CHAPTER I

INTRODUCTION

In 1983, the Department of Transportation (DOT) first solicited proposals for the sale of the Consolidated Rail Corporation (Conrail). In February 1985, DOT announced its intention to sell Conrail to the Norfolk Southern Corporation, but this offer was withdrawn in 1986. Several alternative proposals to sell Conrail have also been put forward. At the heart of the relative merits of these proposals lies the issue of Conrail's viability--that is, its long-term profitability--as a private company. This paper examines Conrail's future and its implications for the terms on which Conrail will be sold.

BACKGROUND

The Consolidated Rail Corporation began operations on April 1, 1976, as a private, for-profit railroad company. Formed from the remnants of seven bankrupt rail carriers in the Northeast and Midwest, Conrail was created to maintain essential transportation services in the industrial heartland of the country. Though established as a private concern, Conrail received government financing from its inception. These funds were used to compensate the estates of the bankrupt carriers, to rebuild the track and equipment transferred to it, and to cover operating losses during the rebuilding period (see Table 1). As compensation for its investment, the federal government acquired nearly complete ownership of the corporation.

Although the major programs to rebuild track were essentially completed by 1980, Conrail continued to produce operating losses and require federal subsidies. The possibility that Conrail might remain a continual drain on federal resources led the Congress to enact the Northeast Rail Service Act of 1981 (NERSA). The act provided Conrail with the opportunity to make the operating changes necessary for it to become a profitable railroad. The company responded with its first operating profit in 1981. Since that time, Conrail has become increasingly more profitable, with total net income for the 1981-1985 period of nearly $1.5 billion.

While NERSA provided Conrail with the opportunity to become a profitable railroad, it also directed the Department of Transportation to examine ways of returning Conrail to private ownership. The act required DOT to initiate a sale of Conrail as a corporate entity if it became profitable. The department solicited proposals for the purchase of the government's interest in Conrail in 1983, and selected a proposal by the Norfolk Southern Corporation to purchase Conrail in a private sale. Although DOT considered a public stock sale of the company, the department cited its concern with ensuring continued service in the Conrail region and its doubt that Conrail could remain viable as an independent railroad company as reasons for selling Conrail to an established railroad with strong financial resources.

In reviewing the Department of Transportation's proposal, the Congress has expressed doubts over DOT's appraisal of Conrail's viability. This study addresses that issue, examining Conrail's projected traffic, net income, capital program, and cash flow and the implications of these measures for Conrail's viability. The study then examines policy options available to the Congress in returning Conrail to the private sector.

TABLE 1. FEDERAL INVESTMENT IN CONRAIL, CALENDAR YEARS 1973-1983 (In millions of dollars)

Investment Period	Type of Investment	Federal Investment	
		Current Dollars	1985 Dollars
1973-1976	Preconsolidation loans and grants	496	934
1976-1981	Purchase of securities	3,280	4,919
1976-1985	Local rail service assistance	208	322
1976-1985	Labor protection payments	552	718
1981-1985	Settlements with estates of bankrupt railroads	2,777	3,252
1982-1983	Transfer of commuter service under NERSA	125	135
	Total	7,438	10,280

SOURCE: Congressional Budget Office.

LEGISLATIVE AND FINANCIAL HISTORY OF CONRAIL

The history of Conrail and its bankrupt predecessors is a history of the problems that have confronted the railroad industry in the past 40 years: rising competition from trucks and barges, restrictive regulation by federal and state authorities, and declining profits and disinvestment in railroad

CONRAIL LEGISLATION, 1974-1985

1974 **Regional Rail Reorganization Act of 1973 (3R Act)** provides for the establishment of the Consolidated Rail Corporation (Conrail) as a for-profit freight railroad and the United States Railroad Association (USRA) as a government corporation to fund and oversee Conrail's operations.

1976 **Railroad Revitalization and Regulatory Reform Act of 1976 (4R Act)** enables Conrail to begin operations and initiates reductions in federal rail regulation.

1980 **Staggers Rail Act of 1980** enacts reforms that reduce Interstate Commerce Commission control and regulation over the railroad industry, and provides railroads with greater flexibility in pricing and provision of service.

