

CHAPTER 2 INTRODUCTION

THE PROBLEM

"How do you turn around a company losing \$500 million per year and have it make \$500 million per year?" The foregoing statement by a United States Railway Association official captures the essence of the ConRail financial issue. The proposed railroad's principal component, the Penn-Central, will lose about one-half billion dollars in 1975. From the merger of the Pennsylvania Railroad and the New York Central in the 1960's, the railroad has been experiencing a steady financial decline. The largest railroad in the United States, the Penn-Central, serves a 16-state territory where half of the U.S. population resides and a major portion of its industry is located.

In the years since the Penn-Central Transportation Company's bankruptcy, other Northeast railroads have experienced a similar fate. Among these are the Central of New Jersey, the Lehigh Valley, the Leigh and Hudson River, the Ann Arbor, the Reading, and the Erie-Lackawanna. Together with the Penn-Central, these lines cover about 22,200 miles. The Regional Rail Reorganization Act of 1973 called for the development of a new rail system to replace the bankrupt carriers operating in the Northeast and Midwest. The traditional process of reorganizing the debt structure of individual bankrupt railroads was acknowledged as inadequate to deal with these bankruptcies. Instead, innovative ideas applied regionally were to form the basis for a new viable rail system. The U.S. Railway Association (USRA) was established to prepare a "blueprint" for the new system.

This assessment is concerned with the financial viability of the restructured railroad entity proposed by USRA and named ConRail, or the Consolidated Railroad Corporation. USRA anticipates that this new entity can profitably operate the bulk of the lines of the bankrupts, after a sizable U.S. government investment at the beginning. The USRA forecast projects profitable operation by 1979.

On February 26, 1975, the USRA published a Preliminary System Plan (PSP) to describe this new regional rail system. Considerable criticism was levelled at that plan by the ICC, bankers, solvent carriers and the public. USRA considered that criticism and on July 26, 1975 published a revised Final System Plan (FSP). A difficulty faced by USRA was implicit in the statute that charged it with the reorganization task. The 1973 law stipulated that the new system was to fulfill many and in some cases conflicting goals. The new railroad was to be profitable. Yet, it was to provide maximum service, which to some implied that unprofitable lines were not to be shut down. The new plan was to provide for competition, but whether this had to be rail-to-rail competition or whether inter-modal, for example, truck-to-rail, would be sufficient was not specified. In short, USRA tried to incorporate

in its plan the conflicting goals of the Act by creating a system that was financially viable yet did not destroy competition among the solvent carriers and still provided adequate service to shippers.

The recommended alternative in the PSP was a three-carrier system with the Chessie and Norfolk & Western Railroads competing with ConRail in the Northeast and Midwest Regions. These currently profitable railroads were to purchase portions of the bankrupts which would provide them with competitive access, along with ConRail, to key market areas such as Newark and Albany. Comments received from the public by the ICC generally indicated that USRA had fulfilled the goal of maintaining competition among the carriers. In the FSP, USRA slightly modified the approach because the Chessie expressed an interest in buying a major part of the bankrupt railroads whereas the N&W did not.

The proposed solution contemplates the purchase by the Chessie System, Inc. of 2,500 miles from the bankrupt lines for \$62.5 million. USRA proposes that another 5,700 miles of light-density lines be pared from the bankrupts and either be closed down or operated with State and Federal subsidies. According to this solution, USRA believes the Act's goal of maintaining competition will be met by giving the 11,500 mile Chessie stronger access to Northeastern markets. The separation of 5,700 miles of light-density lines from ConRail is USRA'S attempt to balance the Act's goal of forming a financially viable entity with its goal of maintaining adequate service to the Northeast.

