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Brian Gurney
Montana State University Billings, bgurney@msubillings.edu

Joshua P. Hill
Montana State University, Billings, joshua.hill5@msubillings.edu

LEVERAGING RAILROAD LANDS GRANTS AND THE BENEFITS ACCRUING IN THE NEW ECONOMIC LANDSCAPE

Brian Gurney
Joshua P. Hill
Montana State University

ABSTRACT

Unlike most companies, the major railroads in the United States have proven highly resilient to the vicissitudes of the market. We argue that this is due neither to the unique nature of rail haulage nor to superior management acumen. Rather this solidity is due to an immense wealth transfer to the railroads in the nineteenth century that has dramatic impacts in the present. Moreover, the government protection and encouragement that rail grants represent did not end in the nineteenth century. It continues and represents an intangible asset that, while not on railroads' balance sheet, is very real indeed.

INTRODUCTION

Fluctuations in corporate fortunes are a part of life nearly as certain as death and taxes. In an invariable cycle, companies establish themselves, rise to prominence, are eventually taken for granted as a central part of the economy, and then fall on rough times. Sears, Roebuck and Company continues its slide toward bankruptcy which has included the closure of 400 stores over the last two years and discharging over 200,000 employees over the last 15 years. Sears was founded in 1886 (Britannica Online, 2018). General Electric (GE), part of the first ever Dow Jones Index in 1896, and the only company that remained part of the Dow Jones Industrial Average (DJIA) since it was formed in 1907, has now fallen on very hard times. GE was recently delisted from the DJIA. (Bird, 2018). This is the ebb and flow of business.

So why is it that the railroads, with over 170 years of history in the U.S., continue to stand strong? Is it the superior intellect of railroad management, fortuitous timing or just blind luck? In an era when a black box can start your vehicle located in the parking garage, how is it that something as low tech as a diesel-electric locomotive running over tens of thousands of miles of rail is still a formidable industry?

The answer to this question lies in federal land grants. Ostensibly in an effort to connect the Louisiana Purchase to the eastern United States and render it amenable to settlement, the federal government granted large swathes of land to the transcontinental railroads. This fact is well known to historians but forgotten in the modern age. Many know that over 130 million acres were granted to the railroads in the 1800s. Most people, however, fail to inquire as to what these companies did with the land and what impact these grants have in the present.

The truth is that railroads are not, as we usually envision them, primarily railroads. Rather, they are diversified conglomerates with railroads making up only a part of their portfolio. Much of the rest of their portfolio is comprised of land and mineral holdings that insulate them from the vicissitudes affecting a single industry. Moreover, unlike many conglomerates, the nature of railroads' holdings serves primarily as a buffer or insulator rather than as yet another sector that is subject to its own ups and downs.

This paper is structured as follows. First, we describe a brief history of the federal land grants to railroads, focusing on land grants served by two railroads west of the Mississippi River. We then examine the impact these grants have had upon the plight of railroads in the present day. Finally, we conclude and offer observations on the role that the close relationship of rail with government will play in the future.

ANCIENT HISTORY: THE FEDERAL LAND GRANT TO RAILROADS

Up to 1850, railroad development and usage was largely confined to the east coast of the U.S. Congress, however, was determined to open the 'frontier' west of the Mississippi River and the extension and establishment of railroads in the west was encouraged with extensive subsidies. The primary incentive employed by Congress was land grants. From the 1850's through the early 1870's railroads were granted over 130 million acres of land out of the public domain (Kammer, 2017). To put that in context, California contains only around 101 million acres (Land Acreage, 2018).

These grants were not an entirely straight forward transfer of fee simple title. The terms varied depending upon the act under which the land was granted. For example, the Pacific Railroad Act of 1862 did not include mineral rights while the Pacific Railroad Act of 1864 enlarged the amount of land granted to railroads and granted full rights to all minerals underneath that land (Cox, 2018). Each congressional act also had strings or obligations attached to it. The obligations sometimes included a timeframe for a given section of railroad completion or a demand that a certain parcel of land be returned to the public domain if it was not utilized for railroad construction. In some instances, the railroad could and did sell off pieces of land in order to generate capital for railroad construction.

Under land grant legislation passed by Congress from 1850 to 1870, todays' Burlington Northern Santa Fe Railroad (BNSF) would have approximately 50,000,000 acres and the Union Pacific Railroad (UPRR) would have approximately 33,000,000 acres. (Kammer, pp. 405) About 1/3 of this total two railroad amount (28 million acres) was eventually returned to the government.

