New Railways Take the Fast Track to Solvency

By Kenji Togii

There is a famous line by Byron about waking up one morning and finding himself famous. The former Japanese National Railways (JNR) was heavily burdened with massive debts before it was split up and privatized. Now it is a profitable company. One might say it woke up one year and found itself solvent.

Quite frankly, nobody expected the new Japan Railways Group (JR) companies to be doing this well, and JR executives are visibly ebullient about this turn of events. With this revival occurring at the same time that much of Japanese industry was reeling from the yen's appreciation, it is almost as though the liquidity glut had buoyed JR's fortunes.

One of the JR companies even looked as though it was going to be six or seven times more profitable than originally expected, and management quickly put their heads together to see if some way could not be found to look a little less profitable. "If all this money goes on the books as profit, the tax office will want half of it. And if the choice is between paying taxes and investing, it's better to find a productive investment." This was a happy problem—and one that nobody at the time of privatization had expected any of the JR companies to be having at this stage.

Decline of JNR

JNR went into debt in 1964, the year the Tokyo Olympic Games were held. This was a time, it was said, when the building of expressways, the increase in road traffic and the greater convenience of air travel had made mass rail transport obsolete. Inaugurated that same year, the Tokaido *shinkansen* bullet train was roundly derided by the public and the media alike. "Railroads are already old hat," the critics claimed, "and the *shinkansen* is going to go down with the battleship Yamato and the Great Wall of China as one of the three worst ideas of all time."

The rapid changes in society had a devastating effect on JNR management, and the JNR went into rapid decline. Fare hikes—instituted almost annually in a desperate bid to get back on a sound financial footing—backfired on JNR, alienating travelers and driving the railways' balance sheet deeper into the red. With problems including snowballing costs of debt servicing, the mounting pension burden, the construction costs for the Seto Ohashi bridge between Honshu and Shikoku which opened May 10 and the Seikan undersea tunnel from Honshu to Hokkaido which opened a month earlier, the JNR wound up ¥37.2 trillion in debt. This is more than the national debt of Brazil and Mexico combined, and it is equivalent to two-thirds of Japan's current national budget. JNR was borrowing money just to pay back its debts, and a vicious circle was created in which it looked like it would not even be able to pay the interest.

JR Planning for Fiscal 1988 (¥ billion)

	Hokkaido Railway	East Japan Railway	Central Japan Railway	West Japan Railway	Shikoku Railway	Kyushu Railway	Japan Freight Railway	Total
Operating revenues	90.9 (88.0)	1,535.3 (1,472.7)	867.7 (825.7)	778.4 (773.8)	35.5 (31.3)	135.1 (120.0)	171.7 (172.0)	3,614.6 (3,483.5)
Operating expenses	142.2 (141.1)	1,266.6 (1,217.8)	801.8 (797.8)	699.2 (693.9)	49.1 (45.9)	160.7 (148.8)	162.6 (163.6)	3,282.2 (3,208.9)
Nonoperating balance	49.8 (49.2)	−211.8 (−233.4)	−18.2 (−18.1)	−66.0 (−72.6)	15.2 (15.1)	28.3 (28.2)	−5.7 (−6.5)	−208.4 (−238.1)
Operating profits	−1.5 (−3.9)	56.9 (21.5)	47.7 (9.8)	13.2 (7.3)	1.6 (0.5)	2.7 (−0.6)	3.4 (1.9)	124.0 (36.5)
Nonrecurring items	3.8 (4.9)	0.3 (−4.9)	– (–)	0.4 (0.5)	0.1 (–)	1.3 (1.8)	– (–)	5.9 (2.3)
Pretax profit	2.3 (1.0)	57.2 (16.6)	47.7 (9.8)	13.6 (7.8)	1.7 (0.5)	4.0 (1.2)	3.4 (1.9)	129.9 (38.8)

Notes: 1. Figures in parentheses are fiscal 1987 plan.
2. Nonoperating balance includes Stabilization Fund interest income for Hokkaido, Shikoku and Kyushu, and JNR debt interest payments for East, Central and West Japan Railway and Japan Freight.
3. Nonrecurring items include subsidies for lines scheduled to be abandoned or spun off.

Fighting the breakup

As if this near-bankruptcy were not enough, JNR discipline deteriorated and employees became unruly and uncontrollable. With the unions having a major voice in personnel deployment decisions, management went into collusion with the unions to maintain a semblance of order at any cost, including illegal payments for hours not worked and travel allowances for trips not taken. JNR became synonymous with poor timekeeping and absenteeism.

In April 1987, JNR was split up and privatized in a bid to revitalize the ailing railroad. Even so, there was considerable controversy within Japan about the breakup and privatization itself, including vehement opposition within the railway unions.

