RAILROAD REORGANIZATION:

CONGRESSIONAL ACTION AND FEDERAL EXPENDITURES RELATED TO THE FINAL SYSTEM PLAN OF THE U.S. RAILWAY ASSOCIATION

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PREFACE

Railroad Reorganization: Congressional Action and Federal Expenditures Related to the Final System Plan of the U.S. Railway Association provides a summary and explanation of the USRA recommendations and likely Federal expenditures. The paper was prepared in response to discussion with staff of the House and Senate Budget Committees. The paper is a summary and explanation of USRA's plan; in keeping with the Congressional Budget Office's mandate to be nonpartisan, it contains no recommendations. The paper was prepared by Porter K. Wheeler of CBO's Natural Resources and Commerce Division under the direction of Douglas M. Costle and Kenneth L. Deavers. Editorial assistance was provided by Melinda Upp.

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SUMMARY

In 1973, the Congress passed the Regional Rail Reorganization Act (P.L. 93-236) in response to the severe financial problems of the railroads in the Midwest and Northeast. The act created the nonprofit U.S. Railway Association (USRA) and directed it to submit a long-range plan for continuing rail service in the 17 states served by the Penn Central and six other bankrupt railroads. Interim financial arrangements now in effect could require an estimated $365 million this fiscal year in federal outlays to cover a portion of the losses being incurred by these railroads and to provide for some maintenance and rehabilitation. These arrangements cannot continue, for the railroad creditors eventually will force liquidation rather than wait until all assets have been consumed by the annual operating losses.

USRA submitted a two-volume plan on July 26, 1975. Because neither branch of Congress disapproved within the deadline fixed by the 1973 law, the plan now stands "approved." Further, both the House and the Senate now have passed an omnibus railroad bill that essentially authorizes implementation of the USRA plan. However, the President has threatened to veto the authorization, and legislation remains to be passed to appropriate funds to carry out the plan.

The Plan

The USRA Final System Plan proposes a consolidated system to be operated by a semipublic, for-profit corporation known as the Consolidated Rail Corporation (ConRail). ConRail would include about 15,000 route miles based around main lines of the Penn Central. This would substantially reduce the approximately 25,000 route miles operated by the bankrupt carriers. An additional 2,000 route miles would, however, be transferred to the solvent Chessie System; this, with other transfers of a smaller scale, would maintain the competitive nature of the rail system in most of the eastern market as specified in the act.

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The plan further recommends that 7,000 miles of lightly used or out-of-service lines be abandoned or subsidized by the states and federal matching funds. Of these, lines still in service (about 5,700 miles) represent about 23 percent of the routes considered in the reorganization, but carry only about 2 percent of the system's freight. USRA concluded that these lines could not be operated on a profitable basis. Congress has authorized $180 million in matching funds to subsidize these lines (an amount sufficient to support them without burdening ConRail); however, funds have yet to be appropriated to implement this authorization.

Full implementation of the preferred USRA alternative clearly depends upon the transfer to the Chessie System. The Chessie Board of Directors has approved the transfer, but only on condition of action by the Congress indemnifying the Chessie against adverse court decisions regarding the fairness of acquisition costs. The omnibus rail bill does provide the assurance desired. If the legislation which provides those assurances does not become law or if other obstacles arise to block the Chessie transfer, then USRA recommends that a "Unified ConRail Plan" be adopted. Under this fallback plan, the routes that would have been transferred to the Chessie would remain under ConRail control, giving it a virtual monopoly over rail services in the East.

Need for Federal Support

USRA has requested $1.84 billion in direct aid over the first five years, plus $250 million in contingency funds, to implement its recommended plan. If the plan's implementation is successful, ConRail would begin to break even at the end of that period and the direct federal contribution (less the contingency funds) would be repaid with interest by the year 2016. Total repayments are projected to be over $7.5 billion, returning about 7 1/2 percent on federal monies invested.

Further substantial federal expenditures for related rail programs have also been identified; ConRail would benefit from several that provide relief from operating losses on particular services, such as passenger service. These related expenditures would amount to an additional $937 million over five years, and would not be repaid.

The direct federal support of $1.84 billion would be used to purchase ConRail securities in the form of debentures and preferred stock. USRA recommended this method of financing, instead of loan guarantees, to allow deferral of cash interest payments, if necessary.

These estimates of direct federal assistance and its repayment depend entirely upon the projections incorporated in USRA's base case. If rail traffic grows more rapidly than projected, and if labor and other resources can be used more effectively than projected by USRA, then private capital might supplant government support, thereby reducing the federal funds required or at least providing greater assurance that repayment will be timely. On the other hand, studies for the House and Senate Commerce Committees have estimated that additional direct federal funding would be required if reality falls even moderately short of the projections. These estimates indicate that $460 million more could easily be required over the five-year period. While USRA has requested $250 million of uncommitted contingency funds, these would not be adequate to meet potential "overruns" of that magnitude.

Finally, if nothing should go well for ConRail -- if for example, no operating improvements are realized or if the courts take action that adversely affects the plan -- then the cost to the government could be considerably higher.

Cost of Alternatives

The cost of not carrying out any plan is even more difficult to estimate than the cost of the USRA-recommended plan. However, it is clear that federal expenditures could not be avoided, and could be even higher than those of implementing the recommendation.

For example, if the plan is not funded, either subsidies would be required to permit the existing railroads to continue service or the courts would be faced with the decision of whether to allow the bankrupt roads to be shut down. The bankrupt railroads recommended for consolidation experienced deficits of more than $30.0 million in the first six months of 1975 (ordinary net income). They were provided emergency assistance by the Congress of $217 million in fiscal year 1975; the level for fiscal year 1976 is estimated to be $365 million, assuming all authorized funds are spent. Such expenditures could continue indefinitely.

Should the courts permit a shutdown of operations by the bankrupt railroads, economic activity in the region certainly would be disrupted, at least temporarily, leading to increased expenditures for unemployment and other assistance programs. Estimates of the reduction in economic activity range from a low of 0.5 percent to as much as 5 to 6 percent, depending on the well-being of the national economy. The range of estimates reflects the extent to which alternative forms of transport were judged to have sufficient additional capacity to absorb diverted rail traffic.

Significance of the Plan

If the USRA plan is implemented and successful, the rail freight option would be retained for most shippers in the region. Because concerns about the environment, energy, and land use, as well as other factors, may affect the desirability of alternative modes of transportation, implementation of the USRA plan, or an alternative that could also result in the profitable operation of railroads in the East, would represent an important contribution toward maintaining flexibility of future choices.

However, even if successful, this reorganization would not solve the longer-term question about the appropriate transportation mix for the region, nor deal with questions of regulatory reform or potential improvements in operational efficiency. Such issues are not treated in this paper, although legislation relating to these matters is incorporated in the pending omnibus rail bill.

INTRODUCTION

The Congress has approved a plan for reorganizing and consolidating seven bankrupt railroads in the Midwest and Northeast, prepared as required by the Regional Rail Reorganization Act of 1973 (P.L. 93-236).[1]

As defined by the act, the 17-state region stretches from the Canadian border on the north to Virginia and the Ohio River on the south; from the Atlantic Ocean on the east to Lake Michigan and Illinois on the west. This region accounts for about half the goods produced in the United States; railroads transport about a third of the intercity freight originating in the region. The traffic on the railroads being reorganized generates about half the region's rail freight revenues. Hence, the region and its railroads are of obvious importance to the entire economy.

The Congress passed the act in response to the bankruptcies of several eastern railroads and the potential liquidation of the Penn Central and other properties. In the act, the Congress declared that the service provided by the bankrupt lines is essential, and that continuation and improvement is required by both regional and national public convenience and necessity.

