No. 17021

INVESTIGATION OF CHICAGO,

MILWAUKEE & ST. PAUL

RAILWAY COMPANY

Submitted January 14, 1927

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Decided January 4, 1928

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Walter L. Fisher, *John J. Hickey*, and *Thos. P. Healy* for Interstate Commerce Commission; *O. W. Dynes* for Chicago, Milwaukee & St. Paul Railway Company; *Nathan L. Miller*, *Robert K. Prentice*, *John Dickey, jr.*, *Gerard C. Henderson*, and *Thomas M. Woodward* for Edwin C. Jameson and others, constituting bondholders' defense committee; *Herman L. Ekern* and *Daniel A. Grady* for State of Wisconsin; *Chauncey D. Pichel* for Otto V. Loth; *William Church Osborn* for security holders of northwestern roads; *Cravath, Henderson & De Gersdorff* for Kuhn, Loeb & Company and National City Company; *Luther M. Walter* for Roosevelt & Son; *Dwight Lewis* for Iowa Railroad Commission; *Pierce & Greer by F. C. Nicodemus, jr.*, for John L. Weeks and associate holders of preferred stock; *John Denny* and *Thomas D. Jennings* for Washington Department of Public Works; *R. D. Lytle* for North Pacific Millers' Association; and *Jay W. McCune* for Traffic Bureau, Tacoma Chamber of Commerce.

Report of the Commission

By the Commission:

On May 12, 1925, the commission, upon its own motion, instituted an investigation into and concerning the history, management, financial and other operations, accounts, and practices of the Chicago, Milwaukee & St. Paul Railway Company, hereinafter for convenience referred to as the carrier or the St. Paul, in order to determine the manner and method in which the business of the St. Paul had been conducted. Exhaustive investigation and extensive hearings have been conducted and a record comprising over 8,000 pages of testimony and nearly 400 exhibits has been made. The road went into receivers' hands on March 18, 1925, and the receivership is the largest in our railroad history. For many years the St. Paul had been considered one of the strongest railroad properties. As of December 31, 1924, it operated approximately 11,000 miles of road, had a total capitalization of over $700,000,000, and in 1924 its operating revenues were nearly $160,000,000. When such a company became bankrupt at a time when general railroad conditions had greatly improved, the country was shocked.

PUGET SOUND EXTENSION

The nucleus of the present St. Paul system was the Milwaukee & Waukesha Railroad Company, incorporated on February 11, 1847, under a special act of the Territory of Wisconsin. On February 1, 1850, the name of the corporation was changed to Milwaukee & Mississippi Railroad Company. On February 25, 1851, operations were commenced between Milwaukee and Waukesha, a distance of 20 miles. The La Crosse & Milwaukee Railroad Company was chartered by the State of Wisconsin on April 2, 1852, for the purpose of constructing a line of railroad from La Crosse to Milwaukee, a distance of 202 miles. On May 5, 1863, the Milwaukee & St. Paul Railway Company was organized, and purchased at foreclosure sale the properties of the La Crosse & Milwaukee. On February 7, 1874, the name of the former company was changed to Chicago, Milwaukee & St. Paul Railway Company. As of that date its mileage was 1,649; on January 1, 1880, it was 2,036; on June 30, 1889, it was 5,679; on June 30, 1899, it was 6,191; and on June 30, 1909, it was 7,511. Most of the mileage was in the States of Illinois, Wisconsin, Minnesota, South Dakota, Iowa, and Missouri. The Missouri River was the western limit of its operations.

As early as 1901 the St. Paul was considering building to the Pacific coast. At that time E. H. Harriman was dominant in Union Pacific affairs, while Roswell Miller, who had previously been president of the St. Paul, was chairman of its board of directors and A. J. Earling was its president. In writing to Earling on March 29, 1901, Miller referred to a conversation with Harriman relative to interchange of business between the Union Pacific and the St. Paul. Miller had recently resigned from the Union Pacific board, as he was unable to help the St. Paul by remaining on it. He was satisfied with the division of freight traffic by the Union Pacific as between the North Western and the St. Paul, but the North Western had the better of the passenger business. Miller then went on to say:

> I said to him [Harriman] that there would be just one result of the Union Pacific policy, that we should be compelled to build a line to the Coast. He said we could not build a line to the Coast as good as his, to which I replied we could build just as good a road as he could build. He said, why don't you start it to-morrow; I said we were not ready, and it might be five years before we got ready; that we could build a line to the Coast and supply terminals for $45,000,000—⅓ of what his line was capitalized at, which would give us an immense advantage over him.

Unfortunately for the St. Paul the figure mentioned by Miller was not quite one-sixth of the investment made by the St. Paul in the Puget Sound extension as of December 31, 1924, which was in excess of $250,000,000.

Meanwhile negotiations for acquisition of control of the Burlington by the Northern Pacific and Great Northern were going on, much to Miller's alarm. He wrote Earling on April 9, 1901, that he had that day seen Jacob Schiff of Kuhn, Loeb & Company and had told him "that if the Northern Pacific and Great Northern tied up with the Burlington we should be compelled to build to the Coast." At that time the St. Paul officials apparently had no clear idea to what part of the Pacific coast they would start; references to various destinations are found in the correspondence. At Miller's request Earling sent an engineer over the Northern Pacific to estimate the cost of duplicating the Northern Pacific line. Miller thought the Northern Pacific line could be duplicated for $45,000,000, excluding rolling stock, and that by building such a line the St. Paul would divide business with the Northern Pacific and Great Northern from the start. Earling was even more optimistic. Before the engineer started on his trip over the Northern Pacific he wrote Miller on April 10, 1901, that he was "sure that it would not cost as much as $45,000,000 to build as good as the Northern Pacific to the Coast." On April 25, 1901, Miller wrote Earling that the board of directors had authorized the expenditure of $10,000 in making a reconnaissance from Evarts, S. Dak., to Butte, Mont., and again stated that "if the Burlington deal goes through we shall be compelled to build to the Coast."

In August, 1902, Miller submitted to William Rockefeller, then very influential in St. Paul affairs, a report on a proposed extension to the Pacific coast at Eureka, Calif., to reach the vast timberlands of Humboldt County, Calif. On March 29, 1905, Miller reported to Earling: "It seems to be the general impression that we are bound to build to the Pacific Coast. Of course, Mr. Rockefeller's absence will prevent a decision in the matter for a month or so." On April 27, 1905, a committee of directors was appointed to take action with reference to acquisition of right of way. On May 25, 1905, Miller reported to Earling that the Harriman and Hill interests had come to an agreement and that "it was supposed both interests would use all the influence they could to prevent the St. Paul from building." As late as July, 1905, W. K. Vanderbilt and William Rockefeller had discussed a line to be built jointly by the North Western and the St. Paul. Rockefeller appeared to favor the idea but Miller did not. On November 4, 1905, Miller advised Earling that in view of a cable from Rockefeller, Earling should go ahead with arrangements for construction. On November 28, 1905, the board formally authorized the building of a line to Seattle and Tacoma. On September 28, 1906, Earling reported:

A careful estimate from the information now available indicates that the completed line from the Missouri River to Butte will cost $20,183,000. The estimated cost of the entire line, Missouri River to Seattle, including equipment, is $60,000,000.

This figure, it will be noted, is less than one-fourth of the money ultimately spent.

In the course of our investigation we have been unable to find that any adequate engineering or traffic surveys were made. On the contrary everything indicates that the project was the result of rivalry between powerful groups. Miller, Rockefeller, and others controlling the St. Paul felt that they could not tolerate its being bottled up in South Dakota with the Hill lines to the north controlling the Burlington, and the Harriman lines to the south working closely with the North Western. It is obvious that the stockholders in general had no voice in the momentous decision, and as it was not necessary to secure a certificate that the public convenience and necessity required the construction of such a line under provisions of law such as are now a part of section 1 of the interstate commerce act, personal rivalries and ambitions were free to do as they willed with a great property. Neither Harriman nor Hill was deterred in his plans by the threats of the St. Paul to build to the Pacific coast. Apparently they did not fear it.

In May, 1905, Hill wrote the following letter to the president of the Burlington:

If I were at the head of the North Western or the St. Paul I would never be satisfied with a connection over some other line that was a natural competitor from the common point eastward. The North Western and St. Paul, with over fourteen thousand miles of railway, would, if they built to the Puget Sound, be a great acquisition to the business of the Sound and would go far toward putting it on a foundation viewed from the commerce of the world ahead of San Francisco. This would, in my judgment, help our lines much more than any possible injury it could do.

In 1905 the St. Paul was earning its interest requirements three times over and after paying good dividends on its stock had something left to put back into the property. In 1906, the common stock sold as high as 199⅝ and the preferred as high as 218. The day after the receivers were appointed the common sold at a low of 5 and the preferred at a low of 8.6.

The Puget Sound extension was constructed through the medium of several companies organized in various States. These were consolidated on December 31, 1908, into the Chicago, Milwaukee & Puget Sound Railway Company. Portions of the line were placed

in operation for freight traffic in 1908. The through line was opened for freight traffic on August 1, 1909, and for passenger traffic the following September. The lines of the Chicago, Milwaukee & Puget Sound were operated independently until December 31, 1912. On December 24, 1912, that company conveyed all of the railway properties and franchises to the St. Paul. On January 1, 1913, the latter company took possession of the property and merged its operations into the system.

The operating results reported by the Puget Sound Company during its independent operation were favorable but can not be relied upon. In our report of February 9, 1914, *St. Paul and Puget Sound Accounts*, 29 I. C. C. 508, serious irregularities in the accounts of the St. Paul and the Puget Sound Companies were pointed out, severely criticized and condemned. The funds for construction were raised by sale of stock and bonds of the St. Paul as well as by the sale to the public of $27,175,000 of bonds of the Puget Sound Company. The accounts of both companies were grossly distorted, primarily to strengthen the credit of the St. Paul.

Since the St. Paul has operated the Puget Sound extension as part of its system no separate accounts have been kept, and while it is obviously impossible to ascertain exactly the results of operating the extension, there are two estimates in the record which are enlightening. It is now operated as a grand division of the system known as lines west of Mobridge, a point in South Dakota on the Missouri River, and comprises about 28 per cent of the total system mileage.

Our accountants compiled an exhibit showing the accounts of the St. Paul for the years 1923, 1924, and 1925, separated as between lines east and west of Mobridge. The income shown in the exhibit was the income shown by the carriers' books modified by adjusting charges for depreciation and retirement of equipment to the basis of rates for depreciation employed by the carrier in stating its accounts beginning with May, 1925. The figures as segregated do not reflect the actual results, but show the result of a segregation for the three years based on a study made by the carrier itself covering April, July, and October, 1925. The result shown in the exhibit is that the net income of the lines west of Mobridge, excluding interest on funded and unfunded debt, was in 1923, $1,995,320.50; in 1924, $1,227,629.89; and in 1925, $1,236,488.28. The investment in road and equipment of the lines west of Mobridge as of December 31, 1924, is shown as $256,968,126 or about 37 per cent of the property investment of the entire system. The net income as shown above is only about one-half of 1 per cent on this investment. A return of 5 per cent on the investment would be about $13,000,000.

There is nothing in this record which shows that the burden on the system is lightened to a substantial extent by indirect benefits to the system, or that the results would be materially changed by taking into account certain factors which upon brief counsel urges should be considered, such as credits for hauling company material, segregation of equipment rentals on other than a car or locomotive mileage basis, divisions to the lines west on a basis better than mileage prorate, etc. The carrier did not undertake to make such a showing, but points out that the showing made by our accountants can not reflect all of the advantages to the St. Paul in having the Puget Sound line as a part of the system; nor can such an exhibit, it contends, reflect such benefits as may have resulted from relieving the lines east of the "bottled-up" situation in which they would be if the lines west were not a part of the system.

The second estimate of earnings of the lines west was made by Coverdale & Colpitts, consulting engineers, after they had made an examination and report on the St. Paul early in 1925. They found the average freight-traffic density of the system to be about 15 per cent greater than that of the lines west; the freight-traffic densities of the through lines of the Northern Pacific and Great Northern to be, respectively, about 46 and 26 per cent greater than the freight-traffic density of the main line west of Mobridge; the average passenger-traffic density of the system to be about 4 per cent greater than that of the lines west; and the passenger-traffic densities of the through lines of the Northern Pacific and Great Northern to be, respectively, about 70 per cent greater and about 2 per cent less than the passenger-traffic density of the main line west of Mobridge. The eastbound freight traffic greatly exceeds the westbound. The passenger traffic is about evenly balanced.

In order to determine the contribution of net income by the lines west to the system they made an approximate estimate of the revenues and expenses of the lines west for 1923 and 1924 on the assumption of operation as an independent company. In the estimate the mileage-prorate earnings from local and interchange freight were ascertained and to the latter was given a division of the rate 2 per cent in excess of the mileage prorate. Other adjustments not necessary to detail were made. Including $15,590,000 interest at 5 per cent for capital requirements, they estimate that the balance earned in 1923 available for interest on funded debt would have been $744,000, and in 1924, $1,479,000.

Colpitts testified that the difficulties of the St. Paul began with the construction of the Puget Sound extension. The record leaves no doubt that first among the causes of the receivership was the failure of that extension to earn anywhere near a return sufficient to help the system carry the burden incurred in its construction. Of course

one can readily agree with the president of the company when he testified:

> The question has often been raised as to whether the St. Paul would be in the financial condition it finds itself in to-day if it had not incurred the financial burdens attendant upon the construction of this line. This is a matter of conjecture, as who can say what the St. Paul's development and revenues would have been if it had not crossed the Missouri River.

We need not indulge in conjecture as to what might have happened if some other course had been followed. We are only concerned with what did happen to the St. Paul after crossing the river. However, a comparison to date with the North Western conveys its own pertinent suggestions.

There is considerable evidence in the record to support the contention of the St. Paul that no better returns on new money invested since 1908 and 1909 have been realized by competitors of the St. Paul such as the Northern Pacific and North Western. Taking the figures at their face value they lead only to the conclusion that the other roads were so conservatively capitalized, particularly as to the relation between stock and funded debt, that they could carry the load during the lean years. In this connection it is interesting to note that in 1923 the fixed charges of the St. Paul were 12.01 per cent of its railway operating revenue, while those of the North Western-Omaha were only 7.44 per cent. That the new money invested in the St. Paul lines east since 1909 earned no more than the new money invested in lines west, likewise does not tend to prove that the lines west have been able to carry their proportionate share of the burden. From July 1, 1905, to March 18, 1925, the net increase in investment in road and equipment of the St. Paul was approximately $450,000,000. As stated before, approximately $257,000,000 of this is represented by the lines west. The increase in investment by the St. Paul was much greater than that of the other lines with which comparison is made. In fact the increase in investment represented by the lines west is greater than the increase of any of the other lines covering all their properties, except the North Western and Omaha combined. The following is extracted from one of the exhibits:

	St. Paul	Nor. Pac.	Gt. Nor.	C. N. W. Omaha	C., B. & Q.
Investment in road and equipment and materials and supplies:					
Average of 1908–09	$275, 891, 116	$391, 067, 276	$303, 665, 402	$323, 107, 258	$365, 687, 487
Average of 1923–24	733, 336, 553	576, 582, 530	521, 891, 317	593, 649, 557	590, 105, 722
Increase 1923–24 over 1908–09	457, 445, 437	185, 515, 254	218, 225, 915	270, 542, 299	224, 478, 235
Rate of return earned on investment:					
Average of 1908–09 per cent	6. 47	7. 05	5. 86	7. 13	5. 55
Average of 1923–24 per cent	2. 67	3. 21	4. 69	3. 29	4. 58
Decrease 1923–24 over 1908–09 per cent	3. 80	3. 84	1. 17	3. 84	. 97

In other words, although no better returns were earned by the Northern Pacific and North Western on the new money invested since 1909 than the return earned by the St. Paul, the amount so expended by the St. Paul was very much in excess of that expended by either of the other lines, and consequently its failure to earn an adequate return on the new money was that much more of a strain. The relatively favorable showing of the Great Northern and Burlington will be noted from the table. The four roads with which comparisons are made are now paying dividends and have good credit.

