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## North American railways

### Stop me before I merge again

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#### What kind of industry asks its regulator to block all deals?

AMERICA'S railways were once the envy of the world, the transport backbone of a scorching economy and the stuff of legend. But over the past few years they have also become a mess so embarrassing that in March their regulator took the unprecedented step of banning all further mergers until they can sort themselves out. Worse, it did so at the request of most of the rail firms themselves, a telling reflection of a once-great industry that has in recent years become its own worst enemy.

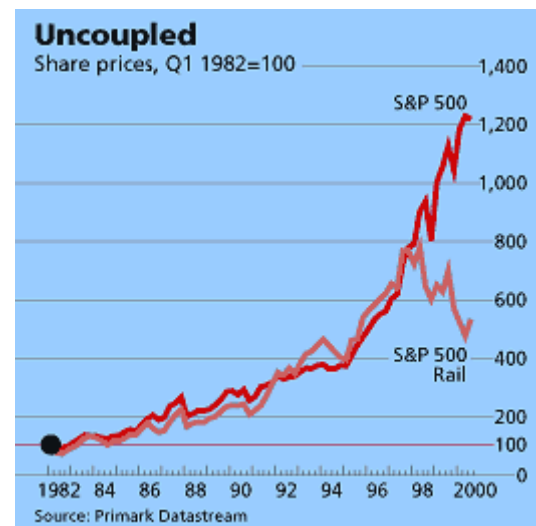
On July 14th, to the surprise of many, an appeal court upheld the four-month-old merger moratorium imposed by the Surface Transportation Board, the rail industry's regulator. The immediate effect of this is to kill the proposed \$19 billion merger between Burlington Northern-Santa Fe (BNSF), one of America's big four carriers, and Canadian National (CN), Canada's largest. This would have created North America's first trans-continental railway, a 50,000-mile network that could carry freight coast to coast.

The broader effect is to halt all such deals for another year, at least. There are few industries where such a Draconian regulatory measure would be tolerated, much less welcomed, but rail is a special case. For all America's natural advantages for rail—long, borderless terrain and lots of heavy industry—it has been dogged by controversy and decay for much of its history.

In its early years, monopolists dominated. But public outrage over the cartels led to a system of heavy regulation that began in 1887 and expanded in power in the early 1900s. Bureaucrats at the Surf Board's predecessor, the Interstate Commerce Commission, decided how much rail carriers could charge, where they could go, what kind of services they could offer and what they could own. In the end they succeeded in busting the trusts, but at the cost of a half-century of decline.

With profits capped, the carriers were unable to invest enough to maintain their tracks, much less to grow. Permitted rate-of-return calculations were arbitrarily set by Washington accountants, based on their guess about what a proper market would allow. Most innovations, from jumbo grain-hopper cars to "rent-a-train" services, were blocked as sneaky ways to gain unfair competitive advantage.

Even worse, the government spent billions of dollars building America's interstate highway system, which allowed trucks to emerge as a strong long-distance competitor, eventually taking more than 80% of the freight business. Although the natural rail response would have



been to carry trucks on trains until they were near their destinations, the government had prohibited the railways from owning trucking firms and so doing this efficiently. As the lightly regulated trucking industry boomed, the shackled rail industry fell further into losses.

## Railing at rules

In 1980, with the railways in a shambles, Congress was faced with a choice between nationalising the entire industry and setting it free. It wisely chose the latter, passing the Staggers rail act, which allowed the market to determine prices, services and, in most cases, ownership. The effect was immediate. Carriers consolidated by the score and closed money-losing lines, investing where business was strongest. Prices fell, productivity rose and volume began to keep pace with trucking for the first time in years. America's rail advantages again began to shine compared with the nationally regulated carriers of Europe, where freight plays a secondary role to passenger traffic (the reverse is true in America, where passenger rail is still a poorly served and money-losing industry).

By the mid-1990s, America's rail industry was back on its feet. Forty major carriers had become fewer than ten. But the nature of mergers was starting to change. The easy gains had already been made: small local lines were now large regional ones, slashing time-consuming handovers from one line to the next that had long plagued the industry. Now the focus was on mega-mergers, mostly between regional competitors with considerable overlap, in a bid for economies of scale that would let the industry switch its focus from competition between rail firms to competition with trucks.

The first big sign that this would prove troublesome was the 1997 merger of Union Pacific (UP) and Southern Pacific to become America's largest rail firm. The two found out too late that their computer systems were incompatible; the resulting chaos snarled freight across America for nearly a year. The chemical industry alone estimated it lost \$300m due to delays; the overall cost to the economy was put at more than \$1 billion.

Then, in 1997, CSX and Norfolk Southern agreed to divide between them Conrail, which the government had created by combining half a dozen small failed railways. After watching the UP fiasco, the three companies were aware of the perils of bungled mega-mergers: they spent the year before their deal was to be consummated testing computers, doing dry runs and assuring regulators that this time it would be different. And when the day came in June 1999, it was, although not quite in the way the firms hoped. If anything, it was worse.

Despite all the preparation, the computers failed again. Rail cars that should have been full arrived empty, and an operator error threw a network carrying 200,000 of them into gridlock, snarling traffic along the east coast. Ford and Chrysler had to halt car production for lack of transport and the chemicals makers complained to Congress.

CSX and Norfolk Southern were better at spotting the problems after the fact than before. Splitting one company between two others was harder than a straight merger. Dry runs and simulations are no substitute for real-world trials. Conrail's culture was more relaxed than those of its buyers, in part because of its sheltered history of government stewardship. Its experience was in short-haul, while its buyers were mostly long-haul. Although CSX thought it had won an advantage by getting most of Conrail's top managers, it ended up blaming them for the mess and firing most of them.

This was the bleak picture that dominated the scene when, last December, BNSF and CN started talking of the biggest rail merger yet. Their timing could hardly have been worse. After three years of track trauma, nobody—neither the still-scarred railways, nor Congress, nor the Surf Board—could bear the thought of another blow. CSX, UP and the others lobbied hard for a 15-month merger moratorium to allow the industry to get its house in order. Without a freeze, they claimed, they too would be forced into merging again (CSX with UP, for instance) with even greater risks of economic damage this time. "Stop the insanity," pleaded Dick Davidson,

UP's boss.

As radical as the measure is—the board believes it is the first such moratorium in American regulatory history—there was little opposition to it in Congress. Indeed, there are now seven bills going through the legislature that would increase regulation to one degree or another in the industry, mostly in response to shipper outrage at the shambolic rail performance of recent years.

Not that anybody expects the moratorium to last forever, or even past next summer. More mergers seem inevitable—even probably including BNSF and CN, despite their bluster that it has to be now or never. This is not necessarily a bad thing. Simply by virtue of the fact that most head-to-head competitors have already merged, future mergers will be mostly end-to-end, combining regional carriers to create those that reach across the country. These should be easier to carry through.

Although this implies a future when only two super-carriers serve most of America, the picture is not as anti-competitive as it might seem. Trucks are the real competition, and anything that takes more freight off the highways and on to the safer and more environmentally friendly tracks is welcome. Rail is also cheaper than trucks, though not always as fast; fewer carrier-to-carrier handover delays will make things speedier.

Looking even further into the future, the general regulatory trend is to separate physical networks from the services offered over them, as in telecoms and electricity. Already Britain's rails are owned separately from the trains that run over them; in the bigger, more freight-oriented United States, this could work even better, alleviating competitive concerns to boot. Some day, America's railways could be great again. It is just hard to see it in the mess they have made today.

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