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CASE STUDY

"Irrational Exuberance:" The Creation of the CNR, 1917 – 1919

MGT 2917

Canadian Business History

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This case was prepared by Professor Joe Martin as the basis for class discussion rather than to illustrate either effective or ineffective handling of a managerial situation.

"Irrational Exuberance:" The Creation of the CNR, 1917 – 1919

This is a story of 'irrational exuberance', a phrase made famous by the former Chairman of the American Federal Reserve Board, Alan Greenspan. This case illustrates how 'irrational exuberance'[1] affected individuals in both the public and private sector, particularly Prime Minister Sir Wilfrid Laurier and corporate giant Sir William Mackenzie.

Our story begins in July 1917, when the consequences of irrational exuberance were being felt, by some for the first time. The world was at war and Canadian Prime Minister Robert Borden had returned to Canada from meetings of the Imperial War Cabinet in London, where the news was not good. Canadian casualties had been heavy that spring, particularly during the Battle of Vimy Ridge, which was captured by the Canadians but at a cost of nearly 24,000 casualties. The war had also revealed divisions within the country. English Canadians were demanding conscription of manpower for the fighting front; French Canadians bitterly opposed it.

Canada's railway situation, however, and not the war, topped Borden's agenda on July 14,[2] when he met with Sir William Mackenzie, one of Toronto's richest and most powerful businessmen and one of Borden's important political and financial supporters. A railway and utility magnate with financial stakes on three continents,[3] Mackenzie was also a major shareholder, President and CEO of the Canadian Northern Railway — at that time one of Canada's three transcontinental railways and one of Canada's five largest corporations.

It was the fate of the Canadian Northern, which was facing seemingly insurmountable financial difficulties, that provoked the meeting. The Prime Minister was not looking forward to the contretemps. The solution to what he called "the railway mess" was not going to be well received by his friend and political supporter.

Summer 1917: 'The Railway Mess'

The recommendation of a Royal Commission — that traditional Canadian tool for problem-solving — appointed in 1916 to study the problem, was that the government take over the ailing Canadian Northern railway. It was a solution that Borden disliked but had decided to accept. Not so Mackenzie. The railway baron argued against the decision, claiming that the Commission had made serious accounting errors in its report. When it was clear the Prime Minister's decision was final and that Mackenzie's plans for expansion of his beloved railway were dead, Mackenzie broke down and sobbed.[4]

Clearly unnerved to witness the distress of this corporate giant whom he admired greatly, Borden tried to comfort Mackenzie. However, the Prime Minister was determined to follow the advice of the majority of Commission members. In any event, 'the wretched railway problems' were among many challenges Borden was facing that year. The year 1917 was for Canada, and perhaps for the entire world, one of the most traumatic and challenging years of the 20th Century.

The all-consuming issue was the war, now entering its fourth year, a war in which 60,000 Canadians would eventually be killed. But there were other problems as well. The introduction of the Military Services Act in 1917 led to riots and demands for money as well as manpower to support the war. The Minister of

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1 Defined as " wishful thinking on the part of investors that blinds us to the the truth of our situation." by Robert J. Shiller in *Irrational Exuberance*, Second Edition, (Princeton: University Press, 2005), p. xvii.

2 Certain distinguished historians disagree as to whether this meeting occurred in June or July – however Borden's Own Memoirs [Volume 2, Page 650] clearly state the date.

3 His original investments in Brazil evolved over time into modern day Brascan (Brazil/Canada), now known as Brookfield.

4 Mackenzie was under tremendous stress, not only from business pressures, but also because he had come directly from his Toronto home, Benvenuto, where his wife lay dying.

Finance was obliged to capitulate to these demands by bringing in, for the first time, a "temporary" income tax.[5] Consequently, pressure was mounting for a federal election, the first in six years,[6] with widespread support growing for a Union Government – a coalition of Conservatives and English speaking Liberals.

Borden and his government were grappling with many issues. Along with major internal political realignment looming at home, revolutionary sentiment abroad — led by Lenin in Russia — not to mention the war and conscription of manpower as well as wealth, the government faced other hot-button issues that needed addressing. These included: the prohibition of the sale and consumption of liquor; the granting of the electoral franchise to women; and inflationary pressures on food prices. And gnawing away amidst all these turbulent issues there was "the railway mess" — three transcontinental railways had been built for a population of just over 8 million, which resulted in far too much capacity relative to demand.

The solution, Borden concluded that summer of 1917, was for the government to take over the Canadian Northern and consolidate several other railway lines, thus beginning a process which would result in the creation of the largest Crown Corporation in Canadian history: the Canadian National Railways, to be known in its short form as simply CN. To understand how Canada faced such a proliferation of railways, one must go back in time, at least 21 years earlier, when 'irrational exuberance' led to the construction of far too much capacity.

Sir Wilfrid Laurier's Railway Policy

In 1896, the Liberal Party, led by Wilfrid Laurier with his 'sunny ways,' was elected to form the Government of Canada for the first time in nearly 20 years. The election marked the beginning of more than a century-long Liberal dominance of Canadian federal politics. In winning the 1896 election, the debonair Laurier became the first French Canadian Prime Minister in history.

Laurier has many claims to fame in Canadian history, including 15 continuous years in office with four successive majority governments, but his railway policy was not considered one of his successes.[7] After defeating the Conservatives in 1896, Laurier simply co-opted most of the Conservative's famous National Policy: a protective tariff, which the Liberals supported until the 1911 election; the settlement of the West; and a national railway, the Canadian Pacific or CPR. However, because he shared with Sir John A. Macdonald a vision for the future of Canada, and because he had the good fortune to be Prime Minister during boom times, Laurier decided to go one better than Sir John A. In 1903, Laurier — who was so optimistic about Canada's future that he famously pronounced that the 20th Century would belong to Canada — authorized the construction of a second transcontinental railroad.

Laurier's grand scheme to encourage the building of a second transcontinental line led to both short- and long-term problems. By the 1890s the railway network in eastern Canada was essentially complete. In western Canada, however, the period was marked by massive investments in new railway construction. In addition to the CPR, two entrepreneurs, Donald Mann and William Mackenzie, who had made their original money building parts of the CPR as contractors, were developing a new Prairie network. They were also lobbying aggressively for a charter to extend their western roads into a transcontinental railway.

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5 The Income Tax War Act provided for three taxes, the Normal Tax - 4% on both personal and corporate incomes, the Super Tax, and the Surtax on incomes over $6,000.

6 This is the only time in Canadian history that there was six years between elections. The normal pattern is every four years, although the maximum term is five years.

7 "Laurier had so far departed from his previous integrity that on occasion he besought Hays (President of the GTR) to alter his location surveys to serve Liberal politicians,", G.R. Stevens, *History of the Canadian National Railways*, (New York: The Macmillan Company, 1973), p. 227.