1981 **Northeast Rail Service Act of 1981 (NERSA)** provides criteria for returning Conrail to the private sector as a profitable and viable entity; exempts Conrail from state taxes; provides for the transfer of Conrail's commuter service to local authorities; requires labor concessions; and permits expedited abandonment of unprofitable lines.

1983 Conrail transfers commuter passenger service as authorized by **NERSA**.

USRA reports that Conrail meets **NERSA** profitability tests.

1985 Conrail restores, retroactive to July 1984, industry-level wages that were reduced for three years in wage negotiations mandated by **NERSA**.

Department of Transportation selects Norfolk Southern Corporation as the preferred purchaser of government interest in Conrail.

operations. The increase in competition from the trucking industry in the period since World War II has had a particularly strong effect on the railroad industry. Highly valued, time-sensitive, and short-haul commodities have been lost to truck competition as the Interstate System has extended its reach, trucking costs have declined, and the quality of truck service has improved.

Over this same period, the railroads' attempts to compete with trucks and barges have been strongly hampered by pervasive and unresponsive economic regulation of the railroad industry. The statutes and administrative rules concerning rates, service, and operations severely restricted the ability of railroads to react to market conditions. Services and prices could not be altered rapidly, and innovations could not be made as markets dictated. The result was a steady loss of market share to competing modes of transportation.

The ability of railroads to leave markets that were no longer profitable also was limited by administrative regulations and delays that forced railroads to maintain unprofitable services for both freight and passenger operations. The resulting pressure on profits led to disinvestment in railroad operations. Investments in track structures were deferred as operating revenues declined. Equipment was permitted to deteriorate, and new equipment purchases were forgone. As a result, the overall quality of rail service deteriorated, and even more traffic was lost to better and more timely service provided by competitors.

While railroads nationwide felt the effects of these problems, railroads in the East and Midwest were particularly affected. Two major railroads in the Midwest and West--the Chicago, Rock Island, & Pacific, and the Chicago, Milwaukee, St. Paul, & Pacific--eventually entered bankruptcy. The railroad predecessors to Conrail--Ann Arbor Railroad, Central Railroad of New Jersey, Erie Lackawanna Railway, Lehigh & Hudson River Railway, Lehigh Valley Railroad, Penn Central Transportation Company, and Reading Company--were all in bankruptcy proceedings by 1973. The bankruptcy of the Penn Central, and the company's inability to emerge from bankruptcy as a reorganized railroad, was pivotal in the collapse of the other rail systems and the threat their collective loss posed to the region. These railroads carried nearly half of all rail traffic in the regions they served, and their bankruptcies threatened the economic health of the Northeast and Midwest.

The Congress responded by enacting the Regional Rail Reorganization Act of 1973 (3R Act). The stated purpose of the 3R Act was to identify a rail system that would provide adequate and efficient rail service in the Northeast and Midwest and to reorganize the railroads in the region into an economically viable system that could provide that service. This act established the United States Railway Association (USRA) as a government corporation whose purpose was to design the system required to meet this goal and to prepare a final system plan incorporating that design. The act also established the Consolidated Rail Corporation as the company that would form this system through the receipt of properties transferred from the bankrupt railroads.

The final plan recommended by the USRA was implemented by the Congress in Title VI of the Rail Revitalization and Regulatory Reform Act of 1976 (4R Act). This title amended the 3R Act to conform its provisions to the final structural, operational, and financial system designed for Conrail. The 4R Act also initiated the first significant reduction in federal regulation of railroads since the enactment of the Interstate Commerce Act in 1887. Because regulatory restrictions had contributed to the bankruptcy of Conrail's predecessors, the Congress began the process of regulatory reform in the 4R Act to prevent additional bankruptcies in the industry, and to improve the opportunities for all railroads, including Conrail, to survive as private companies.

Conrail began operations on April 1, 1976, with over 99,000 employees and a 17,000-mile route system serving 16 states. Extensive rehabilitation of track and equipment was required to remedy years of neglect. Federal investment through the purchase of debentures and preferred stock issued by Conrail financed this rebuilding program. Federal funds also were provided to subsidize operating losses incurred over the rebuilding period. The final system plan projected the completion of the rebuilding program and the attainment of profitability by 1980.