This paper focuses solely on whether or not the ConRail plan fulfills the goal of developing a financially viable system. The significance of this issue for the Congress can be summarized in the following questions:

1. What are the total financial burdens that will be placed on the general taxpayer if the ConRail proposal is implemented? The proposal seeks \$1.85 billion in Federally provided capital with delayed payback provisions on interest and principal. \$650 million in contingency funds are sought in addition to subsidies, guarantees and loans totalling billions of dollars more. But, the total financial burden may be more than twice this amount.
2. Will ConRail succeed financially? This question is not independent from the first, for if enough unprofitable burdens are lifted from ConRail and enough subsidies are provided, presumably financial viability could be assured. But such a solution would be a pyrrhic victory, because it would be little more than an accounting accomplishment. The basic question is: How long will Federal subsidies be needed after initial transfer? The ConRail proposal expects the restructured railroad will earn a

- profit before taxes and extraordinary items of \$36 million by 1979. Is this a reasonable projection?
3. Did the Congress in charging USRA through the 1973 Rail Reorganization Act, or did the USRA in interpreting its Congressional mandate, bias the proposed rail solution to the point that superior options to that favored were not seriously put forward? This question involves the choice of the favored "system." For example, the USRA interpreted the Congress' mandate that competition be provided by the solution as requiring rail-rail competition in the major ConRail market areas. However, trucks and barges or other water borne traffic compete with railroads for freight shipments. This inter-modal competition is extensive. For example, more than half of all commodities shipped by rail are also shipped by truck. Even where inter-modal competition is weak, for example, on some routes for basic commodities such as coal and grain, the Interstate Commerce Commission regulates rates and to some degree service conditions. The price implicit in adoption of the FSP's preferred ConRail solution, with its rail-to-rail competition, is substantial. If inter-modal competition were instead deemed adequate, a one-system or unified ConRail solution could reduce the initial cost to the Federal government to establish ConRail. The amount of the reduction is, according to the FSP, from \$1.85 to \$1.2 billion, a thirty-five percent savings. A unified ConRail might divert revenues from other Northeast railroads, in part because of a greater long-haul service capability, but the size of such diversions as judged by USRA would not substantially alter the financial outlook of other railroads.
 4. What other Congressional actions are possible that might help ConRail to financial viability without incurring additional Federal financial burdens? Since the late 1950's, Federal funding of the Interstate Highway System has greatly enhanced truck competition with railroads for freight traffic. President Ford's Administration has urged regulatory reform of the ICC. In 1974, the Congress enacted legislation allowing truck weights to be increased, thus improving truck competitiveness with railroads.

This study focuses principally on the first three of the above listed four questions. But, indirectly, the financial viability of ConRail relates to the powers exercised by Congress and listed in item 4.

WHAT HAS CHANGED?

Throughout this report, a variety of non-financial considerations will be cited as potentially decisive influences on the financial projections. These are best labelled as structural or

secular forces, beyond the control of railroads. The PSP cited many of these factors in explaining the demise of the Penn-Central. Expectations about a reversal in the financial performance of the Northeast railroads must realistically reflect how these factors will impinge on rail operations in the future. Below, some of these considerations are noted, along with how they might evolve in the future in comparison with the past.

TABLE 1 - EXTERNAL FACTORS AFFECTING RAILROAD FINANCIAL VIABILITY

1960 - 1975

Increasing truck competition for inter-city freight aided by cheap petroleum, interstate highway construction and the flexibility of trucking versus fixed-track limited rail.

High economic growth rates favored other areas of the U.S. compared with the Northeast.

Manufactured goods more commonly shipped by trucks have dominated growth since 1960 whereas basic commodities have suffered a relative decline.

Spatial growth patterns have increasingly concentrated the U.S. population in large urban centers. Greater raw material specialization has increased the average length of bulk commodity movements. These developments should have favored rail freight movement, but railroads for regulatory, management and other reasons did not reshape their systems to fit new patterns.

In the Northeast, over forty million tons of coal-fired electrical generation capacity was converted to oil and gas between 1967 and 1972. Railroads lost a major share of these shipments. Oil and gas moved by water or pipeline.

Post-1975

Truck competition may continue to make inroads but railroads use less energy per ton mile (at least one-half) than trucks and new highway construction is being curtailed.

Economic growth in the Northeast will continue to lag nationwide performance, particularly performance in the South and Southwest.

The energy crisis has boosted coal as a major rail-shipped commodity. But, manufactured goods will continue to pace economic growth.

Projected population growth and movements should favor rail's ability to compete if over-developed rail systems covering low-density routes can be reduced in size and railroad reliability and speed of delivery times improve.