Meanwhile, in eastern Canada, the moribund, British-owned, Montreal-based, Grand Trunk Railway (GTR) was being revitalized. In 1896, the same year that Laurier was first elected Prime Minister, the Grand Trunk board of directors brought Charles Melville Hays up from the United States as general manager of the GTR, with a mandate to introduce "American" methods. Hays, working with Sir Charles Rivers Wilson, president of the GTR, adopted a policy of aggressive western expansion. The consequence was that by 1917 Canada had three major railways, not to mention a number of smaller ones competing for business. (See Exhibit 1 and 1915 Map.)

In 1903, Laurier faced pressure to force a merger of the Mackenzie & Mann railway with the GTR systems led by Hays and Wilson. Laurier refused, or was unable, to do this. Such a merger might have been a logical strategy, given Grand Trunk's prominence in Eastern Canada, and the Canadian Northern's coverage across the Prairies. Instead, Laurier chose the Grand Trunk to build a second transcontinental, declaring in the House of Commons, "that a railway to extend from the shores of the Atlantic Ocean to the shores of the Pacific Ocean, and to be, every inch of it, on Canadian soil, is a national as well as a commercial necessity."[8] (At the time, the CPR ran through Maine to Saint John, New Brunswick.) Unimpressed, Laurier's critics referred to his policy as a plan "to carry elections rather than passengers."

There was some justification to this criticism. The new Grand Trunk transcontinental was to achieve national status by two different methods. In the east the Government of Canada was to build a line eastward from Quebec City to Moncton, and westward from Quebec City through the unsettled part of Quebec and Ontario, across the Canadian Shield, to Winnipeg. (See 1906 Map.) This government-built line was called the National Transcontinental.[9] On completion the National Transcontinental was to be leased to the Grand Trunk Pacific (a wholly owned subsidiary of the Grand Trunk Railway) on very favourable terms. From Winnipeg the Grand Trunk Pacific (GTP), was to build a line to Prince Rupert on the West Coast.

Laurier's decision to build a second transcontinental line ultimately led to the resignation in 1903 of his Minister of Railways, the Honourable A. G. Blair, who opposed Laurier's decision. Blair was a New Brunswick lawyer and former Premier of that Province who was persuaded to run federally by Laurier in the 1896 election. He was sworn in as Minister of Railways and Canals when the Liberals were elected. Blair favoured government ownership and operation of railways, which Laurier opposed. Laurier could accept the idea of governments constructing railways but he was adamantly opposed to governments operating them.

There were longer-term consequences as well. Laurier's decision to build a new transcontinental system set off an unrealistic building boom, similar to the dot.com boom of the late 1990s. This decision and other factors led to a proliferation of railways and much waste of public money in support of building more. It was a policy of 'intoxication' that invited a flood tide of railway construction and led, inevitably, to the ebb of retribution in its wake.[10]

Indeed, when Laurier announced his policy, Canada was already well served by its railways with nearly 20,000 miles of railway trackage (See 1906 Map) for a country with a population of only 5.5 million. Trackage in the United States was ten times that of Canada's, but its population was nearly 14 times greater — and its economy was 20 times greater than Canada's.[11] (See Table 1 and Exhibit 1.)

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8 For the full text of his speech refer to Hansard, 1903, p. 8396.

9 The National Transcontinental built a bridge across the St. Lawrence at Quebec City, which had the unique distinction of collapsing not once, but twice (in 1907 and 1916) with great loss of life and money, the first time killing 75 men. Fortunately 'only' 10 men were killed on the second occasion. Popular legend has it that the iron rings worn by Canadian engineers are made from the steel of a beam from the Quebec Bridge. Although this is not true the ring is a symbol of both pride and humility for the engineering profession.

10 Arthur Meighen's Nov. 5, 1919 address to the Montreal Canadian Club on the topic of the Grand Trunk acquisition.

11 Imperial Russia had twice as much railway mileage for five times the population, while Argentina had approximately one half the mileage for a population that was only 10% smaller than Canada and with a similar GDP.

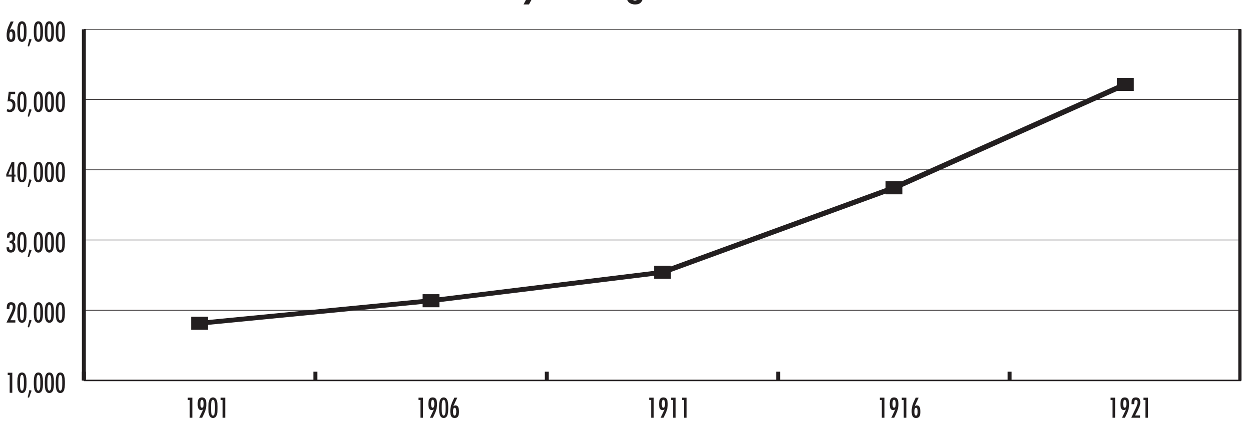
Table 1 – The Canadian Railway System in 1904

- The **Grand Trunk,** the oldest railway, headquartered in London, England, operating in Eastern Canada, based in Montreal, with no extensions West but desirous to go there and with 3,750 miles of track. It had a well-established feeder system in Ontario and Quebec.
- The **Intercolonial,** provided for by an article in the British North America Act, based in Moncton, which united the Maritimes with central Canada by linking Nova Scotia and New Brunswick with Quebec. It operated with 1,300 miles of track plus another 300 miles through subsidiaries.
- The **CPR,** a well-run, Montreal based railway, with 9,000 miles of track from St. John, N.B. to Vancouver, (nearly half the trackage in Canada), operating in both East and West, with a national trunk line supported by regional feeders. Its operations were profitable.
- The **Mackenzie & Mann system,** (to become the Canadian Northern System) headquartered in Toronto with strong ties to the Bank of Commerce. Its nearly 3,000 miles of track were principally on the Prairies between Winnipeg and Edmonton, a part of the country experiencing dramatic growth at the time, although expansion into Eastern Canada was on its wish list. Its operations were profitable.
- There were, in addition, 57 other much smaller companies, ranging in size from the 382.19-mile Michigan Central in Ontario to the tiny two-mile Klondike Mines Railway in the north.

