

RAILROAD SECURITY ISSUES UNDER GOVERNMENT OPERATION

BY THOMAS CONWAY, JR., PH.D.

Railroad securities make up a large part of the assets of banks, life insurance companies, of the investments of trust estates and private individuals. The securities of our railroads, until the outbreak of the European War, were held in large amounts by foreign owners. As a result of the liquidation of these European holdings; the attitude of the Interstate Commerce Commission and other regulatory bodies towards the railroad rate problem; and the liquidation of railroad securities by American investors desiring to escape heavy war taxes by shifting their investments to government bonds, the tendency of the market price of railroad stocks and bonds within recent months has been generally downward. This unfavorable movement has been very pronounced since the fall of 1916, the culmination being reached in November and December, 1917, when the prices of many standard railroad issues were below those prevailing in the panic days of 1907.

This decline in railroad security values occurred in a period of unparalleled traffic. The railroads were overwhelmed with business. It was evident that one of the weak links in the chain of American preparedness was the insufficiency of equipment and terminal facilities on the part of most railroads, notably those in the East.

With the flotation of the second Liberty Loan, the marketing of new security issues by private corporations and the refunding of maturing issues became a grave problem. The government was sucking up all of the available investment funds, leaving nothing for the private corporation. For years, our railroads have followed the practice of issuing short time notes,—a hand-to-mouth method of borrowing which many prophesied would sooner or later lead to disaster. According to estimates which have been prepared by Mr. McAdoo, some \$265,000,000 of railroad securities mature and require refinancing in the calendar year 1918. Private bankers were unwilling to undertake large commitments for such purposes under



existing conditions. The failure to refund maturing issues meant an epidemic of railroad receiverships.

GOVERNMENT PLANS OF RAILROAD FINANCE

The railroad problem thus became one of the grave issues confronting the government, the satisfactory solution of which was necessary if the gigantic preparations of the nation were to go forward satisfactorily. Prompted by the three motives of ending the traffic paralysis, taking care of necessary refinancing, and of providing the funds urgently required to extend the facilities of the carriers in order to handle the enormous volume of business which they were called upon to move, the President, on December 26, 1917, issued a proclamation taking over the control and general management of the railroads. In his proclamation, the President outlined in general terms the financial arrangement which he believed to be equitable. Concerning this matter, he said:

While the present authority of the executive suffices for all purposes of administration, and while of course all private interests must for the present give way to the public necessity, it is, I am sure you will agree with me, right and necessary that the owners and creditors of the railways, the holders of their stocks and bonds, should receive from the government an unqualified guarantee that their properties will be maintained throughout the period of federal control in as good repair and as complete equipment as at present, and that the several roads will receive under federal management such compensation as is equitable and just alike to their owners and to the general public. I would suggest the average net railway operating income of the three years ending June 30, 1917. I earnestly recommend that these guarantees be given by appropriate legislation, and given as promptly as circumstances permit.

I need not point out the essential justice of such guarantees and their great influence and significance as elements in the present financial and industrial situation of the country. Indeed, one of the strong arguments for assuming control of the railroads at this time is the financial argument. It is necessary that the values of railway securities should be justly and fairly protected and that the large, financial operations every year necessary in connection with the maintenance, operation and development of the roads should, during the period of the war, be wisely related to the financial operations of the government. Our first duty is, of course, to conserve the common interest and the common safety and to make certain that nothing stands in the way of the successful prosecution of the great war for liberty and justice; but it is also an obligation of public conscience and of public honor that the private interests we disturb should be kept safe from unjust injury, and it is of the utmost consequence to the government itself that all great financial operations should be stabilized and coordinated with the financial operations of the government.

No borrowing should run athwart the borrowings of the federal treasury, and no fundamental industrial values should anywhere be unnecessarily impaired. In the hands of many thousands of small investors in the country, as well as in national banks, in insurance companies, in savings banks, in trust companies, in financial agencies of every kind, railway securities, the sum total of which runs up to some ten or eleven thousand millions, constitute a vital part of the structure of credit, and the unquestioned solidity of that structure must be maintained.

Almost simultaneously, the administration caused to be introduced in Congress a bill carrying out the general policy outlined. The bill provided that during the period of federal control, each railroad should receive—

as its just compensation an income at an annual rate equivalent as nearly as may be to its average net railway operating income for the three years ending June 30, 1917 (called herein standard return); said net railway operating income for the purposes of this act shall, as to carriers making returns to the Interstate Commerce Commission, be computed from such returns, excluding, however, debits and credits arising from the accounts called in the monthly returns leased road rents and miscellaneous rents: *Provided, however,* That no federal taxes in excess of taxes assessed during the year ending June 30, 1917, shall be charged against revenue in computing such standard return. Any net railway operating income in excess of such standard return shall be the property of the United States. The amount of such standard return as accruing during said period of three years shall be determined by the Interstate Commerce Commission, and the certificate of said commission as to the amount of said net railway operating income shall, for the purpose of such agreement and guaranty, be taken as final and conclusive.