Oil and natural gas shortages will favor coal conversions and the siting of new coal-fired facilities.

The above citations of some of the possible external developments that could make or break ConRail highlight coal as a key consideration. The ConRail plan expects coal to play a major role in the Northeast railroad revival. This report, therefore, gives special attention to coal. Illustrating the decisive role of this commodity are the two other major rail systems operating in the Northeast: the Chessie and the N&W. At the end of the first quarter of 1975, the Chessie led the nation's railroads with cash on hand of \$185 million. It was followed by the N&W with \$175 million. Yet, it is questionable whether a third railroad operating in the Northeast can also base its profitability on coal. These other entities are better positioned vis-a-vis the West Virginia coal fields and both serve the export port at Norfolk. Moreover, - the ConRail plan, rather than focusing on coal-based viability, contemplates selling to the Chessie its only coal line into West Virginia (in 1974, this line carried one-eighth of the coal tonnage that the Penn-Central originated) and strengthening the Chessie's access to the fastest growing 1974 coal market, Canadian exports. A key question, therefore, is how coal fits within the financial plans for ConRail. (See Chapters 3 and 6). In explaining Chessie's earnings gain in the first six months of 1975 while the rest of the economy faltered, ¹ Chessie's President attributed success to "good management and coal." ²

The expectation of good management and the projection of major financial savings because of improved management are central to the profitability of ConRail as foreseen by USRA'S FSP. The plan anticipates that large financial benefits will result from improvement in rail yard efficiency, from the use of a computerized car tracking and allocation system, and from a car blocking system which reduces yard burdens by moving blocks of cars around points of congestion. Improved management performance will be essential if ConRail is to capture, as the ConRail plan expects, \$50 million in revenues from other rail carriers. Innovative marketing by management is assumed in the forecast of an additional \$41.6 million in revenues from piggy-back freight. The management challenge in making ConRail financially self-sustaining cannot be understated. The prospects are made even more sobering by the realization that the nation's largest and most efficient major railroad has consistently proved to be unmanageable.

In weighing the financial viability of ConRail, the possibility cannot be totally eliminated that the density of railroads in the Northeast is greater than that area can sustain. The ConRail plan meets this possibility by proposing the divestiture of 5,700 miles of light-density track. But, some PSP critics deemed that inadequate. Little was done to reduce yards and main line trackage. Even superior management operating a system too large for its markets cannot achieve success. The ICC noted that comments on the PSP repeatedly emphasized that more attention be given to the

¹ Capacity utilization in the industrial Sector was slightly less than 70 percent.

² Business Week, August 11, 1975, P. 51

"problem of mainline and terminal rationalization and that the 'spaghetti' of redundant facilities throughout the Region must be eliminated." ³ The solvent railroads criticized the PSP, saying according to the ICC, "...operating efficiencies could only be achieved by eliminating duplicative terminals, yards, and mainlines, not by simple elimination of branch lines..."⁴ Yet, the FSP includes no significant further measures to reduce redundancy.

In judging the merits of the final ConRail plan, the search for the perfect solution could sacrifice the attainability of a successful second or third best solution. Most critics of the PSP, however vehement, urged that above all something be done quickly to head the bankrupt Northeast railroads in a new direction. The Congress in weighing the USRA proposal must decide whether the possible weaknesses in the ConRail plan justify further delay or whether they can be dealt with in an evolutionary way as the FSP maintains.⁵

THE FINANCIAL FRAMEWORK

The financial viability of ConRail will depend on its ability to generate revenue, control operating expenses and attract financing. The bankrupt carriers were notably unsuccessful in all three areas. Declining revenues in the Northeast coupled with skyrocketing interest rates and labor costs made attracting private capital impossible. These carriers have now turned to the Federal government as the lender of last resort to obtain the cash necessary for continued operations.

The Final System Plan recognizes that a simple injection of new capital will be insufficient to create a profitable railroad. Revenue will have to be generated by competing more effectively for freight with trucks and other carriers. Costs will have to be reduced by employing more advanced control systems, rehabilitating the rails and equipment, and obtaining management of 'the highest caliber.' Finally, capital will have to be provided in large part by the Federal government to accomplish these aims. In return, the nation is to receive a rail system that will provide adequate service to shippers and eventually become a profitable privately owned and operated enterprise.