As a mechanism for attacking the problem, the act created three new organizations:

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1. The seven railroads are the Penn Central, the Erie Lackawanna, the Central of New Jersey, the Reading, the Lehigh Valley, and the smaller Lehigh and Hudson River and the Ann Arbor. The Pennsylvania-Reading Seashore Lines is not a railroad in reorganization, but is wholly owned by two railroads in reorganization and was included in the consolidation. The Boston and Maine is being reorganized separately under normal procedures.

- The U.S. Railway Association (USRA), a nonprofit government organization which was given the responsibility for developing a plan to reorganize collectively the region's bankrupt railroads that could not be reorganized individually. The act established an elaborate calendar of USRA reports and reviews, leading to a Final System Plan, which was submitted on July 26, 1975.

- The Rail Services Planning Office (RSPO) within the Interstate Commerce Commission (ICC) to review and evaluate the various reorganization reports, and to provide legal assistance to rail users and affected communities.

- The Consolidated Rail Corporation (ConRail), which is to acquire and operate railroad properties designated by USRA.

The act specified that the USRA plan would "be deemed approved at the end of the first period of 60 calendar days of continuous session of Congress" after the final plan was submitted if neither the House nor the Senate passed a resolution of disapproval before that date. Since neither House did pass such a resolution by the deadline, which was November 9, the plan has been approved.

However, further legislation is required, because present funding authority in the reorganization act is inadequate to carry out the USRA recommendations; further, numerous amendments to the act are implicit in the USRA plan. An omnibus rail bill which would authorize the required funding and amend the original act, namely the Railroad Revitalization and Regulatory Reform Act of 1975 (S. 2718) has passed in both the House and Senate. However, funds to implement the plan have yet to be appropriated and the President has threatened to veto The authorizinglegislation.

If implemented, the USRA plan would significantly restructure the railroad industry and require a major, new, and direct involvement of the federal government in that industry. If the funding required by the plan is not provided, the courts could authorize termination of the bankrupt railroads' operations to prevent further erosion of their properties. In that event, alternative legislative action would be necessary to preserve rail transportation in the region or to ensure the availability of alternative transportation and to prevent substantial income and employment losses.

This report analyzes the USRA Final System Plan and related Congressional considerations. After outlining the causes of current railroad problems in the East, the report summarizes the Final System Plan, then discusses the federal expenditures that would be required to implement it. It also identifies the costs of additional elements associated with a comprehensive rail program. Finally, the report presents a timetable for Congressional action and outlines the major choices to be made.

BACKGROUND OF THE RAILROAD PROBLEM

Over the last half century, the competitive position of the railroad industry has deteriorated. While railroads continue to transport the most intercity freight in terms of revenue ton miles,[2] they no longer dominate the intercity market for transportation of either freight or passengers. In 1947, the railroads carried nearly two-thirds of the ton miles of intercity freight; by 1973, that share had dropped to 39 percent. Over the same period, revenue passenger miles[3] via rail declined by 80 percent in spite of generally explosive growth in passenger travel.

The railroads' decline has been paralled by the rapid development of competing transportation systems in an expanding total market. Trucks, inland water carriers, and pipelines have roughly doubled their share of the intercity freight market since World War II. These competing modes have improved technologically and have enjoyed substantial government financial support and other encouragement. The expansion of auto, truck, barge and airlines has eroded the railroads' traffic base.

In addition, basic changes in underlying market conditions have favored the newer modes at the expense of railroads. Freight generated from heavy industry and agriculture has declined relative to goods produced by a service-oriented, high-technology economy with dispersed plant locations and new growth centers. Rail facilities that were in place before these changes occurred cannot be easily trimmed back or moved. For a variety of reasons -- including government regulation, management failures,

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2. Ton miles are a product of the weight of lading and the distance transported.

3. Revenue passengers weighted by miles traveled.

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rigid labor contracts, and obsolete capacity and technology within the industry -- the railroads have not responded adequately to changed market conditions. No single cause explains the recent evolution of the transport system, and simple solutions will fail to respond to the complexity of the problem.

Sluggish growth in traffic and revenue has depressed the railroads' financial performance, particularly in the Northeast and Midwest. Revenue ton miles carried in the Eastern District, (which, as defined by the ICC, roughly corresponds to the territory covered by the reorganization act), actually declined by 17 percent between 1947 and 1973, while national rail traffic grew slightly. The relatively slow economic growth in the East, especially in goods for which rail is most competitive, is reflected in this decline. Even recent increases in the East have left traffic levels well below those experienced between 1965 and 1970.

As national traffic grew, increased productivity and abandonment of lightly used tracks allowed rail facilities overall to be reduced slowly. The declining volumes in the East were especially troublesome because a fairly sizeable reduction of rail facilities and overhead was called for, but could not be rapidly accomplished. As indicated in Table I, the bankrupt carriers were unable to reduce their trackage as rapidly as traffic fell, whereas major railroads in the South and West did realize substantial traffic growth and also were able to reduce their system somewhat, thus enjoying operating leverage. The region's railroads also operate a major portion of the country's remaining rail passenger service, both intercity and commuter. Providing passenger service has been an administrative, as well as financial problem. While the inception of Amtrak payments to the carriers for intercity service and local contributions for commuter operations have reduced the financial burden of passenger service somewhat, the burden has not been completely eliminated.

The result of declining traffic, along with other complex and interwoven problems, has been the bankruptcy of eight railroads in the region since 1967. The most significant bankruptcy, of course, was that of the Penn

Table I

GROSS TON MILES VS. MAIN[1] TRACK MILES
1953 TO 1973

	Percent Change	
	Gross Ton Miles	Main Track Miles
Railroads in reorganization	-30.4	-21.4
South (Central of Georgia, Louisville & Nashville, Seaboard Coast Line, Southern Railway System).	+47.3	-5.8
West (Atchison, Topeka & Santa Fe, Burlington Northern, Southern Pacific, Union Pacific).	+19.3	-6.2

[1] Running track, excluding yards, sidings, etc.

Source: USRA, Final System Plan, Supplemental Report, p. 4.

Central in 1970, but two companies, the Central Railroad of New Jersey and the Boston and Maine, had gone into bankruptcy even before the Penn Central collapsed. Other eastern railroads followed, the Lehigh Valley almost immediately, then the Reading Company, the Lehigh and Hudson River, the Erie Lackawanna, and finally the Ann Arbor Railroad, leaving more than 50 percent of the rail mileage in the region in the hands of bankrupt carriers.

These carriers were all unable to generate positive income from operations, much less funds that could be used to contribute toward fixed charges. Table II shows the net railway operating income (NROI) for all Class I railroads and for Eastern District railroads.[4] As indicated, the six bankrupt carriers of Class I under USRA purview all lost money on operations, though other lines as a group did not. While railroad accounts are highly complex, NROI is a useful indicator of the profitability of rail operations alone, before deduction of fixed charges for capital. Class I railroads as a group show a distinct decline in NROI since the high points reached in the late 1920s and after World War II. Eastern District railroads experienced a dramatic decline; USRA bankrupt carriers have recorded deficits in NROI since 1967. Each group has experienced some improvement in NROI for the most recent years, though the recession weakened results in the latter part of 1974 and early 1975.

Traditional reorganization procedures under Section 77 of the Federal Bankruptcy Act were of limited use in this situation, because they tend to assume that a reorganization of existing debt structure would be adequate to establish an ongoing corporation. These bankrupt

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4. Class I railroads are defined by the ICC as those carriers with annual operating revenues of over $5 million. A more extensive discussion of financial measures and conditions, including technical definitions, can be found in USRA, Preliminary System Plan, Volume I, Appendix B.