A Flood Tide of Railway Construction

Between 1903 and 1911 (the year that Laurier was defeated in a general election) the railway-building boom in Canada saw railway track mileage increase by 40% from just over 18,000 miles to 25,400 miles, much of it superfluous. (See Chart 1.) In 1911 alone, 8,000 miles of track was laid. Over the next decade, trackage doubled to more than 50,000 miles of track, and projects that had been approved before the recession could not be stopped in time.

Chart 1: Railway Mileage in Canada: 1901 – 1921



While the Grand Trunk was building its transcontinental line, Mackenzie and Mann were still holding onto their dream of making the Canadian Northern a transcontinental railway. More than a dream, it was also a practical necessity. Mackenzie and Mann's railway needed a transcontinental line in order to keep much of its western feeder traffic. An unexpected bonus for Canadian Northern, therefore, was Laurier's commitment to Reciprocity (an earlier term for free trade) with the U.S. in 1911 which led to the legislative authority and financial assistance for Mackenzie and Mann to build a third transcontinental line.

As Professor T. D. Regehr explains it, "The nationalistic clamour (against Reciprocity) of the Opposition …made it possible for Donald Mann to persuade the (Laurier) government that it must officially recognize and acknowledge the Canadian Northern Railway as the country's third great national highway. The bill was given royal assent on May 19, 1911 and construction began immediately. At the end of 1911 Mackenzie and Mann had 4,500 men at work on the Ontario mileage, and in 1912 there were 9,600."[12]

The 1911 election marked the end of Laurier's 15 years in power and the election of Borden's Conservative government. The new Prime Minister, who came into power on a platform that carefully documented the problems relating to the Grand Trunk Railway, now found his government saddled with 'the railway mess' – three transcontinental railways in a country with a population of less than 7.5 million.

For the Grand Trunk in particular, its problems were exacerbated when its aggressive American-born President, Charles Melville Hays, went down with the Titanic in April 1912.[13] The next year, 1913, the Grand Trunk Pacific reneged on its earlier agreement to take over the National Transcontinental (part of the Grand Trunk System). The company simply couldn't afford it. That same year the Canadian Northern Railway — which had been expanding rapidly and burning up capital — asked the government for a $30 million handout. The government agreed to provide only half that amount and demanded an equity position in return. Canadian Northern repeatedly asked for and received huge amounts of public money.

Both companies, but particularly the Canadian Northern (led by Mackenzie and Mann), had been expanding rapidly (See Exhibit 1.)

As the war approached, however, the railways appeared to be doing well. They were earning over $250 million annually — roughly 30% from passengers and 70% from freight — and spending under $200 million, leaving $50 million to service the debt and provide shareholders with a return on their investment. They were carrying more than 40 million passengers and over 90 million tons of freight using 5,000 locomotives, 5,000 passenger cars and nearly 200,000 freight cars. This was big business all right, but it was big business that was not sustainable.

The capital structure of the industry was split among stocks (40%); and funded debt (closer to 45%) with the remaining 15% accounted for by government assistance mainly at the federal level, although provincial and municipal governments contributed as well. While the CPR capital structure was much less dependent on debt financing than that of the GTR or the Canadian Northern, given the level of debt financing within these two companies, there was bound to be trouble — particularly in the London markets once war broke out.

In addition to heavy reliance on debt, the Grand Trunk and Canadian Northern faced significant overcapacity and their costs had begun to substantially exceed estimates. While railway construction was

[12] T.D. Regehr, *The Canadian Northern Railway* (Toronto: The Macmillan Company of Canada Limited, 1976), pp. 303, 318, and 319.

[13] *The New York Daily News* reported on April 26, 1912 on the recovery of the bodies of: Colonel John Jacob Astor, reputed to be the richest man in the world at that time; Isador Strauss, the millionaire merchant and the man who made Macy's department store a household name; and Charles Melville Hays.

going full tilt, revenue from both passengers and freight fell 5% in the recession of 1913-14, the first revenue decline in years. Canadian Northern went back to the government again in 1914 asking for financial aid – nearly $100 million this time. The government agreed to bond guarantees for half of that amount and the transfer of a larger block of stock (the government now had a 40% equity position in Canadian Northern).

With the outbreak of war in August 1914, the problems — capital cost overruns, over capacity, inadequate rolling stock — all became more evident. They were exacerbated by the fact that the British government banned the export of capital, and the London market had been the main source of Canadian railway financing. Finally, Great Britain nationalized railways for the duration of the war, establishing a precedent for Canada.

The Penalty Stage of Railway Development

As each year of the war passed, problems became more manifest. In 1915, although passenger traffic held up, freight traffic dropped by 14%, causing Gross Earnings and Net Earnings to decline by nearly 20%.

The situation was much worse for the two new transcontinentals[14] (Grand Trunk and Canadian Northern) than for the CPR. Neither company was able to cover operating costs let alone service its debt. In 1915, therefore, the Government of Canada took over the National Transcontinental from Grand Trunk Pacific. In spite of an expenditure of $250 million by the government to build a line from Winnipeg to Moncton, Grand Trunk, the parent company, could not afford to operate the line, even though it was not required to pay interest on the cost of construction.

At the same time that the government was taking over operation of the National Transcontinental, Canada's Minister of Finance was increasingly concerned about the country's credit worthiness and ability to continue the war effort should any of the railways go bankrupt. One of Canada's most prominent businessmen, Sir Joseph Flavelle, raised the possibility of government ownership of the railways in a letter he addressed to Prime Minister Borden in 1915.[15] In light of the Mother Country's embrace of railway nationalization, and the dire financial circumstances faced by Canada, government ownership seemed to be an acceptable option.

The following year, 1916, the government was again required to provide financial assistance to Canadian Northern (in which the government already had acquired a 40% equity position and the railway company was now asking for $15 million) as well as to the Grand Trunk Pacific, which was asking for an additional $8 million.

The financial collapse of the two railways, Canadian Northern and Grand Trunk, would be devastating. Both companies had secured significant provincial guarantees and the Toronto-based Bank of Commerce had huge outstanding loans to Canadian Northern. A collapse would create a negative long-term impact on Canada's general credit worthiness in international financial markets, disastrous for a government that "was already strained to the limit trying to organize and finance the increasingly ghastly war effort."[16]

Desperately seeking a solution, Borden established a Royal Commission in July of 1916. The Chairman of the Commission was A. H. Smith, President of the New York Central Railway. The Commissioners were

[14] "The Canadian Northern was a soundly built line and served the needs of the west….By contrast the National Transcontinental/ Grand Trunk Pacific is seen as an ill conceived, wastefully built system that ultimately dragged down the otherwise reasonably sound GTR. Hays in particular, built 'castles in the air'," according to Graham D. Taylor and Peter A. Baskerville, *A Concise History of Business in Canada* (Don Mills: Oxford University Press, 1994) p. 283.