Almost contemporaneously with the construction of the Puget Sound extension two Canadian transcontinental lines were built, the Canadian Northern and the Grand Trunk Pacific. In this country the Union Pacific system built various lines in the Northwest, and the Northern Pacific and Great Northern spent large sums in adding to their facilities and as a joint enterprise built the Spokane, Portland & Seattle. The Western Pacific was built from Salt Lake City to San Francisco and the Los Angeles & Salt Lake was built from Ogden to Los Angeles. In addition work was being pushed on the Panama Canal. The immediate effect on the St. Paul was to increase the cost of building the extension and the ultimate effect was disaster due to the failure to develop enough traffic to support all of the transportation facilities provided.

The Puget Sound extension is now a first-class railroad in every respect. By the summer of 1926 its maintenance had been brought up to a high standard.

E. J. Pearson, now president of the New York, New Haven & Hartford, was the engineer in charge of construction west of Butte, Mont. He testified that certain extraordinary costs were incurred in its construction on account of forest fires, floods, rock and snow slides and similar contingencies; that because of the great amount of railroad work being done in this country and Canada contract prices were high, in fact "it was a heyday for contractors and their forces," prices reaching the peak in 1906 and 1907 when the St. Paul contracts were let; that much heavier work was done than originally planned so that the first costs of construction covered much work which other transcontinental lines did during a long course of years after original construction in the way of grade revisions, realignment, permanent tunnels, trestles, etc.; and that the road was exceptionally well ballasted for a new line, so that when it was opened for business it was in a position to compete on equal terms from a physical standpoint with the long-established transcontinental lines.

Examination by our valuation engineers discloses that the contract prices were substantially the same as those paid for similar work

done during the same period in the Pacific Northwest. But in many instances classifications were raised to help contractors, instead of paying them bonuses or otherwise taking care of them. For instance, much grading was done during the winter months under severe conditions and in such cases the contractor might be paid on the hardpan basis instead of on the basis for common earth. Or the earth might be fretted with stumps and roots of trees. The carrier's records indicate that in many instances increased classification was allowed for these and other reasons to take care of what would be contractors' losses or expenses due to unforeseen conditions, and certain classes of extra bills, etc. Our engineers testified that the additional amount paid by reason of increased classification was approximately $1,795,000.

It is also clear from Pearson's testimony that the project was started with no adequate comprehension by those controlling the destinies of the St. Paul of its probable cost, particularly in view of the high standard of construction actually attained. It further appears from his testimony and from the records that little, if any, consideration had been given to the building or acquisition of branch lines and feeders later found necessary to secure traffic.

Pearson had had a wide experience in the Pacific Northwest, having been an engineer and operating officer of the Northern Pacific for nearly 23 years, and chief engineer during the last five years of this period. In the light of that experience, and that of various railroads handling construction projects, he built up an organization in such a manner that he was able to keep close to the work of the subcontractors and assure himself of their competency, efficiency, and honesty. It is not necessary to give details of the organization, the contractors, etc. It is sufficient to say that the investigation by our Bureau of Valuation did not disclose losses due to dishonest expenditures.

One other point mentioned by Pearson may be noted. Before proceeding with the location of that portion of the line generally paralleling the Northern Pacific in western Montana, roughly between Lombard and St. Regis, a distance of some 300 miles, he reported informally to his superior that joint use of the Northern Pacific's tracks with the St. Paul as tenant seemed more desirable than expenditure for additional construction. He was authorized to take the matter up informally with the Northern Pacific, but that carrier finally declined to enter into such an arrangement. The St. Paul then proceeded to build its own line.

The building of the Puget Sound extension has been a serious burden to the St. Paul in other ways. H. E. Byram testified that when he became president of the company in 1917 he found the roadway, track, and fixed property in good physical condition, but that

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the situation as to equipment was different. There were not enough cars and a large number were obsolete. There were not enough locomotives, particularly those of modern design. Stating that an adequate quantity of freight locomotives and cars is of first importance to a railroad in maintaining and increasing its business, he added that no doubt the drain on the company's finances in the building of the Puget Sound extension and equipping it, and the unsatisfactory return from that investment, together with the desire to maintain dividends on what had long been gilt-edged investment stocks, accounted for the failure to maintain an adequate amount of equipment of modern design and capacity.

The physical condition of the property became progressively worse. Its condition at the time of the receivership was best described by Mark W. Potter, one of the receivers, who testified in part as follows:

* * * If you could have sat in the conference of the receivers, you would have been amazed to see the vast number of situations, where an expenditure of $2,500, $5,000, $7,500, $10,000, will bring about economies which will mean a saving of 25, 50 and 75 per cent a year on the expenditure. We have made numberless expenditures of that sort and as I say, I haven't any doubt but if the company were in position to do so, it would have been wise to go very much further. In fact, the vast number of opportunities for such expenditures shows one of the serious infirmities of the St. Paul System, and one of the very serious situations that was allowed to be brought about. From one end of the property to the other there is need for such expenditure. The shops of the company, the yards of the company, the roundhouses of the company, were allowed to get into abominable condition, in comparison with other lines. The same was true very largely of equipment. Shops all over the country need rehabilitation. * * * Our figures show conclusively that if we could today spend one and a quarter million dollars on a new shop at Milwaukee the returns on that shop would be anywhere from 25 to 30 or 40 per cent per year on the money investment.

* * * * * * *

We have need for similar expenditures at Chicago. Western Avenue, Bensenville, Green Bay, Council Bluffs, Coburg, Mo., Miles City. Mont., Harlowton, Spokane, Seattle, Tacoma. and a dozen other places. All over the system there is urgent need for these expenditures, and if they could be made—if they could have been made five years ago, or 10 years ago—if the property could have been kept up to standard, it would have been in very much better shape to stand the jolt. It was in very, very bad shape.

With respect to locomotives, Potter testified that there was a serious shortage of passenger locomotives of the right design. Many of the passenger locomotives were too light, and were handling a heavier load than they were designed to handle. "Our passenger cars," Potter testified, "probably are 30 per cent or 40 per cent inferior to those of the other lines of our competitors. All of these conditions have forced high maintenance costs and that began way back there

about 1916 or 1917." Potter's testimony is summed up in the following sentence:

It may be that those now in charge of the property or in charge of it during recent years, have been hesitant about speaking about these conditions, lest it might be thought they were trying to put responsibility on other shoulders, but I want to say to you there has been a very serious condition existing which is largely responsible for the general condition of the St. Paul's prosperity.

To the total investment of the St. Paul in the Puget Sound extension, as stated above, can well be added some $20,000,000 invested in timber properties in Idaho and Washington. It was thought that such an investment would insure a steady traffic for years to come and in addition realize profits through appreciation in the value of the holdings. This venture was entered into through the medium of the Milwaukee Land Company, long controlled by the St. Paul and for years prior to 1906 engaged in land business along the lines of the St. Paul east of the Missouri River. In 1906 the land company commenced buying timberlands in Idaho and Washington and town sites in those two States and Montana. During the years 1906 to 1909, inclusive, when most of the purchases were made, the St. Paul advanced nearly $15,000,000 to the land company. The total of the advances as of March 18, 1925, was in excess of $21,000,000. As of May 31, 1925, the land company owned 321,391 acres of timberlands, the standing timber being valued at $19,581,632.09 with a capitalized overhead of $1,846,946.21. Except for one failure, the land company has not conducted logging or milling operations. Its income is derived principally from the sale of timber, representing a realization of capital assets.

The accounts between the two companies were handled in a very complicated manner. To the amount of advances made by the St. Paul year by year, our accountants added simple interest at 5 per cent per annum and credited the land company with all the money it paid the St. Paul. The result disclosed that as of March 18, 1925, the St. Paul not only had received no reimbursement of any of the advances, but had failed by at least $3,000,000 to receive interest at 5 per cent on such advances. This in spite of the fact that whatever income it has received has come, as stated before, principally from realization of capital assets of the land company. Whether the St. Paul will ever come out whole in this venture is problematical. It is clear that it has added to the burden imposed upon the system by the whole Puget Sound extension.

The properties of the land company were made the basis of a bank loan to the St. Paul in 1922 of $5,000,000, later increased to $7,500,000. The loan is being gradually reduced through realization of the pledged assets.

FINANCING AND EARNINGS

The building of the Puget Sound extension necessitated heavy financing by the St. Paul and thus we come to a consideration of its financial structure as one of the primary causes of the receivership.

We shall go back to 1905, the year the extension was formally authorized by the board of directors. On June 30 of that year the St. Paul's capital stock outstanding was $107,511,300, or 46 per cent of that outstanding on March 18, 1925, $233,686,200. Most of the additional stock was issued in 1907 and 1909. Meantime the long-term debt liability increased almost three times as fast. On June 30, 1905, it was slightly in excess of $115,000,000, whereas on March 18, 1925, it was nearly $440,000,000. In other words since June 30, 1905, to the date of receivership, for every dollar of capital stock issued the company incurred about $2.75 of long-term debt. This does not include over $22,000,000 obligations of leased lines, principally the Chicago, Terre Haute & Southeastern, hereinafter referred to. It will be noted that on June 30, 1905, the capitalization of the company was quite evenly divided between capital stock and funded debt. On May 16, 1925, the capital stock was 34.69 per cent of the total capitalization, and funded debt was 65.31 per cent.

While the aggregate of outstanding capital stock and funded debt was increased 202.53 per cent during this period, the increase in investment was 185.19 per cent. The ratio of 65.31 per cent funded debt to total capitalization of the St. Paul may be compared with 55.89 per cent for the Great Northern, 56.23 per cent for the Northern Pacific, and 55.41 per cent for the Burlington. For the year ended June 30, 1905, interest deducted for funded debt was less than $6,000,000. For the year ended December 31, 1924, the same item amounted to over $20,000,000.

Prior to the beginning of operation by the Puget Sound extension there was a continuing increase in its net current assets and profit and loss balance. Since that date there have been pronounced and quite constant decreases in both accounts. All dividends paid prior to July 7, 1910, were paid out of income. The semiannual dividend declared on that date was paid out of surplus, the next dividend was paid out of income, and all subsequent dividends were paid out of surplus. The last dividend paid was declared on July 26, 1917. It is suggestive of the measures employed to pay dividends during the last few years during which they were paid, to note that in 1917, for example, whereas investments increased only $11,195,000, the long-term debt increased $24,759,000, or an excess of $13,574,000. Dividends declared and paid out of surplus that year amounted to approximately that amount, namely, $13,392,000.

On June 30, 1913, the first report was filed with us covering operations of the St. Paul and the Puget Sound combined. The profit and loss account on that date was $43,417,000; net current assets were $20,653,000. By March 18, 1925, these amounts had shrunk to $13,718,000 and $1,324,000, respectively. In the meantime the equity in investments, namely, the difference between the total investments and long-term debt, had only increased $8,624,000. The Coverdale & Colpitts report, in stating the current position of the company as of December 31, 1924, treated materials and supplies as being other than a current asset, but treated accrued taxes as a current liability. That is on the theory that materials and supplies are not in the form of assets readily available for the liquidation of amounts payable and that taxes must be paid when due. Treating these accounts in that manner shows the company to have had a constant deficit in current operation since 1916, the deficit increasing from $2,817,000 in 1916 to $18,138,000 as of March 18, 1925.

The corporate surplus of the company on June 30, 1910, was $57,738,933. Notwithstanding that no dividends had been paid since 1917 that amount as of March 18, 1925, had decreased over $42,000,000 to $15,070,049.

The following table shows some of the principal items of the accounts for the years named, amounts of money being expressed in thousands:

	June 30, 1905	June 30, 1910	June 30, 1916	Dec 31, 1921	Dec. 31, 1922	Dec. 31, 1923	Dec. 31, 1924
Miles operated	7,132	8,946	10,130	11,030	11,025	10,990	10,987
Railway operating revenues	$49,884	$64,847	$105,646	$146,765	$156,950	$169,628	$158,306
Railway operating expenses	30,662	44,791	73,765	127,957	129,597	134,909	125,550
Railway tax accruals	1,632	2,656	5,264	8,762	9,655	8,614	9,014
Railway operating income	17,590	17,607	31,222	9,703	17,692	26,012	23,674
Gross income	17,820	20,029	34,876	14,135	19,910	28,384	26,200
Hire of equipment—Debit balance		1,410	1,130	3,354	3,039	4,503	3,379
Interest on funded debt	5,962	6,812	15,604	16,960	18,074	19,443	20,448
Interest on unfunded debt			3	1,989	1,149	586	273
Total deductions from gross income	5,962	8,662	18,016	25,098	25,910	28,034	27,928
Net income	11,858	17,367	16,860	*Def. 10,963*	*Def. 6,000*	350	*Def. 1,728*
Income balance transferred to profit and loss	4,385	1,136	10,717	*Def. 11,071*	*Def. 6,143*	207	*Def. 1,669*

The total deficit in net income for the years 1921 to 1924, inclusive, was over $18,000,000. If the depreciation charges put in effect in May, 1925, had been in effect during the other years the deficit would have been much larger. Coverdale & Colpitts in their report stated that the charges were inadequate and the charges put in effect in May are those recommended by them. A comparison of the two schedules follows:

	Formerly used	Effective May, 1925
	Per cent	*Per cent*
Steam locomotives	1.50	3
Electric locomotives	1.50	2.50
Freight-train cars	2	3.50
Passenger-train cars	1.75	2.50
Motor equipment of cars	1.75	2.50
Floating equipment	1.50	3
Work equipment	2.50	4

Notwithstanding the heavy deficit, the company carried on its operations and financed additions and betterments by liquidating materials and supplies, reducing other net current assets, securing bank credits and otherwise, and by increasing its funded debt. It was really borrowing money and drawing on its last dollar of quick assets to pay unearned interest. Obviously, such a process could not go on indefinitely. One of the reasons advanced by W. W. Miller, New York counsel for the company, in advising that interest of about $900,000 due on April 1, 1925, should not be paid, which action precipitated the receivership, was that it would be much better for the company to go into receivership without exhausting its treasury assets.

The real problem of the St. Paul was not merely how it was to meet the 1925 maturities of nearly 50 millions, but that, in the face of the past earnings, it had also to meet the heavy maturities of the 10-year period, 1925 to 1934, inclusive, as well as finance much-needed additions and betterments. These maturities are summarized as follows, figures being stated in thousands:

	1925	1926	1927	1928	1929	1930	1931	1932	1933	1934
Equipment obligations	2,297	2,662	2,663	2,662	2,663	2,662	2,663	2,662	2,663	2,662
European loan 1910	11,832									
Gold fours of 1925	35,100									
C., T. H. & S. E. note	167									
Chicago & Missouri River Division bonds		3,083								
U. S. Government notes			25,000			30,000				
Convertible gold bonds								40,081		
Bellingham & Northern Ry. bonds								455		
Milwaukee & Northern Ry bonds										2,117
Milwaukee & Northern consolidated bonds										5,972
25-year gold bonds										33,2[illegible]5
10-year secured gold bonds										14,000
Total	48,396	5,745	27,663	2,662	2,663	32,662	2,663	53,005	2,663	57,137
Total for the period [1]	236,352									

[1] In addition to the above the company held $1,405,181 of the bonds maturing during the above period in its insurance fund.