The biggest problem in this breakup and privatization was what to do about the debt. In the end, it was decided that the new companies would shoulder 39% of the JNR debt, the government would take 37%, and an effort would be made to pay back the rest by selling off idle assets and stock in the new companies. The plan was to pay off the debt over a

10-year period. Yet if the railways continued to run deficits, it was clear that they never would get out of debt. At the time, JNR was earning ¥3.6 trillion a year, over 60% of which went to salaries and other payments to the more than 300,000 employees. Under the reform plan, the personnel rolls would be trimmed by about 100,000 and the new lines would operate with only 200,000 employees in an effort to create new companies that could compete with other private railways.

The crux of the reform was its assessment that the main causes of the JNR's bankruptcy were that it was a public corporation with no clear managerial responsibility and it was a national corporation too dinosaur-like to react to market changes. The fact that the national government always came to the rescue had made the JNR management indifferent to the debt problem. Very often, new lines were built and deficit-running operations continued not because they made good business sense but for political reasons. JNR had become a plaything for politicians.

Historical reform

Thus the reforms called for abandoning the old public corporation format in favor of private companies and for replacing the national organization with six regional passenger lines and one freight carrier. Behind this was an effort to make each company responsible for its own management and performance, to make them more cost-conscious with the introduction of competitive market principles, and to shield them from corrupting political influence.

It was a major reform, perhaps the biggest in the 115-year history of rail travel in Japan. What were the results? As already noted, the JR companies have earned phenomenal profits in their first year of operation.

East JR pretax profits were ¥60 billion, four times the original forecast, and Central JR profits were ¥50 billion, five times the forecast. Other companies have also done well, Shikoku Railway and Kyushu Railway twice as well as expected and Japan Freight Railway 50% better than expected. Even the companies that were not expected to do very well have done better than expected: West JR earning 20% more than forecast and Hokkaido Railway 50% more. All of these companies have had much better earnings in their first year than anybody expected when they started out.

The main reason for this turnaround is the massive reduction in personnel costs achieved by shedding workers. Personnel costs, which had always been a burden for the old JNR, have been reduced by nearly half under the plan. In addition, the companies have also been helped by the fact that they started with fewer workers than originally planned.

Local identity

In fact, East JR started with 6,000 fewer, Central JR with 3,700 fewer, and West JR with 1,700 fewer. For East JR, for example, this has meant savings of over ¥30 billion.

As a result, there are some people in the private railways and even the Ministry of Transport who tend to take the new railways' profitability for granted, saying, "It doesn't really matter who runs these operations. Their debts have been shelved and they have foisted their redundant workers off onto local governments and big companies. Any fool could make a profit this way."

It is not just JR that is doing well. The other private railways, and even the airlines, are all thriving, and JR has simply managed to ride the crest of this wave. There is some truth to this charge, as seen in the popularity of the JR-operated ferry boats just before they were phased out with the completion of the Seto Ohashi bridge and the Seikan tunnel.

While not denying that times are good, the JR companies attribute their success to the fact that employees now care more about doing a good job. In the past, JNR was criticized for having too many workers and not enough management—and sometimes for having a political strategy but no business strategy. Now that it has been transformed into a cluster of private companies, everyone from the presidents on down has been imbued with a sense of corporate identity: "This is our company. Let's do what we have to to make a go of it." Once-acrimonious labor relations have stabilized, and the distrust that stemmed from frequent schedule disruptions is becoming a thing of the past.

This transformation in JR attitudes has in turn sparked broad popular support from customers, which is buttressed by an increasing identification with the JR companies as local companies. As a result, the JNR's offspring have gotten off to a very good start indeed.

In the face of these unexpected profits, a number of people have suggested that if the railroads are making all this money, why don't they pay off their debt a little

The new JR companies are trying to increase their earnings while presenting a more atractive public image. Railway workders are assigned to promoting sales of special tickets (above), while Tokyo Station now offers a popular weekly concert.

faster. But the debt repayment schedule makes no provision for changes depending on how profitable the companies are. Of the ¥37 trillion debt backlog, the JR companies are scheduled to pay back ¥14.5 trillion. Both the total and the annual repayments are set, and the JR companies are expected to show major profits for the first year even after they pay off this year's share of the debt.

Stock exchange listing

The real problem is the ¥13.8 trillion that has been left for the government to pick up. The question of how it is to be paid is still to be decided, and while the government is studying it, no decisions are expected for another two years or so.

