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CHICAGO, MILWAUKEE, ST. PAUL & PACIFIC RAILROAD

Testimony of Fairman R. Dick in The Reorganization Proceedings before The Interstate Commerce Commission on June 16, 1937

As a member of the special committee appointed by the Board of Directors of the Debtor to determine the position which it should take at this hearing with respect to the 1935 Reorganization Plan, I have, during the last several weeks, given intensive study to the various problems involved. For many months before the appointment of the committee I had been giving substantial consideration to those problems and was greatly puzzled as to what the proper course for the Debtor should be. As financial advisor to the Association of American Railroads, I had been giving a considerable amount of my time to the consideration of the financial problems of the railroads generally and in that consideration I could not help but apply my thinking concretely to some of the problems of the St. Paul, of which I am a director.

The Report of the special committee as embodied in the minutes of the meeting of the Board of Directors held June 3, which has been read into the record by President Scandrett, has my complete concurrence. As the committee's report points out, a vital feature of the 1935 Plan was the provision in Article VI for the purchase by the Reconstruction Finance Corporation of $12,000,000 of Equipment obligations, and the lending by that Corporation to the reorganized company of such additional sums as the Board of Directors might request on or before July 1, 1940, not exceeding an aggregate of $12,000,000. It was upon this provision that the plan depended for additional financing of the reorganized company. The only other financing medium provided in the plan was the issuance of additional bonds secured under the First and Refunding Mortgage. Under present conditions, these bonds would clearly not be salable.

The RFC commitment was by its terms limited to December 31, 1935, and therefore has expired. The Debtor has not taken up with the RFC the matter of whether it would be willing to renew the commitment because of the doubt whether a reorganization at this time should be dependent on RFC financing. It has come to be my view that while the Board was entirely justified in proposing a plan based on such financing in 1935, that is not true in June of 1937. I strongly adhere to the view that a reorganization today must be on a basis to insure sound financing of capital requirements for the future without dependence on a governmental agency and that, the prompt reorganization which was hoped for in 1935 having failed of realization, one of the primary questions which must be solved in any reorganization is how can the new Company be assured of such funds, beyond those provided by earnings, as may be necessary for those capital expenditures which will be required if the property is either to perform its public obligation or to get its fair share of competitive business.

In 1935, the plan had, as therein stated, been worked out after conferences with representatives of more than twenty insurance companies, trust companies and savings banks owning in excess of $100,000,000 of various issues of bonds affected by the plan. Any modification of the 1935 Plan, even for the purpose alone of resolving this question of future financing, will require similar negotiation. Negotiations and conferences of this character necessarily consume large amounts of the time, not only of the directors and counsel of the Debtor but of representatives of and counsel for the various creditor interests. It is neither feasible nor economical for the Debtor to negotiate a whole series of tentative plans with the creditor interests concerned. The part of wisdom clearly lies in not commencing such negotiations until the Debtor is ready to proceed with the negotiation of a revised plan which it may fairly regard as a satisfactory solution of the problem in the light of changed and changing conditions. While it can be pointed out that the earnings for 1936 exceeded the estimate in the original plan, the marked rise in cost of materials and supplies as well as the demand of the men for higher wages has changed many important factors on which the original plan was based.