Eliminating the indebtedness to the Government, the three important maturities shown above are the European loan of 1910, with which the gold fours of 1925 should be considered as hereinafter explained; the convertible gold bonds, most of which were issued in 1912 and 1913; and the 25-year gold bonds, most of which were issued in 1909, totaling about $130,000,000.

It may be stated here that in 1909 the common stock sold at a high of 165⅛, low 141; the preferred, high 181, low 158½; in 1910 the common stock sold at a high of 158⅜ and low of 113¾, the preferred at a high of 172¼ and low 143. In 1912 the high of the common was 117⅝, low 99⅜; while the high of the preferred was 146 and low 139¼. Instead of financing through the sale of stock, bonds were sold during those years at an average rate of about 5 per cent, but apparently with no regard to the fact that heavy maturities were piling up within a short period. All witnesses seem to agree that even if the company had earned its fixed charges in 1924, and by some method the 1925 maturities had been taken care of, the maturities of the following years would have been a most serious problem. As stated by Jerome Hanauer of Kuhn, Loeb & Company, the 1925 maturities had little to do with the receivership except to mark a point where the struggle to keep off the receivership could end.

Kuhn, Loeb & Company, of New York, had financial transactions with the St. Paul as early as 1880, but prior to 1909 the St. Paul's financing was in small amounts and not all of it was through the bankers. From 1909, when the heavy financing started, down to the receivership, Kuhn, Loeb & Company, purchased from or sold for the St. Paul all of its issues of securities with the exception of one equipment-trust issue, a small issue of divisional bonds, and some Terre Haute bonds. The National City Bank of New York, and later its allied institution the National City Company, participated in the financing subsequent to 1909.

The bankers disclaim any responsibility for determining the maturities of the various issues except the French loan of 1910, and state that for the most part their relation to the St. Paul was merely to buy and sell securities and not to determine financial policies. They say that a proper relationship between bankers and a railroad develops only when a railroad does business through one or more houses regularly. The St. Paul did that. They further say that if a railroad needs money it should go to its bankers, discuss the situation fully and confidentially, and receive and follow the bankers' advice. Furthermore, there should be a close contact with the railroad in preparing its budget for possible future needs, so that the bankers can study the financial outlook and market conditions and advise the railroad from time to time as to when it is necessary or advisable to issue securities, and what kind of securities can best be issued. The bankers testify that their relations with the company were never as close as the relations between bankers and railroads should be. In some instances that ideal relationship existed but in many instances the St. Paul merely offered certain securities for sale. The great advantage to a railroad in having a regular banking connection has frequently been urged upon us. If that advantage includes the receipt of advice upon which the railroad may safely rely, the St. Paul apparently failed to secure it, for whether requested to give it or not—the record indicates not—the bankers do not seem to have given any advice that might have prevented the erection of the present financial structure which now must be reconstructed. On the other hand, the following transaction should be noted.

In 1910 the bankers sold in France for the St. Paul an issue of 15-year 4 per cent bonds payable in francs or pounds sterling. The total amount of bonds sold had a par dollar value in excess of $48,000,000. The bankers' commission was at the rate of 1.6 per cent, or over $770,000. In addition Kuhn, Loeb & Company made $113,000 as their share of the profits of the syndicate which distributed the bonds. About June, 1915, the question of reacquiring the French bonds was taken up by the French bankers with Kuhn, Loeb & Company. The latter took the matter up with Vice President Williams of the St. Paul, but the company did not seem interested. Later, Percy Rockefeller, a director, was drawn into the transaction, and eventually a contract was made under which Kuhn, Loeb & Company were to buy all the bonds which the French banks could accumulate. The funds were to be provided by the St. Paul through the issue of an equal amount at par of 4 per cent bonds with the same maturity date but payable in dollars, Kuhn, Loeb & Company to take the risk that the funds so provided would not be sufficient for the purpose. The profits were to be evenly divided between the bankers and the railroad. Eventually about $34,000,000 of the bonds were acquired under the agreement, but when it was made the bankers knew that they could secure $29,000,000 at a favorable price. The bankers made no legal commitment with the French banks until the agreement was made with the railroad, and the risk of the bankers which is stressed in justification of the large profits which they realized was in judging the market as to whether dollar bonds could be sold on a favorable basis as the French accumulated the French bonds. But when the agreement was made the bankers knew, as above indicated, that they could exchange over $29,000,000 and of this amount $26,000,000 was in the possession of J. P. Morgan & Company as

part collateral for a loan to the French Government. There certainly was no risk involved in connection with that great block. While Kuhn, Loeb & Company seem to have done most of the work in connection with the transaction the bankers' share of the profits was divided evenly between them and the National City Company. It amounted to $1,813,000. The railroad received a like amount and in addition saved about $800,000 through remission of certain French taxes.

The transaction in view of all the circumstances is obviously inconsistent with any theory of the relationship which is supposed to exist between a railroad and its regular bankers. The St. Paul issued about $35,000,000 of 4 per cent gold bonds maturing in 1925 to acquire the French bonds, and the bankers' profits amounted to over 5 per cent of that amount. Under the relation which Hanauer says should exist between a railroad and its bankers, the railroad was entitled to the profits; the bankers, to fair compensation for their services. In view of commissions received on other loans 2 per cent would have been generous. The transaction is defended on the ground that in it Kuhn, Loeb & Company were not acting as the bankers for the St. Paul. That is exactly the point. They had acted as bankers for the St. Paul as far back as 1880; since 1909 they and the National City Bank had exclusively handled vast sums for the St. Paul; and yet at this opportunity to render to the St. Paul an important banking service the banker-railroad relation was suspended and profits greater than regular banking compensation were received. Hanauer testified that the profits were greater than expected when the agreement was entered into, as the spread between the purchase price of the French bonds and the selling price of the dollar bonds increased rapidly.

The only director of the St. Paul who seems to have been directly or indirectly interested in the transaction was Percy Rockefeller. His family, long one of the dominant factors in St. Paul affairs, was largely interested in the National City Bank. The other directors when questioned could remember little or nothing of the transaction. One director, himself a banker, admitted that it might be considered that "it was a pretty juicy piece of business for the bankers." Again, John D. Ryan, although a member of the board, could remember nothing of that important transaction except that there was "some kind of a change of the securities."

Roswell Miller, long chairman of the board of the St. Paul, died on January 21, 1913. Since that time the road has been without an executive officer of long experience or recognized standing in financial circles. Byram was selected solely on his operating experience. On the whole since Miller's death the executive management appears to have been uninformed, inexperienced, and incompetent to handle large financial transactions, or to determine large financial policies. Percy Rockefeller and other directors recognized this as one of the weak spots of the company, and Hanauer also recognized that the St. Paul had no one after Miller who was a financial representative in the large sense.

The directors do not seem to have exercised any responsibility for the financial structure. The record fails to disclose any consideration by them of the possible effect of the successive bond maturities which they were creating, or any comprehensive forecast of the future of the company, while this financial structure was being built up. Likewise, although knowing that Byram was solely an operating man and inexperienced in large financial matters, the board put the burden on him of conducting negotiations with experienced bankers of Chicago and St. Louis in connection with the acquisition of the Terre Haute and Gary roads hereinafter discussed.

BOARD OF DIRECTORS

During the course of the hearings the following, who were either directors at the time of the receivership or who had been directors previously thereto, testified: Percy Rockefeller, C. H. MacNider, Mortimer N. Buckner, John D. Ryan, John D. McHugh, Edward S. Harkness, Stanley Field, J. Ogden Armour, Samuel H. Fisher, H. E. Byram, Donald G. Geddes, George G. Mason, William E. S. Griswold, and Samuel McRoberts.

For many years there were four large stock-holding interests in St. Paul, which undoubtedly for all practical purposes controlled it. At the time of the receivership all but one of these interests had been sold out, but nevertheless the representatives of the sold-out interests were members of the board of directors.

The late William Rockefeller for many years was a very heavy stockholder, holding at one time as many as 150,000 shares. He served as a director and member of the executive committee and took an active part in the decision of questions of policy. His son, Percy Rockefeller, was a director from 1906 to January 1, 1921, when he resigned to meet the requirements of section 10 of the Clayton Act. He was also a member of the executive committee for many years. Although he had officially resigned as a director, nevertheless he continued to attend board meetings and received the reports and weekly letters usually sent to other directors. The Rockefeller estate holdings, as well as various trust holdings, were disposed of, some in 1922 and the remainder in 1924. Percy Rockefeller never was a large stockholder, but what he had was sold prior to the receivership.

The second large holding was that of J. Ogden Armour. His father, Philip D. Armour, had been a member of the board and the son succeeded him in 1901. At one time the Armour holdings amounted to approximately 125,000 shares. It was through Armour's influence that Byram was made president in 1917. The Armour holdings, except 100 shares, were all liquidated three or four years prior to the receivership. Nevertheless Armour continued as a director. It was necessary to have 100 shares in one's name to qualify as a director.

The third large holding was a block of approximately $20,000,000 in bonds and stocks owned by the George Smith interests of England. They were represented on the board first by Peter Geddes and later by his son, Donald G. Geddes, who was a director at the time of the receivership, although the Smith holdings had been liquidated some years before, principally during the war. Geddes' personal holdings, never large, had all been sold, except 100 shares, prior to the receivership. A part of the Smith holdings passed by inheritance to George G. Mason, who became a director in 1920. Mason started to liquidate his holding in 1918, and when receivership came he had only the 100 qualifying shares, but had continued as a director and member of the executive committee up to the receivership.

The fourth large holding was that of the Harkness family. At the time of the receivership E. S. Harkness held over 100,000 shares of stock. This was the only large holding which was not liquidated before receivership. E. S. Harkness had been a director of the St. Paul since 1916, and his brother was a director before that. The family also had substantial holdings of bonds. The Harkness holdings were represented on the board, in addition to E. S. Harkness, by Samuel Fisher, his attorney, and by M. N. Buckner, chairman of the board of the New York Trust Company, in which Harkness is substantially interested.

The following were the 13 directors of the St. Paul at the time of the receivership: Byram, Geddes, Mason, Armour, McRoberts, Harkness, Fisher, Buckner, McHugh, Griswold, MacNider, Philips, and Crosby. Of these only Harkness, Fisher, and Buckner represented substantial interests. The Smith family holdings represented by Geddes and Mason, the Rockefeller holdings represented by McHugh and Griswold, and the Armour holdings had all been liquidated. McRoberts was long associated with the Armour interests. The financial institutions with which he is connected had sold most of their St. Paul securities before receivership, and for years he held only the necessary qualifying shares. Griswold was made a director to represent the Rockefeller holdings and 100 shares of William Rockefeller's stock were placed in his name to qualify him. McHugh was considered by Buckner to be a representative of the Rockefeller interests; in fact William Rockefeller suggested him as a director. He held some stock for a short time, but before receivership had sold out. MacNider, an Iowa banker, who was made a director at Byram's suggestion, held only a few hundred shares, and only occasionally attended meetings. Ex-Governor Philips of Wisconsin was made a director at Byram's request, and Crosby of the Washburn-Crosby Company, Minneapolis, was made one at Harkness' suggestion. The financial interests of the last three named were not considered and it is apparent that they exerted no important influence in the board.

Apparently vacancies in the board were filled after informal discussions of the executive committee, and members were selected without regard to the amount of their holdings in the securities of the company, but in the belief that they would strengthen the board. Thus the board was a self-perpetuating body. John D. Ryan, then president of the Anaconda Copper Company, and interested in water projects, was asked to become a member of the board in 1909 by William Rockefeller, ostensibly on account of his great familiarity with the country through which the Puget Sound extension was about to operate. William Rockefeller always had a heavy interest in the Anaconda Copper Company and in 1915 and subsequent years acquired large blocks of stock in the power companies which had contracts to furnish St. Paul with power to operate its electrified divisions. Many of the directors had no special qualifications for the duties of the board and took little or no interest in the company's affairs. It is significant that during the months immediately prior to the receivership directors like Buckner and Fisher, who represented a real interest in the property, were the most active in trying to find some way out of the trouble. And it is apparent from the record that Harkness was the only one really pressing for a plan which would avert receivership, and had indicated his willingness, if such a plan could be evolved, to stand back of it in a large way by putting up cash to pay dissenting bondholders.

EFFECT OF FREIGHT RATE STRUCTURE ON THE SITUATION

The carrier and others attribute the failure of the St. Paul largely to the freight-rate adjustment in the territory it serves. The carrier's traffic representatives state that they have done all in their power to correct low rates, but that the present unfavorable freight-rate structure is due to conditions beyond their control, brought about in part by excessive and unreasonable competition between rail carriers and influenced in part by rates in effect via water carriers. The western carriers did make several concerted efforts to obtain general increases in their interstate rates through proceedings before us prior to Federal control, but for the most part met with indifferent success. See *Advances in Rates-Western Case*, 20 I. C. C. 307; *1915 Western Rate Advance Case*, 35 I. C. C. 497; *Rates on Hay from the Northwest to Chicago*, 25 I. C. C. 680; *1915 Western Rate Advance Case-Part II*, 37 I. C. C. 114; and *Western Trunk Line Rate Increases*, 43 I. C. C. 481. In the three cases last cited various increases on specific commodities were found justified. In 1917 the western lines again appealed to us for permission to increase all their rates, this time by 15 per cent. Such permission was denied, except as to coal and coke. *The Fifteen Per Cent Case*, 45 I. C. C. 303.

During Federal control rates were increased 25 per cent except that on certain commodities, including livestock, grain, and lumber, which constitute a large portion of the St. Paul's traffic, specific increases were made which probably averaged less than 25 per cent. In 1920, following *Ex parte 74* the rates of the carriers in the western group were increased 35 per cent and those in the Mountain-Pacific group 25 per cent, and interterritorial rates were increased 33⅓ per cent. However, soon afterwards we rendered three decisions which affected the St. Paul materially. Receiver Potter estimates that the reduction in livestock rates following *National Live Stock Shippers' League* v. *A., T. & S. F. Ry. Co.*, 63 I. C. C. 107, reduced the net of the St. Paul approximately $1,400,000 annually; while the decision in *Rates on Grain, Grain Products, and Hay*, 64 I. C. C. 85, took $3,400,000 annually from the net. Following this decision a general reduction of 10 per cent, in all rates not reduced that much in the two previous cases cited, was made in accordance with our decision in *Reduced Rates, 1922*, 68 I. C. C. 676. This reduction, Potter estimates, cost the St. Paul $14,000,000 annually. It is probable that had the St. Paul continued to realize the full increased revenues authorized in *Ex parte 74*, assuming that the traffic would have held up under such rates, the company would have been in a fairly comfortable position with sufficient credit to finance its maturities and thus avoid receivership.

In *Revenues in Western District*, 113 I. C. C. 3, we considered applications of the carriers in the western district seeking increases in their freight rates, generally averaging 5 per cent. We concluded that so far as the major portion of the western district was concerned no financial emergency existed. We found that in that portion the carriers appeared to be both financially and physically sound, but that in the northwestern region and in western trunk-line territory the revenues of certain of the important carriers had not yielded 5.75 per cent upon any rate bases that can reasonably be adopted in advance of a final determination of present values for rate-making purposes. We further found that the least favorable conditions in the district, so far as carriers' revenues are concerned, appeared to exist in western trunk-line territory. Those findings were particularly applicable to the St. Paul as it is one of the principal roads in the northwestern region, with a large mileage in western trunk-line territory. We said that the record tended to show that the rates in western trunk-line territory generally were on a materially lower level than rates in other sections of western territory, including the Southwest. On page 37 we said:

Carriers in the western district requested a 5 per cent horizontal increase in freight rates, subject to certain exceptions. Security holders of the northwestern carriers requested in addition a 15 per cent horizontal increase in freight rates in western trunk-line territory. Both requests were based upon the assumption of an existing financial emergency. It is evident that no such emergency exists in the western district as a whole. Furthermore, having regard to what has been already said as to the terms of the re-olution, concerning the inequalities and discriminations in existing freight rate structures, we can not find on this record that such an emergency exists in western trunk-line territory as would warrant us in prescribing a general percentage increase in freight rates in that territory. As we have already stated, while we have power to prescribe such changes, we can properly prescribe them only upon clear evidence of urgent necessity. No such evidence is at present before us. The petitions of the carriers in western district and of the security holders with reference to western trunk-line territory will therefore be denied.