During the period of such federal control adequate depreciation and maintenance of the properties of the carriers shall be included as a part of the operating expenses or provided through a reserve fund, in accordance with such principles and rules as shall be determined by the President.

In case of a dispute as to what constituted "the average net railway operating income" of a railroad, the matter should first be referred to a board of three auditors, appointed by the Interstate Commerce Commission, which, after a full hearing, should report to the President the amount due the carrier as just compensation. The bill further provided that in the event of the failure of the carrier and the government representatives to agree upon proper compensation, appeal could be taken by the carrier to the Court of Claims, and that pending the decision of that court, the government should pay to the carrier an amount not exceeding 90 per cent of such standard return, the balance due, if any, as determined by the Court, to bear 6 per cent interest during the period required for the adjudication of the matter.

Additions and improvements made to a railroad while under federal control out of the capital or surplus of the carrier are to receive a return "reckoned at a rate percentum to be fixed by the President" upon the cost of such additions and improvements. Additions and improvements made out of funds advanced by the government are to entitle the carrier to an additional allowance in its earnings "equal to the rate accruing to the United States" upon any advances, thereby enabling the carrier to make payment to the government without encroaching on its own share. The administration bill further provides that:

no carrier, while under federal control, without the prior approval of the President, may declare or pay any dividends in excess of its regular rate of dividend during the three years ended June 30, 1917, *provided, however*, that such carriers as have paid no regular dividends or no dividends during said period may, with the prior approval of the President, pay dividends at such rate as the President may determine.

The Act makes provision for the issue and sale of railroad securities during the period of government control. Section 7 provides:

That for the purpose of providing funds requisite for maturing obligations or for other legal proper expenditures, or for reorganizing railroads in receivership, carriers may, during the period of federal control, issue such bonds, notes, equipment trust certificates, stock and other forms of securities, secured or unsecured by mortgage, as the President may approve as consistent with the public interest. The President may purchase for the United States all or any part of such securities at prices not exceeding par, and may sell such securities whenever in his judgment it is desirable at prices not less than the cost thereof; any sums available from the revolving fund provided in section six may be used for such purchases.

At this time, when only the broad outlines of the President's plan have been sketched in and the administration bill has not emerged from committee, much less received final action in either house, it is impossible to indicate with any degree of exactness the resultant effects upon the carriers. Presuming, however, that the general plan recommended by the President is adopted by Congress and that the intentions of the administration are accurately reflected by Director General McAdoo's testimony before the Congressional committees, a general estimate can be made of the effect of government control during the war.

Director General McAdoo, in testifying before the House Committee on Interstate Commerce, explained the close connection

between financing the railroads and the successful financing of the needs of the government. He said:

Over and above the deficit and other measures now before Congress, the government faces the necessity of raising \$10,000,000,000 between now and June. With our financial situation as it is now—uncertainty largely prevailing—we can do nothing. Our savings banks, investment concerns, and other fiduciary institutions hold \$4,000,000,000 of railroad securities. So long as these institutions are uncertain as to the status of the securities they hold, what income they will get, and what the future holds for their interest and dividends, they are in no position to buy the bonds which we must offer.

At an earlier hearing, he explained that government control was inevitable for two reasons, because:

It was apparent that under private management close coördination of facilities could not be effected, because each of the roads naturally was seeking to get all the business it could. Only under government control could this coördination be achieved. It was also necessary to stabilize, or clarify, the financial situation. There are \$4,000,000,000 of railroad securities held by banks, trust companies, and fiduciary institutions throughout the country. These form a considerable portion of the country's basis of credit. Under existing conditions the shrinking in value of these securities created a serious situation.

Mr. McAdoo also said, "I don't believe a very great sum comparatively will be needed for financing the roads." In commenting upon railroad obligations maturing in 1918, he said "I expect the railroads to take care of those obligations themselves either through re-issue or some other method."

In detailing the needs of the railroads before the House Committee, Mr. McAdoo stated that the necessity for the \$500,000,000 fund proposed in the bill was due in part to need of maintaining and improving the roads and in aiding those in a weak credit position. Asked what sum total the government might finally expend in this manner, he submitted the following figures on the roads' own expenditures for the last five years: 1912, \$477,000,000; 1913, \$600,000,000; 1914, \$550,000,000; 1915, \$263,000,000; 1916, \$281,000,000.