The FSP projects the performance of ConRail during the planning period 1976-1985. The USRA analysis relied extensively upon field surveys, consultant reports, simulation models, analysis of historical data and internal staff work. USRA in preparing the FSP as the final plan for reorganizing the Northeastern railroads synthesized these voluminous studies choosing those assumptions which they felt best reflected future ConRail operating conditions.

³ICC **Evaluation of U.S. Railroad Association Preliminary Systems Plan.** p. 11

⁴Ibid., p. 13

⁵See FSP, p.5-6. 'A task so complex as the restructuring of the rail system in the Region must be evolutionary. . . In the longer term, after the ConRail system is established, further sales, mergers and consolidations of facilities may be desirable.'

On closer examination, however, the financial viability of the plan proves quite sensitive to a few key assumptions. Varying these assumptions between optimistic, pessimistic and moderate scenarios demonstrates the impact on the profitability and capital demands of the proposed system. The critical assumptions examined fall into the following categories:

Revenue Generation

1. Baseline growth - The USRA forecast foresees an improved performance by the Northeast economy. Recently, the Northeast economy has grown at a slower rate than other regions of the U.S.
2. Coal - Because of the energy crisis, USRA foresees a major increase in coal shipments and revenues.
3. Trailer on Flat Car (TOFC) - Rapid growth but questionable profitability is USRA'S outlook for this railroad market area.
4. Inter-modal Competition - USRA forecasts a decrease in incursion by trucks into ConRail markets.
5. Inflation/Regulatory Action - The USRA anticipates that in the future the railroads will expedite their requests for and the ICC will act more rapidly in allowing rate increases to pass through cost increases borne by railroads.

Operating Expenses

1. Yard Efficiencies - USRA expects significant savings from improved yard efficiencies.
2. Car Utilization - Improvements in car management, according to the USRA outlook, will increase car utilization and reduce the required investment in rail cars and locomotives.
3. Track Utilization - By increasing rail density - the number of cars per mile of track - USRA expects ConRail can reduce operating costs.
- 4* Cost Control Systems - Future potential savings are expected because of closer cost control.
5. Labor Productivity - Few improvements in labor performance are forecast by USRA.
6. Management - ConRail expects great improvements will result from better management.

Financing

1. Valuation of Properties - Significant disagreement exists between the creditors of the bankrupt railroads and USRA on the value of railroad assets. If the lower USRA estimate prevails in court tests, the cost of ConRail implementation will be substantially lower.
2. Depreciation Accounting - Various accounting options can impact on profits. USRA'S approach departs from conventional railroad practice and improves ConRail's outlook.

3. Rehabilitation Cost - A major use of capital is in upgrading rails and equipment. USRA has carefully weighed the possible impact of inflation on the cost of such improvements.
4. The Form of Federal Investment - The future flexibility of ConRail is affected by how deeply the government, as ConRail's principal creditor, is involved in control of the company.
5. Passenger Subsidies - Large passenger subsidies from the government to ConRail are viewed by USRA as essential for successful ConRail financial performance.

The approach of this report is to examine the critical assumptions just reviewed in light of the background data provided by USRA, the views of other key parties such as the ICC, the creditors of the bankrupts, and independent analysts. The methodology of the report is summarized in the accompanying simplified schematic (Figure 1). Step 1 is to assess likely railroad revenues, expected costs of operating the railroad and the required capital investment to acquire and upgrade the bankrupt rail track and equipment. Chapter 3 examines the revenue outlook, covering such considerations as baseline economic growth in the Northeast, coal, TOFC, and inflation and regulatory lag. For example, a key assumption is how quickly the railroads can document a cost increase, request an appropriate ICC rate increase, and obtain an ICC decision. Chapter 4 looks at operating expenses and assesses FSP projections in such areas as yard, track and car utilization improvements. USRA's expectations for major gains in these areas are evaluated against performance by other railroads and in the context of ConRail's unique structural characteristics. The third major determinant of financial viability is the cost to ConRail of acquiring from the creditors of the bankrupts the assets of the bankrupt companies and the cost of upgrading these run-down facilities. Chapter 5 addresses these issues.