The difficulties in reaching a proper decision at the present time in regard to a capital structure which will best be adapted to solving the problem of the St. Paul are, in my opinion, insuperable. The problem of creating some method of supplying the St. Paul with the money needed to proceed in the modernization of plant which, as I have already stated is the primary problem, cannot be intelligently solved under today's conditions. Obviously, the First and Refunding Mortgage is unsalable as the General Mortgage secured by Prior Lien on the more productive lines is selling at 60, and with the General Mortgage selling at 60, it is obvious that that mortgage is not salable even if the security holders would consent to open it up. If we assume for the sake of argument that this First Mortgage was scaled to 50% and opened up at that figure, even then there is considerable doubt as to its salability under present conditions. If we assume, however, that such a drastic scaling was feasible and necessary to meet credit conditions, it should be pointed out that the St. Paul debt, scaled to this figure, would stand at a ratio of but approximately 20% of its investment. If a standard so conservative is deemed to be necessary in order to solve the St. Paul problem today and enable it to survive in the next depression, obviously further improvements to plant cannot be bonded in excess of 20% of cost, or at least whatever debt is issued in excess of this ratio must be retired by junior financing prior to the next depression so that the Road may enter the next depression in the financial condition now decided to be sound. It must be recognized that such a plan, necessitating 80% of the cost of improvements financed out of earnings and non-fixed interest securities, means a considerably higher level of earnings during prosperity than was formerly deemed necessary for any railroad. For reasons to be discussed later, it is probably not sound to determine a proper capital structure for the St. Paul on such a conservative basis. On the other hand, if we critically analyze the ability of the St. Paul to finance at the present time even at such a radically low debt ratio and furthermore take into consideration the sharp rises that have already taken place in cost of materials and supplies and the demands of the men for increased pay, not to mention pending legislation, it is clearly evident that even such a drastic scaling might not be effective in the immediate future for raising any money whatsoever.

It must be understood that if the security holders are to be asked to agree to such a change in their present status, aside from the difficulty of obtaining assents there is a further difficulty of adjusting the relationships between the various securities based on the underlying mortgage making sacrifices which had not been contemplated in the original plan.

If such a radical debt scaling and such a drastically conservative policy for the future were determined to be correct, then it would be advisable at the present time to undergo the burden of adjusting the changed relationships brought about by this drastic policy. However, as already indicated, such a drastic policy may be inadequate for the immediate future and at the same time in the long run unduly burdensome on the public in necessitating the additional cost of an unnecessarily high proportion of what might be termed "speculative money" for future financing.

The committee's report indicates that the second main question which the members of the committee had with respect to the 1935 Plan, had to do with the cumulative feature of the contingent interest to be payable upon the modified 50-Year 5% Mortgage bonds. As I see it, that problem ties directly into the first problem, i.e. that as to financing. It seems to me that in determining what means shall be provided for future financing, consideration must be given to the advisability of opening up the contingent interest mortgage as a means of future financing. Financing by means of a contingent interest mortgage would be a new development in railroad financial practice and it was not contemplated in the original plan. On the other hand, the increased volatility of railroad net earnings in recent years is an obvious fact. This increased volatility is due to the narrowing margin between expenses and revenues and also due to the far greater decline in traffic volume in this depression as compared with other depressions. This greater volatility means relatively lower earnings in depressions and relatively higher earnings during normal times, and lower earnings in depressions necessitate a lower percentage of financing by fixed interest securities than was formerly thought conservative. To limit the supply of low cost capital in conformity with a conservative debt standard, and then to leap to equity financing even of a preferred variety prevents a railroad from availing itself of a reasonable supply of medium cost money which could be obtained from a class of investors such as certain insurance companies and discount banks, who will purchase bonds adequately protected by mortgage at reasonable rates of interest even where the interest is not fixed in extreme depressions. For example, if we assume that 4% would be the cost of fixed interest money, contingent interest money might be obtained at 4 1/2% to 5%, whereas marketing of prior preference or preferred stock would necessitate a charge of at least 1/2 to 1% more; in other words, a charge of possibly 5 1/2% to 6%, depending of course on the demonstrated earning power of the carrier in question. There must be considered also the more limited supply of this higher cost, more speculative money. Probably the largest reservoir of funds seeking investment today is of the conservative or semi-conservative type, requiring bonds with fixed interest or contingent interest. If the carriers are prevented from availing themselves of this reservoir of capital to the utmost extent consistent with conservatism, it may develop, at least during periods of extensive railroad modernization, that the supply of higher cost preferred stock money might not be available in sufficient quantity to satis... mands of the railroads, and this would entail even higher costs for th... of financing. In other words, the whole problem revolves around the devis... of methods by which the railroads may maintain conservative standards now deemed advisable and at the same time obtain future supplies of money at the lowest possible cost. The opening of and development of a broad market for contingent interest bonds would seem essential to a sound solution of the problem. If this additional change in the plan is thought advisable it should be pointed out that this also entails treating anew the relationship between the various creditor groups.