While, land grants and other government subsidies directly funded only 18,738 miles of railroad, these government incentives had a knock-on effect. Between 1850 and 1887 the national railroad system grew from 9,000 miles to 87,000 miles. Furthermore, according to an Interior Department Auditor on Nov. 1, 1880, the total value of land grants to railroads was $391,804,610 but the total investment made by railroads in 1880 in the U.S. was $4,653,609,000 (Henry, 1945).

HARD TIMES: 1950-1980

Despite the buffer that land grants provided, rail companies fell on hard times in the 1960s and 1970s. However, the insulation from markets that government officials had provided did not end there. The original land grants continued to provide insulation for their recipients but government largesse was extended in other ways during the rough times. Most notably, the Interstate Commerce Commission (ICC) worked assiduously to constrain competition with and competitive pressure between rail companies.

Nevertheless, in 1957 the number of passengers carried by air finally exceeded those carried by rail. By 1978 railroads carried less than 1% of passenger traffic. The 1970s saw a host of railroad bankruptcies—Penn Central in 1970, Ann Arbor in 1973, Rock Island in 1975, among others. Interestingly, none of these companies had large, government granted, land holdings to buffer them. Burlington Northern, with their massive land grants, did suffer a $1.1 billion loss from 'discontinued operations.' However, they did not go into receivership like others.

It is not entirely clear what drove the railroads on such hard times. It is possible that it was simply the economic cycle hitting rail particularly hard or it may be that, insulated from the market through government grants, managers became complacent and slow to react to change. It also could have simply been that the railroads faced a new and, in certain segments of the haulage market, institutionally superior competitor, the trucking industry–which also received subsidies in the form of government provided rights of way. Two things are clear, however. First, rail companies had already had an extremely impressive run between 1850 and 1950. Second, the true historical asset of the rail companies, government insulation, was far from exhausted.

A prime example of continued government insulation is the Rail Passenger Service Act of 1970. This act created Amtrak with an initial subsidy of $200 million. Today, Amtrak receives approximately $1.3 billion annually in federal subsidies. Another example is the passing of the Railroad Revitalization and Regulatory Reform Act of 1976. Congress also passed the Staggers Act in 1980. This act effectively deregulated the railroads and allowed them to shed unprofitable routes. Additionally, consolidation within the industry and the displacement of several thousand employees across the nation increased their competitiveness with the trucking industry. Additionally, and rather exceptionally, in many cases of railroad spin-offs, if cash was to be paid-out, the Internal Revenue Service ruled that distribution to be tax-exempt (Ziemba,1990).

RECENT HISTORY: THE LEVERAGING OF LAND ASSETS AND DIVERSIFICATION

After over 100 years of sitting on the land assets acquired in the early days of railroad construction and extension, rail companies began to leverage and diversify their assets in the last decades of the twentieth century. There was a veritable flurry of divestments, spinoffs, mergers, and acquisitions by rail companies, very few of them even tangentially related to the management of rail networks or haulage of freight.

In 1989, Burlington Resources spun-off a portion its timber assets and created a new company called Plum Creek. Plum Creek raised over $500 million and purchased 2 million acres of railroad grant lands from its parent, Burlington Resources. In 1999, Plum Creek recast itself as a real estate investment trust (REIT). Additional capital was raised and the result was a $3.8 billion merger with Georgia-Pacific becoming the second-largest private timberland owner in the country. By 2005, Plum Creek was the largest private landowner in the country (Jamison, 2007).

In 1997, Kinder Morgan purchased Santa Fe Pacific Pipeline for $1.16 billion. The pipeline subsidiary was part of Santa Fe Pacific, which was a unit of Burlington Northern Santa Fe railroad. The acquisition included 3,300 miles of pipeline in several Western states. The BNSF railroad has thousands of miles of right-of-way in several Western states. The pipeline transported 1 million barrels a day of gasoline and jet fuel serving California, Arizona and other states (Ewing, 1997).

In 2000, Anadarko Petroleum Corporation purchased Union Pacific Resources Group (UPRG) for $4.4 billion. The sale included 1.2 million acres of surface holdings formerly associated with the Union Pacific land grant. UPRR is the parent company of UPRG. Anadarko averages $1 million per day in taxes and royalties to the state of Wyoming. The company has made over $3 billion in investments in Wyoming and has also granted almost $3 million to the University of Wyoming in recent years (Research/Outreach Partner, 2015).

Burlington Resources was created as a stand-alone company by its parent, Burlington Northern Railroad. In 2005, Burlington Resources had revenues of $1.5 billion and 2,200 employees. It was sold to ConocoPhillips in 2006 for $35.6 billion (Pirog, 2007).