[15] Donald MacKay, *The People's Railway, A History of Canadian National*, (Vancouver: Douglas & McIntyre, 1992), p. 18.

[16] Michael Bliss, *Northern Enterprise*, (Toronto: McClelland and Stewart, 1987), p. 374.

Sir Henry Drayton from Kingston, Chairman of the Board of Railway Commissioners and soon to be Canada's Minister of Finance, and W.M. Acworth, a British railway expert.

The three Commissioners delivered a split decision in May 1917. Smith, the American Chairman, delivered the minority report and dissenting view. Smith recommended three main approaches: first, that Canadian Northern take over Grand Trunk Pacific's lines in the West and provide competition to the CPR in that part of the country; in Eastern Canada he recommended that the Grand Trunk do the same with Canadian Northern's eastern lines; and finally that the government take over and operate the uneconomic route that ran across the Canadian Shield from Quebec to Manitoba, for both Canadian Northern and Grand Trunk.

Arthur Meighen, the most powerful man in the Cabinet next to the Prime Minister — and Borden's eventual successor — favoured the minority report. But the Cabinet was of two minds on the issue with the majority of Cabinet favouring the majority report. Commissioners Drayton and Acworth opposed the acquisition of the Canadian Northern and Grand Trunk Railways by either the CPR or the government.

Rather, the majority report recommended that all the railways of Canada be nationalized, except for American lines and the CPR. Those to be brought into one system and nationalized included: the Canadian Northern, the Grand Trunk, the Grand Trunk Pacific, the Intercolonial and the National Transcontinental. They were all to be transferred, by Act of Parliament, to a Board of Trustees, called the Dominion Railway Company. The new company would own the rail lines and the government would be responsible for the interest on the existing securities.

The new board was to be non-political, permanent, self-perpetuating and not subject to either direct government or parliamentary control. The new Canadian National Railways would require at least $50 million to get started for both existing fixed charges and for interest on new capital. (By this point the various railways had received over $1 billion in government assistance through loans, sale of lands, subsidies, guarantees, etc.)

Immediately after the report was presented, the President of the CPR, Sir Thomas Shaughnessy, met with the Prime Minister. Shaughnessy, fearing competition from a publicly owned system, proposed that all the railways, including the CPR, be taken over by the government but managed by the CPR with guaranteed returns for the CPR shareholders. Cabinet rejected this proposal, partly because the idea of a railway monopoly was anathema — particularly in Western Canada.

As offensive as the Commission's majority recommendations were to both Shaughnessy and the CPR, not to mention to Sir William Mackenzie, Borden was resolved and worked to enact them. While Shaughnessy fumed and Mackenzie wept, Borden had other issues to deal with — life and death issues in proportions that no Prime Minister has faced, before or since. The government, which already held 40% of the equity, was taking over the railway, Borden told Mackenzie in their meeting that summer. It was, he believed, the right decision.

In August 1917, the Minister of Finance introduced a bill to acquire the stock in Canadian Northern Railway for not more than $10 million (par value of the stock was $60 million), subject to arbitration. That same month, another bill was passed placing all government railways under the Railway Commission. This included: the Intercolonial, which had been created and owned by the Government of Canada since Confederation in 1867; the National Transcontinental from Moncton to Winnipeg; and now the Canadian Northern System, operating primarily in the West and but with some lines in the east. D. B. Hanna was appointed General Manager. A Scotsman with a strong railway background, Hanna had served as the third Vice President of Canadian Northern before this appointment.

In spite of strong objections from the Liberal opposition in the House of Commons to the legislation — with allegations that it was a payoff for: the Bank of Commerce[17], National Trust[18] and Mackenzie, a well-known Conservative supporter — the bill was introduced.[19] Although the Minister of Finance, Thomas White, brought the legislation forward, the principal spokesperson for the legislation was Arthur Meighen, the youthful Solicitor General.

Although a relatively junior member, Meighen is described by his biographer thus: "More than any other single individual he was the creator of the Canadian National Railway system."[20] The opposition Liberals seemed to agree with that assessment, describing him, somewhat ungraciously, as 'the gramophone of Mackenzie and Mann.'

The Best Choice under Unfortunate Circumstances

While the 'railway mess' was a major issue, so too was the much postponed election in which the volatile issue of conscription loomed large. Prime Minister Borden finally went to the polls in December 1917 as the leader of a coalition Unionist party, made up of traditional Conservatives and Anglo Liberals. Although other Prime Ministers[21] have won larger majorities in the House of Commons, no other leader has ever scored such a commanding percentage of the popular vote: 57%.

One of the new government's priorities was to acquire both the Grand Trunk Railway and its poorly performing, wholly-owned subsidiary, the Grand Trunk Pacific. It led to furious debate. "The nationalization of these lines, especially the Grand Trunk itself, aroused another furious dispute over public ownership and Meighen … found himself once again in the centre of controversy."[22]

Although government-owned railways had been the norm in most countries, this had not been the case in the United Kingdom, the United States or Canada, prior to the war. In these three countries, government involvement had been confined to providing all manner of financial incentives and to developing regulation, particularly with regard to rates, but not to operating the railways.

But the war changed everything. In the United Kingdom, for example, railways were immediately nationalized in August 1914 for the duration of the war. Even in the free enterprise United States, the government temporarily took over the railways for a brief period in the spring of 1918.

While Sir Wilfrid Laurier had always strongly opposed government ownership of Canadian railways, the Intercolonial had actually been a condition of the Articles of Confederation in 1867. More recently, in 1902, the Ontario Liberal government had created a government-owned railway, the Temiskaming and Northern Railway Company, to encourage development in the northern part of the province.

The idea that government should actually own and directly operate a huge enterprise like a railway was

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17 Although only two thirds the size of the Bank of Montreal, which was still Canada's major bank, the Commerce was the second largest bank and the dominant bank in Toronto.

18 Sir Thomas White, Minister of Finance, had been President of the National Trust.

19 Allegations that the deal was excessively generous towards Mackenzie and Mann later proved to be unfounded. The amount awarded to them from the government takeover was barely sufficient to discharge their indebtedness to the bank. Although Mackenzie lived comfortably for the remainder of his life, the amount left to his heirs once his estate was settled and his debts were paid was relatively modest. Op. cit., Regehr, pp. 453-454.