Declaring that it was the right and duty of the carriers to take the steps necessary to correct improper rate relations as they may be found to exist, and to supply revenue deficiencies by instituting suitable changes in rates, we held the record open and under it we are now considering specific proposals of the carriers to increase class rates in western trunk-line territory. But in view of the provisions of the Hoch-Smith resolution the carriers were admonished that—

the record, however, warrants us in concluding that in proposing changes in existing rate structures either for purpose of improving earnings in western trunk line territory, or for the purpose of rectifying inequalities in existing rate structures, carriers should propose no advances in the rates on products of agriculture, including livestock

except where particular rates needed adjustment to remove inconsistencies, or where the product is not affected by depression. This condition has a serious effect on the St. Paul, as its revenue from agricultural products and livestock appears to be about 30 per cent of its total freight revenue, based on some studies of its 1924 traffic.

It should be said that in proposing increases in rates in the western district the carriers have in general followed the policy of seeking

horizontal percentage increases in all freight rates, without undertaking to differentiate between the various portions of that very extensive territory or between the various commodities. The difficulties encountered by the commission in connection with such cases were very clearly manifested in *Revenues in Western District*, *supra*. The record failed to justify any increase in revenue in certain portions of the western district, and even in the northwestern region and western trunk-line territory no emergency was shown justifying an increase in the rates on all commodities. Apparently the resort to the comparatively crude expedient of a horizontal rate increase has been due in large part to the competition of the carriers and to the fact that the shippers of many important commodities are located at competitive points where they have the opportunity, if they so desire, to penalize particular carriers in the routing of traffic. Under such circumstances each carrier is reluctant to make the first move toward an increase. Within the past three years rather substantial increases in class rates and some commodity rates have been made in western trunk-line territory as a result of *Indiana Public Service Commission* v. *A., T. & S. F. Ry. Co.*, 88 I. C. C. 709, and *Fargo Commercial Club* v. *A. & W. Ry. Co.*, 98 I. C. C. 691; but these increases followed complaints of undue prejudice by shippers, and no initiative upon the part of the carriers was responsible for them.

Other conditions affecting the St. Paul, such as increased wages, taxes, cost of supplies, restriction of immigration, Panama Canal competition, and lack of buying power of the farmers need not here be discussed as it does not appear that the St. Paul was more severely affected by such conditions than other roads in the Northwest. These conditions have been reviewed by us in several of the rate cases cited above, particularly since 1920. Its passenger traffic has not declined as much as that of some of its competitors, but nevertheless the loss has been severe. The passenger revenue in 1924 was $9,266,000 less than in 1920. This decline was accompanied by only a slight decrease in passenger-train miles.

ELECTRIFICATION

Three divisions of the Puget Sound extension are electrified, as follows:

Division	Between—	Electric operation commenced	Mileage
Rocky Mountain	Harlowton and Deer Lodge, Mont	April, 1916	226
Missoula	Deer Lodge and Avery, Idaho	November, 1916	212
Coast	Othello and Tacoma, Wash	1919–20	210

The first two divisions adjoin each other. The Missoula and Coast divisions are separated by the Idaho division which has not yet been electrified. The Federal court recently authorized the receivers to proceed with the electrification of the Coast division into Seattle from Black River Junction, Wash., a distance of 10 miles, and it is our understanding that the work has been completed.

The direct-current, overhead-trolley type of electrification is used. Current is purchased by the railway at taps in its high-tension lines, transmitted to substations, which are spaced about 30 miles apart, where it is stepped down from three-phase alternating current at 100,000 volts to a working voltage of 2,300, and thence converted through motor generators to direct current at 3,000 volts for distribution on the trolley. The motors of the locomotives are so constructed as to act as generators when descending grades, thus returning current to line and controlling the speed of trains to a considerable extent without the usual braking, which removes some of the difficulties of mountain operations. The three electrified divisions take the line over five distinct mountain ranges, viz, Belt, Rocky, Bitter Root, Saddle, and Cascade.

This was the first great electrification of a steam railroad and has attracted wide attention. There is considerable evidence in the record on the subject due to that fact, and also due to the relation of John D. Ryan and others with the railroad, the power companies, and the copper companies interested in the subject.

As before stated, Ryan became a director of the St. Paul in 1909 upon the request of William Rockefeller, who for many years had a large interest in the Anaconda Mining Company and was a director of that company during the St. Paul's electrification. When Ryan became a director he was president of the copper company, which had extensive interests in Montana, and he was also interested in water power. He and his associates had acquired control of the Great Falls Water Power & Town Site Company from the Hill interests and water power was being developed at Great Falls, Mont., when he became a director.

Ryan frankly admitted that when he became a director he was interested in railroad electrification from two standpoints: (*a*) As one of the important new uses for copper; and (*b*) in securing an outlet for the great undeveloped water power controlled by him and his associates. Throughout the negotiations leading up to the power contracts subsequently referred to he states that he felt that his interests in power and copper were such that he ought not to be an active party representing the railroad in the negotiations, but he has always thought that electrification of the St. Paul was a good thing for the

railroad. He says there was never any doubt as to the capacity in which he was acting. Everyone knew he was acting for the power producers, and he was very careful not to take part in the discussions in the board as to electrification, and in fact avoided meetings with the board when the question was to come up. In framing the contracts he was the active negotiator for the power companies and Earling, then president, and Goodnow, his assistant, represented the railroad. Ryan depended principally upon the railroad officials to protect the carrier's interests.

As early as 1906 electric supply companies had made reports with respect to electrifying the Butte, Anaconda & Pacific Railway, a short line controlled by the Anaconda Copper Company, engaged principally in hauling ore from Butte to Anaconda, a distance of about 25 miles. For many years the St. Paul owned 49 per cent of the stock of this road but sold it to the Anaconda Company shortly before the receivership. Operation of this road by electricity commenced in May, 1913. The work was done by the General Electric Company under an absolute guaranty of performance. In the meantime that company made various studies and investigations with regard to electrification of the St. Paul.

There are three different contracts for power furnished to the three electrified divisions as follows:

Division	Power company	Date of contract	Length of contract
			Years
Rocky Mountain	Great Falls Power Co.[1]	Nov. 25, 1912	99
Missoula	Thompson Falls Power Co.[1]	Feb. 11, 1913	99
Coast	Intermountain Power Co	Mar. 13, 1917	98

[1] The capital stock of these companies, except directors' qualifying shares, is owned by the Montana Power Company.

The Montana Power Company is a New Jersey corporation chartered on December 12, 1912, and was the result of the merger of several companies. On February 13, 1913, it acquired control by exchange of stock of the Great Falls Power Company and the Thompson Falls Power Company, Montana corporations, chartered on May 25, 1910, and November 12, 1912, respectively.

Since the contract was made with the Great Falls Power Company that company has greatly increased its capacity, but this increase was not due entirely to the requirements of the St. Paul. During the 10-year period of 1916–1925, the latter took a little over 10 per cent of all the power delivered by the Great Falls Company. A large part of the power generated is taken by the Anaconda Mining Company.

The Thompson Falls Power Company has a plant at Thompson Falls. Although the St. Paul never has taken over 50 per cent of the power generated, nevertheless the plant was constructed primarily for the purpose of furnishing power to operate the Missoula division of the St. Paul under the contract of February 11, 1913.

The St. Paul once controlled the Thompson Falls power site. Ryan testified that at one time he and another owned a half interest in the site which they sold to the St. Paul. Later at Earling's request he acquired and sold at cost to the St. Paul the other half interest, the total cost to the railroad being about $300,000. Still later, according to his testimony, Earling suggested that Ryan buy back the Thompson Falls site and also take over a site on the Missoula River and make a contract for furnishing power to operate the Missoula division as Earling had become convinced that the railway could not develop its own power as cheaply as it could be purchased under the contract with the Great Falls Power Company.

The records of the power companies show that on November 25, 1912, Ryan made a formal acceptance of a proposition to take over the Thompson Falls and Missoula River power sites from the St. Paul at a price equal to double the amount which the rights had cost the St. Paul, with interest at 5 per cent per annum since the railway acquired the titles. These properties were turned over to Ryan on February 11, 1913, and on the same date the contract between the St. Paul and the Thompson Falls Power Company was executed. Ryan's interests thus acquired from the St. Paul, together with some other property of no consequence, were conveyed to the Thompson Falls Power Company on February 12, 1913, for which he received $5,000,000 par value of stock of the Thompson Falls Company, and immediately exchanged that stock for an equal amount of stock of the Montana Power Company.

The record indicates that Ryan and his associates did not expend over $925,000 for the property for which they received $5,000,000 nominal par value in stock of the Montana Power Company. The principal thing that gave value to the stock of the Thompson Falls Company was its contract with the St. Paul. The stock of the Montana Power Company given to Ryan did not become entitled to dividends, according to the agreement, until 1917, when one-half became entitled to dividends after power had been furnished to the St. Paul for six months, and the other half became entitled to dividends one year later. In the meantime the stock had been held by voting trustees. Ryan stated that the stock paid to him for the Thompson Falls stock was worth when received about $19 per

share, as at that time the market price of the Montana Power stock was about $37. Inasmuch as the stock issued to Ryan and his associates was not to receive dividends except under the provisions outlined above, it was of course not worth the market price of the stock receiving dividends. The Montana Power stock has since sold on the New York Stock Exchange as high as $114 per share. It is obvious that this transaction has been of great profit to Ryan and his associates. In return for an investment of less than $1,000,000 they received $5,000,000 par value in stock of what has since become one of the strongest power companies in the country. Ryan and his family have held large blocks of stock in the company and have received dividends of over $1,600,000 since 1913, the great bulk of which was received after 1917, when the stock he received in the Thompson Falls deal started to receive dividends. With the exception of Ryan, the stock records of the Montana Power Company indicate that no director, trustee, or officer, of the St. Paul, the Chicago, Milwaukee & Puget Sound, or the Milwaukee Land Company has ever received, directly or indirectly, any portion of the $5,000,000 block of Montana Power stock referred to. As stated before, the principal element of value in the Thompson Falls project which Ryan turned over to the Montana Power Company was the 99-year contract of the St. Paul with the Thompson Falls Power Company which was executed at the same time that the railway turned its rights over to Ryan, because as Ryan says the railway was obligated to pay for enough power to warrant development of the site. The St. Paul continues to be the principal customer of that company, its payments under the contract being about 40 per cent of the total revenue of the power company.

At the time of the contract of November 25, 1912, Ryan and his associates controlled a half interest in the Great Falls Power Company. This interest was turned over to the Montana Power Company on February 11, 1913, in return for $5,000,000 preferred and $17,500,000 common stock of the Montana Power Company, dividends not to be payable until the St. Paul started to pay for power under the contract. Here again a large element of value to the interests of Ryan and his associates was the contract negotiated by Ryan with the St. Paul. At the time of the hearings in this proceeding the preferred stock of the Montana Power Company was paying 7 per cent dividends and the common 5 per cent.

Goodnow and Earling, who handled those matters on behalf of the railroad, died before the receivership, and we are without the benefit of their versions of these matters. Ryan admits that he always insisted that the railway company could not develop its own power sites and furnish itself with power economically. Nevertheless, he denies ever urging Earling to sell the St. Paul power sites to him, but his recollection is that Earling forced him to buy the sites in return for a contract similar to the Great Falls contract. But we find in the St. Paul's correspondence files a letter from Goodnow to Earling, dated November 24, 1911, reading in part as follows:

> I am quite sure he [Ryan] is very anxious to have the Thompson Falls power. I think you have one strong argument which I could not use, that inasmuch as the company [St. Paul] has got to have an electrical development, it would only be a step to develop Thompson Falls power and get the full benefit thereof. This is quite true, and it seems to me that rather than make concessions which you consider unwarranted, we ought to consider the development of this power.

Ryan remarks as to this that Goodnow "was the hardest trader I ever had anything to do with." Undoubtedly he was working at all times for the sole interest of the railroad, but as he was not in a dominant position his views did not prevail at all times. In fact we gather from Ryan's testimony that Earling was much more reasonable to deal with than was Goodnow.

The cost of electrifying the two sections was as follows:

	Total cost	Cost per mile	Cost per locomotive
Harlowton-Avery (438 miles):			
Fixed property	$7,741,689	$17,675	
37 locomotives	3,920,684		$105,950
Total	11,661,773		
Othello-Tacoma (210 miles):			
Fixed property	7,178,991	34,185	
22 locomotives	4,149,490		188,610
Total	11,328,481		
Total cost of electrification	22,990,254		

It will be noted that the cost of electrifying the section between Othello and Tacoma was nearly the same as the cost of electrifying the line between Harlowton and Avery, although the mileage was less than half. The former work was done during the period of high prices, being completed early in 1920, while the latter was completed in 1916.

Of the total cost of electrification over $4,000,000 was for copper purchased from the United Metals Selling Company, the selling agency of the Anaconda Copper Company, both headed by Ryan.

The power contracts with the two subsidiaries of the Montana Power Company are practically the same, except that in the case

of the Thompson Falls contract the railroad has a right to take over and operate the project as against a mortgagee, etc.

Under the contracts the railway purchases power for $0.00536 per kilowatt-hour, but with the limitation that the minimum payment shall be for 60 per cent of the number of kilowatt-hours which would have been taken if the fixed amount of power, which from time to time the railway company is obligated to receive, and the power company to furnish, had been taken continuously. This fixed amount of power was 10,000 kilowatts for each of the two electrified divisions, and it has been increased from time to time under the provisions of the contract, as amended December 30, 1922, until in 1925 it was 16,000 kilowatts for each division. The traffic and kilowatt-hour consumption have fallen off to such an extent that the minimum provisions in the contracts have served to considerably increase the net rate per kilowatt-hour which the railway has paid for the energy actually received as shown below. It was not until 1917 that the power companies insisted on payments according to the minimum provisions of the contracts, and these proved so burdensome that negotiations were opened for modification of the requirements that the St. Paul continue to increase the minimum payments. The amendments of December 30, 1922, resulted. Thereby the highest minimum of 18,000 kilowatts was to be reached in 1927. The railroad can take a maximum of 28,000 kilowatts.