Mr. McAdoo added that he thought the \$500,000,000 should be regarded as a one-year appropriation, and that if government control should last longer, similar sums might have to be asked of Congress periodically. He hoped to add to this sum by the profits which the government, by unified operation and other economies might effect,

With respect to maturities, he said:

I hope the railroads, aided by the government guarantee, will be able to take care of their own. If it should be required, government aid should be given wherever it is necessary to protect the credit position of roads taken over. I assume a first-rate railroad bond, guaranteed as it is by the government, should easily be refunded. The great needs of the government are such at any rate that all bond flotations necessarily will have to be conducted with the approval of the national Treasury.

The response of the market to the President's action showed unmistakably the dread and anxiety which had filled the minds of investors in railroad securities. There was a sharp rise in practically every stock. In the three stock market sessions following the President's announcement, there occurred an advance of more than one-half billion dollars in the market values of the stocks of seventy-eight railroads. Since that time there has been a gradual decline in railroad stock quotations so that by the close of January, 1918, a considerable part of the sharp advance had been offset in many cases.

EFFECTS OF THE GOVERNMENT PLAN OF RAILROAD FINANCE

In advance of the final enactment of a bill carrying out the President's plan for control of the railroads, it is impossible to do more than estimate the effect of government control during the war upon railroad securities upon the basis of the administration's proposal. There is some dispute as to exactly what return is contemplated. In the first place, the item "net railway operating income" as used in the proposed act, appears nowhere in the reports of the Interstate Commerce Commission. In other words, it is necessary to calculate the sum contemplated from the returns as published. Again, the Interstate Commerce Commission's official figures for the fiscal year ended June 30, 1917, are not as yet available. The estimates of the Bureau of Railway Economics and the Interstate Commerce Commission's experts vary considerably as to the return which will be shown when complete figures are at hand. The Interstate Commerce Commission's statement as to what the President's plan contemplates, including its estimate of net railway operating income, for the fiscal year ended June 30, 1917, is as follows:

Year ended June 30	Net Railway Operating Income	Investment in Road and Equipment—Book Value	Ratio of Earnings to Investment—
1915	\$683,104,833	\$16,499,124,491	4.14%
1916	984,872,959	16,872,373,900	5.84%
1917	1,020,800,000	17,250,000,000	5.91%

The Commission estimates the three year average to be 5.31 per cent.

The Bureau of Railway Economics disputes the conclusions of the Commission, alleging that it has more accurate figures than the Commission for the fiscal year ended June 30, 1917, and that by using these figures it finds that the average return would be only 5.22 per cent. An examination of the conclusions of the Commission and of the Bureau shows that the former was estimating on 95.87 per cent of all mileage while the Bureau's estimates covered approximately 86 per cent of the mileage.

Objections to the plan proposed by the President concern individual companies rather than general equities, with the exception of the general objection of the carriers that the year 1915 was the worst year that they had experienced in fifteen years, and that an average made up by the inclusion of this year with two average years was not fair to them, and does not adequately reflect the earning power of the railroads. The reply is made to this objection that the years ended June 30, 1916 and 1917 were unusually good and that in any event war times are abnormal times, and under such conditions the railroads cannot expect a guarantee of a rate of return equal to that which the properties might earn under peace conditions.

The second objection is, that the President's plan is most unjust to the speculative stocks and to stocks of recently reorganized companies. The Missouri Pacific, for example, has recently passed through a drastic reorganization in which a large amount of money was raised through a heavy assessment on the stockholders, whose subscriptions were based upon the reasonable assumption that they would receive a dividend almost immediately. Because of the fact that the receiver put a large part of the earnings of the property into rehabilitation work, the returns shown for the years 1915 and 1916 were very poor, although as a matter of fact the company's earning power had been quite satisfactory. This rehabilitation program is practically completed, and it is argued that the road has a demon-

strated earning power much beyond the amount which would be guaranteed under the President's plan. The stockholders, however, cannot share in these earnings because of the large amount which was invested in the road in two of the three years selected as the basis of calculating the guarantee. It is contended that for similar reasons the Pittsburg & West Virginia, the Western Maryland, the Pere Marquette and the St. Louis-San Francisco railroads will not receive anything like an adequate return under the President's plan.

