MEMORANDUM ON THE RAILROAD SITUATION

A YEAR AFTER THE END OF FEDERAL CONTROL.

March 21, 1921.

I

The Condition from the Standpoint of the Security Holders.

During the first six months of private control - the guaranty period - the deficit below the standard return of federal control to be paid by the government is about $650,000,000.

The net earnings of the large roads applicable to capital purposes dropped from $516,290,090 in 1919 to $62,264,420 in 1920; the operating ratio increased from 85.25% in 1919 to 93.59% in 1920. For the first twelve months of private control ending February 28, 1921, the showing is worse; preliminary returns for January indicate an actual operating deficit; February is not likely to show much better. While gross revenue increased over $1,000,000,000, expenses and taxes increased nearly $1,500,000,000, almost wiping out the net earnings shown in 1919.

The railroads are owned by the holders of about $10,500,000,000 of bonds bearing an average interest rate of a little under 5 per cent; by the holders of about $4,000,000,000 of stock regularly dividend-paying for many years, and of about $3,000,000,000 of nondividend-paying stock. The annual interest requirements on the bonds and current indebtedness are about $500,000,000 and the regular dividend requirements about $300,000,000. About $800,000,000 is therefore required for regular annual disbursements in order to preserve the integrity of the present financial structure. This is more than $100,000,000 less than the standard return during federal control. Few, if any, of the roads have, during the last six months, shown earnings warranting any dividend distributions in April or July next. A still larger proportion are not earning fixed charges and interest on bonds. Not a few large roads, including the New England roads as an aggregate, are showing large operating deficits. The result, as a generalization, unless conditions radically and speedily improve, is that dividends must shortly be passed on a large part of the $4,000,000,000 (-plus) of stock and interest be defaulted on a substantial part of the $10,500,000,000 of bonds. Otherwise stated, a large part of the approximately $15,000,000,000 of income-producing railroad securities will soon be discredited.

Apart from the effect upon the millions of persons beneficially interested therein and upon the institutions which hold these securities, what will be the effect upon the general financial and business situation? Considering the amount of "frozen credit" already existing, can the savings banks and trust companies stand a railroad smash? Can the Reserve Board control the financial situation if the threatened railroad crash is allowed to come?

Under present organization and management Capital is faring very badly. After the experience of this year of private management it seems hopeless to look for restored private credit for railroad securities. New money, either for extensions or for refunding, cannot be obtained on any tolerable terms. New stock issues are obviously impossible.

It is high time the owners of our railroads realized their dangerous position.

II.

From the Standpoint of the Public and the Government.

The railroads produce and sell transportation; its price, maximum and minimum, is made by the Interstate Commerce Commission. For years the executives have contended that the rates were made too low. The decision of the Interstate Commerce Commission last summer gave the executives practically everything they asked. There is now general agreement that the rates are at least as high as the traffic will bear. In some spots they are too high, - destructive of traffic, of net earnings and of general business. Great quantities of cereals and other food products are not worth moving to market at present prices and freight rates. Broadly speaking, no more money can be extracted from the railroad-using public by any increase of rates.

In spite of the large drop-off in traffic and resulting excess capacity, the service is said not to be good. Transcontinental railroad traffic is being badly cut by water competition, - in essence subsidized, - by ships built from government money passing through the government-constructed Panama Canal. Seventeen lines between the Atlantic and Pacific coasts are already operating, with less rates and shorter time than the railroads require. Auto-truck and auto-bus competition are increasingly destructive forces practically subsidized, because operating on free rights of way. Yet the rail carriers are absolutely essential for the maintenance and development of our economic and social life; they cannot be allowed to decay as canal transportation has decayed.

The inclusive and exclusive federal rate-making power is questioned by 43 states and has just been submitted to the Supreme Court. Even if the position of the Interstate Commerce Commission as to rate-making is fully sustained, many hampering and confusing complications in the federal control and administration of state-chartered railroad corporations will remain. Until the roads are a federal agency the federal commerce power cannot be completely and effectively exercised.

Moreover, the government is now a railroad creditor for about $1,500,000,000 - approximately 10% of the gross valuation of all the roads. Substantial parts of these loans and claims would be uncollectible if the financial condition is not improved. Merely as creditor, the United States cannot view with unconcern the condition of its debtors.