20 p. Roger Graham, *Arthur Meighen, Vol. 1, The Door of Opportunity*, (Toronto: Clarke, Irwin & Company, Limited, 1960), p. 98.

21 John Diefenbaker in 1958 and Brian Mulroney in 1984.

22 *Op. cit.*, Graham, pp. 196-197.

not generally accepted in spite of government ownership of other forms of 'public utilities.' For example, the Conservative Government of Ontario had become involved as a monopoly provider of electrical generation and distribution; and the three Prairie Provinces had all created government owned monopolies to provide the new telephone service.

Government negotiations with the Grand Trunk began in January 1918 and dragged on for nearly two years before they were finally resolved. The federal government was intent on obtaining Grand Trunk's well-established feeder system in Ontario and Quebec to complement the various systems that it had been required to take over in 1917. The Grand Trunk's strategy was to persuade the government to take the Grand Trunk Pacific off its hands, since the Grand Trunk Pacific was seen as a major drain on its parent.

Meighen and the government would have none of this. The Grand Trunk Pacific ran from Winnipeg to Prince Rupert in British Columbia and had limited traffic because of an absence of feeder lines that both the Canadian Pacific and the Canadian Northern (now owned by the government) had in abundance. When the Grand Trunk's position became intractable, Meighen applied private sector principles to a public sector situation and simply waited out the Grand Trunk, refusing to provide any additional financial support to the financially troubled Grand Trunk Pacific.

Amidst these protracted negotiations the Great War finally ended. Canada had sent 640,000 men into combat, 60,000 of whom died on the battlefield, a higher fatality rate than the country would endure in World War II. Not that peace brought an end to railway problems, of course. The war was followed immediately by a devastating post-war recession.

Due at least in part to the economic downturn, the Grand Trunk Railway informed the government in March 1919 that the railway could no longer operate its subsidiary line, the Grand Trunk Pacific. In response, the government appointed the Minister of Railways and Canals, the Honourable J.D. ('Doc') Reid as Receiver (the largest receivership in Canadian history to that date by far) in charge of managing and taking over the bankrupt line. Now that the government effectively had the Grand Trunk Pacific under its control, all that remained was for it to acquire the Grand Trunk.

But 1919 saw further bitter debate in the House of Commons, not just around the bill to acquire the Grand Trunk Railway, but also around the bill to create the Canadian National Railways. The Canadian National legislation package was comprised mainly of the Canadian Northern Railway, the National Transcontinental and the old Intercolonial. All the arguments against public ownership were trotted out. In Meighen's argument in closing the debate he stated that public ownership was appropriate in the case of a 'monopoly.' While this claim of a monopoly was not precisely true – the newly created Canadian National would be competing with Canadian Pacific – it was true that in most of the geographic areas where they operated, the two companies would not be competing with each other.

In October 1919, after extensive negotiations between the government, led by Meighen, and the Grand Trunk, led by Alfred W. Smithers, Chairman of the Board, a Bill to acquire the Grand Trunk was presented to the House of Commons. The two main arguments against the Bill were: (1) the government should take over the Grand Trunk Pacific subsidiary but allow the Grand Trunk parent to continue operating it; and (2) if the Grand Trunk parent was close to bankruptcy, the government should let it go bankrupt rather than take over a losing proposition.

Meighen responded to the two arguments in the following fashion. The new Canadian National needed the Grand Trunk lines in eastern Canada to complete its system in a logical fashion. Although it would have good feeder lines in the West the same was required in the more populous East. Meighen also contended that liquidation would lead inevitably to the CPR's acquisition of the Grand Trunk, and that such a situation was not tolerable.

Finally, at 3 a.m. on Nov. 5, 1919, the Grand Trunk Acquisition Act was passed, nationalizing the Grand Trunk System. Then, with very little sleep, Meighen caught a train to Montreal later that morning to address a hostile audience at a Canadian Club luncheon.

In justifying the government's decision to acquire the Grand Trunk, Meighen said: "We now have…the Grand Trunk system in eastern Canada. If we had not acquired that company, may I ask: Was the Canadian National Railway to be called upon to duplicate the succession of feeding systems now spread through Ontario and Quebec? Would that be a sound business investment? Would that be a proper application of capital? Is it even common sense? If not, will anyone argue or suggest that there is any possibility in the known world of making a system of railways a success which has only one gathering system in western Canada and has to support two trunk lines protruding eastwards for thousands of miles?"

Montreal was not impressed. Meighen was denounced as 'the father of railway nationalization,' a socialist and worse. The Montreal business community, heavily influenced by the Bank of Montreal and the CPR, not only disliked public ownership but felt that the deal had been too generous to the Canadian Northern because of its Toronto base, and because of its links to the Bank of Commerce and the National Trust Company.

However, the Act passed in the House and there was no turning back. The consolidation of the various railways into one operating system would take until 1922. In the relatively brief span of three years required to complete the consolidation of the new system, Meighen became Prime Minister and served for 18 months before he and his party were thrown from office when the Liberals were elected under William Lyon Mackenzie King, with support from the Western based, free trade Progressive Party. The new government replaced Hanna as GM with the appointment of Sir Henry Thornton, an American born railroader.

For the next 70 years Canada was unique in the world, possessing two major railroads that competed with each other — one a Crown Corporation, CN, owned by the government, the other owned by shareholders, the CP.

What Should Arthur Meighen Have Done?

There is no doubt that the Conservatives inherited a mess in terms of the railways when they were elected to office in 1911 after 15 years in Opposition. Over one quarter of the Conservative's 1911 "Handbook" was devoted to railway matters, particularly the party's criticisms of the Grand Trunk/ Grand Trunk Pacific transcontinental railway project.

The roots of the railway mess lay in the previous government's failure to create one transcontinental line to compete with the CPR back in 1903, rather than allowing for the possibility of two. The problems relating to the Grand Trunk were compounded when, during the 1911 election, Liberal Prime Minister Sir Wilfrid Laurier, authorized a third transcontinental railway, the Canadian Northern. For a country with a population at that time of less than 7.5 million, it was unsustainable.

Both the Grand Trunk and the Canadian Northern had weak to non-existent feeder systems in large parts of their territory. In addition — and in contrast to the CPR — those same two railroads were heavily reliant on debt as distinct from equity financing. The CPR was the only moneymaking railway at the time.

The Minister "for everything" who was to become the future Prime Minister, Arthur Meighen, laid out the problem this way in his speech to the Canadian Club in Montreal. "We are at the penalty stage of railway development in this country; a price in some form has to be paid by the people of Canada. We are at the point now where an awakening of bitterness follows a night of intoxication; an ebb of retribution now follows in the wake of a flood tide of railway construction."