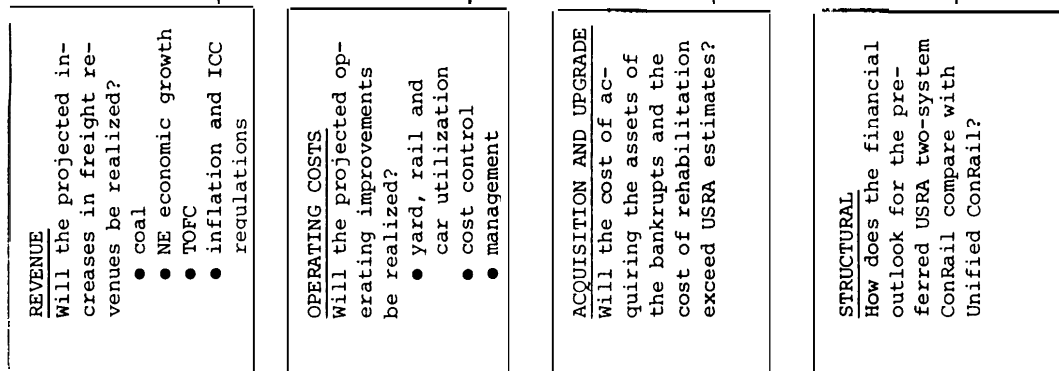
The second step in the analysis (Figure 1) is to pick from the many determinants of performance in the areas reviewed in Chapters 3, 4, and 5 a handful of the most critical ones. For these, a sensitivity analysis is presented in Chapter 6 to show how outcomes in these areas could alter ConRail's financial outlook. Some of the possible developments, for example coal, could give ConRail a financial boost. Others could worsen the financial outlook. At the end of Chapter 6, a conclusion is drawn on whether the likelihood is greater that the ConRail forecast is optimistic or pessimistic.

The third step is to incorporate the sensitivity analysis into revised financial accounts for ConRail. A new income statement and a sources and uses of funds analysis is provided.

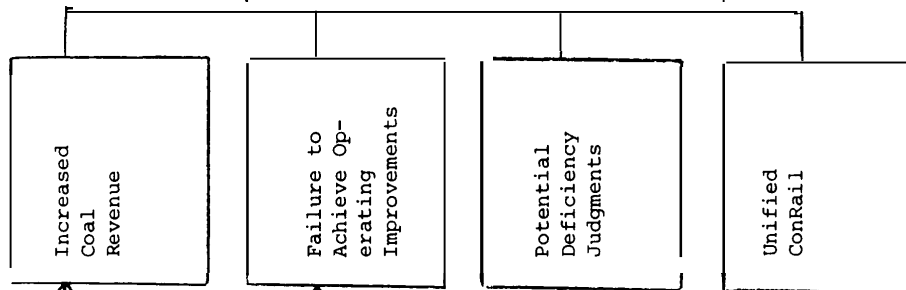
The final step in the analysis (Chapter 7) is an assessment of the consequences of various ConRail financial outcomes for the size of the Federal government's commitment to the railroad reorganization. Abbreviated financial statements provide a financial overview and permit the reader to readily assess the size of the Federal commitment.

FIGURE 1 - SCHEMATIC OF STUDY METHODOLOGY

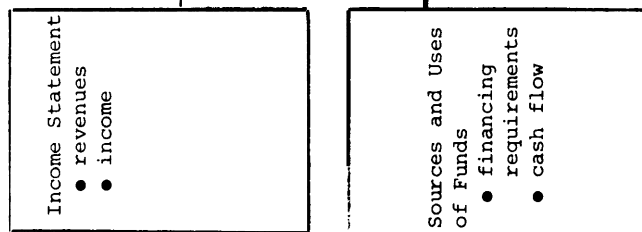
STEP 1
BASIC ASSUMPTIONS



STEP 2
SENSITIVITY ANALYSIS



STEP 3
FINANCIAL ASSESSMENT



STEP 4
CONSEQUENCES FOR FEDERAL GOVERNMENT

