RAILROAD WEEK IN REVIEW

September 17, 2021

“The KCS Board of Directors has determined that CP’s revised proposal constitutes a ‘Company Superior Proposal’ as defined in KCS’s merger agreement with CN. Under the terms of CP’s proposal, each share of KCS common stock would be exchanged for 2.884 CP common shares and $90 in cash. In addition, holders of KCS preferred stock would receive $37.50 in cash for each share of KCS preferred stock held.

“The proposal is binding on CP and may be accepted by KCS at any time prior to 5:00 pm EDT on Monday, September 20, 2021. The transaction would be subject to approval by the stockholders of CP and KCS, receipt of regulatory approvals, and other customary closing conditions.” — KCS Press Release, September 12, 2021

“Customers will not experience a reduction in independent railroad choices as a result of the transaction. CP-KCS have committed to keep all existing freight rail gateways open on commercially reasonable terms, while simultaneously competing aggressively to attract traffic via new single-line north-south lanes between Canada, the Upper Midwest and the Gulf Coast, Texas, and Mexico.” — Canadian Pacific Press Release, September 15,

“*Since 2010, the five U.S.-based Class 1 railroads have paid out $114 billion in stock buybacks and another $77 billion in dividends. during the same period. Thus, the railroad owners have taken back an astonishing $191 billion in stock buybacks and dividends … far more than the $138 billion spent on the railroads’ infrastructure.” — STB Chair Martin Oberman, NARS 2021 Annual Meeting, September 8.*

“Where,” Oberman asks, “would rail customers, rail workers and the public be if a meaningful portion of that $191 billion had been re-invested in expanding service and making service more predictable and reliable? Clearly, we would have more freight moved and at a lower rate. We would have more employment with better working conditions and the public would benefit with lower consumer prices, less highway congestion and less polluted air. And all of this could be achieved with the railroad owners continuing to receive a healthy return on their investments.”

Clearly he sees a disturbing trend among railroads as the owners put more focus on <u>earnings right now</u> than on creating competitive advantages when they ought to be building a customer base whose <u>value tomorrow</u> comes from the customer base created today. “Financialization ” is the word coined to define the process.

What I wrote in 2018: I worry when railroads stop being owned and run by railroaders. This is what happens when companies are “financialized” — meaning there is a shift of focus from running the customer-creating core business to generating maximum financial returns for the true owners whose financial success depends on the financial success of the company.   The Cult of the Operating Ratio, which I wrote about here August 3, is one manifestation.

Once the newly-financialized company is floated on the markets, management's main objective is to juice up the stock price, because that's how they get compensated. How different that is from the operating owner whose main objective is to survive and prosper by being there. (Like Woody Allen said, 80 percent of success in life is showing up.) So an entrepreneur's job — a business owner's job — is not to be separated from his company.

On the other hand, the financial manager's incentive is completely different. He doesn't have three generations invested into this factory. He needs to make his stock options work over the next three to five years. The ownership of business becomes financialized and you end up with a company that's run by people who are interested in the next 24 months. The former operating-owner who used to have something that was robust and potentially multi-generational becomes a speculator.

The cult of the operating ratio can turn every Class I railroad but one, BNSF, into a "financialized" company. Head-counts are drastically reduced, locos are parked, low-yield commodities are shunned, and share buy-backs get precedence over capex. Market managers are managed more by their markets than the other way around, losing their original role of creating customers. This is not a promising trend and it leads straight to more business on the highway.

Listening and reading between the lines of recent STB Decisions, one gets the feeling that the STB sees its mission as leveling the transportation playing fields between and among and between the players. He would like to see the end of "competitive pricing" whereby customers with the lowest margins get the highest rates, partly to keep the operating ratios down. In a similar vein, the practice of charging demurrage on privately-owned equipment constructively placed on a railroad-owned track to accommodate less frequent switching moves has got to stop.

The whole business of charging more money for less work is patently unfair. Seeming to discourage the sale of large railroads to even larger railroads is a good place to start.

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