Laws might derail railroad mergers

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When it comes to railroad consolidation, most opponents hark back to the mid-1990s, when a series of mergers at the time were blamed for lost cargo, derailments, death and billions of dollars lost by businesses and taxpayers.

During three decades through 2001, the number of major railroad operators in North America shrank to seven from 56. The fallout from that consolidation spurred new rules in 2001 to make rail mergers harder by denying potential acquisitions that could cause a domino effect.

Now, for the first time since they were passed, these rules are being tested.

Canadian Pacific has made three attempts to acquire Norfolk Southern in what could be a $27 billion deal. Norfolk Southern has repeatedly repudiated the offer, largely out of concern that regulators would not approve a deal.

Yet if Canadian Pacific succeeds, Matthew Rose, executive chairman of Fort Worth-based BNSF Railway — which is owned by Warren Buffett's Berkshire Hathaway — has said that BNSF would need to do a deal as well.

And Kansas City Southern, a Midwestern railroad operator, could loom as a potential target for railroad companies. With a market value of about $8 billion, it is attractive because it is exempt from the 2001 rules, making it a potentially easier target.

Kansas City Southern has interviewed external and internal candidates who could take over for David Starling, its 66-year-old chief executive, who may decide to retire next year, people briefed on the interviews said.

The company is leaning toward choosing Patrick Ottensmeyer, its current president, as the successor, these people said, but they said that decision could change. They asked not to be named because the process was private.

While it is unclear whether Ottensmeyer or any other successor would be open to a takeover, a change in management could motivate potential acquirers to enter the fray.

Yet there are plenty of doubts about whether consolidation is even possible in the U.S. railroad business.

Chief executives like James Squires of Norfolk Southern, former regulators and those that use rails to ship goods argue that large mergers would be detrimental to the industry. About 71 percent of shippers surveyed by Cowen & Co., the New York brokerage firm, said they would not support the Canadian Pacific and Norfolk Southern deal.

"The domino effect will be a significant variable here," said Jeff Moreno, a partner at the law firm that represented rail customers suing the operators during the 1990s. "The shipping community is leery of any further mergers because of the service problems before."

Hunter Harrison, the 71-year-old chief executive of Canadian Pacific, is pursuing an acquisition nonetheless, and shareholders are along for the ride, especially the chief of Pershing Square Capital Management, William Ackman, who is Canadian Pacific's largest investor.

Harrison and Ackman argue that railroads, especially Norfolk Southern, need to improve their operating efficiency and that the best way to do that is by combining.

Regulatory burden

A big question is how current regulators see things.

"It's a pretty tough regulatory burden, given that this is all about what's in the public's best interest and the likelihood that commissioners see a whole lot more risk in this than reward," said Mark Levin, an analyst with BB&T Capital Markets. "But I don't think you can extrapolate that just because mergers failed in the past means it will fail in the future."

The railroads were partially deregulated in 1980, allowing them to compete more on price differences, forcing a wave of mergers, as documented by data from Dealogic.

Burlington Northern announced in February 1995 that it would acquire Santa Fe Pacific Corp. for more than $5 billion. One month later, Union Pacific announced a $2 billion purchase of

Chicago & North Western Transportation Co., followed by the August takeover of Southern Pacific Rail Corp. In October 1996, CSX Corp. and Norfolk Southern jointly acquired Consolidated Rail Corp., or Conrail, for about $12 billion and split it in two. Then, in February 1998, Canadian National acquired Illinois Central Corp. for $3.5 billion.

When Union Pacific was integrating Southern Pacific, computer problems resulted in lost or delayed cargo. Crews were overworked, leading to at least one deadly accident and more than a dozen crashes and derailments. Researchers estimated that the crisis cost businesses and taxpayers, especially those in Texas, more than $2 billion in just six months.

Similar travails occurred with Conrail's deal as well. Trains were late on Norfolk Southern and CSX tracks, and some customers' rail cars were lost, according to reports at the time.

As a response, the Surface Transportation Board, the regulator within the Department of Transportation responsible for overseeing rail carriers, created rules in 2001 to govern major mergers. Focusing on railroads with at least $250 million in revenue, or so-called Class I railroads, the board said that any merger must show that it enhanced competition and was in the public interest. The rules also required the board to consider "downstream effects" or how a merger might serve as a catalyst for additional deals.

Regulatory concern has not thwarted Harrison, however. Earlier this month, Canadian Pacific sought to sweeten the bid for Norfolk Southern, offering as much as $3.4 billion in additional value to Norfolk Southern shareholders through a contingent value right, or CVR.

Canadian Pacific offered $32.86 in cash per share in May, plus 0.451 shares in the new company, plus 0.451 of the CVR.

Canadian Pacific argues that railroad consolidation could be in the public interest.

Not strong enough

If the deals enhance railroads' stock prices, the companies might then pass on the benefits to their customers, said Josh Duitz, a portfolio manager at the Alpine Global Infrastructure Fund, noting that he did not think the argument was strong enough to persuade regulators.

"As a shareholder of CP, I would love if they could consolidate," said Duitz, who manages more than $1.5 billion in assets, many of which are in railroad companies such as Canadian Pacific.

"If I were a customer of one of these rails," he continued, "I would be very leery of it because it could potentially reduce competition."

Hardly any merger arbitrage traders are trying to play the Canadian Pacific and Norfolk Southern deal because they do not see a path to completing the deal.

Canadian Pacific, however, has shown a willingness to start a proxy fight at Norfolk Southern, which could elicit more participation from traders.

“I don’t think we should count this merger out yet,” Terry Whiteside, chairman of the Alliance for Rail Competition, said by phone from Billings, Mont. “Hunter Harrison doesn’t say no, he just keeps going.”

Leslie Picker,

The New York Times

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