Table II

NET RAILWAY OPERATING INCOME[1]
(Millions of dollars)

CLASS I RAILROADS
(Selected Years)

		Eastern District Railroads		
	United States[2]	All Eastern	USRA Bankrupts[3]	Other Eastern
1929	1251.7	634.6	-	-
1939	588.8	331.1	-	-
1947	780.7	304.4	-	-
1952	1078.2	439.1		
1957	922.3	385.3		
1962	725.7	196.6		
1967	676.4	174.6	-16.2	190.8
1968	677.6	139.7	-54.4	194.1
1969	654.7	118.7	-69.2	187.9
1970	485.9	-101.6	-256.2	154.6
1971	695.5	- 32.3	-184.5	152.2
1972	827.7	38.6	-141.5	180.1
1973	849.3	50.1	-123.7	173.8
1974	978.9	111.1	-118.3	229.4

[1]After taxes, but before other income or fixed charges.
Figures are before provision for deferred taxes (not restated).

[2]Excludes Amtrak.

[3]Six bankrupts, includes Erie-Lackawanna, but excludes Lehigh and Hudson River Railroad as non-Class I. Does not include Pennsylvania - Reading Seashore Lines.

Sources: USRA, Preliminary System Plan, Volume I, p. 244; Association of American Railroads.

railroads are contributing nothing to debt service. Indeed, after several attempts to reorganize the Penn Central, the trustees filed a reorganization plan that proposed to liquidate the company's assets, rather than an operating plan of reorganization traditional under Section 77. The seven bankrupt eastern railroads have since been deemed unable to be reorganized individually on an income-making basis, and thus the new procedures of the rail act brought them under USRA purview for consolidation and reorganization.

The statutory goals guiding preparation of the _Final System Plan_ were outlined in section 206 of the act. These goals stipulate that the restructured regional rail system should:

- Be financially self-sustaining.
- Meet regional rail transportation needs adequately.
- Promote improved high-speed rail passenger service in the northeast corridor and reflect USRA's identification of other corridors in which major upgrading of track for high-speed passenger operation would yield substantial public benefits.
- Preserve, as much as possible, existing patterns of service.
- Preserve facilities and service for coal transport and conserve scarce energy resources.
- Retain and promote competition.
- Attain and maintain desirable environmental standards.
- Achieve efficiency in train operations.
- Minimize unemployment and adverse effects on communities.

THE FINAL SYSTEM PLAN

The Final System Plan (FSP) submitted by USRA to the Congress in July, plus a Supplementary Report that followed in September, address in considerable detail four dominant issues:

- The structure of the railroad system to be operated by successor corporations, that is, the nature of mainline reorganization and consolidation.
- The importance of light-density branch lines and the extent to which they might be abandoned.
- The method and extent of financial support for the newly reorganized railroad industry in the region.
- Finally, the organizational and financial programs that might be undertaken to achieve operating economies or reduce other costs, which are dealt with primarily in the supplementary report.

While this is by no means an exhaustive list of the issues requiring resolution, they are the ones most relevant to current Congressional considerations. The first two are discussed in this section, the latter two in the following section.

System Structure

While the act established the Consolidated Rail Corporation (ConRail), it gave USRA the duty to define the

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5. A two-volume Preliminary System Plan also was issued by USRA on February 26, 1975, and a Supplement in May, 1975.

scope of the rail system over which ConRail would assume responsibility. The FSP proposes a ConRail system that would consist of about 15,000 of the approximately 25,000 route miles operated by the carriers in reorganization. Major Penn Central routes would be included, along with mainlines formerly operated by the Central Railroad of New Jersey, the Lehigh Valley, the Lehigh and Hudson River, the Pennsylvania-Reading Seashore Lines, and smaller portions of the Ann Arbor, the Erie Lackawanna, and the Reading. Thus, the proposed system gives the for-profit ConRail the major role in the reorganization, basically opting to preserve the private enterprise character of railroad activities.

Agreement has been reached with the Chessie System (Chesapeake and Ohio Railway, Baltimore and Ohio Railroad, and the Western Maryland Railway), a solvent railroad in the region, to transfer to it from the bankrupt estates about 2,000 route miles, including substantial portions of the Erie Lackawanna and Reading railroads. The acquisition price has been set at $54.5 million. The agreement is conditional upon Congressional action, primarily to affirm the adequacy of the negotiated price and to indemnify Chessie against later court judgements regarding the fairness of the price.

These transfers to Chessie were proposed primarily in response to the act's goal of preserving competition. They would retain at least two competitive rail services to major markets such as Philadelphia and New York, where traffic was judged to be sufficient to permit such competition. Otherwise, the consolidation of seven existing railroads into a single network supported by federal funds would leave little or no rail-versus-rail competition in most northern markets, and no private railroad with which to compare ConRail operations.

The Norfolk and Western Railroad (N&W) would continue in its present configuration and remain a leading carrier of coal from West Virginia, but USRA was unable to reach agreement with the N&W regarding a proposed acquisition of Erie Lackawanna trackage. However, the Chessie System since has agreed conditionally to acquire this trackage as well. Other small-scale transfers were proposed to the N&W, the Delaware and Hudson, and the Southern Railway.

Alternative Structures

Several alternative structures to USRA's preferred plan received considerable attention; two appear to remain as options that could still be implemented:[6]

- A "Unified ConRail" structure that would consolidate all the bankrupt carriers in the region, without transfers to other solvent carriers. This alternative would create a mammoth system with virtual rail monopoly in many major Eastern cities, Unified ConRail represents USRA's second option if the conditional agreement for the Chessie purchase cannot be finalized.

- The liquidation of the bankrupt properties via a a "controlled transfer." Controlled transfer, particularly transfer to solvent carriers outside the Northeast, has attracted considerable support, especially within the Administration and Department of Transportation (DOT), but none of the solvent railroads has signified Interest In this proposal. Proponents of controlled transfer

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6. Many other structures for the eastern rail system have proponents and have been evaluated by USRA. For example, RSPO strongly advocated two publicly supported carriers, the first primarily a restructured Penn Central, the other usually identified as Mid-Atlantic Rail Corporation/Erie Lackawanna (MARC/EL). USRA determined that two government-funded systems in competition were neither desirable nor necessary, and that the MARC/EL system would inherently possess limited on-line service capability and market penetration.

> believe that it would reduce the risk that government aid would lead to nationalization, that it would enhance the importance of the private market, and that it would enable more significant restructuring of the rail industry toward transcontinental operations.

Future evolutionary changes in the regional and national rail system may occur in response to market conditions, and are dealt with in pending legislation. For example, the FSP proposes amendments to the act that would allow the rail system to be adjusted, after it is conveyed to ConRail; such adjustments could include transfers.

Discussion

The system structure delineated in the USRA plan determines the relative scale of government-supported operations versus the remaining privately operated system, the degrees of railroad competition and monopoly within the Eastern District, and the total size of the railroad system to be operated. Any structure would represent some compromise among the act's conflicting goals; the FSP is no exception.

The FSP reflects two general USRA positions. First, USRA accepted the general policy goal of retaining and promoting rail-versus-rail competition, and thus tended to favor transfers to solvent carriers over the Unified ConRail solution. The failure of the Penn Central in 1970 undermined faith in the economic viability of large monopoly carriers. It was felt that a still larger railroad, supported by federal funds and exempt from other rail competition, could become a high-cost, high-rate, and low-quality system, and that little or no effective cost control would be possible. Therefore, effective rail-versus-rail competition was preserved in key markets. In fact, many critics felt even the proposed system, much less a larger one, would be too large to be managed effectively. The counter-arguments focused on potential economies of traffic consolidation and elimination of duplicate mainlines that would be made possible by incorporating everything into a single system.

The larger Unified ConRail appears to require broader initial public financial support, primarily to rehabilitate more railroad; however, that support eventually would be offset by greater profitability if operating improvements are achieved.