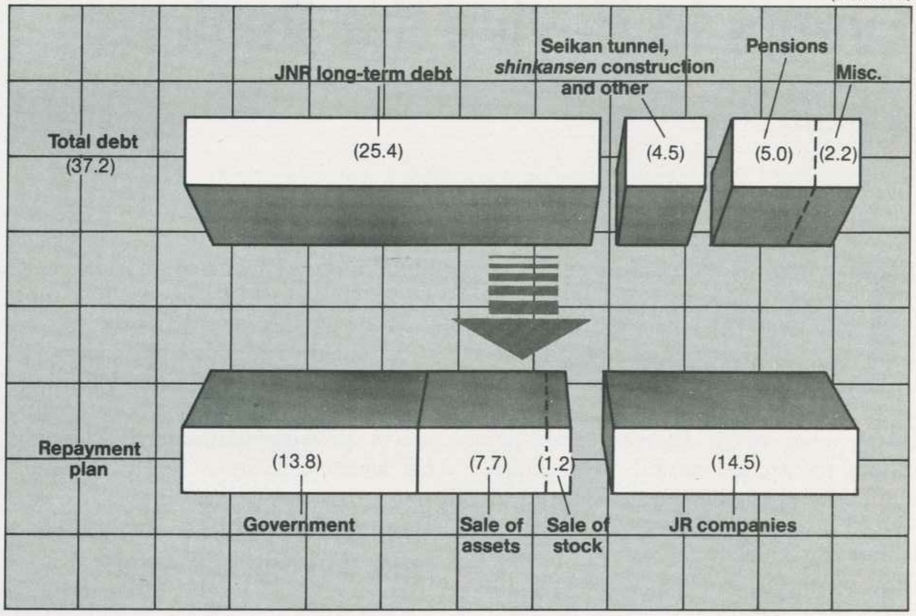
One way to pay back part of the debt would be to sell some of the land that the JR companies are not using. This has been valued at ¥7.7 trillion—which seems to be a very conservative estimate the way land prices have been rising in Japan. Yet concern has been expressed that selling this land to the highest bidders might further fuel soaring land prices, and sales have been temporarily suspended in the Tokyo area. The plan to sell old assets has run into a roadblock in its first year.

Yet if this debt is not paid off, the interest alone adds another ¥1 trillion—equivalent to the cost of the Seikan tunnel—every year. Thus it is that attention has turned to JR stock. At present, the national government is the sole shareholder in the various JR companies, and it is not expected to start selling its holdings for another five years. Yet with the JR companies doing so well, the possibility has arisen that they could be listed on the nation's stock exchanges in another two years.

The forerunner in this privatization process has been Nippon Telegraph and Telephone (NTT), which was the darling of Japanese investors everywhere when its stock went on sale last year. Even if the government cannot sell its JR stock for the same 40-times par value that the NTT stock went for, it still stands to make an enormous profit from the sale—¥10 trillion even if it just goes for the 20-times-par that is common for private railway lines. This alone would cut the government share of the debt by more than two-thirds.

Long-term Debt Repayment Plan

(¥ trillion)



Of course, it is not just in Japan that railroads have had trouble making ends meet. This is a common phenomenon, and there is a widely held view throughout the world that railroads are not a paying business.

Most countries are heavily subsidizing their railroads, though JNR, with its nationwide network crisscrossing the Japanese islands, was one of the biggest loss-makers. The question now is whether the breakup and privatization of JNR will prove or disprove the accepted wisdom, and whether it will provide just a temporary respite for the headache of JNR debt.

Rail's advantages

There are still a number of problems to be overcome in repaying this JNR debt—one of the purposes of the breakup and privatization—and the government's position is complicated by the fact that 5,000 of the people who were laid off in the JNR rationalization have yet to find work after a year of looking. Even employees who the new JR companies kept on are rumored to have worked long hours of unpaid overtime for the overriding imperative of getting the company back on its feet, and there is some doubt about whether or not these people will be as willing to make such a sacrifice in the second year.

Japan is said to provide a better climate for mass-transport railways than Europe or the United States, since large cities are located along the coasts of Japan like a string of pearls. Homes are crowded together in the little arable land that is available, most of the major roads are invariably congested, and soaring land prices make it very difficult to build new roads and bypasses. Railways are the best and often the only means of commuting to school and to work in Japan's big cities.

Given this, the fact that the JR companies are doing so well may have less to do with any revival stemming from the breakup and privatization and more to the fact that most of the problems were due to managerial lethargy and complacency fed by an assumption that the government would always come to the rescue. In fact, its past debts aside, JNR was showing an operating profit even in its trouble-plagued final year. Thus it may well be argued that in the final analysis, it was the politicians who were responsible for JNR's demise. Even though the JR companies are doing well, this has been a very dear set of reforms for many, and breakup and privatization is by no means a surefire way to put a government operation in the black.

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