The list could go on, producing multiple pages of instances such as those listed above. The point here, however, is that railroads are extracting value from land grants, and these actions help bolster their balance sheet and insulate them from the vagaries of the market. However, they are not currently, nor have they ever been fully insulated. In fact, railroads were struggling to survive in the 1960's – 1970's.

Railroads have a longer and deeper history with the federal government than other transportation modes—with the possible exception of canals. Beyond the relationships with individual members of Congress, key agencies work with the railroads and have for decades. These include the Federal Railroad Administration, the Surface Transportation Board and the Pipeline and Hazardous Material Safety Administration.

The tight relationship with the federal government and the importance this relationship is highlighted by the case of Catellus. Catellus was a real estate subsidiary spun-off by Santa Fe Pacific Corp. ProLogis then purchased Catellus and a key driving factor for the merger was that Catellus, "…has a huge inventory of land and expertise at getting government approvals for new construction (Vincent, 2005)." Good government relations is an intangible asset.

NEW MARKETS

Forty (40) % of the 'ton miles' of U.S. freight is transported by rail. This compares to 33% for trucks and .3% for air (Davidson, 2014). Much of the newer freight is intermodal containers and the transport of crude oil. While rail's share of freight transport has remained relatively constant, the volume has increased dramatically, particularly for intermodal shipping.

As the U.S. has developed an increasing appetite for imported goods, many of those goods arrive by container ship on our coastlines. In 1980, intermodal shipping was approximately 3 million carloads per year. By 2013, 14 million carloads were being moved by rail. Today, railroads have hundreds of intermodal terminals across the country that receive, process and distribute containers. Much of the Intermodal traffic is of domestic origin, with United Parcel Service (UPS) earning 1st place as the largest domestic Intermodal shipper.

A second relatively new opportunity is the transport of crude oil. With the advent of directional drilling and fracking, over 1 million bb/day is transported by rail from interior states, such as Colorado and North Dakota, to refineries located along the nation's coastlines. To date, pipeline capacity is insufficient to address the increased volume, therefore railroads are necessary to fill that transport need.

A MATURE INDUSTRY? (VALUATION VERSUS IMPORTANCE)

For 2017, (BNSF) reported an 'operating income' of $7.3 billion (BNSF's 2017 Financial Performance), far less than Facebook's annual profit of around $20 billion ($4.99 billion 1st quarter, 2018) (Cherney, 2018). For the 2nd quarter of 2018, (UP) reported 'revenue' of $5.7 billion (UPRR News Release, 2018) while for the 1st quarter of 2018, Verizon reported 'revenue' of $31.8 billion (Salinas, 2018).

Two questions should be kept in mind for the reader. First, if Facebook ceased operations tomorrow, what would be the impact on our economy? While there would certainly be some disruption in many people's social lives, contrast this disruption with the impact that a complete halt in the transportation of crude oil from the western 2/3 of the nation would have if BNSF abruptly discontinued operations. The relatively slight size of railroads' profits and revenues belies their importance for the economy.

Secondly, with 170 years of railroad history compared to 25 years of social media/wireless communication, the strategic importance of the railroads for American macroeconomic health far outstrips the importance of other contemporary economic juggernauts.

CONCLUSION

Five Class I railroads (CSX Transportation, Kansas City Southern, Norfolk Southern, Union Pacific and Burlington Northern Santa Fe) generate almost 90% of total railroad revenue (Berridge, 2015). With some geographical overlap, they are essentially five regional monopolies. They hold an incredible strategic position in land-based transportation. They may not have the glitz and glamour of other Wall Street firms, but the probability of their being supplanted by another form of transport is not on the horizon.

This perspective on the railways is not terribly contentious. However, what is often overlooked is that the railways have been able to draw upon a huge asset base of federal land grants dating back to 1850. Moreover, the special relationship with the federal government that those grants represent has also served them well for a century and a half, serves them well in the present, and is likely to continue to serve them for the foreseeable future

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BIOGRAPHY

Brian Gurney is an Adjunct Assistant Professor of Management at Montana State University Billings. He holds an MBA in Information Systems from the University of Colorado. He has many years of experience working in industry and clients have included Montana-Dakota Utilities, Stillwater Mining Company and the U.S. Army Corps. of Engineers. He returned to higher education in 1999 as an adjunct assistant professor in Operations Management and Project Management. E-Mail: bgurney@msubillings.edu

Joshua P. Hill is an Assistant Professor of Economics at Montana State University, Billings. He holds an MA (2007) and Ph.D. (2010) in Economics from George Mason University in Virginia. His research interests include political economy, economic development, law and economics, and the economics of organizations. He has published articles in Perspectives on Political Science and The Independent Review. E-Mail: joshua.hill5@msubillings.edu