MAPPING A RAIL MERGER

AS CEO OF Canadian Pacific Railway, Hunter Harrison over the past several months has raised a very relevant aspect of the U.S. railroad industry through his efforts to acquire Norfolk Southern. Although segments of the transportation industry have consolidated to gain network efficiencies, the railroads continue to operate with the structural constraints of a bygone era.

After deregulation of the trucking and passenger airline industries more than three decades ago, both experienced major consolidation. The $35 billion less-than-truckload industry has seen more carriers acquired or closed than are currently operating.

Even the U.S. domestic parcel industry, with annual revenue of $75 billion, has been reduced from three to two companies with DHL's 2009 exit. Likewise, the much larger, $175 billion global parcel market will be reduced from four to three carriers in a few months with FedEx's acquisition of TNT Express.

Moreover, the passenger airline industry, with a market size of $80 billion, had more than 20 large national network airlines just a few years ago. With the federal government's blessing, just four airlines now dominate U.S. skies — United, Delta, American and Southwest — each having their own fortress hubs limiting competition in major markets.

In contrast, the $70 billion U.S. railroad industry still operates with the inefficiencies of not having a single railroad that can seamlessly move shipments across the country. The last major consolidation occurred in 1999 when Conrail was sold in pieces to CSX and NS.

The current structure of two railroads in each half of the country requires the shuttling of railcars and intermodal containers between the two eastern and two western railroads in time-consuming and environmentally unfriendly ways at interchange points such as Chicago and Memphis.

On the surface, the regulators may perceive that having five railroads promotes competition. Kansas City Southern, however, mainly operates between Mexico and the U.S., and of the other four, with Union Pacific and BNSF operating in the West and CSX and NS in the East, there are only two railroads in each market from a competitive viewpoint.

So a merger of an eastern and western rail that results in two railroads with nationwide coverage would retain today's competitive landscape. Two national railroads also would eliminate the shuttling of railcars and intermodal containers between the railyards of each regional railroad. It would speed up transit time and reduce traffic congestion and air pollution in the interchange markets.

In addition, having just two competitors still can ensure competition. In the parcel industry, there are only two private carriers, yet FedEx and UPS compete aggressively even after DHL pulled out of the U.S. domestic market in 2009.

Having more carriers also doesn't ensure more competition, which would usually suggest lower operating margins for the carriers. The LTL industry has 20 carriers, and, although many large LTL carriers generate mid-single-digit operating margin, Old Dominion Freight Line generates high-double-digit margins while providing great value to its customers, as illustrated by its ability to grow shipment counts at a faster rate than its competitors.

Moreover, even with just two competitors, the operating margins of FedEx's and UPS's parcel segments are lower than that of ODFL, illustrating that fewer or more carriers don't ensure less or more competition.

Harrison is right about the need for consolidation in the railroad industry, but he's chosen the wrong railroad to pursue such mission. A CP-NS merger would primarily benefit the executives and shareholders, while the more important stakeholders — employees, customers, suppliers and communities — would be hurt.

NS is a very profitable railroad whose operating margin increased from 13 percent in 2000 to 31 percent in 2014 while doubling revenue over the 14 years. Given such a high operating margin, if the railroad merger were permitted, it wouldn't be for the railroads to increase their operating margins but for the benefits derived for shippers, communities and their employees.

A CP-NS merger would not pass such a test because there is little freight transfer between the two railroads and minimal service improvements for the shipping community.

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In contrast, the merger of eastern and western railroads would result in faster transit times and reduced cost of such rail service, which would put pressure on the competing trucking industry to improve service to support its higher rates. The resulting conversion of truckload shipments to intermodal shipments would be welcomed by the motorists who would see fewer trucks on the roads and reduced wear and tear on highways.

With such advantages for all stakeholders, Harrison would find a more receptive audience for his ambition to operate a larger railroad and leave his mark on the railroad industry, joining the ranks of industry legends such as Fred Smith and J.B. Hunt. However, Warren Buffett, who owns BNSF, could spoil that by acquiring CSX or NS to create the first national railroad.

For CP investors looking to capitalize from the efforts of Harrison, they should invest in one of the U.S. railroads and then convince the board to appoint Harrison as its CEO so he can create a full national railroad in the U.S. and show the merits of such a merger. JOC

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