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Norfolk Southern, Cincinnati Southern Railway board started far apart on $1.6B deal

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Norfolk Southern

Norfolk Southern Corp. is trying to buy the Cincinnati Southern Railway.

When trustees overseeing the Cincinnati Southern Railway and representatives of Norfolk Southern began negotiating a new lease at the end of 2020, they had vastly different ideas of what the Cincinnati-to-Chattanooga railroad was worth, both in terms of lease payments and an outright sale.

The *Business Courier* has obtained letters between Norfolk Southern and the railway board and its representatives over an 18-month period detailing their offers and counteroffers, a process that resulted in the trustees agreeing to sell the railroad for $1.6 billion.

The railway board, which was appointed by then-Mayor John Cranley, opened negotiations in late 2020 trying to secure a new lease term at a much higher annual payment – $65 million per year, increasing annually based on the consumer price index for urban wage earners, a slightly more generous escalator than is used under the present lease.

The city also proposed it receive a portion of non-freight rail revenue, whether it came from passenger or commuter operations and "longitudinal occupancies on the right of way," meaning money from fiber optics or other installations beneath it.

The city currently gets about $25 million per year. Under the proposed plan to invest the $1.6 billion and deliver 5.5% annual returns, the sale proceeds will earn $88 million per year, with the city receiving $56 million and the remainder reinvested. The returns would be used by the city to fix, maintain or replace its existing infrastructure, including streets, bridges, buildings, parks, recreation facilities and other infrastructure. Mayor Aftab Pureval said the city intends to grow the trust fund.

"We believe that the economic terms in the attached term sheet reflect a fair financial outcome … while ensuring continued, long-term access to the Cincinnati Southern for Norfolk Southern," wrote Paul Muething, the attorney who leads the railway board, on Dec. 30, 2020.

Even as negotiations continued and an outright sale was discussed, the railway board never reduced the amount it for which it was willing to lease the railroad.

More than six months later on July 12, 2021, Norfolk Southern Vice President Michael McClellan responded with an offer to buy the railroad for $915 million, which included an $865 million lump sum, plus a one-time $50 million payment within four years.

Norfolk Southern also offered alternative sale terms – a 50-year, $865 million note, with the railroad paying interest-only for 50 years at a 3.5% coupon rate that would escalate each year. At the end, the railroad would pay the $865 million in a balloon payment. Norfolk Southern would pay $30.3 million in the first year of that scenario.

Under that structure and depending on how inflation escalated the payments, Norfolk Southern likely would pay more than $2.5 billion for the railroad by the end of the 50-year term, but inflation would eat away at the value of the balloon payment, which would not arrive for a half century.

That proposal "would provide an annuity similar to the type of lease annuity that the CSR currently receives," McClellan's letter said. "However, the interest payment would be 30% higher than the current lease payment. [T]hese proposals, in departing from the current leasing framework, provide the CSR an additional benefit – a hedge against any sort of rail industry structural decline."

Norfolk Southern said such threats could include reregulation, autonomous trucking and 3D printing.

The railroad came up with its numbers by looking at the real estate's value as well as how much it would cost Norfolk Southern to move freight on alternative routes if it lost access to the Cincinnati Southern Railway, McClellan wrote.

But the railway board was not impressed.

"The compensation offered is grossly inadequate," wrote Robert Dovenberg, managing director of BMO Capital Markets, which represented the city railroad board in negotiations. His letter, dated July 30, 2021, asked Norfolk Southern to respond by Aug. 16 to the board's initial $65 million lease proposal. The railway board did not propose a sale price.

Norfolk Southern responded, proposing to lease the railroad starting at about $29 million per year, while also giving the trustees the right to sell the railroad at any time over the next 40 years for

$915 million. Both figures would be adjusted for inflation annually by something called the implicit price deflator.

It's a figure that measures the effects of inflation on the current year's gross national product. It's different from the consumer price index measure of inflation in that it incorporates all of the goods produced by an economy. It is an economic indicator developed by the U.S. Department of Commerce's Bureau of Economic Analysis.

Over the past 10 years, the consumer price index for all urban wage earners and clerical workers has risen 29%, according to the Federal Reserve Bank of St. Louis, while the implicit price deflator has risen 28%.

If the railway board agreed to sell within a certain period of time, Norfolk Southern also would pay a transaction fee, totaling $50 million if the sale occurred by the end of 2022, $40 million if it happened by the end of 2023 and $30 million if it occurred by the end of 2024.

"If the trustees come to recognize the benefits of a sale, then there is a path to do that," McClellan wrote. "One key benefit of a sale is that the city would be positioned to invest the proceeds in a portfolio that could be both well diversified and better adapted to the city's risk tolerances instead of being tied solely to one company in one industry."

But the railway board still said no. In an Oct. 21, 2021 letter, the trustees proposed selling the railroad for $2 billion, with the price increasing using the CPI for urban wage earners on Jan. 1, 2023 and every year after until the deal closed. It also continued to offer a 40-year lease renewal starting at $65 million.

The railway countered again on Nov. 23, 2021, proposing a just over $1 billion sale price or a $29 million starting lease payment. On Jan. 14, the city rejected it and countered with the same $65 million starting lease figure it had proposed all along, as well as a $1.8 billion sale price, with a transaction bonus of $30 million to $50 million, depending on what year the sale closed.

On April 19, Norfolk Southern made the offer at the dollar amount the city via the railway board eventually would accept in November: $1.55 billion, with a $50 million transaction fee once

Cincinnati voters approved the sale. Separately, it proposed a starting $35.16 million rent payment.

The deal also includes 21 miles of right-of-way at the east end of the Peavine rail line that runs between Cincinnati and Portsmouth that the state can use to build a multi-use trail.

“Both the lease amount and the purchase price have been increased significantly,” McClellan wrote. “[T]he proposal related to extension of the lease still would be operative as the fall back position should the transaction fail to receive the necessary approvals.”

While the city and Norfolk Southern were able to agree on a sale price, the correspondence show a wide gap between them on the starting lease price – $65 million for the city, $35.16 million for the railroad. If the sale fails, the negotiation is likely headed for arbitrators and a convoluted process to determine what the final lease price would be.

In order for the sale to go through, the Ohio General Assembly must approve legislation, city voters must agree to the sale and federal regulators must give their OK. The deal has faced early turbulence in the General Assembly.

The city completed the 337-mile railroad, which runs to Chattanooga, Tenn., in 1880 as an economic development tool and way to provide a key north-south rail line. It is used to ship freight today. The railroad is operated under a lease agreement with Norfolk Southern, which leases the railroad from the city.

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