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CENTER SAYS STATE SHOULD BUY OUT PRIVATE SHAREHOLDERS IN N.C. RAILROAD

The state should buy out the private shareholders in the North Carolina Railroad to maximize the public benefit from the 317-mile rail line, the N.C. Center for Public Policy Research says in a report released today. The Center says the state, which now owns 75 percent of the railroad running from Morehead City to Charlotte, should use revenue from a proposed lease with Norfolk Southern Corporation to accomplish the buyout.

"Few people realize that North Carolina citizens own three-quarters of a rail line that cuts through prime downtown real estate across North Carolina," says Mike McLaughlin, editor of *North Carolina Insight*, the Center's magazine. "The railroad is a unique and valuable asset. But its awkward ownership structure prevents the state from using the railroad to its full economic development potential, and it keeps the public business behind closed doors."

The Center takes a comprehensive look at the North Carolina Railroad (NCRR) -- constructed before the Civil War with a huge investment of public and private funds -- in the latest edition of *Insight*. The rail line links such Piedmont cities as Charlotte, Concord, Salisbury, High Point, and Greensboro. To the east, it connects Raleigh, Goldsboro, Kinston, and New Bern. It provides the sole rail service to the Global TransPark facility in Kinston and to the state port in Morehead City. The TransPark is the state's planned rail, highway, and air cargo hub.

A 1979 report by the N.C. Department of Transportation states, "[W]e know of no other state in the union that owns (controls) a corridor as significant...." But for most of this century, the rail line has done little more than collect rent. A 99-year lease expired at the end of 1994. For months before it expired, the railroad's board of directors engaged in secret negotiations with Norfolk Southern Corporation over the terms of a new agreement. The railroad announced a tentative agreement on several key issues in November 1994, and in August 1995 the NCRR board approved the new agreement. The agreement goes before the Council of State -- the governor and the nine other officials elected statewide -- in October. It has yet to be approved, however, by the NCRR stockholders.

Because of federal Securities and Exchange Commission requirements, not even the governor was privy to the discussion that led to the new agreement. Yet the new lease governs how the NCRR will be operated, and thus limits the state's options for the rail line's use. In addition, the interests of the private shareholders and those of the state may conflict. The state would like to keep freight rates low and rail lines open for economic development purposes. This goal would seem to dictate a lower lease rate. But private shareholders want maximum return on their investment, which dictates a higher lease rate.

The state also has an interest in using the rail lines for public transportation, which could conflict with freight traffic. Two state-subsidized passenger trains -- the *Amtrak Carolinian* and the *Piedmont* -- currently operate on NCRR tracks between Charlotte and Raleigh. In addition, the stretch between Charlotte and Raleigh is part of one of five corridors designated nationally for high-speed rail. Tentative plans for commuter rail service in the Triangle also depend upon use of NCRR tracks.

The conflict between the state and private shareholders -- particularly the state's need to keep lease rates low for economic development purposes -- has led private shareholders to charge that the state negotiated a sweetheart deal with Norfolk Southern at their expense. "All of the shareholders, I am certain, are in favor of continued economic development of North Carolina," writes Luther Hodges, Jr. in a letter to fellow private shareholders opposing the proposed new lease. "It is unfair, however, for this economic development to be at the expense of the private shareholders who made an investment in anticipation of a properly negotiated lease. The state has, in fact, taken advantage of the minority shareholders." Hodges is the son of former N.C. Governor Luther Hodges and is a former bank executive in Charlotte.

NCRR Board President John McNair, III says the railroad negotiated the highest lease rate it could. "If they've [the private shareholders] got a buyer who will pay more, I'd love to hear about it," McNair says. Four separate lawsuits have been filed to block the lease. And a group of private shareholders has mounted a boycott of the shareholders meeting at which the agreement would be ratified, possibly in December.

"The secrecy around the negotiations has made it hard to refute the charges that the private shareholders got railroaded," says McLaughlin. "Yet the NCRR board is bound by its fiduciary duty to negotiate the best deal it can for the corporation. What is best for the corporation may not be what is best for the state."

The state owns the railroad because the state's initial investment made the railroad possible. During the 1850s, the legislature appropriated $4.35 million of the $5.8 million required to build what is now the NCRR. The rest was raised from private sources. The NCRR's first president was John Motley Morehead, who was governor from 1841-45. He proclaimed that the new railroad would be "The Tree of Life to North Carolina." Ironically, his great, great grandson, Walker Rucker, is a leader of the effort to block the new lease through a boycott of the shareholders meeting.