If it is determined that contingent interest bonds should be provided as part of the new financing media, then the provisions of the 1935 Plan with respect to contingent interest on the 50-Year 5% Mortgage bonds present a difficulty even more acute than that presented by the 1935 Plan itself. Cumulative provisions, unqualified and unlimited may result in distortion of railroad capital structures. One of the best examples of that is the accumulation on the adjustment bonds of the St. Paul today, and there can be no doubt that this feature of the St. Paul plan as well as other plans should be restudied, and examined in the light of the advantage of using the adjustment mortgage as a financing medium. It may be advisable and sound policy to limit accumulations to a definite period of years, for example three or four, and it may be that such a limitation will not injure the security as a financing medium. No investor will buy a cumulative adjustment bond in the belief that large accumulations will develop. The reason for desiring cumulative features is in order that failure to pay interest during a depression will be made up later, and that the bondholder will not be in the position of giving up his interest during a depression and then later, when earnings increase, see the stockholders reap all the benefits. A limited cumulative feature could probably be devised, adequate to protect the bondholder from making sacrifices in favor of the stockholder and at the same time prevent the accumulations reaching a point where they materially distort the capitalization.

Even if the 50-Year Mortgage bonds are to be given fully cumulative contingent interest, it seems to me that further study must be given to the provision of the 1935 plan that a ten year accumulation of interest on those bonds would constitute a default. This provision was intended to place the bondholders in a position to negotiate and endeavor to bring about whatever adjustments might be necessary if, for a long period of years, actual earnings fell far short of the estimates on which the plan was based. The purpose of this provision seems entirely sound but further study may reveal a better means of accomplishing the same results. For example, if it is determined to open up the general mortgage for a limited amount of future low cost financing, it is obvious that some leeway must be given to management to exceed the standard deemed to be conservative during depressions when junior financing is impossible. It may be advisable, therefore, to provide for either a technical default or some form of bondholder control in the event that debt was piled up in excess of the limit agreed to by the bondholders in opening up their mortgage. In such event, it is just and equitable that some suitable provision should enable the bondholders to determine what their policy would be, either, for example, in authorizing a further violation of the standard, or, possibly effecting another capital readjustment through reorganization.

It seems to me also that further consideration must be given to the provisions of the 1935 Plan with regard to sinking funds. These provisions were inserted at a time when there was a great wave of enthusiasm, in part sponsored by the Commission, for sinking funds, particularly in railroad financing. As the Commission now knows, the Federal undistributed earnings tax creates a most serious problem taxwise with respect to such sinking funds. Furthermore, I have substantial doubt as to their effectiveness in the field of railroad financing. Studies into railroad economics have revealed the fact that sinking funds will not in fact reduce debt unless either the demands for money for modernization are very much less than they were in the past, or on the other hand, earnings are far in excess of what they were in the past. During periods of depression, it will generally be necessary to increase fixed interest debt and, as the Commission has frequently pointed out, all debt once issued must not be regarded as permanent. It is believed that some method for accomplishing the Commission's policy of reducing debt to a conservative figure can be devised through inducing or, in fact, compelling retirement of what might be termed excess debt by junior financing when conditions permit. In this connection, convertible features applying to what might be called excess debt might prove very effective.