Second, controlled transfer was judged to be impractical, particularly in light of the difficulties encountered by USRA in negotiating transfers with Chessie and N&W. Those who favor controlled transfer anticipate gains from end-to-end mergers that would help solve railroad operating problems and promote technical innovation.[7] Such mergers would offer the potential to bypass yards, to reduce time-consuming interchanges of equipment, and to eliminate other areas of interface between multiple small carriers. A recent review for the Office of Technology Assessment suggests possible industry-wide benefits of up to $300 million from "ideal" restructuring, but concludes that the role of mergers in improving operations generally is cloudy. In particular, there is very little transcontinental traffic from which to realize benefits from end-to-end mergers.[8]

The immediate problems of deteriorating rail facilities and imminent liquidation, coupled with the act's legislative mandates, required an immediate solution. Time was insufficient for extensive and inherently indeterminate negotiations with many solvent carriers, particularly those outside the region. Further, the interest of western carriers in taking on the special railroad problems within the region has not been established and is not evident. The eastern carriers have problems of

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7. End-to-end mergers are mergers of nonparallel railroad lines.

8. "The Impact of Selected Legislative Options on the Solvent Railroads," Draft Copy, October 27, 1975, prepared for the Office of Technology Assessment, U.S. Congress, by Harbridge House, Inc.

sprawling urban terminals, and of extensive commuter and Amtrak intercity passenger operations. Transfers also would necessarily reduce the scale of the resulting system, since solvent carriers are unlikely voluntarily to absorb light-density lines in poor condition, whereas Congress has shown an inclination to preserve such lines, Future flexibility would be retained if Congress accepted the FSP recommendation to provide contingency funds for future mergers and consolidations.

Light-Density Lines

The plan does not include, and thereby recommends for potential abandonment or subsidy about 5,800 miles of railroad now in service and an additional 1,200 miles not in service. The plan notes that these lines carried only about 2,2 percent of all freight carried in 1973 by the railroads in reorganization, so that the restructured system would serve 97.8 percent of the freight currently carried, even though almost 23 percent of the existing route-miles would be excluded.

USRA concluded that continued operation of the unprofitable, light-density lines was not consistent with tht goal of creating a financially self-sustaining rail system.

The act recognizes that there would be situations where service would not be deemed profitable, but at the same time important to the locality or state. Mechanisms were included t© continue service with federal funds to supplement §tate and local contributions on a 70/30 sharing basis. Authorizations appear to be adequate, but eligibility requires state and local initiative and participation, which has been difficult t© achieve. USRA has proposed that ConRail ©perite any sections ©f light-density lines that are brought int© the subsfdized service continuation program, but has not proposed to include the lines in the ConRail system.

Alternatives

Three basic alternatives for light-density lines have emerged:

- Provide heavier subsidies for several years. For example, Section 805 of the omnibus Railroad Revitalization and Regulatory Reform Act of 1975, S. 2718, provides for a 100 percent federal share over the first 12 months, declining by 10 percent in the following year. Several other bills also address this issue.

- Require inclusion and/or operation of all lines inside the ConRail system, or at least return abandonment proceedings to normal ICC jurisdiction.

- Provide broader options for affected shippers, such as defrayal of additional shipping costs where freight might be diverted to other modes in lieu of rail service.

Discussion

No area of USRA planning generated more controversy than the light-density branch lines. It was clear that not all interests could be satisfied: testimony of public witnesses at the hearings conducted by RSPO clearly demonstrated heated opposition to USRA's proposals and highlighted the difficulty of balancing the act's conflicting goals.

The losses from these lines represent roughly only 10 percent of overall operating deficits. USRA identified overall operating deficits from these branch lines of $33 million annually for 1973 traffic and prices. Updated USRA estimates based on 1976 revenue and cost levels put the operating deficit for in-service lines at $49 million. However, there appears to be little hope of the light-density services becoming profitable in the future. Further, USRA and its consultants questioned whether the services are truly essential. They have suggested that their importance to local communities has been overstated in many cases.

USRA's viability test for light-density branch lines generally excluded those that were not generating traffic revenue sufficient to cover the cost of continued service. A few technical problems hampered the analysis of such a large number of branch lines. Data were inadequate and the accounting practices of the railroads are inconsistent. Where new data were revealed in public hearings or other sources, the analysis was reviewed.

One controversial aspect of the profit test applied was USRA's inclusion of an annualized cost for maintaining and rehabilitating track, a cost that cannot easily be calculated for operations at the margin. When RSPO sought to identify actual expenditures, it often found that no recent maintenance or rehabilitation costs had been incurred, implying lower actual costs. However, USRA has argued that the condition of most branch line trackage is very poor and would require rehabilitation soon, so that decisions regarding the future of these lines should incorporate rehabilitation costs.

A policy of complete federal subsidy would raise questions regarding the incentives for the local or state bodies to identify wisely services for continuation. Further, it would not resolve some structural problems resulting from the operation of light-density lines, including the requirement to continue separable-car railroading to service small-volume shipments. Where service continuation is contemplated, Congress could consider alternatives such as subsidies to defray higher rates via truck or assistance to relocate adversely affected industries before becoming committed to long-range support of submarginal rail services. Rail service need not be continued with federal support if other alternatives could be provided at less overall cost.

FINANCIAL AID BY THE FEDERAL GOVERNMENT

The USRA plan calls for the federal government to invest $1.84 billion in ConRail through the purchase of debentures and preferred stock; it also proposed that an additional $250 million be made available for contingency purposes. The plan recommends that the federal government invest in ConRail securities, rather than simply guarantee private loans, in order to provide ConRail with the flexibility to defer cash interest payments in the early years while retaining the private-enterprise character of the proposal.

USRA anticipates that this federal investment of $1.84 billion ($2.1 billion if contingencies are used) would be repaid, with interest, since the funds would be used to finance property rehabilitation and service improvements that are projected to result in a successful income-based reorganization of the rail properties. However, future repayment of both principal and interest does hinge on the earning power of ConRail, which would compete with privately financed railroads as well as other transportation modes.

This section discusses USRA projections for ConRail operations, then outlines the projected federal outlays, including federal assumption of other rail-related costs in addition to direct support of ConRail. Finally, it discusses several potential variations from the USRA scenario that could substantially increase the Federal financial commitment.

Direct Costs of ConRail Operations

Highlights of USRA's projected income statement for ConRail for 1976 to 1985 are presented in Table III. As compared to deficits since 1967, net revenues from railway operations are expected to be positive in 1976, the first year after consolidation, and to increase steadily thereafter, as shown in the table. (The ConRail projections are based on accounting procedures that differ

Table III

CONRAIL PRO FORMA STATEMENTS OF NET INCOME (LOSS):
SELECTED ITEMS
(Millions of inflated dollars)

	Years Ending December 51									
	1976	1977	1978	1979	1980	1981	1982	1985	1984	1985
Net railway operating revenues	222	585	516	652	885	995	1,152	1,258	1,390	1,520
Income (loss) before income tax expense and extraordinary items	(552)	(220)	(79)	56	259	554	415	475	544	597
Net income (loss)	$(332)	$(220)	$(79)	$56	$259	$554	$415	$545	$554	$597

Source: USRA, Final System Plan, Volume I, p. 51.

from the standard railroad accounting used by its predecessors.) Income before income taxes and extraordinary items Is projected to turn positive in 1979, as is net income adjusted for those items. Thus, USRA projects a profitable operation in the fourth year of consolidated operations, with profits amounting to $597 million annually by 1985 (in inflated dollars). Although ConRail would show a cumulative loss of $336 million in net income over the first five years, after ten years aggregate after-tax profits of $1.53 billion are projected.

The early deficits would be supported by cash inflows from federal purchase of ConRail debentures and preferred stock, representing essentially a federal Investment In the corporation, and, if necessary, deferral of cash interest payments. The direct cash needs from the federal government excluding $250 million in contingency funds total just over $1.84 billion, as projected in the ConRail income statements. The profits in later years would then be used to pay accumulated interest and gradually to retire or redeem the federally held securities. Repayments are projected to total over $7.5 billion, returning principal and interest at about 7.5 percent on the direct cash invested.