Not that many years later, his successor as Prime Minister, the Liberal William Lyon Mackenzie King, would confide in his diary: "The whole railway business is one horrible mess – waste, waste so vast that no one can intelligently grasp the whole situation."[23]

Under the circumstances, the status quo was not an option. As Meighen went on to say in his Montreal speech: "What confronted the present government was not a choice between something alluring on the one hand and something less alluring on the other, but a choice as to the best course that could be pursued under all the unfortunate circumstances which surrounded us – a course which would ultimately prove in the best interests of the people."

Mieghen's speech brilliantly summarized the consequences of a period of irrational exuberance, but was the government's choice the right one? It was true that it had to do something, but were there options available to the government other than nationalizing the railways and creating a Crown Corporation, which inevitably would be subject to political as well as commercial considerations?

[23] Op. cit., MacKay, p.61.

QUESTIONS FOR STUDENTS

In addressing the railway situation, the Borden government had four major options to consider. They were:

1. To do as the government chose – create a Crown Corporation to own and run all major non CPR railways while allowing the CPR to continue operating as a private enterprise transcontinental railway;

2. To let the railways go bankrupt, leaving market forces to determine the new entity/entities to emerge;

3. To permit the CPR to take over the competing railways;

4. To allow the Canadian Northern to operate in the West, where it had a good feeder system, and the Grand Trunk to operate in the east, with the National Transcontinental in government hands, providing joint running rights across the barren and unprofitable Canadian Shield.

Based on the facts of the case and other readings, which option would you have chosen and why?

Addendum

CN Today: The Most Efficient Carrier in North America

"The year 1923 was the first year of the consolidation of the Grand Trunk Railway and all the other units of the National Systems – the Canadian Northern, the Grand Trunk Pacific, the Canadian Transcontinental, the Inter-colonial and the other Government lines in the lower Provinces."[24] The new railroad would be an even larger enterprise than the CPR, Canada's corporate private sector giant. It would handle more passengers than the CPR (nearly 24 million, compared to CPR's 14.5 million) and employ more than 100,000 personnel.

From the time of its first year of consolidated operations in 1923, the CN was burdened with substantial long-term debt and was regarded as a dubious business venture. Total income before fixed charges was only $13.4 million (on gross operating revenue of $263.6 million) with total fixed charges of $66.1 million, leaving the railway with a deficit of $52.7 million. With total assets of just over $2 billion, the new company's long-term debt topped $1.9 billion.

Right from its inception, in fact, the CN was regarded as a 'white elephant,'[25] a terrific drain on government coffers. Year after year, the company required huge subsidies to keep operating. "The …Canadian National Railways was…critically viewed by financial and business interests, both as an experiment in public ownership and as a charge, in its annual deficits, on the national revenues. To have it fail, and allow its component lines to be sold, seemed to many both sound business and good national policy."[26]

But that did not happen, and as bad as finances got in the 1920s, the situation got considerably worse in the Great Depression of the 1930s. The company began posting even larger deficits, year after year, decade after decade. Finally in 1992, the Conservative government under Prime Minister Brian Mulroney decided to do something about it. Mulroney appointed Paul Tellier, the Clerk of the Privy Council and Secretary to the Cabinet, to serve as President and Chief Executive Officer of the railway.

Tellier believed strongly that the CN had to be privatized in order to be successful, and he drove the process. In November 1995, after nearly eight decades in government hands, the railway was privatized. Under Tellier's leadership, the company made significant operational improvements as well as strategic acquisitions in the United States. In 1998 CN acquired Illinois Central for $2.4 billion and three years later Wisconsin Central for $1.2 billion. More recently CN acquired both Great Lakes Transportation for $500 million and BC Rail (including associated tax losses) for $1 billion.

When Tellier left CN in 2002 to become the CEO of Bombardier, he was succeeded at CN by Hunter Harrison, an American who was formerly with Illinois Central. A "railroader's railroader," Harrison has taken the company to new heights. In Harrison's brief term in office, CN has seen a dramatic increase in market capitalization. While CN is a widely held Canadian company, the largest single shareholder is the American computer magnate Bill Gates, who owns nearly 6 % of the company.

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[24] *Canadian Annual Review*, 1923, p. 342.
[25] A prestigious Siamese beast whose upkeep exceeds its worth.
[26] W.L. Morton, *The Kingdom of Canada*, (Toronto: McClelland & Stewart, 1970), p. 442.

Within an overall Canadian context, CN is one of Canada's most important companies employing well over 20,000 employees with assets of nearly $20 billion and revenue of over $7 billion. Now it is not only Canada's largest railway, but also the most efficient of the six major North America freight railroads with significant free cash flow.

The current period is a good one for railways given Asian demands and the commodities boom, plus the fact that the price of oil is hitting the trucking industry harder than the railway industry

All of this is a remarkable change from CN's chaotic beginnings as a Crown Corporation in 1917, through its long years as a major drain on the taxpayers of Canada, to its relatively recent privatization, and current success, with glowing near term prospects.

Key Players at the Time of the CNR's Creation

The Prime Ministers

Sir Wilfrid Laurier was born in 1841 in Lower Canada (now the Province of Quebec). A lawyer by profession, he was first elected to the House of Commons in 1873. He sat almost continuously until his death in 1919. First appointed to the cabinet at age 36 he became Canada's seventh Prime Minister but the first French Canadian Prime Minister in 1896. He held that position until 1911, winning four successive majority governments before losing. He remained Leader of the Liberal Party until his death.

Laurier is one of Canada's greatest Prime Ministers. During his terms in office, Canada enjoyed spectacular growth. Laurier coined the phrase that the 20th Century belonged to Canada. Caught up in the irrational exuberance of the era, he authorized a second and then a third national transcontinental railway that eventually led to bankruptcy and government takeover.

Sir Robert Borden succeeded Laurier as Prime Minister in 1911. Borden was born in 1854 in Nova Scotia. A lawyer by training he went into politics in 1896 and served almost continuously until 1921. Borden led the Conservatives to victory over the Liberals in what is known as the Reciprocity Election of 1911. In 1917 he led a coalition Unionist party to the largest share of the popular vote in Canadian history.

The 'railway mess' was one of the many problems that Borden had to deal with as a wartime Prime Minister. He faced up to the unpleasant choices before him and made difficult policy decisions including those affecting his friends, such as Sir William Mackenzie. On retirement from politics he occupied a number of important positions in the financial community including the Presidency of Crown Life and also the Presidency of Canada's first mutual fund company.

Arthur Meighen succeeded Borden as Prime Minister in 1920, chosen by the members of his own Conservative caucus, as was the custom of the time (over the objections of his fellow Cabinet members). Meighen was born in southwestern Ontario in 1874. He attended the University of Toronto and graduated with a degree in mathematics. He went west as a young man to Portage la Prairie, Manitoba where he became a lawyer and entered politics in 1908. He served in the House of Commons almost continuously until 1926.