On the whole, however, the guarantee tremendously strengthens the financial position of the railways. While injustice may be shown in a few cases, yet the amounts which the government guarantees most of the railroad systems are sufficient to enable them to pay their fixed charges. In most cases the balance remaining is considerably in excess of the dividend payments which have been made in the last three years.

It should be emphasized that the government does not guarantee the payment of dividends. The President's plan merely guarantees to the corporation a certain income, which will be disbursed in accordance with the contracts heretofore entered into by the corporation, and actions taken from time to time by the boards of directors. The directors of a railroad can at any time suspend dividends in case they feel that the money should be invested in the property, or if for any reason it seems advisable to conserve resources. The government does not guarantee dividends, but the practical certainty that with the government's aid new capital requirements can be financed makes it likely that dividends heretofore paid will be continued in most cases.

The President's plan will doubtless accomplish the two great aims which he had in mind. It will take care of the problem of refunding the \$265,000,000 of security issues falling due in 1918 and the maturities in subsequent years, in case the war continues. It also makes possible control over railroad financing so as to avoid any conflict with the government's plans. Above all, a method is provided by which the railroads can secure whatever additional money is necessary during the period of the war for the purchase of equipment and the extension of facilities.

THE GOVERNMENT PLAN NOT A PERMANENT SOLUTION

The President's plan in no sense constitutes a permanent solution of the so-called railroad question from the security holders' point of view. It merely preserves the integrity of railroad investments during the period of the war. It does not carry assurance that present prices of railroad securities will be maintained. In fact, it would appear that any general appreciation in the prices of dividend-paying railroad stocks and bonds, above the figures prevailing in the latter part of January, 1918, is hardly to be anticipated, until the conclusion of peace begins to be discounted. It is true that the government's guarantee makes the dividend and interest on railroad securities especially secure, but with standard stock issues selling on a $5\frac{1}{2}$ to $6\frac{1}{2}$ per cent basis and with railroad bonds of the higher grade yielding from 5 to 6 per cent at present prices, the likelihood of further large advances is not very great. So long as the war continues, competition by the government for investment funds will become increasingly insistent. The consequent strain on credit will tend to increase rather than ease up, with the result that investors will demand even a higher yield than now prevails on taxable securities. If the war should last for a number of years taxes will almost certainly increase, with the result that high class taxable investments will suffer by comparison with tax-free government bonds. It must also be remembered that in so far as the security holder is concerned, the earning power of the railroads during the period of the war has to a large extent become fixed. Increased earnings will not mean increased dividends, for it is probable that Congress and the Administration will take the view that the companies' share of excess earnings should go into extensions. The great uncertain element is, of course, the duration of the war, and the extent to which the present situation as regards earning power and methods of operation will be changed before the end is reached. It is furthermore uncertain at the time this article is written, exactly when the government will return the operation of the railroads to their owners. It appears probable, however, that they will be returned within a few months after the conclusion of peace.

The real problem of the railroad security holder concerns his status after his property is returned to him. The old problems of high operating costs and fixed rates; the unwillingness of regulatory

commissions to advance rates; the failure on their part to realize that capital has been gradually forsaking the railroad field, because an attractive return was not offered, must all be faced again. The situation will be aggravated by the practical certainty of high post-war income taxes, which will cause the investor to demand an addition to his rate of return, offsetting at least in part the taxes which he must bear. The most serious element in the situation from the investor's standpoint, is the problem of readjusting railroad wages to a peace basis. It is evident that the administration intends to have no quarrel with the railroad brotherhoods, which means substantial increases in wages. The possibility of reducing wages when living costs decrease after the conclusion of the war, are not at all clear. If it proves impossible to reduce labor costs, the outlook for the railroad security holder upon the return of peace is not very encouraging, particularly when the time is reached—as it must be reached—for a general economic readjustment with a consequent reduction in traffic and in operating revenues. The political significance of a general increase in rates while the roads are under government control would be so profound as to cause every expedient to be used to avoid taking this step. Whatever economies can be effected through centralized control and unified operation will offset in part the higher wages which the Director General will without doubt authorize. Mr. McAdoo, moreover, has indicated that he expects to use the \$500,000,000 appropriation contemplated by the administration bill to constitute the so-called "revolving fund" to meet, among other things, any operating deficiency which may arise.

It is very possible, therefore, that the roads may be returned to their owners operating on a deficit under unified control and with the probability of still larger deficits under individual control. The significance of the wage problem at once assumes its true proportion when this contingency is kept in mind. The future of railway investments, therefore, depends upon the breadth of vision and courage shown by the Interstate Commerce Commission and the state commissions in adjusting rates from time to time so as to assure a fair return and adequate protection to the security holder.