As shown in Table IV, cash needs for calendar year 1976 would be $698 million and would decline to $74 million in 1980. Table IV also shows USRA estimates of these cash needs by fiscal year! $465 million for 1976 (including the transition quarter) and $515 million for 1977, then a gradual decline to 1980. Some of the contingencies could be needed early to cover start-up needs for working capital or delays In collecting accounts receivable. Anticipated appropriations of $600-700 million through the transition quarter ending September 30, 1976, are larger than projected deficits In recognition of these potential start-up needs.

TABLE IV

DIRECT FEDERAL EXPENDITURES TO IMPLEMENT THE FINAL SYSTEM PLAN[1]
(Millions of Dollars)

Year	1976	1977	1978	1979	1980	Five-Year Total
Calendar Year:						
USRA Purchases of						
ConRail Securities[2]						
7.5% Debentures	698	302	—	—	—	
Series A Preferred	...	203	287	277	74	
TOTAL DIRECT FUNDS	698	505	287	277	74	1,841
Fiscal Year Needs:						
USRA Estimate[3]	465[4]	515	400	345	125	1,850

[1]Direct ConRail needs under USRA assumptions; does not include Federal assumption of other rail-related expenditures, from which ConRail could benefit.

[2]USRA estimates, FSP, Volume I, pp. 55.

[3]Does not include allocation of $250 million in contingency funds requested for USRA.

[4]Includes the transition quarter to new fiscal year beginning Oct. 1, 1976.

Sources: USRA, FSP, and USRA staff estimates.

Achievement of the Projections

A major turnaround from deficit to profit is required to achieve the USRA projections of ConRail operating results shown in Table III. Expressed in 1973 dollars, reconciliation of the 1985 income statement with actual 1973 levels implies a turnaround in ConRail net income of $516 million. This improvement includes increased operating revenues amounting to $325 million and a reduction in expenses by 1985 of $191 million.[9]

The revenue improvement of $325 million consists of:

- Increases in volume/mix of $242 million from basic traffic growth.
- Selective rate increases of $53 million, primarily applied to specific commodities and services judged to be noncompensatory at the present time.
- Traffic diversions to ConRail of $30 million.

Basic traffic growth accounts for most of the projected ConRail revenue increase when stated in constant 1973 dollars. Real revenues are expected to decline until 1980 or 1981, due primarily to the sluggish traffic resulting from the current recession and a small downturn or mini-recession in 1978, forecast by an USRA contractor. Projections by other groups do not include this mini-recession, however, so the traffic forecast may prove conservative.[10] After that time, USRA

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9. USRA, Final System Plan, Volume I, pp. 74 & 75.

10. Two prominent projections of economic activity, those of Data Resources, Inc., and Wharton Econometric Forecasting Associates, do not reflect the small recession in 1978 which was forecast for USRA by Chase Econometrics Associated, Inc.

contractors forecast a reversal to an upward trend in traffic revenues, including a sharp increase in coal traffic. Coal represents 62 percent of the projected Increase in tonnage, though it represents a smaller proportion of the projected revenue increase. Piggyback traffic, truck trailers moving by rail flatcar, is expected to result in about 15 percent of projected revenue growth.

The importance of coal warrants closer attention. Coal production and transport projections are closely related to domestic energy problems. Numerous studies have forecast different levels of national demand. The projections used by USRA are relatively conservative, being lower than the "Business as Usual" forecast under Project Independence.11 On the other hand, coal traffic growth could be constrained below the level projected by USRA by a reluctance of utilities to enter long-term contracts for coal because they may convert to methods that would not require coal transportation, that would transport it by other modes, or that would convert coal to synthetic fuel. Further, ConRail does not serve areas west of the Mississippi River where the majority of coal reserves are located.

The selective rate increases forecast by USRA, which would produce about 16 percent of the revenue increase, would be applied to the charge for transit privileges, as well as charges for major commodities such as farm products, pulp and paper, and waste and scrap. The assumption that selective rate increases can be imposed may be optimistic, since current rate regulation by the ICC has tended more toward approval of across-the-board changes, making selective increases very hard to accomplish. However, one of the purposes of the omnibus rail bill agreed to by the House and Senate is to "permit railroads greater freedom to price their services in

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11. USRA, Final System Plan, Volume I, pp. 74-75.

competitive markets."[12]

The final revenue item, traffic diversion, would apply to traffic now originating or terminating on the Lehigh Valley or Central of New Jersey but not now moving via Penn Central. Traffic diversion implies that ConRail would be able to sell shippers longer routings for traffic. However, ConRail would have to offer preferred-quality service to achieve this diversion.

The remaining improvements in 1985 are projected to be realized by a reduction in expenses amounting to $191 million (1973 dollars). There would be a number of increases in expenses, particularly in maintenance-of-way and maintenance-of-equipment accounts, but these would be offset by substantial reductions in fixed charges and transportation expenses. The latter reductions alone account for $147 million of the projected improvement of $191 million in 1985. These savings would result from improved car handling systems, coordinated and consolidated operations, rehabilitation of facilities, and improved management. Specifically, car utilization is projected to improve by 28 percent; yard operating expenses are expected to decline by 8 percent, primarily from better blocking; and yard rehabilitation is expected to yield a further 6 percent reduction in yard expenses.[13]

If ConRail operating expenses were no higher than the average Class I railroad, these reduced costs could be accomplished; however, major improvement would be required to achieve that level. The bankrupt railroads

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12. Section 101, S. 2718, the Railroad Revitalization and Regulatory Reform Act of 1975.

13. USRA, FSP, p. 79.

have been significantly less efficient than Class I railroads in the past, showing a 1973 operating ratio (operating expenses over revenues) of 83.3 versus a Class I average of 79.4. The bankrupt railroads have experienced freight expenses per thousand gross ton-miles that were 26 percent higher than the average Class I railroad. The FSP notes that a delayed and/or partial realization of these improvements in operating efficiency might increase the required level of government financial support by as much as $1 billion.

Interest Considerations

The private-market aspects of the reorganization funding deserve consideration. Whenever government funds are provided to a program via federal borrowing by the Treasury or Federal Financing Bank, federal outlays for interest are increased. These interest payments are not generally associated with program costs, though they might be considered implicit costs.

The FSP proposes federal purchase of ConRail securities on which interest and dividends would be earned for the Treasury, thereby offsetting the implied federal outlays for interest. Since ConRail will be unable to pay cash interest, Series A preferred shares would be issued by ConRail in lieu of cash interest and dividends in the early years. These "in-lieu" shares would not be in themselves federal expenditures on behalf of ConRail, but would be implicit interest payments on federal debt. The amount of deferral, as measured by the face or redemption value of outstanding Series A shares issued in lieu of dividends and interest, is projected to total $510 million at the end of 1980.

The omnibus rail bill agreed to by the House and Senate would eliminate the issue of "in-lieu" shares and not require ConRail to pay interest and dividends except as cash earnings are available. This would avoid the build-up of a heavy debt burden and increase the possibility of an income-based reorganization. Even so, the proposed financing is different from a grant, since positive earnings would generate federal receipts.

Sensitivity of Projections

In summary, the basic five-year federal cash requirements for ConRail are a minimum of $1.84 billion. This is the USRA base-case projection. Evaluations of the USRA financial projections carried out for the Transportation Subcommittees of the House and Senate Commerce Committees, however, indicate that the risk of shortfalls in revenues and operating improvements far outweighs the small upside profit potential and makes it likely that the cash requirements will be higher. Three illustrative possibilities of particular interest are noted below.