The difficulties in framing such a plan of reorganization for the St. Paul at the present time are, in my opinion, insuperable. The problem to be solved is the determination of the type of capital structure which will enable the St. Paul to function in the immediate future and at the same time give every assurance that the St. Paul will be enabled to weather the next depression. In this connection a most important factor is not only that both these problems should be solved correctly but that they should be solved in a way that will enable the St. Paul to raise its money for modernization at the lowest possible cost consistent with the two principles above mentioned. Stating the matter in another way, the problem is to devise a capital structure that will correctly conform to the future earning power and variations in earning power of the St. Paul. Studies into what this future earning power may be, reveal the fact that the St. Paul and, in fact, many of the other roads in receivership have gotten into difficulties to a far greater degree through a low level of earning power than from a high burden of fixed charges. For example, in 1929, fixed charges on the St. Paul required for service 8 2/10% of the gross operating revenue received from shippers, whereas for all Class I roads for the same year fixed charges consumed 11.0 cents. The St. Paul, therefore, was materially stronger than the average of Class I roads in relation to fixed charges. On the other hand, the number of cents on the dollar paid by the shipper coming down to net for the St. Paul in 1929 was 15.3 cents as compared with 19.9 cents for all Class I roads. For the period from 1922 to 1929, out of a shipper's dollar the St. Paul was able to save 12 cents as compared with 17.5 cents for all Class I roads. It is seen, therefore, that in earning power the St. Paul was distinctly inferior to the average. This inferiority in earning power of the St. Paul prior to the depression in itself does not tell the whole story because the St. Paul, along with other roads of subnormal earning power, produced such earnings as they did under a pressure of economy far in excess of the more prosperous roads. Less reserve strength, therefore, was available to meet the depression so that the actual weakness of the Road was in fact greater than might be indicated by a mathematical demonstration of the vulnerability of a narrow margin between expenses and gross revenues. As a result of the weakness in the margin and the lack of reserve

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A proper determination of a capital structure for the St. Paul today depends on the extent to which these unfavorable earning factors will be corrected. In this connection, it should be pointed out that these unfavorable factors in regard to the St. Paul are common to many of the roads which have gone into bankruptcy or receivership. In the Chicago & North Western hearing, Mr. Sargent introduced in evidence maps showing a high concentration of railroad receiverships and bankruptcies in Western Trunk Line territory, and particularly the territory North and East of the Missouri River. An inspection of this map shows conclusively that this deficiency in earning power and in ability to resist depression conditions is largely territorial. An analysis of the real causes of the disaster would seem to lie in a study of what might be called the territorial factors affecting this group of roads.

Following the North Western hearing I made some further studies into this localization of receivership conditions, and I find that of approximately 70,000 miles of road in receivership today, 43,000 miles are of roads heavily involved in Western Trunk Line territory. This group of roads is made up of the following: Chicago Great Western, with 100% of its mileage in Western Trunk Line territory; the St. Paul with 75%; Chicago North Western, including "Omaha" with 100%; Rock Island, with 65%; Minneapolis & St. Louis with 100%; Missouri Pacific with 59%; Wabash with 63%; and Wisconsin Central with 100%. If we compare this group of 43,000 miles of railway involved in Western Trunk Line territory with the rest of the United States, we find in the Central West but two important roads in bankruptcy or receivership - the Western Pacific and the Denver, with but 3,800 miles; in the South we find 8,000 miles consisting of the Central of Georgia, Florida East Coast, Mobile & Ohio and Seaboard Air Line. Turning likewise to the Southwest we find the important carriers are four, with 10,000 miles - the International Great Northern with 1,100 miles; the New Orleans, Texas & Mexico with 1,700; the St. Louis-San Francisco with 6,400; the St. Louis-Southwestern with 1,700. Again, in the Eastern district we find the New Haven with 2,000 miles, and aside from the New Haven we find but three relatively unimportant roads - the Ann Arbor with 294 miles (and this is really a part of the Wabash System) and the Chicago & Eastern Illinois and the "Monon," with a total of 1,500 miles; both these latter roads running south out of Chicago are on the borderline of Western Trunk Line territory.

This grouping of roads shows roughly that among the important roads in the hands of the courts, 43,000 miles are involved in Western Trunk Line territory and 25,000 miles are outside of Western Trunk Line territory.

