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Rail Business

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Rail operator: re-regulation would hurt shortlines

Argus has asked a variety of individuals who have extensive knowledge of freight operations what the passage of current rail regulation legislation, namely H.R.2125 and S.953, would mean in practical terms for railroads.

Latest in an occasional series

Rail industry veteran Henry Posner III spoke to *Argus* about the effect a ban on "paper barriers" contained in this legislation would have.

Posner is chairman of Railroad Development Corp. (RDC), a Pittsburgh, Pa.- based railway investment and management company that operates railroads in six countries, including the Class II Iowa Interstate Railroad. RDC has operated under numerous forms of government regulation and this year faced actual expropriation of two of its lines by governments in Estonia and Guatemala. The latter case will be arbitrated under the Central American Free Trade Agreement.

Posner's views as expressed are his own, and are included to provide his unique insights into the rail industry.

Argus: HR. 2125 and S.953 contain a prohibition on paper barriers, which limit a Class III railroad's ability to interchange freight with all Class I carriers except for the seller. What effect do you think this ban might have on the availability of Class I lines for potential purchase?

Posner: If I were a Class I, I at least would certainly want a much higher purchase price from a buyer if I didn't have the prospect of holding onto traffic. Many Class III railroads have been formed from pieces of Class Is — at a discount — because of the Class Is' ability to implement paper barriers.

If the proposed laws were implemented, existing Class III buyers would, in effect, be receiving a windfall profit at the expense of the Class I seller.

Argus: Would we see spin-offs from Class I carriers to Class III carriers end completely?

Posner: Presumably there would still be potential buyers who would be willing to pay more because they would be able to access more traffic without the paper barriers. And some Class Is may still see some worthwhile spin-offs. However, if I were a Class I, I would think long and hard about walking away from a piece of my franchise without being able to hold onto the traffic. There will be substantially fewer reasons for the Class I to sell.

Argus: How would the shortline industry be affected overall?

Posner: We have to ask: If the price to acquire a shortline is high because of a prohibition on paper barriers, does it really promote the ability of light-density shortlines to compete?

Remember, Class Is are the most efficient "wholesalers" in the industry, while shortlines are the more cost- and service-focused "retailers." If we become higher cost retailers because we have to pay higher purchase costs to acquire these lines, we'll have one hand tied behind our backs when it comes to competing with trucks. For a potential buyer or investor, this would represent a major increase in risk.

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Argus Q&A: Henry Posner III

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Argus: RDC is both investor in and operator of rail lines around the world. Drawing on your experience in both areas, what other impact would the proposed rail regulation bills have on the way you would run a Class I?

Posner: I can't give an answer as to the steps I'd take immediately, because these bills would change the economics of the industry overnight. If the aim of the policy is to produce perfect rail-to-rail competition throughout the industry, then I think you would probably end up operating like the US airline industry or the United Kingdom's rail freight industry — and both of these models are economic disasters.

As an investor, I do know that capital markets do not like uncertainty, and complex regulation with unpredictable outcomes increases that uncertainty. These bills would increase industry-wide financial risk, and increased risk raises the cost of capital. Yet at the same time, there will be a lot less capital available.

This situation certainly would affect a railroad's capital expenditures. As allocators of scarce capital, rail management develops a list of potential projects and then simply ranks them in order of expected return. A project isn't pursued if it doesn't exceed the cost of capital.

A lot of proposed projects are going to be whacked off the bottom of the list if your cost of capital is rising because of regulatory uncertainty.

Argus: In your view, then, will branch line spin-offs and capacity expansion be the major areas of change if a new regulatory regime is implemented?

Posner: In my opinion, this legislation would not be good for any stakeholder in the industry. Again, take a look at the airline industry. Is labor, for example, better off in the airline industry than it was 10-20 years ago? Anything that artificially increases cut-throat competition has to exert downward pressure on wages.

Lawyers, however, might do well, particularly if the carriers file a claim for the expropriation of the value of their enterprise.

I'm uncertain whether they would be successful. But I would at least make the claim — as we have to the governments of Estonia and Guatemala — that although the public sector can make whatever laws it likes, where there is the rule of law there needs to be compensation for those having their property expropriated.