III.

From the Standpoint of Labor.

The American railroad plant of about 260,000 miles is operated by approximately 2,000,000 of employees, who must render faithful, efficient and justly, - and only justly, - compensated service; otherwise the rights of both the using public and the owning public will be infringed. Wages now constitute 60 to 65% of the price of the transportation product. Under the Transportation Act, wages are practically, if not technically, made by the Wage Board in Chicago. There are outstanding so-called "national agreements and working practices" under which the railroad managers claim that gross and unjust discriminations obtain. Under many conditions time-and-a-half for overtime seems to put a premium on delay and inefficiency.

Whether, considering dropping prices and decreased cost of living, railroad wages are or are not, in general, too high, - it is contended that a substantial part of the wage fund is not now paid for loyal and efficient service rendered.

But the attitude of Labor toward present railroad management is one of distrust and bitter antagonism. Labor contends, rightly or wrongly, that the present management does not desire a just and amicable readjustment of wage schedules and working conditions, but is engaged in a ruthless campaign to destroy "Union Labor" as such. Broadly speaking, Labor contends that the present control of railroads is not in behalf of stockholders, but of supply houses, bankers and various adverse and exploiting interests. No opinion is intimated as to the accuracy of this attitude; it is referred to merely as a factor in the labor situation.

The general result is: a chaos of bitter-tempered conflicts between managerial and labor forces, precipitating complicated and almost insoluble controversies upon the Labor Board, whose legal powers to deal with them are of doubtful adequacy.

Whether the fault is in the machinery or in the management, the outstanding fact is that the railroad plant is not, after a year of private control, operated efficiently or economically.

Responsibility for labor conditions cannot - a year after the end of federal control - be disclaimed by the executives. The roads are now in general under the same operating officials as during and before federal control. They were returned under a law approved by the executives as giving them ample power to deal with Labor and all other operating factors.

IV.

A Suggested Remedy.

1. As a generalization: Our railroads must be unified, by induced but voluntary trades with their real owners - the bondholders and stockholders - and their securities stabilized by the use of government credit. Obviously, if the government furnishes the credit, it must also have a strong and perhaps dominating position in the management.

2. To effect these ends, let Congress incorporate (say) the United States Railroad Company, with very broad charter powers, to be exercised under the control of the Interstate Commerce Commission. Probably the members of the Interstate Commerce Commission should be the original incorporators. The act should, inter alia, authorize the new company to

(a) Assume, principal and interest, the bonds and other debt obligations (properly outstanding) of the existing railroad companies.

(b) Issue its 6% standard dividend stock in exchange for outstanding dividend-paying railroad stocks on the basis of giving a return not exceeding the rate of dividends paid on existing railroad stocks during, say, 6 to 10 years ending December 31, 1920. Thus, Pennsylvania stockholders would swap share for share; Northern Pacific stockholders would receive 1-1/6 shares for 1, etc., etc.

(c) Exchange its stock for the stocks of non-dividend-paying railroads for an amount at par not exceeding the value of the equity above the debts and obligations of such railroads as determined by or under the direction of the Interstate Commerce Commission.

(d) The act should provide that the stock certificates of the new company should contain a provision authorizing the government at any time to take over the stock at par and accrued standard dividends.

(e) The usual constitutionally necessary provisions for taking care of dissenting stockholders should, of course, be included.

(f) Possibly the act should require the contingent deposit of, say, two-thirds of the stock of the large dividend-paying roads before the proposed consolidation should be declared effective.

(g) Power to take stock as well as property by eminent domain should be included. (See Offield V. New York, New Haven & Hartford Railroad Company, 203 U.S., 372).

(h) Many other powers obviously necessary need not now be stated.

3. Without now stating further legal details of this plan, the general result would be to consolidate, by direct induced but voluntary trade with the security holders, the railroads into a single federal corporation which would assume the outstanding bonds of about $10,500,000,000, exchange its own 6% standard dividend stock to the amount of perhaps $5,000,000,000 for the outstanding stocks of the existing railroads. Power of the government to expropriate all the stock at any time at par and accrued standard dividends would eliminate all questions of valuation arising under ordinary eminent domain procedure.