- Among the various operating improvements projected by USRA, improvement in freight car utilization was the most severely questioned by these evaluations. In fact, a shortfall was believed to be probable. By itself such a shortfall was estimated to increase the federal cash costs of ConRail by about $460 million to a total of $2.3 billion over the first five years, not including deferral of interest payments.[14]

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14. Princeton University Transportation Program, "Evaluation of the Final System Plan's Financial Analysis," September 15, 1975, prepared for the Subcommittee on Interstate and Foreign Commerce, House of Representatives, Section 4, pages 9, 13, and 14.

- If the package of delays and partial realization of operating improvements examined by USRA were realized, then ConRail's funding requirements would increase by about $1 billion.[15] Additional expenses incurred as a result of these negative factors are estimated to exceed the USRA-projected net income over the period, jeopardizing the concept of an income-based reorganization.[16]

- Assuming that no improvements at all in operating efficiency were achieved after 1976, the cash needs were estimated to rise by $1.3 billion to $3.1 billion. While this outcome is unlikely, it suggests an upper limit of possible direct five-year federal financing costs for ConRail. If the no-improvement situation persisted over a longer period, the federal costs would grow rapidly.[17]

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15. USRA, FSP, p. 79.

16. Energy and Environmental Analysis, Inc., "The Financial Viability of CONRAIL -- Review and Analysis," prepared for the Office of Technology Assessment, U.S. Congress, at the request of the Subcommittee on Surface Transportation, Committee on Commerce, U.S. Senate, p. 61.

17. Princeton University's "Evaluation."

Other Related Federal Expenditures

Several additional related federal expenditures, both current and potential, support eastern railroads. Most of these are not directly reflected in the above projections of ConRail cash needs. Some of the expenditures would benefit ConRail; these appear as receipts in the projected income statement and are essential to ConRail's financial success. Still other related expenditures are not specifically associated with ConRail and would not benefit ConRail, but result from Congressional action on other related programs. Related items of both types are presented in Table V and include:

- Passenger operations, which would continue to require federal support. USRA proposes that ConRail continue passenger operations on a custodial basis, but the ConRail income statement anticipates that Amtrak and the local commuter authorities would finance capital projects, working capital needs, and total operating deficits from their own resources. In order to achieve break-even results on passenger operations, USRA estimates a requirement for a total of $699 million, through 1980 in inflated dollars, over and above the level of reimbursement prevailing in 1973.[18] An estimated $384 million of the total relates to Amtrak operations and is included in Table V. The remaining $315 million for state and local commuter services is not included in Table V, but might receive federal support in the event of an

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18. Some revisions in Amtrak contracts have been made which would increase current reimbursement and thus decrease the additional amount needed, without changing the total.

Table V

OTHER RELATED FEDERAL EXPENDITURES[1]
(Millions of Dollars)

Program Type	Calendar Year 1976	1977	1978	1979	1980	Five Year Total
Passenger Service (intercity)[2]	86	62	68	81	87	384
Diversion From Corridor[3]	9	53	52	38	59	211
Labor Protection[4]	107	34	12	11	10	174
Light Density Subsidy[5]	34	35				69
Section 215 Maintenance[6]	58					58
Section 213 Emergency Assistance[7]	41					41

[1] Does not include direct cash purchases of ConRail securities.

[2] Amtrak share of total (from USRA, FSP, p. 60) increment to existing shortfall estimated at 55%. Does not include Federal contribution to commuter increments.

[3] USRA, FSP, p. 60. Does not include acquisition of route or trackage rights.

[4] USRA, FSP, p. 166. Does not exhaust $250 authorized.

[5] Includes Federal share of property return at $7 annually. Assumes two-year continuation at 70% share. Based on FSP, p. 11, and USRA staff estimates.

[6] Original authority of $300, less outlays to 9/30/75 of $105.5, less $72.5 for one-half commitments outstanding to 3/1/76, less $64 to be included in ConRail debt structure.

[7] Authorization of $282, less outlays to 9/30/75 of $199, less assumed outlay of $42 for remainder of 1975. Requires supplemental appropriation.

expanded rail program -- see Table VI below. If ConRail were required to continue passenger services without the assumed increase in the subsidy, then receipts and net income would be reduced, whether or not the amounts are justifiable as passenger expenses.[19] Expenditures related to passenger service may be expected to continue indefinitely.

- Upgrading of the Northeast Corridor passenger services to truly high-speed operation, which would involve major expenditures. This program is referred to in the act, but it is not an integral part of the reorganization scheme. USRA did, however, base the ConRail freight system on the accommodation of upgraded corridor service. USRA assumed that two costs would be defrayed by federal support: the purchase of B&O right-of-way or payment for trackage rights (amount subject to negotiation) in order to separate freight from high-speed passenger trains, and the net cost of diverting freight traffic to that route. The latter cost is estimated at $211 million.[20] These costs are entirely related to the Northeast Corridor program, not the proposed reorganization.

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19. The amount of justifiable subsidy is quite controversial. A New Jersey Department of Transportation report entitled, USRA Projection of Subsidy Payments to ConRail for Passenger Operations, suggests that passenger expenses have been significantly overstated by USRA and adequate compensation already exists.

20. Further costs to implement improved Northeast Corridor service are highly dependent on the decision as to top operating speed and have been variously estimated at $1.5 to $3.0 billion. In Section 206(2) (3) of the act, Congress established the goal of improved passenger service on the Northeast Corridor.

- Federal expenditures for labor protection, not to exceed $250 million, as authorized in Section 509. This would include allowances for employee displacement, separation, and moving expenses. USRA estimates that five-year labor protection costs would total $174 million, 81 percent of which will be incurred in the first two years of operation. These costs are primarily related to Congressional action in Title V of the act, though existing labor contracts would have required some protection costs as a result of the reorganization. Thus ConRail would benefit marginally from these funds.

- Light-density lines that were not included in the ConRail system. These are eligible for subsidy under Section 402, which authorizes $180 million ($90 million in each of two years) and a federal share of 70 percent to subsidize rail service continuation. If all lines in service were continued, the federal share should be about $69 million for the first two years, based on USRA figures for 1973 traffic and operations and including payments as return to the property holders.[21] This figure does not include rehabilitation of branch-lines, nor does it incorporate possible acquisition by the states under Section 403. If all in-service branch-lines were rehabilitated and operated for five years, the total additional cash requirements should be about $316 million, of which a

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21. Based on $38 million operating loss for first year (FSP, p. II), and $10 million property return (USRA staff). Lines out of service during the planning period are not incorporated and would show proportionately higher cost. Should it become law, the omnibus rail bill (S. 2718) would increase the federal share.

70 percent share would amount to $221 million.[22] Revised estimates by USRA staff, which reflect estimated costs and revenues for 1976, are about 40 percent higher than the figures presented here. These costs are not actually associated with the proposed ConRail system; it appears that they could be largely avoided if the lines were abandoned. If ConRail were required to operate the lines without subsidy, net income would be reduced commensurately.

- Payments to the bankrupt railroads for emergency assistance (provided under Section 213) and for maintenance and improvement (provided under Section 215). Section 213 authorized $282 million for DOT and Section 215 provided $300 million in USRA obligational authority. These funds have already been substantially spent or committed, and are expected to be exhausted by the time of conveyance of the bankrupt lines to ConRail in early 1976. Calendar 1976 outlays were roughly estimated to be $99 million, based on the remaining authorizations as of September 30, 1975.[23] These funds are closely related to the reorganization, essentially providing for operation and maintenance until the ConRail start-up date.

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22. An attempt is made here to estimate the implied federal share of 70 percent, including property returns and/or acquisition costs. Constructed from USRA ten-year total, FSP, p. 78.