Lower traffic and higher operating losses than projected, however, persisted through 1980. Federal investment in Conrail--the purchase of its securities to finance track rehabilitation and subsidize operating losses--grew commensurately (see Table 2). At the same time, the railroad regulatory reforms enacted in the 4R Act were proving to be insufficient to improve the financial health of the railroad industry in general. Conrail was doing worse than expected, as was the entire industry. To attack these problems, the Congress enacted two laws: the Staggers Rail Act of 1980 (Staggers Act) and the Northeast Rail Service Act of 1981 (NERSA).

The Staggers Act significantly reduced the government's regulation of pricing and marketing activities for all railroads. Changes made by the act enabled railroads to restructure rates and services to improve their profits and, if losses could not be avoided, to abandon more easily their unprofitable routes and services. Conrail has made extensive use of the Staggers Act to

TABLE 2. CONRAIL'S INCOME COMPARED WITH FEDERAL FINANCING, CALENDAR YEARS 1976-1985
(In millions of current dollars)

	1976 a/	1977	1978	1979	1980	1981	1982	1983	1984	1985
Net Operating Income b/	-173	-361	-386	-178	-187	66	49	288	466	397
Net Income b/	-246	-412	-430	-221	-244	39	174	313	500	442
Federal Financing c/	484	668	774	729	490	135	0	0	0	0

SOURCE: Compiled by the Congressional Budget Office using data from Conrail.

a. Nine months, April-December.

b. Income figures are for consolidated results of Conrail, including subsidiaries.

c. Federal financing includes only the purchase of securities to cover operating losses and track rehabilitation.

price and market aggressively its transportation services. An important part of the improvement in Conrail's financial condition since 1980 stems directly from the Staggers Act and its reduction of the federal economic regulation of railroads.

Conrail's continuing drain on federal resources led the Congress to enact the Northeast Rail Service Act of 1981, the other key element in the improvement in Conrail's performance. The act required Conrail to show by 1983 that it could be a profitable private railroad. If Conrail failed to satisfy the profitability tests mandated by NERSA, the Department of Transportation would be required to begin negotiating the transfer of Conrail's rail properties and freight service responsibilities piecemeal to other carriers.

The Northeast Rail Service Act of 1981 also permitted Conrail to make important changes in its operations by eliminating its obligation to provide commuter passenger service; expediting abandonment of unprofitable lines; terminating the lifetime job protection benefits in the 3R Act; completing the restructuring of its labor agreements; and obtaining wage concessions from its employees. These actions combined to reduce Conrail's operating costs markedly and improve the productivity of its workforce. The resulting effect on Conrail's net income can be seen in Table 2.

The restructuring of Conrail's operations as a result of the Staggers Act and NERSA steadily moved Conrail to an emphasis on the profitability of its services and the discontinuance of those services on which losses were being incurred. Conrail's current emphasis is one of maintaining and increasing the services it provides in the region only so long as it can provide them more efficiently than its competitors. The result has been a steady improvement in its financial condition and a strong ability to respond to changes in the demand for its services.

SALE OF THE GOVERNMENT'S COMMON STOCK INTEREST IN CONRAIL

The Northeast Rail Service Act of 1981 required the U.S. Railway Association to determine in two test periods--ending June 1 and November 1, 1983--whether Conrail would be a profitable railroad. The USRA found that Conrail was a profitable carrier and, under the provisions of NERSA, the Department of Transportation was required to initiate the return of Conrail to the private sector as a single entity through the sale of the government's common stock interest in the company.

According to the criteria established by NERSA, the plan devised for the sale of the government's stock had to ensure continued rail service, promote competitive bidding for the stock, and maximize the return to the federal government on its investment. Beyond these broad guidelines, the nature of the proposed plan for the transfer of Conrail was left to DOT. The plan prepared by DOT proposed a private sale of the government's stock through an agreement negotiated with the Norfolk Southern Corporation, a railroad holding company that controls the Norfolk and Western Railway and the Southern Railway. Norfolk Southern's proposal for a private sale was selected from among 15 proposals received by DOT in response to its sale solicitation.