Initially, the NCRR ran from Charlotte to Goldsboro. A sister railroad, the Atlantic and North Carolina Railroad, was constructed between Goldsboro and Morehead City. The two rail lines merged through an exchange of stock in 1989. Freight traffic is light on the eastern leg of the railroad. One appraiser told a legislative study committee in 1982 that an operator might do just as well to close the line and sell it for scrap metal. But the line is important to the state because it serves underdeveloped eastern North Carolina, including the Global TransPark at Kinston and the state port at Morehead City.

Historically, there has been conflict over the railroad's ownership structure. In 1895, when the NCRR was signed over to Southern Railway Co. through a 100-year lease, the deal was labeled "The Crime of a Century" on the front page of *The News & Observer* of Raleigh. That lease in 1994 generated $674,277 -- less than 1 percent of the value of the railroad's assets. The low return generated some discussion in the mid-1980s that the state should sell its shares and invest the proceeds.

The new lease would produce a substantially higher return for both the state and the minority shareholders -- $8 million a year with annual adjustments to approximate inflation, plus a one-time payment of $5 million. The lease would run 30 years, with Norfolk Southern holding an option for a 20-year renewal. The NCRR also would be restructured as a real estate investment trust (REIT), freeing it from state and federal income taxes. But given the disgruntled private shareholders, there are no guarantees that the deal can be consummated.

There also are no assurances that the state's interests in economic development and public transportation have been protected through the secretly negotiated lease agreement. For these reasons, the Center makes the following recommendations:

(1) The state should *not* sell its stock in the North Carolina Railroad. The tracks are the backbone of the state's east-west rail freight system and they provide the primary rail link between the state port at Morehead City and the Global TransPark in Kinston. Of the state's 19 counties that lost population during the 1980s, 15 were in eastern North Carolina, and the TransPark and port are key to eastern economic development hopes. The tracks also are critical to passenger service between Charlotte and Raleigh and to proposed commuter service in the Research Triangle area. In addition, they represent a key link for futuristic high-speed rail.

(2) The North Carolina Railroad Co. Board of directors should buy out the private shareholders in the company so the state can take maximum advantage of this valuable state asset in the formation of transportation and economic development policy. The board should use the revenue from the rail lease to accomplish the purchase -- without spending state tax money -- through the issuance of revenue bonds or a similar financing vehicle. The governor appoints 10 of the 15 members of the board of directors, so he needs to take the lead in moving the buyout further down the tracks, says the Center.

Two North Carolina governors -- former Gov. Jim Martin (1985-1993) and Gov. Jim Hunt (1976-85, 1993-present), the Council of State, and a study committee headed by C.C. Cameron, retired chairman of First Union Corporation, all have recommended that the state buy out the private shareholders.

The Center says there are at least four advantages to full state ownership of the NCRR: (1) The state could have full control over the future of the rail corridor and could negotiate to keep vital but less profitable rail links open in eastern North Carolina. (2) Any future lease negotiations could be more open to public scrutiny and debate. (3) The state could negotiate lower lease rates if necessary as a catalyst for economic development or press for a higher rate to subsidize public transportation. (4) The terms of any lease could include accommodation of passenger service.

A primary disadvantage is cost. It would take a minimum of $25 million and perhaps as much as $50 million to buy out the private shares. But the renegotiated lease provides a revenue stream that could be used to finance a buyout without using state tax dollars. Thus, the Center believes the best course for the railroad is to ratify the new lease agreement and use the revenue to buy out the private shareholders.

The N.C. Center for Public Policy Research is an independent, nonpartisan, nonprofit corporation created to study public policy issues facing North Carolina and evaluate state government programs. The Center receives general operating support from the Z. Smith Reynolds and Mary Reynolds Babcock Foundations, 10 other foundations, 156 corporate contributors, and some 900 individual and organizational members.

In addition to publishing *North Carolina Insight* magazine, the Center has conducted studies on how the University of North Carolina system evaluates and rewards excellent teaching, how the state regulates pesticides, and the health of minority citizens. It also publishes a citizens' guide to the legislature, rankings of the effectiveness of all 170 legislators, and rankings of the most influential lobbyists.

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Copies of the September issue of *Insight* magazine containing the Center's research on the North Carolina Railroad can be obtained from the Center for $8.00 plus $3.50 for postage, handling, and taxes. To order, call (919) 832-2839, fax to (919) 832-2847, or write the N.C. Center for Public Policy Research at P.O. Box 430, Raleigh, N.C. 27602.

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