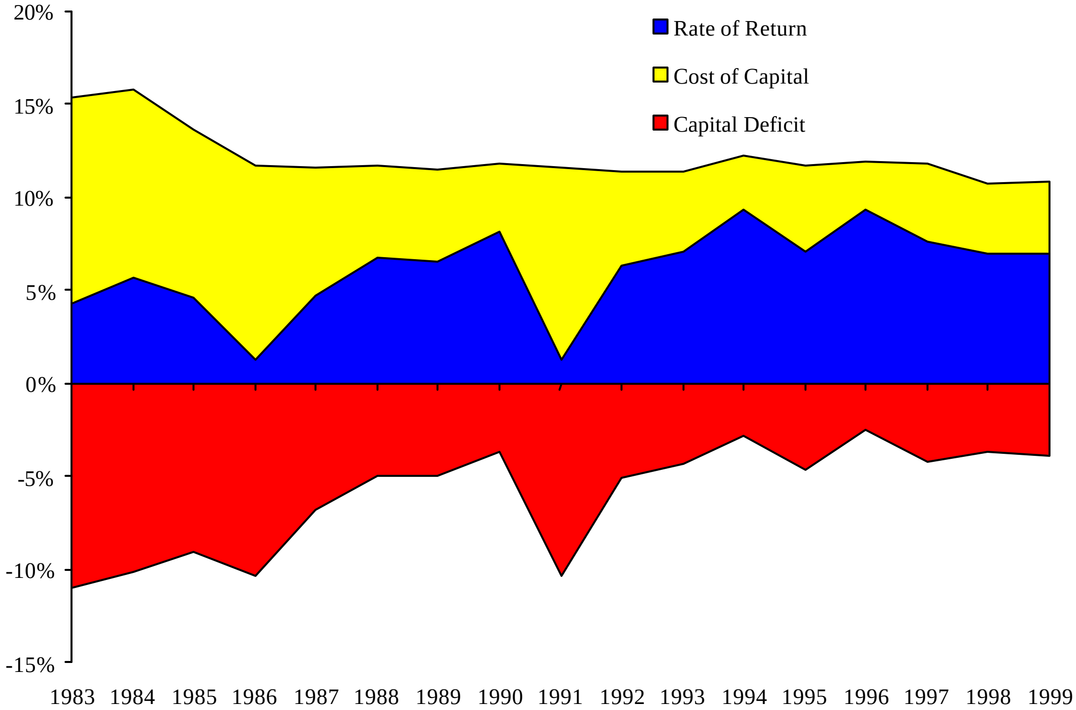
U.S. Railroad Industry Freight Revenues, 1964-1999



Source: Association of American Railroads, Morgan Stanley Research

Exhibit 7

U.S. Railroad Industry Cost of Capital, Return on Capital and Deficit, 1983-1999



Source: Association of American Railroads

[1.] In 1980 the S&P Railroad index was 2.2% of the S&P 500 index and has dropped to 0.29% at the end of 2000.
[2.] *Railroad Ten Year Trends* Rate of Return on Net Investment and Cost of Capital, Association of American Railroads.
[3.] *Transportation in America*, Eno Foundation.
[4.] *Internet Strategies: Surveying the Freight Carriers*, Morgan Stanley Dean Witter, August 15, 2000.
[5.] *Railroad Ten Year Trends* Rate of Return on Net Investment and Cost of Capital, Association of American Railroads

[6.] *1997 Federal Highway Cost Allocation Study*, U.S. Department of Transportation, Federal Highway Administration. "…combinations (trucks) registered over 80,000 pounds will pay on average only about 60 percent of their highway cost responsibility."