The annual requirements of such a corporation for return on capital would be between $750,000,000 and $900,000,000 - somewhat less than the standard return during federal control. But the important point is that such assured return on consolidated railroad securities would stabilize substantially all the bonds and stocks that represent real and intrinsic values.

4. General management might well be vested in fifteen directors, paid reasonable but not exorbitant salaries, located in Washington, required to give practically their exclusive time to the business, and authorized and required to divide the railroads into a desirable number of effictive managerial operating units. Local control of operation as complete as practicable should be sought. Five of these directors might be elected by the stockholders for, say, five-year terms; five by classified Labor; and five appointed by the President and confirmed by the Senate from both political parties, representing purely public interests and required to have no financial interest in the enterprise. Or, the majority might be public directors, - leaving the minority to be divided between Labor and Capital. Or, the majority might be elected by the stockholders, leaving a minority to be divided between Public and Labor directors. Their terms should be arranged so that only one of each class should expire each year. The essential point is that Labor should be given a position of initial responsibility in management, that Capital should also be given a large, if not controlling, responsibility, and that the public, which furnishes the credit, should be given an effective, if not dominating, voice in management. Reasonable stability of tenure should be sought as in the organization of the Interstate Commerce Commission. Probably the Wage Board with somewhat modified powers should be retained.

5. Stockholders' returns should depend in part upon the efficiency of the management to which they contribute. The government might well guarantee, say, 4% of the standard 6% dividend, with a provision that in prosperous times and under efficient management the dividend might be increased to possibly 7% but not more. Perhaps any income in excess of standard dividends accruing in

any year might be divided into three equal parts, - one-third to be applied as above to an increased dividend up to but not exceeding 7%, any balance of this third to go into a reserve fund to stabilize dividends for hard times; the second third to go as a dividend to Labor on a classified wage schedule; and the remaining third to the government to amortize its investment and to provide a reserve fund against possible claims under the guaranty. At any rate, this or some other analogous sliding scale arrangement should be made so that Capital and Labor should each carry its just proportion of the risk of the business and of the results of efficiency or inefficiency of management.

6. Rates should probably be initiated by the United States Railroad Company under a statute requiring the company (and the Interstate Commerce Commission, as now), to make rates as nearly as possible adequate to cover operating expenses, including, of course, just and adequate - and only just and adequate - wages, annual charges by units for maintenance and depreciation, fixed charges, and a standard 6% dividend. In a word, the mandate should be for service-at cost, including as a part of cost a fair, and only a fair, return on the capital used. The Interstate Commerce Commission should have full revising power over rates, as conflicts between community and community, industry and industry, and shipper and carrier are always sure to arise. To the Interstate Commerce Commission the shipping public, as hitherto, should resort for all rate grievances. Rate supervision by the Interstate Commerce Commission would operate as an effective check against any possible tendency on the part of the company to make rates high enough to cover inordinate wages. Rates essentially local, such as commutation rates around our large cities, should be left primarily under the control of the state utility boards, with a carefully guarded power of review by the Interstate Commerce Commission. Federal functions may be constitutionally and legally thus delegated to state officials.

7. Extensions, additions and security issues: - up to a reasonable maximum, the company might well act in its uncontrolled discretion; but large expenditures should be submitted to the Interstate Commerce Commission for approval, substantially as under the Transportation Act. Extensions should be authorized somewhat as under the federal highway act, combining federal capital with local capital; but title to new roads thus created should be vested in the federal corporation. Refunding issues should probably be subject to approval by the Interstate Commerce Commission.

Other details necessarily involved need not now be set forth.

V.

Results Reasonably Expected.

1. Unification of plant and of operation would eliminate enormous wastes now suffered from unnecessary duplication and in administration and

operation. In no other business, except telephony, are unification and coordination so fruitful of economy and efficiency. Without such economy there is no reasonable prospect of any rates the traffic will bear yielding a fair return either to Labor or to Capital. Failing such economy and increased effiency, railroading is decadent - moribund. The days of endurable waste are past.

2. Given such management, in which Labor shares initial responsibility and from which forces now causing suspicion and antagonism are largely or wholly eliminated, loyalty and greatly increased labor efficiency may reasonably be expected. Railroad labor is highly intelligent. Fairly treated it will respond to the call of duty. Every decent American likes to do a good job and to have the reputation of doing a good job.

Under present organization, neither Labor, Management nor Capital is doing a good job.