In an attempt to throw further light on the subject I consolidated certain factors in regard to earnings and burden of debt for these two groups, with the following result. The fixed charges of the Western Trunk Line group in 1929 required 9 1/2% of gross revenues for servicing. The group outside of Western Trunk Line territory required 13.1% of gross revenues to service fixed charges. As previously stated, the comparable figure for all Class 1 roads was 11%. Analysis, therefore, in regard to the debt burden would seem to indicate that the wholesale receiverships in Western Trunk Line territory power during the depression, the earning power of the St. Paul suffered a further relative decline. For the years 1931 to 1936, out of every dollar received from the public the St. Paul was able to retain only 6.5 cents, as compared with 13.9 cents for the average of all Class I roads.

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These general statistical studies indicate not only that the wholesale bankruptcies in Western Trunk Line territory are due to causes lying largely outside the burden of debt and that a restoration of sound credit conditions in this territory can probably not be brought about merely by tinkering with capital structures, but they further point out the dangers of attempting to restore sound credit conditions by a revision of capital structures when there are obviously involved in the problem other factors so serious as to create grave doubt as to whether a revision of capital structures will even partially improve the situation. Certainly it would seem the height of recklessness to effect reorganizations of this group of roads without any serious attempt to discover the real nature of the disease that has caused the disaster. A sound capital structure is sound only if it is adapted to the conditions which it has to meet, and at the present time no evidence is available as to the future course of the disease in Western Trunk Line territory that has brought about the disaster. If, therefore, a capital structure based on present knowledge actually proved to be the best adapted to meet the conditions of roads in this territory, it would be purely a matter of chance.

On account of the many changes that have taken place since the depression, a thorough investigation would seem to be necessary to determine what the true reasons for the inadequate earnings are today, or what are the proper methods of remedy, but for whatever light it may throw on the subject we mention some of the reasons for inadequate earnings which were well recognized to be a factor prior to the depression. For example, unquestionably at that time in the various western rate cases it was well demonstrated that the inferiority in earnings in Western Trunk Line territory was not due to the poverty of the territory, the inefficiency of operation or the unduly low level of traffic, but was primarily due to the depressed rate structure. In the brief of the security holders of March 8, 1926, Page 45, the lack of reserve power in that region to meet emergency or adverse conditions was pointed out. I quote from the brief as follows:

> "From the investors' standpoint this factor is
> important, since lack of such reserve power not
> merely hampers needed improvements which might

> lessen costs of operation, but actually threatens dividends and in many cases interest also, should anything occur either materially to increase expenses or to diminish volume of traffic."

In the Commission's decision in that case they pointed out that:

> "Rates in western trunk line territory generally are on a materially lower level than rates in other sections of western territory, including the southwest." ......
>
> "It is clear that rate increases in that territory, particularly the portion east of the Missouri River, will tend both to produce a more uniform level of rates throughout the west and to benefit directly many of the weakest carriers in the western district."

In view of the record and the Commission's decision there would seem to be no doubt as to the increased reserve power and improvement in ability to resist depressions that would have resulted in western trunk line territory if increases in rates had promptly taken place. Whether adequate increases would have eliminated all the receiverships in this territory is, of course, not determinable at the present time as no important increases in general became effective. In connection, however, with the solution of the present problem, there is no evidence at the present time on which to base a conclusion that a remedy which would have been very helpful if applied in 1926 would in fact be a proper remedy to apply today in view of the changed conditions. Therefore, a history of the causes of these receiverships in the past does not in itself form an adequate basis for determining what corrections could be made now or in the future and thus help in planning sound capital structures for the roads in this territory. In this connection I submit in evidence an Exhibit placed on the record in the Livestock Case in the Western District and brought up to date. This is put in to show the earning factors which must be faced if capital structures are to be devised, based on the record during, and in the years prior to, this depression. It shows that the return on the Interstate Commerce Commission's value from 1921 to 1929 was approximately 3 1/2% and that from 1932 to 1935 it was approximately 1%. The purpose of this Exhibit is to indicate the conditions which a capital structure will have to meet if it is assumed that the earnings in the next period of prosperity and the following depression will be similar to those of the past. On the other hand, if the causes of the lack of earning power in this territory can be discovered and remedied, the conditions which a capital structure will have to meet may be entirely different from those indicated by this Exhibit. One thing would seem to be clear, and that is, if the earnings of the future continue at the low level of the past, no capital structure that can be devised will permanently stand up. This is for the reason that with average earnings both during prosperity and depression of substantially less than 3%, the burden of debt will necessarily have to be continually increased, as no other form of financing will be possible, and with the burden of debt continually increasing, capital structures become progressively weaker.