Period	Kw.-hrs. consumed	Kw.-hrs. paid for	Total payment	Cost per kw.-hr. consumed	Traffic ton-miles (000 omitted)	Kw.-hrs. per 1,000 ton-miles
Rocky Mountain division, Harlowton to Deer Lodge:				Cents		
Year 1916	57,832,141	69,737,005	$320,195.17	0.536	845,000	68
Year 1917	69,954,950	71,534,244	369,591.26	.536	1,380,000	51
Year 1918	66,593,959	66,593,989	356,943.78	.536	1,422,000	47
Year 1919	69,054,000	77,006,177	391,313.11	.567	1,492,000	46
Year 1920	64,325,000	78,868,169	422,733.39	.657	1,450,000	44
Year 1921	42,716,000	63,072,000	338,065.93	.791	931,000	46
Year 1922	51,672,529	63,072,000	338,065.93	.654	1,038,000	47
Year 1923	54,243,902	73,584,000	394,410.27	.727	1,160,000	47
Year 1924	51,800,641	79,056,000	423,740.16	.818	1,097,000	47
Missoula division, Deer Lodge to Avery:						
Year 1916	4,802,193	4,802,193	25,639.75	.536	793,000	61
Year 1917	52,014,625	52,014,625	278,798.39	.536	1,293,000	40
Year 1918	58,753,609	58,753,609	314,919.34	.536	1,337,000	44
Year 1919	63,157,000	63,286,195	339,214.01	.536	1,402,000	45
Year 1920	59,374,000	67,250,572	360,463.07	.607	1,360,000	44
Year 1921	41,429,000	63,072,000	338,065.93	.816	878,000	47
Year 1922	48,149,926	63,072,000	338,065.93	.702	1,022,000	47
Year 1923	48,867,530	73,584,000	394,410.27	.807	1,088,000	45
Year 1924	45,131,825	79,056,000	423,740.16	.939	1,032,000	44
Coast division, Othello to Tacoma:						
Year 1919	4,466,073	14,011,212	75,100.10	1.681		
Year 1920	37,209,000	56,749,559	304,177.63	.818	691,674	54
Year 1921	34,056,000	63,072,000	338,065.93	.992	664,238	51
Year 1922	37,925,143	63,072,000	338,065.93	.892	734,121	52
Year 1923	39,394,311	63,072,000	338,065.93	.858	740,405	53
Year 1924	34,846,132	63,244,800	338,992.14	.973	691,470	50

The following table shows the monthly load factors for 1923 and 1924, with 14,000 and 15,000 kilowatt fixed power, respectively:

Month	Rocky Mountain division	Missoula division	Month	Rocky Mountain division	Missoula division
Year 1923:			Year 1924:		
January	49	45	January	37	33
February	50	40	February	43	38
March	49	46	March	45	36
April	50	44	April	38	35
May	45	43	May	35	31
June	42	40	June	35	30
July	43	39	July	33	28
August	42	38	August	36	33
September	42	36	September	42	36
October	44	37	October	44	38
November	39	33	November	39	35
December	37	32	December	44	37

It will be observed that in no month did the load factor ever approach the 60 per cent load factor named in the contracts and in fact during many months it was more nearly half that, the result being that the unit price per kilowatt-hour consumed was forced up to 0.727 cent in 1923 and 0.818 cent in 1924 on the Rocky Mountain division; and 0.807 and 0.939 cent in 1923 and 1924, respectively, on the Missoula division.

Under the contracts as modified covering the three divisions, the St. Paul paid during the years 1921 to 1924, inclusive, at least $1,500,000 for power which it was unable to use.

An electrical engineer connected with the Federal Power Commission criticized these contracts, principally on the ground that the provision with respect to the 60 per cent load factor, that is, an average kilowatt demand throughout the month of 60 per cent of fixed power available, is unreasonable because (1) the purpose of a minimum charge is, in general, to protect the power company against abnormally low use of the power which it stands in readiness to serve and it is not intended that the minimum charge represents the ordinary use of the power available; (2) actual operating conditions show that a 60 per cent use can be attained only rarely, and that for a large percentage of the time power is being paid for which can not be used; (3) this high load factor makes necessary a balancing of the cost of additional fixed power against the cost of train delays due to the operation of a limiting device which was installed in an attempt to get the most use out of the power. Under another provision of the contracts if over 60 per cent use is attained one year, that automatically fixes the minimum for the next year. Thus the railroad must pay for 60 per cent of the fixed power, and it is held down to a 60 per cent use by the obligation to take additional fixed power when an annual load factor of better than 60 per

cent is obtained. This leaves the railroad practically always in the position of having to pay for power which it does not use.

He also testified that it is not agreed that 0.536 cent per kilowatt-hour on a 60 per cent minimum-use basis is such a favorable price for power as to warrant the contracting of it for 99 years. This price represents an annual income of $26.17 per kilowatt of fixed power, or $21.13 per horsepower. In other words, the power companies are under a 99-year guaranty of $21.13 per horsepower.

There are vast undeveloped water-power resources within 200 miles of the St. Paul in the States of Washington, Idaho, and Montana, and this engineer states that reliable estimates of the cost of development, including transmission lines, make it appear that power could be supplied by the railroad for its lines, for at least the price it is now paying. These estimates, however, appear to be based on the assumption that the railroad could build plants for just the capacity needed and could be expanded at the same cost per kilowatt as the power requirements increased. The power companies question his conclusion on the basis of what it would cost to develop two complete projects at Great Falls and Thompson Falls which would generate more than enough power to supply the railroad. In consideration of this question the railroad officials seem always to have assumed that it would not be able to sell its excess power to others.

With regard to the unusual length of term of the contracts, we are again handicapped by the death of those who negotiated them for the railroad. Ryan testified that he insisted on a 30-year contract, as some bonds of the power company would mature within that period. He says that at first Earling agreed to that but later insisted on 100-year contracts. Ryan believes that at that time E. W. McKenna, operating vice president of the St. Paul, was responsible for this. We find in the files of the St. Paul a letter from Goodnow with reference to one of the contracts wherein he said: "I purposely left the term of this contract blank because I believed that we ought not to enter into a contract covering a period of more than 30 or 40 years." Recent contracts made by the Illinois Central and Great Northern covering their electrification projects have been for much shorter periods.

Another unfair feature of these contracts is that two separate contracts covering adjoining divisions, viz, Rocky Mountain and Missoula, cover one continuous stretch of line from Harlowton to Avery. Both contracts were negotiated at the same time, practically concurrently, by Ryan, and the interests in the power companies held by Ryan and his associates were turned over to the Montana Power Company at about the same time. Shortly after the contracts were signed Goodnow made strenuous efforts to have them consolidated. The operation of both divisions under one contract and one minimum would result in a reduction of the combined peak demand and better load factors.

The making of these separate contracts of course added measurably to the value of the Ryan holdings in the companies making them. We find a letter in the files of the St. Paul written by Goodnow to Ryan, dated May 29, 1914, strongly insisting that the two contracts should be treated as one, pointing out how unfair to the St. Paul it would be to treat them separately. On the letter there is this notation:

> This letter was not sent because President Earling told me that he and Mr. P. A. Rockefeller had seen Mr. Ryan and that he had agreed to combine the contracts, and to give us power for the first year in such quantities as required; that he would see to it that Mr. Maroney and Mr. Kelly understood that the contracts were to be adjusted to meet the interests of both parties.

When that was called to Ryan's attention he categorically denied having made any such agreement. As a matter of fact the contracts were combined during the first year of electrical operation. But as Ryan's sole interest was to make the business profitable for the power companies the contracts have never since been combined. In trying to justify this Ryan seems to give the impression that the Great Falls contract was all closed up before any negotiations as to Thompson Falls took place. But while the negotiations as to the Great Falls contract probably started first, the two contracts obviously were pending at the same time. They are practically identical in terms, and were signed within a few months of each other. As a practical matter the power for operating the two divisions may come from any of the various plants of the Montana Power Company or its subsidiaries, which include the Great Falls Power Company and the Thompson Falls Power Company, all of whose stock it owns.

The contract for furnishing power to operate the Coast division (Othello to Tacoma and Seattle) is with the Intermountain Power Company and is dated March 13, 1917. Its term is 98 years. Ryan was also interested in that contract. About 1915 he learned that the Washington Water Power Company had a surplus of power which was being developed at its Long Lake plant in the vicinity of Spokane. At that time the Anaconda Company was becoming interested in electrolytic zinc, which requires a low-priced power. The Coeur d'Alene district of Idaho was becoming an important zinc-producing district. Subsequently Ryan and other officials of the Montana Power Company and Anaconda Mining Company secured a contract with the Washington Company for 30,000 horsepower, 10,000 to be bought firm with options on blocks of 5,000 horsepower

for either 25 or 99 years as they might elect, at $10 per horsepower per year, which was a low rate. Vice President Kerr of the Montana Power Company, who participated in the transaction, says that when they secured this power they had no definite idea as to what was to be done with it. Before the contract was actually made negotiations were started with the St. Paul officials. Ryan testified that either Earling or Goodnow started them, as a contract for fuel oil which was used on the Coast division was to expire within a year or two, and the best terms for fuel oil which they could secure were much higher than they were paying. The upshot of the matter was that the railway company agreed to another contract with Ryan and his associates, who formed the Intermountain Power Company. This company was incorporated on October 30, 1916. The price for the power was the same as under the Montana contracts. Not until the agreement with the St. Paul was reached did those who afterwards organized the Intermountain Power Company take up in more definite form the possibility of providing power which might be resold to the St. Paul, and that resulted in the definite agreement with the Washington Water Power Company for $10 power.

The contract of March 13, 1917, modified March 14, 1921, is very similar to the other two contracts. The railroad agreed to take 10,000 kilowatts with a 60 per cent load factor. The following monthly load factors represent the use of 12,000 kilowatt fixed power during 1923 and 1924:

Month	1923	1924	Month	1923	1924
January	41	31	July	35	28
February	43	36	August	37	32
March	43	35	September	36	35
April	41	46	October	34	37
May	40	33	November	31	32
June	39	31	December	29	33

It will be noted that with such load factors the railroad is paying for about twice as much power as it uses.

The following table shows the list of principal consumers of the Washington Company in 1925, their consumption in kilowatt-hours, amount paid therefor, and the average cost per kilowatt-hour:

Consumer	Consumption kw. hrs.	Amount paid	Average cost per kw. hr
Pacific Power & Light Co. (Lind, Wash., acct.)	39, 966, 445	$418, 080. 00	$0. 01046
Pacific Power & Light Co. (Lewiston, Idaho, acct.)	6, 333, 340	36, 619. 92	. 00578
Mountain States Power Co.	5, 946, 735	41, 152. 28	. 00692
Hecla Mine & Mill	11, 613, 870	72, 550. 71	. 00625
Bunker Hill & Sullivan M. & C. Co. (mine)	23, 507, 400	146, 921. 26	. 00625
Bunker Hill & Sullivan M. & C. Co. (smelter)	11, 245, 800	60, 230. 15	. 00536
International Portland Cement Co.	3, 658, 900	29, 418. 89	. 00804
Northwest Magnesite Co.	2, 819, 230	35, 212. 64	. 01249
Modern Electric Water Co.	6, 720, 878	44, 285. 66	. 00659
Spokane United Railways	17, 303, 558	207, 642. 68	. 01200
Inland Empire R. R. Co.	4, 663, 025	27, 978. 15	. 00600
Spokane Eastern Ry. & Power Co.	2, 948, 295	22, 789. 62	. 00773
Inland Empire Paper Co.	17, 589, 500	71, 457. 90	. 00406
Great Northern Ry. Co. (Hillyard shop)	1, 896, 810	21, 356. 47	. 01126
Puget Sound Power & Light Co.	23, 616, 000	90, 485. 23	. 00383
Roslyn Fuel Co.	2, 164, 835	18, 638. 12	. 00861
Totals excluding C., M. & St. P.	181, 994, 621	1, 244, 855. 58	. 00739
C., M. & St. P. Ry. Co.	37, 318, 324	338, 065. 93	. 00906
Grand totals	219, 312, 945	1, 682, 921. 51	. 00767

For the period July 1, 1922, to December 31, 1925, the St. Paul contributed approximately 9 per cent of the Washington Company's gross revenues from the sale of light and power, while its proportion of the power taken by all customers was approximately 10 per cent.

As the Intermountain did not develop any power of its own it contracted with the Puget Sound Traction Light & Power Company to furnish 10,000 kilowatts at the western end of the Coast division. The Intermountain built 122.79 miles of transmission lines at a cost of about $700,000 in order to serve the St. Paul. It will be recalled that Ryan's supposed interest in the cheap surplus power of the Washington Company was with respect to its possible metallurgical uses. However, nothing ever came of that and the St. Paul was the only customer of the Intermountain Company.

There was also entered into on March 13, 1917, an agreement between the Intermountain Company and the St. Paul with reference to power to be furnished in case the Idaho division (Avery to Othello) was electrified. To obtain the benefits of this contract the railroad was to notify the power company of its desire to electrify on or before September 1, 1919. Federal control came and the road was not in a position to do the work and the director general did not further it. The Intermountain refused to grant the railway an extension beyond September 1, 1919, but offered to sell all of its assets to the St. Paul for actual cash outlays it had made plus 6 per cent. The total would have been in excess of $1,000,000. Nothing was done about that.

On March 14, 1921, a so-called option contract was entered into between the St. Paul and the Intermountain for power to operate the Idaho division and simultaneously a "use" contract similar to the one covering the Coast division was entered into, but the rail-

road was to notify the power company of the desire to electrify on or before October 1, 1925. This was later extended to October 1, 1926. During the operation of this "option" contract from October 1, 1921, to September 30, 1925, inclusive, the railroad paid a net amount of $375,269.87, although it was not in a position to use the power in question. Payments under the contract were suspended on the latter date.

The last of the carrier's contracts with the Intermountain was signed on March 14, 1921. On June 30, 1922, all of the stock of the Intermountain was sold to the Washington Company, under an agreement dated April 18, 1922. Up to that time the former had paid no dividends. In fact, as the St. Paul did not take any power under its contract until late in 1919 the Intermountain showed deficits in 1919 and 1920 on account of the payments it was making. It had $745,400 capital stock outstanding and had something over $700,000 invested in transmission lines. Yet the consideration agreed upon was $1,300,000, $501,600 in cash and $798,400 in stock of the Washington Company. If the gross receipts of the Intermountain for any 12-month period up to and including December 31, 1939, exceeded a certain amount, $600,000 in stock or cash additional was to be paid. Up to December 31, 1925, no part of this amount had been paid. During the years 1922 to 1925, inclusive, dividends of 8 per cent per annum were paid on the stock so exchanged. Of the cash received, $50 per share was paid to the stockholders and $127,300 was reserved to pay some indebtedness of the company. Of the 7,454 shares of Intermountain, Ryan held 1,500 shares and received 1,608 shares of the Washington Company.

In the Washington Company's annual report to its stockholders for 1922, the following comment was made on the purchase of the Intermountain:

> The purchase of the company brought to the Washington Water Power Company useful physical assets, and contracts of considerable importance in connection with the Chicago, Milwaukee & St. Paul Railway Company's present and future electrification.

It is obvious that those contracts were the elements which gave such a high value to the stock of the Intermountain.

There does not appear to have been any good reason for interjecting the Intermountain into this situation. The only purpose it has served has been as a vehicle for profits to Ryan and his associates. The railway was prospectively a heavy user of power; the surplus power of the Washington Company was or should have been known to St. Paul officials. It was known to Ryan, who was a member of the board of directors and of the executive committee, and as a result the railway should have been in a position to secure power just as reasonably as did Ryan. Likewise the railroad could have contracted for power on the west end on the same basis as did the Intermountain.

As stated before, William Rockefeller, long one of the dominant men in St. Paul affairs, was interested in the power companies and the Anaconda Copper Company. His son, Percy, testified that in 1915 his father bought about 20,000 shares of Montana Power stock and later bought several thousand shares of Intermountain stock. William Rockefeller was also heavily interested in the Anaconda Mining Company and was a director of that company at the time when the St. Paul's electrification was undertaken.

As bearing on the fairness of the contracts there is considerable evidence of record comparing the cost of power furnished, for instance, to the Rocky Mountain division and what it would have cost under the operation of contracts similar to those recently executed by the Illinois Central for its Chicago suburban electrification and by the Great Northern with the Washington Water Power Company covering a proposed electrification of over 300 miles between Wenatchee, Wash., and Troy, Mont. The various contracts discussed of record are so different that it is difficult to reach a fair comparison because of the many modifications, assumptions, and adjustments involved. If the comparisons disclose anything it is that the disadvantage of the St. Paul is its inability to furnish traffic to use the power it is bound to pay for. It is paying for enough power to move a very large amount of additional traffic. If it had the traffic, the contracts would compare favorably with those of the Great Northern and Illinois Central.