23. See Table V, Notes 6 and 7, for construction of the amount. USRA has designated that $236 million of the obligations incurred under Section 215 should be forgiven, as provided for in the act, and this amount could appear as a rail-related budget item in fiscal year 1976 if it is brought on-budget, but no new expenditure would be reflected.

- Substantial federal liability in the event that USRA projections prove overly optimistic and/or the courts require additional compensation to the bankrupt estates. These items are discussed in the next section, but were not included in Table V.

These other rail-related expenditures for 1976 to 1980 total $937 million, nearly half as much as the $1.84 billion in direct costs of ConRail operations. Combining these funds with the direct costs included in the previous section gives a five-year federal cost of $2.78 billion for general rail programs in the East. This figure does not include allowance for a federal contribution to rail commuter costs (see Table VI), nor does it include the contingency funds requested by the plan ($250 million), nor Northeast Corridor passenger service improvements. Also, while the direct costs are projected to terminate after five years, many of the indirect costs, such as passenger subsidies, would continue into the future.

Alternative Projections of Total Federal Expenditures

A large number of projections about the future were required in order to construct the forecasts of ConRail revenues and expenses incorporated in the projected income statement. Such forecasts are inherently imprecise; only the course of future events can be the final arbiter. However, a discussion of several cases will serve to illustrate potential federal costs if projections critical to ConRail's financial self-sufficiency are not realized;

- A moderate shortfall in ConRail earnings relative to USRA projections would bring into play the contingency funds and uncommitted authorizations, assuming such funds have been authorized and appropriated, and would be fully utilized. The funds available would include the remaining authorization of $49 million under labor protection (Section 509), USRA contingency funds of $250 million, and possibly the requested DOT contingency fund of $400 million, assuming that Congress provides it and DOT would choose to utilize it for this purpose. The resulting additional federal expense would be $699 million over the five-year period, as shown in Table VI.

- An expanded program of federal support has been approved by the Congress. Two areas included are sharing of the added state and local cost burden for rail commuter services implied by USRA projections and support of branch-line continuation. Numerous bills on each were introduced in the Congress to achieve particular rail service goals without burdening ConRail. Table VI shows the federal expense authorized by the omnibus rail bill for expanded programs covering commuter and branch-line operations. The total comes to $236 million, even though commuter support is proposed only through fiscal 1978. Both authorizations are considerably less than the five-year deficit burden projected by USRA.

- A failure by ConRail to achieve the operational improvements incorporated in USRA's projections could result in the need for major additions in federal support. Such a failure is in part implicit in the moderate shortfall case, where all contingency funds were assumed to be utilized. An estimate was presented earlier of the additional federal support that would be required if improvements in car utilization were only 14 percent instead of 28 percent as projected by USRA. The added cost was $460 million in new federal cash, not including issuance of more

Table VI

SENSITIVITY OF FEDERAL EXPENDITURES TO ALTERNATIVE PROJECTIONS

(Millions of Dollars)

		Five Year Total	
Basic ConRail			
Direct Costs		1,841	
Other Related Costs		937	
Moderate Shortfall			
Labor Protection Exhausted[1]	49		
Contingency Funds Expended[2]	650		
Subtotal Additional Cost of Moderate Shortfall		699	
Expanded Program Example[3]			
Commuter Service Funded	125		
Branch Lines Funded	111		
Subtotal Additional Cost of Expanded Program		236	
TOTAL For Both Alternatives			935

[1]Allocates remainder of $250 authorized.

[2]Assumes USRA contingencies of $250 and DOT'S $400 are needed in the first five years.

[3]Based on authorizations in the omnibus rail bill, S.2718. See Sections 805 and 808. Commuter subsidies authorized only through fiscal 1978. Branch line figure is $180 less $69 already in Table V. USRA projects considerably higher five-year deficit burdens for both services.

"in-lieu" shares.[24] This figure compares reasonably with USRA's estimate of $1 billion in increased funding requirements over ten years (twice as long) under the assumption that many of the projected improvements in operating efficiency would not be fully obtained.[25]

Other Federal Liabilities

Two other sources of federal liability are even less predictable than those discussed above: the certificates of value, and the possibility of a deficiency judgment. These costs are associated with the conveyance of properties to ConRail as provided for by the act rather than actual ConRail operations.

The USRA plan calls for compensating the creditors of the bankrupt railroads' estates based on the net liquidation value of the properties to be acquired by ConRail. The net liquidation value for ConRail properties was estimated to be $422 million, excluding Northeast Corridor properties designated to Amtrak.[26] In order to insure that the estates of the bankrupt carriers receive at least the $422 million evaluation designated by USRA, the FSP stipulates issuance of certificates of value redeemable by the government through USRA under certain circumstances should the ConRail common stock fail to represent fair and equitable consideration. Since

24. Princeton University Transportation Program, "Evaluation of the Final System Plan's Financial Analysis," Section 4, pages 9-14.

25. USRA, FSP, p. 79.

26. Inclusion of the net liquidation value of Northeast Corridor properties would add another $86 million.

government guarantees would be attached to these certifi-cates of value, a failure of ConRail earnings to materialize at the projected levels would ultimately require additional federal funds to redeem the certifi-cates. If allowed to accrue interest until the scheduled redemption date in 1987, the federal liability would grow to $1.05 billion.

The USRA valuation process used to derive the $422 million figure is controversial and will undoubtedly be contested. The process incorporated several assumptions that might be the subject of judicial review, The major assumptions were that:

- Obtaining the authority to dispose of the assets would take time, and disposal could not begin until January 1, 1979.
- Disposal itself would take time and would be of sufficient magnitude to depress prices for the assets.
- The cost of liquidation would be substantial and should be deducted from gross proceeds.
- Finally, that the net proceeds to be realized in the future should be discounted back to January 1, 1976, using a discount rate of 15 percent on real estate, and 12 percent on other assets.

It seems likely that this valuation is a bare mini-mum and that it could be increased when reviewed by the courts, even though the approach is affirmed by the omnibus rail bill. A judgment against ConRail on narrow grounds concerning the details of the calculation, such as the liquidation costs or the discount rate used, could raise the valuation considerably. For example, if the assumed liquidation costs were reduced by one-half and a uniform discount rate of 10 percent were used, the resulting valuation would roughly double to $856 million.[27]

On the other hand, if the USRA approach were rejected entirely, a very large judgment could result. For example, the Penn Central trustees have recently suggested a going-concern evaluation of roughly $7.4 billion, and a bare minimum of $3.5 billion as liquidation value. The First National City Bank suggests a figure of $4 billion to $8 billion.[28] A judgment in this range coupled with no operating improvements at all could push total costs into the $8 billion to $12 billion range. If the courts were to rule for reproduction costs of the properties in question, the federal liability in a deficiency judgment could go even higher. The government would also be asked to assume liability for deficiency judgments on properties to be transferred to other railroads, primarily the Chessie System.

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27. CBO staff calculation, based on USRA, FSP, p. 155.

28. First National City Bank, "A Capital Markets Analysis of the Final System Plan as Proposed by the United States Railway Association," statement by John W. Ingraham before the Transportation Subcommittees, September, 1975, p. 38.

TIMETABLE FOR CONGRESSIONAL ACTION

An unusual feature of the act stipulated that the FSP would be deemed approved after 60 days of continuous session unless disapproved by either chamber. The plan was submitted on July 26, and the 60-day period expired on November 9. With almost no debate on its merits, the USRA plan was therefore tacitly approved when neither chamber passed a resolution of disapproval before the deadline. Since then, both the House and Senate have passed an omnibus rail bill, in effect authorizing the plan's implementation. The President has indicated he will veto the bill, however, primarily because of opposition to other titles in it. Regardless, additional legislation is needed to appropriate funds for the purposes authorized in the omnibus bill.