Meighen entered the cabinet in 1915 and quickly assumed a heavy load, often being referred to as the Minister of everything. One of the most accomplished orators in the history of the Canadian Parliament, he had the task of shepherding through the legislation which created the Canadian National Railways. Arguably the most brilliant person to hold the office of Prime Minister, he was not successful politically.

Although he served as Prime Minister twice in the 1920s, he only held that office for 20 months in total. When he returned to politics in 1942 as leader of his party, he went down to ignominious defeat in a by-election. While unsuccessful in politics, he did well in business serving first as legal counsel and then as Chairman of Canadian General Securities (CGS) which controlled Traders Finance Company, the oldest and largest all-Canadian national finance company, as well as a number of insurance companies.

The Railwaymen

Sir William Mackenzie was born in 1849 in Canada West (modern-day Ontario). He was one of the most successful businessmen of his era. Beginning in the field of railway construction with his partner Donald (later Sir Donald) Mann, Mackenzie expanded into a variety of businesses not only in the major cities of Canada but also on three continents. It was his company that founded what became Brascan, based in South America, which is now known as Brookfield.

Mackenzie's major enterprise was Canadian Northern Railways, which prior to its demise was the second largest railway system in Canada. In 1904 it was the third largest, after the Grand Trunk system, with less than 3,000 miles of track, primarily on the Prairies. In the next decade, in an act of 'irrational exuberance' it more than doubled in size and became a national transcontinental railway. Mackenzie died in 1923 at his Toronto home – Benvenuto. His beautiful home was torn down shortly thereafter and is now an apartment building which is being converted to condominiums and which houses the upscale restaurant Scaramouche.

Charles Melville Hays was born in Illinois in 1856. He was a railroader who became general manager of the Wabash system in 1889. In 1896 he moved to Canada as the general manager of the Grand Trunk system, at that time the second-largest system in Canada. The Grand Trunk, although based in Montreal, was British owned and Hays was brought in to introduce 'American methods'.

Under Hays the Grand Trunk received the go-ahead to build Canada's second transcontinental railway system in 1903. Hays died in the sinking of the Titanic in 1912. As the *Dictionary of Canadian Biography* has noted, history has tended to eulogize Hays, but in point of fact his policies of irrational exuberance led to receivership for the Grand Trunk Pacific in 1919 and to the acquisition of the Grand Trunk's stock by the government of Canada.

Baron Shaughnessy was born in 1853 in Wisconsin and came to Canada in 1882 as the general manager of the newly created Canadian Pacific Railway (CPR). Shaughnessy was a manager who paid careful attention to cost control. In 1899 he succeeded William Van Horne as President of the CPR. He continued in that role until 1918 although he stayed on as Chairman of the Board until his death in 1923.

Under Shaughnessy's leadership, the CPR became the preeminent Canadian corporation. He served on the boards of other prestigious Canadian corporations including the Bank of Montreal, which was the largest Canadian bank at that time. He viewed the idea of competing with a government owned railway as 'abhorrent'. The affluent suburb of Shaughnessy in Vancouver is named after him.

Exhibit 1: Major Railway Company Mileage, 1904 and 1913

Company	**1904**	**1913**	**% increase**
Canadian Northern System[27]			
Canadian Northern	2,287.50	4,760.65	
Canadian Northern, Ontario	na	503.95	
Canadian Northern, Quebec	na	742.02	
Bay of Quinte	na	105.00	
Brockville, Westport & N.W.	na	45.00	
Central Ontario	na	149.73	
Halifax and South Western	289.00	380.76	
Inverness Ry., and Coal Co.	61.00	60.91	
Irondale, Bancroft & Ottawa	na	51.00	
James Bay	4.00	na	
Under Construction	556.00	1,297.00	
Total	**2,859.50**	**6,709.02**	**134.62%**
Canadian Pacific System			
Canadian Pacific	8,747.50	11,943.55	
Dom. At. & Que. Central	na	552.00	
Kingston & Pembroke;	112.85	na	
Tillsonburg L.E. & Pac.	35.33	na	
Esquimalt. & Nanaimo	78.00	na	
Under Construction	481.40	768.00	
Total	**8,973.68**	**12,495.64**	**39.25%**
Grand Trunk System			
Grand Trunk	3,162.76	3,120.89	
Canada Atlantic	458.60	456.26	
Grand Trunk Pacific	na	1,401.97 [28]	
Central Vermont	125.20	125.20	
Under Construction	na	720.00	
Total	**3,746.56**	**5,104.32**	**37.20%**
Canadian Government System			
Intercolonial	1,310.26	1,502.76	
Prince Edward Island	209.00	279.23	
Canada Eastern	136.00	na	
Total	**1,655.26**	**1,781.99**	**7.66%**
All other Railways	2,352.37 [29]	3,732.59 [30]	58.67%
Grand total	**19,587.37**	**29,823.56**	**52.26%**

Source: 1906 and 1915 Department of Interior Atlases of Canada.

[27] In 1904 it was referred to as the "Mackenzie & Mann System."

[28] The National Transcontinental is clearly identified as part of the GTP system in the 1915 Atlas

[29] There were an additional 57 railway companies, ranging in size, from the 382.19 mile Michigan Central in Ontario to the tiny two-mile Klondike Mines in the Klondike.

[30] By 1913, there were 48 other companies, ranging in size from the 682.68 mile, American-owned Great Northern System, operating in western Canada, to the tiny Rutland and Noyan Railway in the east.

RAILWAY TIMELINE

Early 19th Century
Steam powered railways are invented in the United Kingdom.

1829
George Stephenson's Rocket wins a competition sponsored by the Liverpool & Manchester Railway, with a speed of about 26 miles (42 km) per hour.

1830s
First railway is built in Canada.

1834
The railway company that became the Great Western Railway is incorporated. Based in south-western Ontario the railway runs from New York State to Michigan.

1849
The Province of Canada passed the Guarantee Act, sponsored by Sir Francis Hincks, which facilitates the financing of railways.

1852
The British-owned Grand Trunk Railway (GTR) based in Montreal is incorporated. The GTR line from Montreal to Sarnia, Ontario is for a time the longest railway in the world.

1853
The St. Lawrence and Atlantic Railroad is built from Montreal to Portland, Maine – an ice-free port.

1864
The Fathers of Confederation meet in Quebec City and agree to build a railway – the Intercolonial – from the Maritimes to Quebec, as a condition of Confederation.

1867
The British North America Act is passed by the British Parliament, creating the Dominion of Canada.

1871
The colony of British Columbia joins Canada as a Province on the condition that a railroad be built within 10 years – it took 15 years.

1871
The repair shops of the Great Western Railway and the Grand Trunk Railway are among the largest industrial enterprises in Canada.