The contracts with the subsidiaries of the Montana Power Company compare favorably with the contracts these companies have with other large users, particularly the Anaconda Copper Company. In 1925 this company took over 60 per cent of the power delivered by plants owned or controlled by the Montana Power Company. Moreover, about half of this consumption was at Great Falls, close to the large power houses at that point. The St. Paul did not take more than 10 per cent. Much of its power is transmitted as far as 150 miles.

As stated by Ryan, the first contract was given considerable publicity, inasmuch as it was necessary to secure permission from the Federal Government to build transmission lines across the Government lands. The permit of the Secretary of the Interior, dated January 6, 1913, which set forth the terms of this contract, was printed as a public document by order of the Senate, Sixty-second Congress, third session. That was a permit to cross public lands under the conditions therein stated and nothing more. This can not be held to justify the statement in the carrier's brief: "The govern-

ment of the United States quite formally endorsed the benefits to the railway company and to the public through the railway company of the 1912 power contract."

The carrier introduced an exhibit to show the savings resulting from electrical operation. These are set forth below:

	Harlowton to Avery		Othello to Tacoma		All electrified sections	
	Volume of traffic gross-ton miles, freight and passenger	Net savings by electrification	Volume of traffic gross-ton miles, freight and passenger	Net savings by electrification	Volume of traffic gross-ton miles, freight and passenger	Net savings by electrification
Year 1916	[1] 1,630,054,000	[1] $1,098,166			1,630,054,000	$1,098,166
Year 1917	2,677,097,000	1,641,369			2,677,097,000	1,641,369
Year 1918	2,759,178,000	1,734,687			2,759,178,000	1,734,687
Year 1919	2,894,063,000	1,888,037			2,894,063,000	1,888,037
Year 1920	2,710,745,000	1,679,623	[2] 691,674,000	[2] $249,003	3,402,419,000	1,928,626
Year 1921	1,812,714,000	658,651	664,238,000	12,363	2,476,952,000	671,014
Year 1922	2,109,868,000	996,485	734,121,000	103,301	2,843,989,000	1,099,786
Year 1923	2,247,102,000	1,152,508	746,405,000	119,285	2,993,507,000	1,271,793
Year 1924	2,129,426,000	1,018,721	691,476,000	47,808	2,820,902,000	1,066,529
Total		11,868,247		531,760		12,400,007

[1] Tonnage and savings for six and one-half months.
[2] Tonnage and savings for nine months.

The figures with regard to steam operation are based on actual costs for the last 12 months of such operation adjusted to the costs obtaining in 1923; and for electrical operation the actual costs as determined for 1923. The latter year was used because the traffic for 1923 more nearly approached that of 1915, the last full year of steam operation between Harlowton and Avery, than any other year. Our accountants and engineers made a very careful and extensive examination of all of the underlying data on which the exhibit is based and reached the conclusion that under the assumptions that must be made in a study of this kind the exhibit represents a careful and conscientiously prepared estimate of the comparison of cost of operation, under steam power of the type used at the time of electrification, and under electric power, as between the years 1915 and 1923 for the Rocky Mountain and Missoula division; and as between the year August, 1918, to July, 1919, and the year 1923 for the Coast division. The unit costs for 1923, as ascertained by the railroad, were applied to the traffic for the years shown to ascertain annual savings in those years. That many assumptions, estimates, and opinions are necessary in order to reach such results for 1923, and then to go further and apply them to years other than 1923, is obvious.

It will be noted that the carrier estimates the saving for 1923 on the Rocky Mountain and Missoula divisions as $1,152,508, and on the Coast division as $119,285, a total of $1,271,793. On the same basis, after making some adjustments, our engineers' figures are $1,047.291 and $19,524, respectively, or a total for the three divisions of $1,066,518. In other words, these are the differences between the cost of moving the 1923 business with the steam equipment of the carrier in 1915, and the cost by electrical equipment in 1923. Elimination of some of the questionable items would reduce those figures still further, but there can be no doubt that the aggregate cost of operating those three divisions by means of electricity has been much less than the cost of operating those three divisions by means of the older type of steam locomotives would have been.

Contending that such a comparison was misleading, our engineers made a similar study, based not on the old type of steam equipment displaced by electric power, but on the most modern and suitable type of steam locomotives whose efficiency is probably 30 per cent greater than that of those in general use in 1915. Coverdale & Colpitts in their report, commenting on the study made by the railroad officers, said that it would appear that certain factors had not been taken into consideration, such as the improvement in steam operation that has taken place since the date of electrification of the Harlowton-Avery section. Such types of modern locomotives are in service on the Great Northern. The conclusions to be drawn from the study of our engineers are that if the Rocky Mountain and Missouri divisions had been operated in 1923 by means of modern and suitable types of steam locomotives instead of by electricity, the cost would have been about the same; and that the electrification of the St. Paul has probably resulted in some savings. Certainly it has not resulted in losses. Of course no railroad operates wholly with modern power as necessarily there are older and more or less obsolete units in service which are being periodically replaced with units of more modern type. Of the locomotives owned or leased by the St. Paul on December 31, 1924, over 80 per cent were more than 10 years old.

There are many collateral advantages in electrified operation. Many of the difficulties of mountain operation are eliminated as the motors of the locomotives are so constructed as to act as generators when descending grades, thus returning current to the line and controlling the speed of trains without mechanical braking. The power so returned, however, is practically a gift to the power companies on account of the railway's power demands being so far below the minima. Then too, larger passenger revenues possibly accrue due to the greater comfort in traveling on the electrified lines.

It is estimated that the Idaho division (Avery to Othello) could be electrified for $5,000,000. If this be true considerable savings probably could be effected, because it is estimated that with the

present thin traffic on the Puget Sound lines it would not be necessary to buy additional electric locomotives.

In connection with this subject of electrification, as well as the Puget Sound extension itself, it might be stated that the development of traffic carried over the western lines has been very disappointing. In 1923 and 1925, the traffic handled over the Rocky Mountain and Missoula divisions was almost exactly the same as that of 1915, while that handled over the Coast division in those years was less than in 1915. The business to, from, and via Seattle and Tacoma has especially declined since the war years, so much so that in recent years the water-front properties of the company in the two ports have to a large extent been lying idle. In 1918 the St. Paul handled 10,126 cars of domestic traffic to those cities. During the five years 1921 to 1925, inclusive, the average was less than 3,000 cars per year. The export and import transcontinental tonnage through the same ports declined from 457,515 tons in 1918 to 42,656 tons in 1925.

ACQUISITION OF CHICAGO, TERRE HAUTE & SOUTHEASTERN

Before becoming president of the St. Paul, Byram was a vice president of the Chicago, Burlington & Quincy, and thus was very familiar with the great development by the Burlington in the southern Illinois coal fields. When he came to the St. Paul he found that the road was depending on mines located on foreign lines for two-thirds of its fuel supply. At that time the St. Paul controlled three coal companies, viz, the St. Paul Coal Company, which owned or leased 31,093.70 acres of coal lands in northern Illinois; the Republic Coal Company, which owned or leased 6,723.64 acres in Montana, and the Excelsior Coal Company, which owned 2,419.11 acres in Iowa. As of March 18, 1925, the St. Paul had $1,460,604 invested in these properties. The mines in Montana furnished fuel coal to the lines west of Montevideo, Minn., while the output of the mines in Illinois went to the lines east of that point. The production in Iowa was not important and the properties recently have been leased or sold to other interests.

The Terre Haute was leased by the St. Paul, effective July 1, 1921. For the 12 months prior to that date the consumption of coal on the lines east was over 3,500,000 tons. Only 20 per cent came from mines served by the St. Paul. Eleven per cent of the total was from the company mines in Illinois; 5 per cent came from lake docks; and nearly 70 per cent came from mines on other lines, the principal ones being the Chicago & Eastern Illinois, Illinois Central, Terre Haute, and Pennsylvania. The freight charges paid to foreign lines for the movement of the coal amounted to nearly $3,000,000.

There are many obvious advantages to a large system like the St. Paul in having an adequate supply of fuel coal on its own rails. It eliminates payment of freight charges to foreign lines, as well as per diem, and above all assures an uninterrupted flow to all parts of the system under the one management. Prior to the acquisition of the Terre Haute the St. Paul found it necessary to store large quantities of coal, particularly during the winter months. During his first winter on the property Byram found it necessary at one time, in order to keep passenger trains running, to run a special train of coal from Chicago to Aberdeen, S. Dak. His experience on the Burlington, coupled with difficult fuel conditions during the war period, seem to have placed the acquisition of a coal road uppermost in his mind as a necessity for the St. Paul, even though it was then in an unstable financial condition. There were a few independent coal lines serving the Illinois and Indiana fields. Among these were the Chicago & Eastern Illinois and the Terre Haute. The former was far too big for the St. Paul to handle, and attention was turned to the latter.

There was some inquiry of record as to whether the St. Paul could not have further developed its properties in northern Illinois so as to secure a greater proportion of its fuel from those mines. The evidence is that it is much more costly to operate mines in northern Illinois than in southern Illinois and Indiana, due principally to thin seams, and that even with a substantial differential in the freight rates in their favor commercial mines in that field find it difficult to meet competition from the mines farther south. It also appears that prior to 1924, the Santa Fe and North Western had purchased large quantities of coal in this field but had withdrawn their support. The result was that the value of undeveloped coal acreage in the district had declined to almost nothing; in fact there was no market. More shafts could have been sunk on the St. Paul coal properties but it seems fair to conclude from the recent history of the field that its costs have been higher than those farther south.

Percy Rockefeller testified that some years ago the St. Paul, in view of the Burlington's success, had made a study with reference to a possible entrance into the southern Illinois coal fields. The question came up several times but a plan never could be worked out. Before Byram became president he expressed the view to Rockefeller that the coal situation of the St. Paul would have to be improved, and that it was a vital necessity for the St. Paul to get an adequate fuel supply on its own rails.

At any event Byram determined to acquire the Terre Haute and started negotiations in 1920. That the Terre Haute was a distress property there can be no question. It was originally a promotion by the late John R. Walsh which collapsed in 1905, involving several Chicago banks. The Chicago clearing-house banks took over the banks along with a large block of Walsh securities and other assets which were liquidated as fast as possible. They were unable to realize on the railroad securities. The railroad properties were sold at foreclosure and were acquired by the Chicago, Terre Haute & Southeastern Railway Company of Indiana, which was chartered March 26, 1910. At the time of its acquisition by the St. Paul it owned and operated a line of nearly 300 miles extending from Chicago Heights, Ill., a point within the Chicago switching limits, to Westport, Ind. It had trackage over the Baltimore & Ohio Chicago Terminal north from Chicago Heights to Harvey Junction.

Following the reorganization, the Chicago banks had received for their holdings 40 per cent of the income bonds and 40 per cent of the stock of the Terre Haute. The banks were still faced with the problem of realizing on these securities. In 1918 the Continental & Commercial National Bank sold the income bonds which it held, amounting to $595,100 to one of its directors at a price of approximately 20 cents on the dollar. The bank was inclined to sell the lot at a price of less than 10 cents on the dollar, but finally the director paid $8,000 more than the highest outside offer. The circumstances were such that the greatest care was taken to avoid any suggestion that they were being sold to a director for less than they were worth. It must be considered a fair test of what they were worth. The income bonds had paid very little interest prior to the lease to the St. Paul; in 1918 2.5 per cent; and in 1920 only 1.25 per cent. Its coal cars were obsolete, its locomotives were in poor shape, and it was "awfully hard up" for working capital. As for the stock the circular issued by the president of the Terre Haute in 1920 to the stockholders with reference to the proposed lease and acquisition of stock recited that the stock "had, during the past 5 years a merely nominal market value of only one or two dollars per share." In the face of these facts Byram, totally inexperienced in such matters, entered into negotiations with the bankers who controlled the Terre Haute. Most of the negotiations were with the chairman of the bankers' committee, Frank D. Wetmore, one of the most prominent bankers of the country.

Upon examination in this proceeding Byram's mind was a blank as to all phases of whatever negotiations he had with the bankers. All he knew was that the St. Paul agreed to lease the Terre Haute upon the terms finally agreed upon as follows: (*a*) Assumed the payment of principal and interest of the fixed-interest bonds, amounting to $11,981,000; (*b*) assumed a floating indebtedness of $837,000 to the Chicago banks to be paid in installments; (*c*) guaranteed the full principal and interest at 5 per cent, of all the income bonds, amounting to $6,336,000; and (*d*) agreed to pay $10 per share for the 43,000 shares of capital stock outstanding. As of March 18, 1925, the St. Paul had purchased 39,545.75 shares at a cost of $395,457.50. The total obligations were thus $19,584,000, assumed at a time when the St. Paul was not earning its fixed charges. But this was not the full extent of the burdens upon the St. Paul. The equipment of the Terre Haute, particularly the freight cars, had to be rebuilt or repaired at heavy expense, or even discarded. During the four years following the acquisition of the Terre Haute by the St. Paul, the latter was forced to make a total expenditure for additions and betterments, less retirements, to the property of the Terre Haute of $3,839,710.33. During the four years prior to its acquisition only $328,591.53 had been so expended. The total amount paid out during the four years following the acquisition and charged to "rent for leased roads" was nearly $4,000,000.

The funds required for capital expenditures as well as to pay maturing obligations of the Terre Haute were advanced by the St. Paul, which was later reimbursed in part by the sale, at heavy discounts, of Terre Haute refunding and improvement bonds, bearing the St. Paul guaranty. The net loss in liquidating these advances was about $700,000.

Our accountants, after a thorough examination of the whole situation, testified that the total financial burden as of June 30, 1925, which had fallen upon the income of the St. Paul as a result of this lease was nearly $11,000,000. This amount includes the unearned rentals paid for the leased lines, the net deficit from the operation of those lines, the net loss suffered in liquidation of advances, and various other cash expenditures by the St. Paul for which it was not reimbursed. In addition, there was a contingent liability due to the guaranty of the principal of the funded debt of over $22,000,000.

Of the former figure over $4,000,000 represents an estimated deficit from the operation of the leased lines. This the St. Paul vigorously disputes. Since the lease the operation of the Terre Haute has been merged with that of the St. Paul and therefore any segregation of revenues and expenses is at best an estimate. The St. Paul apparently tried to keep track of the operation by means of so-called side records, but they were so faulty as to be nearly worthless. During the course of our hearings the St. Paul made three attempts to show the situation, each one successively showing the Terre Haute in a

more favorable light. Coverdale & Colpitts, in their report to the directors, made an estimated segregation of earnings and expenses for 1923 and 1924. This showed deficits in net income of $1,815,000 and $1,319,000, respectively. No credit was given for hauling St. Paul fuel coal. In their estimates the St. Paul officials credit the Terre Haute revenues with full tariff rates on all fuel coal hauled for the St. Paul. They also made very generous allowances to the Terre Haute on commercial coal moving over its rails. In the study made by our accountants the Terre Haute was credited with 5 mills per ton-mile for hauling company fuel. This is the rate at which the St. Paul for many years has computed freight revenue for transportation of materials transported by it and used by it for construction purposes. No useful purpose would be served by going into a detailed discussion of the various studies, for even at the figures most favorable to the St. Paul the Terre Haute was operated at a considerable loss at first and imposed additional burdens on the St. Paul at a critical period. Its position has steadily been growing better.