Action by December 9

The designated transfers of bankrupt properties to various railroads, especially the Chessie System, are important to the system structure recommended by USRA, especially because they ensure continued competition in major rail markets and provide for the presence of a solvent railroad against which to measure ConRail's performance. The approval of the USRA plan established a deadline of December 9, 1975 (or 30 days following approval of the FSP), for the acceptance by solvent railroads of designated transfers.[29] This deadline has of course passed, but the pending rail bill would amend it to fall five days after enactment of the new bill.

USRA and the Chessie System reached conditional agreement for the transfer of approximately 2,000 miles from the bankrupt estates to Chessie for a purchase price of $54.5 million. The Chessie board of directors approved the

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29. P.L. 93-236, Section 206(d)(4).

agreement on November 17, but, as a condition of the agreement insisted on protection or indemnification against additional acquisition costs that might be imposed by a court judgment. The conditional agreement obviated the need for ?mmediate Congressional action to provide assurances to Chessie regarding protection against deficiency judgments; however, the purchase cannot be finally completed until the assurances are provided.

The omnibus rail bill does provide this protection against future court judgments for solvent railroads and ConRail. The potential financial exposure related to solvent transfers is subject to judicial determination, but based on USRA's net liquidation values it could add about 10 percent to the ConRail exposure. However, if the bill is vetoed or if other obstacles block Chessie's participation, presumably that would convert the USRA plan to the larger Unified ConRail system with its monopoly position in several major eastern markets. The same rail lines also would be included in this alternate plan, so the risk of a deficiency judgment would revert to the government regardless. According to USRA, the larger system would also require larger initial five-year funding of $2.03 billion, versus the $1.84 billion for the basic system. While offering the potential for higher earnings in the future, much rail-versus-rail competition in the East would be eliminated, and the potential losses would be greater if projected operating improvements are not achieved.

Action by February 7 (or March 11)

The current timetable requires the submission by February 7, 1976, of the FSP to a special court established pursuant to Section 209 of the act, and, more importantly, certification of "the amount, terms, and value of the securities of the corporation (including any obligations of the Association [USRA]), to be exchanged."[30] The pending rail legislation provides for a time extension to not later than March II at USRA's option. The funding authorized by the original reorganization act is inadequate for full realization of the plan and might lead the court to question the adequacy of the value of ConRail securities.[31] Therefore, the conveyance of rail properties to ConRail and the solvent railroads could be delayed or enjoined in the absence of further Congressional action, thus increasing the likelihood of a deficiency liability.

If the omnibus rail bill is vetoed and the veto is sustained, Congress will have to find an alternative mechanism to amend the act in ways that are both explicit and implicit in the USRA Plan, such as providing protection for Chessie, continuing jurisdiction for the Special Court for review of system changes after conveyance to ConRail, and adjustment in the composition of ConRail's board of directors. In addition, if the plan is to be implemented, Congress will need to authorize and appropriate the funds required to make the plan operational, which was estimated above to include $1.84 billion in direct cash investment and $250 million in contingency funds. Most of the additional related expenditures are currently authorized.

Failure of the Congress and the Administration to reach agreement on implementation of the FSP (or some substitute) within these time periods increases the likelihood that the special court would delay conveyance of properties to ConRail and the other solvent railroads involved, or would decide that the terms of exchange were not fair and equitable to the bankrupt estates. Such a combination

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30. P.L. 93-236, Section 209(c)(3).

31. Sections 210 and 211 of the reorganization act authorize loans of up to $1.0 billion to ConRail by USRA and provide guarantees for USRA obligations in that amount.

of events holds out the threat of trustee action leading to a cessation of rail freight service in the East. The railroads' deficits could be argued to be an erosion of creditors' assets; during the first six months of 1975, the railroads recommended for consolidation experienced a combined deficit in ordinary net income of over $300 million. Therefore, the trustees would undoubtedly apply to the courts for relief or permission to cease operations. Interim subsidies would then be required for service continuation.

Current experience with emergency assistance under Section 213 resulted in the expenditure of about $192 million, plus another $25 million in interim rehabilitation funds under Section 215, over a period of about 18 months in order to preserve operations. Combined expenditures for these programs in fiscal year 1976 are projected to be $365 million, or approximately $1 million per day, assuming that all funds currently authorized will be expended. Such expenditures probably could be expected to be demanded indefinitely by the trustees as long as operations were required by the government, and the level would perhaps rise to provide for more maintenance and rehabilitation of capital plant as time passes, though economic recovery provides some offset via increased revenues.

A complete stoppage of rail service by the bankrupts would also have important implications for federal expenditures. The level of economic activity is certain to be disrupted and depressed, at least in the short run, leading to increased levels of unemployment and increased expenditures for assistance programs. Eight weeks after a Penn Central stoppage, a reduction or economic activity in the region on the order of 5 to 6 percent has been projected by DOT, representing a $47 billion loss in output (annual rate, 1975 dollars). The estimates are quite sensitive to assumptions regarding the availability of excess capacity in other railroads and other transportation modes; a more recent update suggests a much smaller impact of about 0.5 percent on eastern output.[32] The reduced impact estimate reflects excess transport capacity resulting from the current recession and the reduced traffic share of Penn Central. Both estimates assume that other railroads and truckers could absorb fairly smoothly a considerable redirection of traffic; the impact would tend to moderate over time as adjustments are achieved.

In addition to its general impact on economic activity, a railroad shutdown implies a diversion of freight shipments to trucks, which would cause a major increase in truck movements in the region. Such an increase has two major impacts: first, a comparison of current freight rates suggests considerably higher shipping costs for the region; second, increased trucking levels would have substantial impact on the level of highway construction and maintenance required, and therefore on the level of highway expenditures by all levels of government.

The transfer to trucks implicit from a rail shutdown was estimated in a study for USRA, which covered the diversion of intraregional shipments of II selected commodities in six major states.[33] Diversion to truck was estimated to increase truck movement by 3.5 million vehicle miles and to increase traffic via tractor-trailer combinations by 47 percent, with a 72 percent increase in Pennsylvania. However, this would increase total traffic, including autos, by only 2 or 3 percent. Highway construction and maintenance requirements, and therefore expenditures, would certainly increase. Increased trucking would

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32. Jack Faucett Associates, Inc., "Projected Impacts of a Penn Central Railroad Work Stoppage: February, 1975", submitted to U.S. Department of Transportation.

33. Wilbur Smith and Associates, Economic Study of Alternative Modes for Rail Traffic and Their Costs: Final Report, January 15, 1975, prepared for USRA.

also tend to require more fuel and produce more exhaust emissions, although the impact varies considerably with assumed local conditions.

Extending these estimates of traffic diversion to intra-regional shipment of the II commodities across the entire region, USRA has estimated that annual highway expenditures would increase by $170 million for capital outlays and $129 million for maintenance expenditures, implying additional 20-year highway needs of $5.8 billion for the region.[34] In addition, shipping costs were estimated to increase by approximately $800 million annually, particularly when traffic shifts from rail to truck; these cost increases suggest the need at least for transition-period assistance to shippers by the federal government where rail service is withdrawn.

The Significance of the Plan

The USRA reorganization plan, if implemented and successful, would maintain the rail freight option for most shippers. Since future scenarios about energy costs, environmental protection, land use, and other factors affecting the desirability of various transport modes are so uncertain, maintaining system flexibility could prove very important. Thus, the USRA plan for ConRail, or an alternative that could also result in profitable reorganization of the bankrupt lines, would represent a contribution toward this broad goal. However, even if successful, this reorganization would not solve the longer-term question about the appropriate transportation mix for

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34. *Ibid.*, and USRA Draft Memorandum to Members of Congress "Impact of Total Shutdown." Figures in 1975 dollars.

the region, nor deal with questions of regulatory reform or improvements in the efficiency of operations. However, legislation on several of these other matters is incorporated in the pending omnibus railroad bill.