1873
The Conservative government of Sir John A. Macdonald is forced to resign because of the Pacific[30] Scandal (some called it the Pacific Slander). This transition slows the construction of a transcontinental railway because the Liberals are not as enthused with the idea of a national, transcontinental railway.

1878
Sir John A. Macdonald returns to power, committed to a 'National Policy' which includes the construction of a transcontinental railway.

1881
The CPR is incorporated to build a transcontinental railway.

1882
The Grand Trunk and the Great Western railways merge.

1883
The CPR builds its first locomotive.

1884
International standard time, invented by the Canadian surveyor and engineer Sir Sandford Fleming, is adopted. It is a means of ensuring that train time is consistent among cities.

1884
The first Dow Jones Index is published and 9 of 11 stocks are railway companies.

1885
Within one week the 'last spike' of the CPR is driven at Craigellachie, B.C., and Louis Riel, whose second uprising did much to ensure the success of the CPR, is hanged in Regina.

1891
Ontario has by now passed more than 500 acts of incorporation for railway companies.

1896
The Liberals under Wilfrid Laurier defeat the Conservatives to become the 'perpetual governing party'.

1899
The Canadian Northern Railway is incorporated with a head office in Toronto, but comes to have a strong operating system on the Canadian prairies.

1902
The Liberal Government of Ontario creates the Temiskaming and Northern Railway Company (now the Ontario Northland Railway) as a Crown Corporation.

1903
Laurier chooses the Grand Trunk Railway to build a second transcontinental railway.

The Minister of Railways, A.G. Blair, resigns over this decision.

1904
Nearly 20,000 miles of railway track now exist in Canada.

1906
The Ontario Conservative government creates Ontario Hydro as a Crown Corporation.

1911
During the federal election, Laurier commits to a third transcontinental railway.

1911
Laurier loses the general election to Robert Borden's Conservatives.

1913
Nearly 30,000 miles of track now exist in Canada.

1913
400,000 immigrants arrive in Canada, the highest number in a single year in Canadian history.[31]

Since 1896, the Canadian economy has been growing at an annual rate of 5.5% in terms of GDP/capita.

1914
World War I begins. Great Britain prohibits the export of capital and nationalizes its railroads.

1916
A Federal Royal Commission is appointed to Inquire into Railways and Transportation .

1917
The Commissioners deliver a split decision as to what to do with the 'railway mess' in Canada.

Legislation is introduced to place all government railways under a Railway Commission.

1917
The first federal election in six years is won by a coalition led by Sir Robert Borden.

1918
World War I ends.

1919
The government acquires the Grand Trunk Railway and creates the Canadian National Railways (CNR).

1921
Canada experiences a severe post World War I Depression.

1922
The consolidation of the various components into one operating system within the CNR is completed.

1923
More than 50,000 miles of railway track now exist in Canada.

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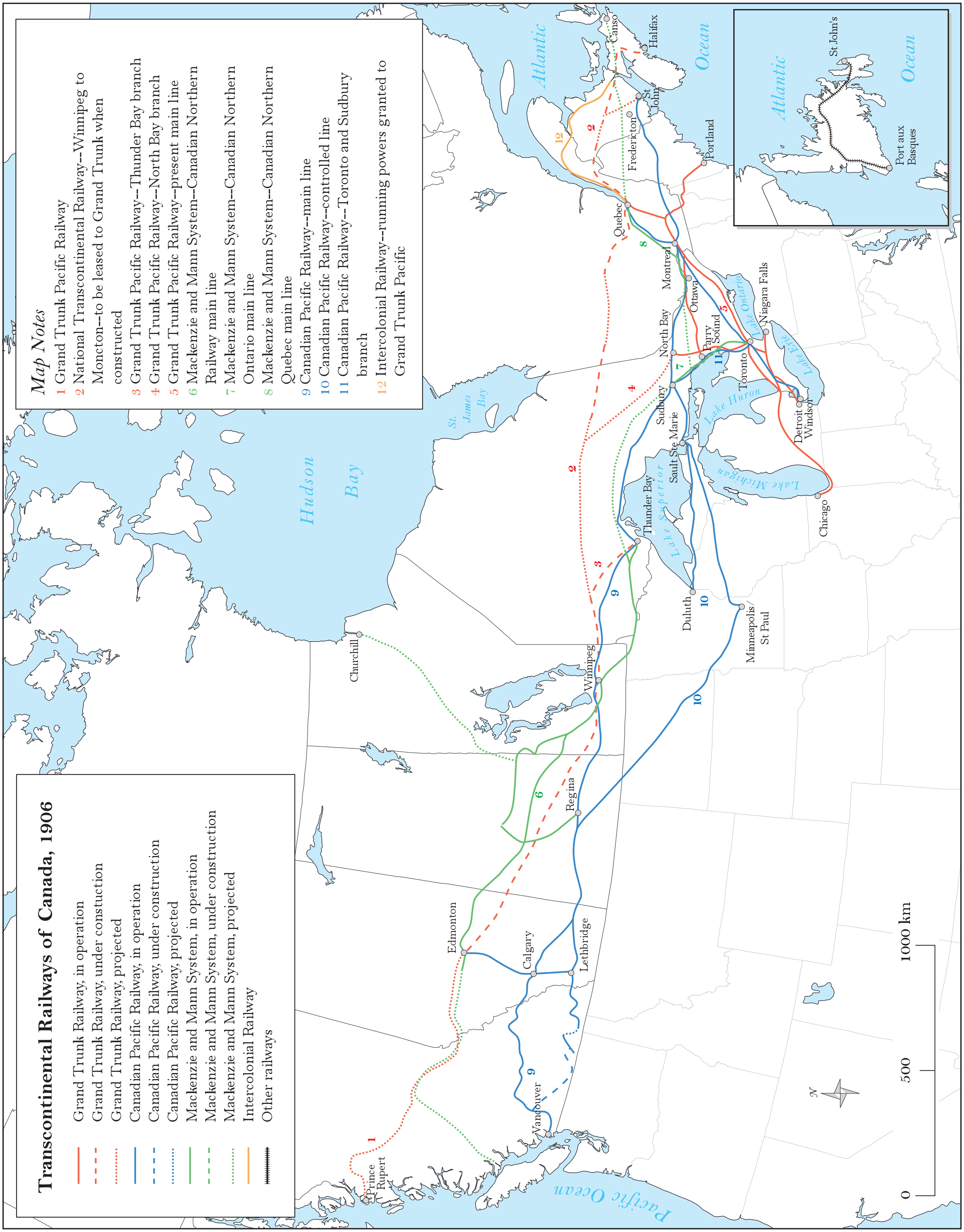
31 In reference to the construction of a railway to the Pacific Ocean.

32 The year 2005 saw the second highest number in Canadian history, when 262,000 people immigrated.

Railway Map of Canada, 1906



Railway Map of Canada, 1915