Conceding that Byram was right in his judgment that the St. Paul needed a coal road such as the Terre Haute and that his judgment has been vindicated by the recent results, it is obvious that the terms upon which the property was acquired were improvident and to that extent adversely affected the financial condition of the St. Paul. He justifies the terms of the acquisition in part upon the ground that the par amount of the securities guaranteed by the St. Paul was less than the value for rate-making purposes found by us as of June 30, 1916, which was $20,151,223, *Chicago, Terre Haute & Southeastern Ry. Co.*, 97 I. C. C. 535 (June 19, 1925). Very little had been expended in additions and betterments between valuation date and the date of the lease. Byram also relies upon the fact that interest payments guaranteed as of July 1, 1921, were slightly less than the amount fixed as compensation for the use of the Terre Haute properties during Federal control. In addition the St. Paul has to pay taxes on the property amounting to over $235,000 annually.

The improvidence of the transaction is principally in the guaranty of principal and interest at 5 per cent of the income bonds. During the 10 years those bonds had been outstanding the interest had been infrequently paid, and had averaged only about 1.25 per cent per annum. Even this could not have been paid if the property had been adequately maintained and a sufficient depreciation reserve set up.

The Terre Haute did not occupy any strategic position which would enable it to secure its own terms. Its physical and financial condition had been alluded to; it was a distress property controlled by a committee of Chicago bankers who wanted to liquidate and who had written the securities off the books of their banks as losses; it had no entrance into Chicago; and Byram testified that it was useful to the St. Paul where it would not have been useful to any other railroad, as all the other roads had their own sources of fuel and further "it was suited to our use and it was not suited to the use of any other property."

As Byram was unable to give any account of the negotiations between himself and the bankers, Chairman Wetmore of the bankers committee was examined. He testified in great detail on various matters concerning the Terre Haute, but it is only necessary to refer to the principal points which seemed to him to justify the terms agreed to by the St. Paul.

He testified that prior to the negotiations with the St. Paul he made every effort to sell the road to other trunk lines. He "could not get any of them to even turn around and look at it. They were not paying any attention to it." But after negotiations with Byram had gone on for some time the presidents of the Burlington and New York Central at different times evinced interest in the Terre Haute and declared they would be interested in it if his negotiations with Byram fell through.

A letter addressed by Wetmore to F. J. Lisman, a New York banker interested in the Terre Haute securities, indicated that the first negotiations between Byram and Wetmore were on the basis of the St. Paul issuing collateral-trust bonds at par in payment for the income bonds of the Terre Haute at 70. A memorandum in Wetmore's files also indicates that he had figured out the result to the security holders of the Terre Haute on that basis. Wetmore strenuously contends that he never agreed to any such proposition, stating that he was seeking the equivalent in cash of 70 or 75 cents on the dollar for the income bonds. He went on to state in his letter to Lisman, which was dated December 27, 1920, that Byram suggested a leasing arrangement so that the St. Paul could operate the property without keeping separate accounts; that after talking the matter over with Byram the prospects of the plan finally agreed upon developed and he, of course, promptly lined up with Byram's ideas, they being so much more advantageous to the income-bond holders. He concluded his letter by stating that he felt the present deal was so much more advantageous that he would hesitate to reopen the question with Byram. Wetmore testified that Byram insisted on a lease, apparently upon the advice of Burton Hanson, then general counsel of the St. Paul, who died before receivership. As stated before, we were unable to secure any light on this subject from the viewpoint of the St. Paul, as Byram could remember nothing. Hanson was dead, and the directors apparently left it to Byram. They could recall little or

nothing of the whole transaction, except that some of them had hazy recollections that at the time there was some discussion as to whether the acquisition should take the form of purchase or lease. The St. Paul's bankers testified that they knew nothing of the proposed acquisition.

During the negotiations Wetmore was well aware of the straitened circumstances of the St. Paul, and finally, before the lease was consummated, he had a long conference with Byram, on December 16, 1920, at which time the St. Paul's situation was fully discussed, with particular reference to the use and profit it could obtain from the Terre Haute. It was finally concluded by Byram's expressing the opinion that the Terre Haute would be of such great importance as a coal supply and as a producer of tonnage that even a receiver of the St. Paul could not afford to default on the lease. Wetmore, and others interested on his side, agreed with this view and the deal was made. The first act of Byram as receiver was to go before the court and secure permission to pay interest on the income bonds so as to obviate a default on the lease.

The banks with which Wetmore was connected had about $500,000 of the income bonds, some of which were sold in 1915, but the majority of them were not sold until a few months prior to the receivership at prices averaging about 62. Wetmore was watching the monthly reports of the St. Paul as closely as anything in his bank, and succeeded in completely liquidating about three months prior to the receivership.

Another phase of the Terre Haute matter is worthy of note. One of the stated purposes of the St. Paul in acquiring the Terre Haute was to increase the earnings of the St. Paul by the development of commercial coal shipments from mines on the Terre Haute to points on the St. Paul. During the first year of the lease the results were very disappointing, so the following policy was decided upon. There are over 50 mines on the Terre Haute controlled by less than 40 operators. In order to develop commercial tonnage the St. Paul contracted for 65 per cent of its estimated fuel requirements. These contracts were apportioned on the basis of the annual coal shipments made by each operator to points on or via the St. Paul beyond Chicago. As a result most of the fuel contracts actually went to three operators. The remainder of the St. Paul's fuel requirements were supplied by monthly coal orders to various operators and even that tonnage was for the most part apportioned on the basis of the commercial coal shipments.

Then, too, as the principal commercial demand was for screenings the St. Paul contracted for lump or egg coal at prices at least 20 cents per ton higher than run-of-mine coal. The contract prices in turn were higher than the market prices as evidenced by the prices paid for the 35 per cent of its requirements under the monthly orders. No consideration was given to the relative efficiency of lump and run of mine. Lump was purchased solely to help the operators and it seems clear that the prices paid under the contracts were higher than were necessary for such a purpose. The prices contracted for during the year beginning on April 1, 1925, were 10 to 15 cents per ton higher than those recommended by the chief purchasing officer. Likewise, there is in the record copy of a letter from the chief operating officer of the St. Paul to the chief traffic officer, expressing the opinion that "we are paying too much of a premium for our coal, and I question if the traffic we get from it would make up the difference."

After this proceeding was instituted the St. Paul made some tests as to relative efficiency of mine-run and lump coal. These indicated that it takes some 10 per cent more mine-run than lump to produce 1,000 gross-ton miles, and the St. Paul people figure that with a differential of 20 cents per ton they break even, but the differential appears to have been in many instances greater than 20 cents, ranging as high as 40 cents.

It is significant that roads like the North Western, Rock Island, Chicago & Eastern Illinois, and Chicago Great Western use mine-run coal for 91 to 98 per cent of their total requirements.

There is also of record a report made by the Engineering Experiment Station at the University of Illinois, showing comparative tests of the use of six sizes of Illinois coal by a mikado locomotive in which the conclusion is expressed that the test results offer no support for the popular belief in the superiority of lump coal over mine run.

The carrier in its brief says that the fundamental principle of patronizing preferentially, in the purchase of company material, industries that favor a railway with their freight shipments is, and always has been, observed at all times by all railroads. "It is a reciprocal business principle, not only of railroads but of all other industries as well." However that may be, we think that the record shows that in a desperate effort to justify the acquisition of the Terre Haute by increasing commercial coal shipments the St. Paul has come perilously near to granting undue concessions to a few large operators on the Terre Haute. It is obvious that in pursuing such a policy price and quality can quickly become secondary considerations as contracts for purchases are traded for revenue business and may even lead to violations of the Elkins Act.

ACQUISITION OF CHICAGO, MILWAUKEE & GARY

The Chicago, Milwaukee & Gary, through its predecessor company, was projected as an outer belt line around the Chicago district from Milwaukee, Wis., through Rockford, Kirkland, Aurora, and Joliet, Ill., to Gary, Ind. Only two portions were built, one between Rockford and Aurora and the other between Joliet and Delmar, Ill., where connection is made with the Terre Haute. Trackage over the Elgin, Joliet & Eastern between Aurora and Joliet, 22.4 miles, was secured to connect the two constructed portions. This latter company promptly rendered its budding competitor impotent by restricting the traffic that the Gary could handle over the trackage so that it excluded business to and from plants of the United States Steel Corporation, which controls the Elgin, Joliet & Eastern, and traffic to points on that line and its connections east of the Indiana-Illinois State line. As the Elgin, Joliet & Eastern connects with all eastern trunk lines in the Chicago district the original purpose of the Gary as a belt line was effectually destroyed and for years it was operated at a large loss with very little traffic. The total length of line operated is about 140 miles.

Byram stated the situation correctly in a letter dated November 9, 1921, to Percy Rockefeller, who, although not a director at that time, was active in St. Paul affairs. Byram stated:

> I saw Mr. Pryor yesterday and he informed me that the I. C. C. already had given them a permit to build the section of the lines they need to get away from the E. J. & E. and I told him I thought in that situation it would be advisable for the Gary Company to proceed vigorously on the plans for the construction of the line in case they were unable to negotiate with the E. J. & E. for a satisfactory contract to continue the use of the line. In other words the property is worth nothing as long as that contract is in existence either to its owners or to anyone else, and I have felt that the bondholders could very well afford to build these 20 miles of line in order to salvage the rest of their property.
>
> I hope you will agree with this view of the case and Mr. Pryor probably will talk with you about it, and I hope to have an opportunity to discuss the subject with you in New York next week.

Nevertheless, within a short time thereafter the St. Paul agreed to take over this property, and on January 14, 1922, Byram appeared before division 4 to justify the proposed acquisition. Control of *C., M. & G. Ry. by C., M. & St. P. Ry. Co.*, 71 I. C. C. 124.

The St. Paul in exchange for the stock and bonds of the Gary which were controlled by the St Louis Union Trust Company of St. Louis, Mo., as manager of a syndicate, agreed to guarantee principal and interest at 5 per cent from January 1, 1924, upon $3,000,000 of the Gary's first-mortgage bonds, which has not received interest. The St. Paul received $2,700,000 of the bonds and $1,000,000 of capital stock without other consideration than the above guaranty.

The St. Paul has used the Gary principally to handle coal from the Terre Haute, but that has proven relatively unprofitable, so much so that as late as June 25, 1925, the general superintendent of the St. Paul reported to the general manager that unless the restriction between Joliet and Aurora was removed operation of the Gary ought to be discontinued. This trackage-right contract expires in 1930, but can be indefinitely carried on until canceled by either party on six months' notice.

The St. Paul secures a collateral benefit from control of the Gary in that it receives about $400,000 gross revenues annually on business originating at industries served by the Gary at Rockford.

Undoubtedly the Gary was another drain upon the St. Paul which was incurred at a most inopportune time. When the Terre Haute and Gary were acquired the St. Paul was failing to earn its fixed charges by a large margin. Coverdale & Colpitts estimated in their report to the directors that the total loss after interest, resulting from the operation of the Gary in the three years following its acquisition on January 1, 1922, was $930,000; and $5,700,000 would be required for construction to utilize it fully. Byram has tried to interest the Pennsylvania and New York Central in the Gary, but with no result. Even the latest figures furnished by the carrier itself shows that the deficit after interest for the period January 1, 1922, to June 30, 1925, was nearly $1,000,000.

As stated before, the control was acquired from the St. Louis Trust Company. S. B. Pryor, referred to in Byram's letter above, was formerly a director of the trust company, which for at least 10 years had tried to dispose of the property. Pryor was a close business associate of Percy Rockefeller, and undertook to sell the Gary for a 10 per cent commission. During the negotiations Pryor found that another was on the same mission, so they joined forces and agreed to split the commission. Rockefeller took a particular interest in getting Byram and Pryor together, and after the acquisition Pryor received as his share of the commission $150,000 of the 5 per cent bonds, with the guaranty of the St. Paul. These bonds were immediately contributed by Pryor to the Owenoke Corporation, a personal investment corporation of Rockefeller, Pryor, and another.

Rockefeller denied that he attempted to influence Byram. He testified that he acted merely as a channel of communication between Byram and Pryor, and that he had no knowledge of the fact that Pryor was to receive a commission. But the net result of the

transaction was that Rockefeller, a former member of the board, became the owner of an undivided third interest in $150,000 of the Gary bonds received by Pryor for putting the deal through.

In addition, after the acquisition Byram made Rockefeller a member of the board of the Gary so that he could receive free transportation, including a general Pullman pass, on the theory, as Rockefeller expresses it, that "one never gets all one wants." John D. Ryan, too, was made a member of the Gary's board by Byram so that he could receive free transportation. As a result he may ride over the St. Paul and other northwestern roads in a private car without cost to him. Neither Rockefeller nor Ryan up to the time of our hearings had ever attended a meeting of the Gary board. Aside from this phase of the matter there is the much more serious question of their resigning from the board of the St. Paul admittedly on account of the provisions of section 10 of the Clayton Act and almost immediately becoming members of the board of a subsidiary controlled by the St. Paul. It would not seem possible that the spirit of section 10, if indeed the letter, could be so easily circumvented.

Examination of the directors discloses that they took little or no interest in the Gary transaction, apparently assuming that it would fit into the Terre Haute.

On June 11, 1926, we found that the final value for rate-making purposes of the property of the Gary owned and used for common-carrier purposes was $2,789,475, as of June 30, 1915.

AUTHORIZATION BY COMMISSION

Acquisition of control by the St. Paul of the Terre Haute and also of the Gary was authorized by division 4 in *Acquisition of C., T. H. & S. En. Ry. by C., M. & St. P. Ry.*, 70 I. C. C. 20, and *Control of C., M. & G. Ry. by C., M. & St. P. Ry.*, 71 I. C. C. 124. In neither case should the acquisition have been approved upon the terms and conditions proposed. No opposition was offered and the records were, therefore ex parte. Both cases illustrate the desirability of independent inquiry and investigation by the commission, so far as practicable, in uncontested matters of this character. They further illustrate the process by which the commission may, and we trust does, gain in knowledge and wisdom through experience.

EVENTS LEADING UP TO RECEIVERSHIP

As early as 1921, Charles E. Mitchell, president of the National City Bank and the National City Company, the latter one of the reorganization managers, became skeptical of the future of the St.

Paul. He took the junior bonds off the daily lists which went to the salesmen, and when he became president of the bank in the same year he recommended that the junior bonds held by the bank be sold. But due to William Rockefeller's stand they were not sold until after his death in 1922. Nevertheless, in 1923 the National City Company published an elaborate brochure on the St. Paul, which, while not definite, would give one the distinct impression that this well-informed organization believed that the St. Paul had "turned the corner." Several of the large insurance companies which had been watching the situation closely sold as many of the junior bonds as the market would absorb.

The St. Paul's requirements for 1923 were met by temporary loans from the bankers aggregating $5,000,000. A further loan of $2,000,000 was made to meet the requirements on January 1, 1924, and then arrangements were made for the sale of $14,000,000 of 10-year 6 per cent bonds secured by $20,000,000 of first-mortgage bonds. It was expected that this would carry the company until 1925. At the time of this financing the officers of the company furnished the bankers with a statement of the expected requirements and income for 1924, but as the year went on it became apparent that the estimates as to income were too optimistic, and the year ended with a deficit of nearly $2,000,000 with an inadequate rate of depreciation charged.