Two other Exhibits are introduced which show the difficulties involved in determining a capital structure best adapted to the St. Paul. The first of these Exhibits shows the adjustment of earnings and expenses and burden of charges for the years 1902, 1924, 1929 and 1936. This Exhibit shows that in the reorganization of 1928, the fixed charges were scaled until they consumed the equivalent of 8.8% of the gross amounts paid by the shippers in 1924. Data as to the year 1902 is included because 1902 was the earliest year in which the St. Paul earned all these charges. Figures for the year 1929 are given and also for 1936. It should be pointed out that in 1902, with $45,000,000 gross revenues, the St. Paul earned more than its present interest, whereas in 1936 with $109,000,000 of gross revenues, it earned approximately but 70% of this interest. It might be further pointed out that in 1902 when the St. Paul was regarded as one of the strongest roads in the country, the burden of charges consumed 13.6% of gross revenues, whereas in 1936 the burden of charges consumed 13.7% of gross revenues. This Exhibit indicates that the difficulties of the St. Paul lie largely outside of the burden of debt. The figures for 1936 also show the extreme hazard in estimating the immediate future earnings for the St. Paul. For example, with the burden of debt in 1902 approximately the same as 1936, the St. Paul in the former year could increase its total expenses 32% and still earn its charges. Last year a 10% increase in expenses would practically wipe out all net earned, while a 30% increase in expenses would leave a deficit of $18,000,000 after paying taxes.

It is obvious, therefore, that with such a narrow margin, increases in rates will be necessary as substantial increases in expenses become effective, and likewise accurate forecasts here are hazardous. The next Exhibit is put in to throw additional light on the matter by showing the income of the St. Paul in 1883, 1929 and the present day, in connection with the amount of money necessary for serving its underlying interest. The year 1883 is chosen because in that year, with gross revenues of $23,000,000, the St. Paul earned all its present underlying interest. In 1936, with gross revenues of $109,000,000, the St. Paul likewise earned its underlying interest, but with no margin of safety. These charts are presented to throw light on the problem and to demonstrate that with the maladjustments that have developed in the economy of the St. Paul, a cure cannot be found in a scaling of charges no matter how far back you scale. On these charts are given certain figures indicating the tremendous increase in efficiency of operation that has resulted from the modernization of plant in the past.

It is because of the considerations which I have thus pointed out, taken in the light of all the uncertainties mentioned in the report of the special committee to the Debtor's Board, that I feel that a reorganization of the St. Paul property can neither intelligently nor fairly be had under the conditions now prevailing.

How soon these conditions will have changed sufficiently to permit reorganization, I would be rash to predict. I may say, however, that I am an optimist with respect to the future of the railroads and would be hopeful that sometime during 1938 conditions would permit the Board, with the cooperation of the principal security holders, to suggest modification of the 1935 Plan which it would be hoped would commend themselves both to the Commission, as the guardian of the public interest, and to the security holders, interested in the preservation of their private investments and the proper recognition of their respective relative priorities. For that reason, I join in urging an adjournment of at least six months, although, in frankness I must state to the Commission that I believe that six months from now another adjournment may be necessary.

June 16, 1937

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