In the summer of 1924, a committee of directors was appointed to consider the problem presented by the maturity of the 1925 bonds. This committee consisted of Byram, Fisher, McRoberts, Geddes, and McHugh. The burden of the work of this committee fell on Fisher, who, as stated before, represented the Harkness interests. He of the five was the only one of the committee representing a substantial interest in the property. Buckner toward the end sat in at many conferences. As stated before, he too was considered a representative of the Harkness interests. McRoberts and McHugh took little part in the work of the committee. The committee formulated some plans for meeting the 1925 maturity and met the bankers in August, 1924. The bankers raised several objections to a possible extension; they questioned whether additional collateral could properly be given; and whether Government loans could be extended and additional Government loans secured. They also stated that there would have to be a down payment, and finally 10 per cent of the bonds would have to be paid in cash. The bankers had in mind the experience of the New Haven in securing a short extension of 4 per cent bonds maturing in 1922. Of the matured bonds 10 per cent was paid in cash; and interest on the balance was raised to 7 per cent. About 10 per cent of the holders refused to extend and were paid in

full with money borrowed from the Government. The bankers stated that to secure any extension it would be necessary to assure the extending bondholder that he would surely get his interest during the extension and his principal at the extended maturity. The committee met the bankers again in December, 1924, when the unfavorable results for the year were apparent. Further objections were raised by the bankers, attention being called to the increase in fixed charges of $800,000 in connection with the Chicago Union Station and the lack of wisdom in exhausting the current assets to meet fixed charges. In the meantime, at the suggestion of Hanauer, a vice president of the St. Paul had been sent to London to secure a list of the holders of the French bonds, as the last opportunity to secure such a list would be when the December, 1924, coupons were presented for payment.

At the December meeting of the special committee and the bankers, the latter suggested that an independent study of the property be made by independent engineers. Coverdale & Colpitts were recommended by the bankers. Some of the members of the committee demurred because the officers were engaged in making a special study and it was thought that as Byram had not been with the property a great while a report prepared under his direction would be more or less an independent survey. However, they decided that as directors they could not take the responsibility of declining to have an independent study made and by any possibility have anything happen to the road without having done so. The appointment of Coverdale & Colpitts was authorized at a meeting of the directors on January 7, 1925, and the resolution recites that the action was taken at the request of the company's bankers. It was at this meeting that the confidential special report of the road's officers was presented to the directors. Ostensibly Coverdale & Colpitts were retained by the railroad; as an actual matter they were working for the bankers, who prepared a questionnaire for them as follows:

1. Can the company be successfully operated and its solvency maintained, assuming (*a*) that the French loan could be renewed at the same rate of interest (*b*) that 6 per cent interest may have to be paid thereon? (*c*) If in case of either *a* or *b*, it will be necessary to pay off 10 per cent of the bonds, who would not renew on any terms? (*d*) If in cases *a*, *b*, or *c*, it will be necessary to pay to all bondholders, pro rata, 10 per cent of the face value in order to induce extension?

2. What will the fixed charges be for 1925 without figuring any increase on French loan? In this connection, the Chicago Union Station Company and any similar situations must be considered.

3. What are the earnings applicable to interest charges after rentals, hire of equipment, taxes, etc., for the year 1924? Is there any item, such as interest on deposit of the proceeds of sale of $14,000,000 bonds last January, which will not appear again?

4. Depreciation charges.

5. What capital requirements for equipment, etc., are necessary or advisable during the next few years?

6. What is the company's cash position now, and what will it be each month up to and including January 15, 1926?

7. What securities has the company available for sale?

8. What are the yearly *cash* requirements of the company for all purposes, and what is the amount, in addition to earnings available *in cash* on account of depreciation funds or otherwise?

9. If the company could increase its gross earnings by $10,000,000, how much net increase should that yield?

10. What is the situation in reference to bad-order cars and motive power?

11. Are the causes responsible for the low net earnings of a temporary character, or are they more or less due to permanently changed conditions? Future opportunities?

12. What effect upon the earnings of the system has the Puget Sound extension had?

13. Are leases profitable?

The report covered more ground than that called for by the above questionnaire. For instance it estimated the earnings of branch lines and properties covered by separate mortgages. It digested the various mortgages in detail and concluded with the statement that "a readjustment of the financial structure of the company is necessary." This of course was a virtual recommendation for receivership. In the meantime counsel for the bankers had "prudently" prepared as early as January the pleadings necessary to institute receivership proceedings.

About the end of February the bankers and some of the large bondholders like the Metropolitan Life Insurance Company were aware of the nature of the adverse report which Coverdale & Colpitts were to make upon the completion of the examination of the property. On March 3, oral report was made to the special committee by Colpitts, but Hanauer, Mitchell, Ecker, and others now knew that a receivership was inevitable.

Prior to this time most of the directors and the board itself had virtually ceased to function. The executive management, of course, was helpless. Only a few knew the real situation. Those included a few of the directors, the bankers, and some of the large bondholders. About the first of 1925 Mitchell definitely reached the conclusion that receivership was inevitable. The theory seemed to be that the financial situation made further progress hopeless and that there was no use of informing the security holders or inviting them to determine for themselves what action, if any, would be taken or attempted.

E. S. Jameson, president of the Globe & Rutgers Fire Insurance Company, representing large amounts of junior bonds, suggested to Hanauer and others the advisability of forming a protective com-

mittee to facilitate the extension of the maturing bonds, but such an effort was discouraged.

As stated before, by the end of February, the bankers were aware of what Coverdale & Colpitts would report. Hanauer took charge of the situation and the directors individually and as a board ceased to exercise any real influence in the situation. It was left to them only to approve formally on March 17 institution of the receivership proceedings. Hanauer first asked the president of the Mutual Life Insurance Company to serve as chairman of the bondholders' committee. He declined and suggested F. H. Ecker, vice president of the Metropolitan Life Insurance Company. Fisher was asked to become chairman of the preferred stockholders' committee, but he wanted to go on the bondholders' committee. The Harkness family had large holdings of bonds as well as of stock. He resigned from the board just prior to receivership. Buckner was then asked to become chairman of the preferred stockholders' committee, and Geddes was asked by Hanauer also to become chairman of the common-stock holders' committee. The chairmen of these two stockholders' committees represented the Harkness holdings. The other members of the committee represented no substantial stock interest. They were selected with the idea that the prestige of their names and positions would insure the success of the committees in securing deposits of stock. With the exception of Hanauer and Mitchell the members of the bondholders' committee represented large bondholders. Hanauer also inquired of Potter, who had retired on February 20, 1925, from this commission, as to his availability to act as receiver. Counsel for the bankers conferred with New York counsel for the railroad and revised and perfected the drafts of receivership papers. The bankers' counsel communicated with associate counsel in Chicago so that the latter might ascertain if a district judge would be available on a certain date and to advise him as to the wishes of the company and the bankers as to the personnel of the receivers. The railroad people in Chicago secured as a friendly creditor a coal operator with whom it had had large dealings and the bill in equity was filed March 18. The protective committees had been completely organized on March 16 and 17.

Counsel for the bankers say that the directors would have been derelict in their duty if they had failed to do what they did. The fact is that outside of the Harkness representatives they did nothing, except to take action on March 17, as indicated before. They had no substantial interest in the property, and did not represent any such interest except that of Harkness. For months prior to the receivership they were impotent. It was an ideal situation for the bankers to control. This they promptly did, arranged all the details, framed up the committees favorably to themselves, put themselves on the bondholders' protective committee and constituted themselves reorganization managers. The details of the reorganization plan are fully set forth in our report in Finance Docket No. 6240, *Chicago, Milwaukee & St. Paul Reorganization*, 131 I. C. C. 673.

GENERAL CONCLUSIONS

The primary purpose of an investigation of this character is to ascertain and make known how and why the carrier failed in its appointed task. The ultimate purpose is to draw lessons from its experience whereby it may be determined what courses should be shunned by other carriers and what, if any, further public safeguards are necessary or desirable in this connection. With this purpose in mind we shall now proceed to consider the various topics which have been discussed in the report.

1. *The Puget Sound extension.*—The construction of this extension was, perhaps, the chief of the causes which finally culminated in the receivership of the St. Paul. So far as the future is concerned, however, the interstate commerce act has since 1920 contained, in paragraphs (18), (19), and (20) of section 1, provisions designed to safeguard the country against ill-advised railroad construction. While these provisions are not a perfect safeguard, inasmuch as they are dependent upon the wisdom of this commission and its ability to obtain the necessary facts, they do ensure preliminary public consideration of a construction project and a much more careful examination into its merits than was had in the case of the Puget Sound extension.

2. *Financing and earnings.*—Against an impairment of the financial structure of a railroad company by a disproportionate issue of bonds with ill-arranged maturities such as occurred in the case of the St. Paul, provisions of the interstate commerce act now furnish a similar safeguard, so far as one can be provided by public regulation. These are the provisions of section 20a which require all railroad security issues to be approved and authorized by this commission. The same may be said of the policy which the St. Paul pursued in according certain New York bankers a monopoly of all of its financial operations. The problem involved in such a policy is one which we have recognized and which we are endeavoring to meet in the light of experience and careful observation by such steps as we may be persuaded will produce the results contemplated by the law. One step has already been taken in the requirement that issues of equipment-trust certificates be sold with the aid of competitive bidding. In our judgment the managing staff of a railroad should, wherever possible, include an officer with sufficient financial

skill and experience to be able not only to guide the railroad in shaping its capital structure to the best advantage but also to represent it competently and effectively in its negotiations with bankers.

3. *The board of directors.*—Under present conditions, especially when the stock of a railroad company is held, as it usually is, by a very large number of comparatively small holders, the tendency is clearly towards a self-perpetuating board of directors. Many of the men selected in this way have no substantial financial interest in the property which they are directing, and not infrequently they appear to have little appreciation of the great responsibility of their office and of the degree of trusteeship which they owe to the stockholders. This investigation has shown that many of the St. Paul directors knew comparatively little about the affairs of their company, that many of them did not even attend the meetings of the board with any regularity, and that some of them were affiliated with interests which conflicted in one way or another with the interests of the railroad company.

One phase of the problem thus presented has been met in some degree by the Clayton Antitrust Act. Section 10 of that act which became effective January 1, 1921, provides in part as follows:

> That after two years from the approval of this Act no common carrier engaged in commerce shall have any dealings in securities, supplies or other articles of commerce, or shall make or have any contracts for construction or maintenance of any kind, to the amount of more than $50,000, in the aggregate, in any one year, with another corporation, firm, partnership or association when the said common carrier shall have upon its board of directors or as its president, manager or as its purchasing or selling officer, or agent in the particular transaction, any person who is at the same time a director, manager, or purchasing or selling officer of, or who has any substantial interest in, such other corporation, firm, partnership or association, unless and except such purchases shall be made from, or such dealings shall be with, the bidder whose bid is the most favorable to such common carrier, to be ascertained by competitive bidding under regulations to be prescribed by rule or otherwise by the Interstate Commerce Commission.

The purpose of this provision is sufficiently clear without further explanation. It resulted, in the case of the St. Paul, in eliminating Ryan and Percy Rockefeller from the directorate.

The problem, however, extends considerably beyond this particular phase. It is akin to that presented by the election of public officials by the people and is of equal, and in some respects even greater, difficulty. Here the electorate is the body of stockholders. Can some means be found, better than those which now exist, of impressing upon the stockholders the importance of their duty, and also of supplying them with the information necessary to an intelligent judgment and with adequate opportunity to act upon such judgment? We confess that we have no definite answer to that question. Certain provisions in State laws which permit minority representation upon the boards seem desirable and worthy of general adoption. We are also inclined to believe that it would be well if it were made a requirement that each stockholder of an operating carrier be furnished every year by the corporation with a printed statement setting forth succinctly the name and the business affiliations of each director whose election or reelection is proposed, and for whom stockholders' proxies will be voted, and the amount of stock owned by him. The matter is one which obviously requires a more thorough discussion than it has received in connection with this investigation.

The state of affairs shown by this record is unfortunately neither new nor rare. Inertia upon the part of stockholders and inattention and irresponsibility on the part of at least some directors, have usually attended railroad insolvencies in the past. Reliance is generally placed upon someone else; stockholders rely upon directors to choose managers, directors having chosen managers rely upon them, and there the matter ends. Theoretically stockholders are supposed to check up their directors and directors are supposed to check up their managers. In the present case few or none such checks seem to have been applied. Stockholders seem to have been indifferent to their rights and directors to their duties. Whether this is a situation which can be remedied by legislation is doubtful. It is doubtful because men can not in general be compelled by law to exercise their rights, nor can they be forced by law to more than a narrow and technical compliance with their duties when those duties lie more in the domain of conscience than in that of prescribed or statutory actions. No machinery of a legal kind has yet been devised which will effectively control these things. The only force fully competent to influence them is that of public opinion. Improvement comes, if it comes at all, as a result of a more enlightened and sensitive public conscience tightening up ethical standards and quickening in men the sense of responsibility in the performance of trusteeship for other people.

The main value of a proceeding such as is here represented is that by bringing the facts of failure to public judgment in a concrete and definite way, the public conscience is, at least to some extent, aroused, and stimulated to a more exacting and effective control of business ethics. In this, rather than in attempts to reach the desired result by imposition of additional legislative rules and penalties, seems to lie the main hope of improvement.

4. *The effect of the freight-rate structure on the situation.*—The law with respect to the regulation of freight rates is, in our opinion, ample and adequate for the protection of both shippers and carriers. Whether the commission has administered that law wisely and justly

others must decide. Our published reports contain the reasons for our decisions.

5. *Electrification.*—The evidence indicates that the St. Paul entered into contracts with respect to the supply of electric power for portions of its lines which were not altogether wise and prudent. The decree of foreclosure gives to any purchaser the right to disavow within one year any contract, not fully performed, made or assumed by the St. Paul or any predecessor company. This right will inure in the new company. In our judgment the management of that company should give careful consideration to these contracts with a view to the modification of such features as may be deemed unsatisfactory.

6. *Acquisition of the Terre Haute and Gary.*—The interstate commerce act now contains, in paragraph (2) of section 5, a safeguard against unwise and improvident acquisitions of control of one carrier by another, and this safeguard existed when control of these properties was acquired by the St. Paul. We have already commented upon this situation and have pointed out the lessons it teaches.

7. *The receivership and reorganization.*—Under this head we have a situation which is fundamentally unsatisfactory and requires reform. In the case of the St. Paul a plan of reorganization was prepared, was submitted to security holders, and after many months of negotiation approved by them; it was presented to the court having jurisdiction and approved by that court, and only after all these steps had been taken was it presented to us for approval of the securities proposed to be issued thereunder, according to the law. The effect was that we were confronted with two alternatives. The first was to approve in toto the securities proposed to be issued; the other, to reject them in toto, for in the nature of the case for us to require any real modification of the plan in this respect would void all the agreements made between security holders and compel the negotiation of new agreements with the likelihood of considerable additional delay and expense in taking the railroad out of receivership and restoring it to control of those interested therein. It seemed to a majority of the commission that the first alternative better served the major public interest, despite the obvious shortcomings of the structure represented by the securities for which application was made. We should not, however, have been forced to make a choice of this sort. It is not our business to devise reorganization plans for insolvent carriers any more than it is our business to initiate financial structures for solvent carriers. These functions belong to management and not to regulation, and both the letter and the spirit of the law require that the distinction between regulation and management shall at all times be strictly

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observed. It is, however, our duty to see that securities issued by carriers conform to the requirements of the statute whether they are issued in the reorganization of an insolvent carrier or to provide necessary capital for a solvent carrier. Both the letter and the spirit of the statute require that securities issued shall as fully as may be possible in the circumstances of each case, conform to accepted principles of sound finance, so that railroad capital shall be obtained on terms as economical as prevailing conditions in the investment market will permit. This is the prime object of the law's provisions in section 20a.

It is therefore deemed desirable that hereafter in each case of reorganization application by the new company be made at an early stage for exercise of our authority under section 20a to approve issuance of the securities or assumption of the liability contemplated by the reorganization, and that the plan be not declared operative until such approval has been had.

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