The agreement with Norfolk Southern contained numerous covenants designed both to ensure continued service in the Conrail region for the five years after the sale and to determine the purchase price and the recapitalization of Conrail before the sale. These covenants include stipulations on the required level of investment in Conrail, restrictions on financial transactions and requirements for financial reports, specification of tax treatments of the transactions involved in the stock sale, divestiture requirements for ameliorating anticompetitive effects of the merger, and provisions requiring the settlement of outstanding labor claims.

The Department of Transportation viewed these covenants and the sale to the Norfolk Southern Corporation as essential to preserving the services provided by the Conrail system. The department believed that the long-term viability of Conrail was in doubt and that, consequently, a sale agreement with operational covenants could best assure service in the short run and that a purchaser with strong internal financial resources was required to provide the capital it would need in the long run. Furthermore, DOT suggested that Norfolk Southern's railroad experience and commitment to the industry would provide the expertise and support necessary for Conrail during unstable economic conditions.

Alternative proposals by two groups--one led by Morgan Stanley & Co., Inc., and the other by Allen & Co. and First Boston Corp.--were for negotiated sales of the government's stock to the respective investment groups with eventual resale of the stock to the public. These proposals differed from the Norfolk Southern offer in both their sale price and other terms, and in that each of these proposals for public sale would maintain Conrail as an independent railroad. By remaining independent, Conrail would not have the internal corporate financing available that it might have as the subsidiary of a larger corporation. An independent Conrail, however, would avoid the potential adverse effects on competition from a merger with Norfolk Southern, and would avoid conveying tax advantages to a parent corporation.

VIABILITY OF CONRAIL

A principal point of contention between the competing Conrail sale proposals is whether or not Conrail can remain viable as an independent railroad company. In its original sale plan, the Department of Transportation asserted that Conrail could not remain viable over the long term and, consequently, that service in the region could best be preserved by merging Conrail into the Norfolk Southern system of strong rail carriers. The department contended that the loss of competition that might result from the merger could be partially offset by divestiture of properties to potential competitors in the region. In addition, if DOT's view of Conrail's long-term viability was correct, competition would be adversely affected in any case, because Conrail's loss of traffic and worsening financial condition would reduce its ability to compete in the region.

The proponents of maintaining Conrail as an independent company contend that Conrail can remain viable over the long term. In their view, an independent Conrail would produce sufficient income to meet its operational and financial commitments without needing the cash infusions or temporary financing of a corporate parent and without being forced to seek government subsidies in the future.

Determining whether Conrail would be viable over the long term depends in part on how viability is measured and over what period it is estimated. This study uses four criteria for assessing viability:

- Absent extensive economic dislocations in the region it serves, Conrail should be able to maintain its traffic base within the range of its recent experience.
- Net operating income should remain positive and at a level consistent with the size of the railroad and the traffic it carries.
- Capital investment should be sufficient to maintain the quality of the track and equipment at current levels.
- Net income and cash flow from operations should be sufficient to meet the company's capital, debt, and dividend requirements.

The four criteria roughly correspond to sections of a corporation's financial statement. The first criterion concerns the quantity of services the Conrail corporation will provide. The second involves whether those services are profitable, and corresponds to operating income on a corporate statement.

The third criterion involves the firm's capital investment program and the capital charges arising from it. Finally, the fourth criterion brings together the financial activities and commitments of the firm and investigates whether all of these can be satisfied simultaneously.

This paper, in fact, follows the organization of a corporate financial statement (see Figure 1). In Chapters II through V, the Congressional Budget Office (CBO) has projected Conrail's traffic, net operating income, capital program, and cash flow. Each of these chapters begins with a brief summary of the projections and their implications for Conrail's viability. The study covers the period from 1986 through 1995. This 10-year period is sufficient to gauge the potential of the firm while keeping the projections within a reasonable forecast range.

METHODOLOGY

The analytic method used by CBO to forecast Conrail's future viability consists of four parts: projections of Conrail's traffic, net operating income, capital investment, and cash flow. Underlying the analysis in all four parts are basic assumptions concerning the legal status of the corporation and the macroeconomic environment of the study period.

Baseline Scenario. The assumption concerning Conrail's legal status is that there is no change in current law and that Conrail's financial and operational structures remain essentially as they were at the end of 1985. This baseline scenario has the following implications:

- The federal government retains ownership of all of Conrail's outstanding debentures.

- The government holds all of Conrail's Series A and Series B preferred stock.

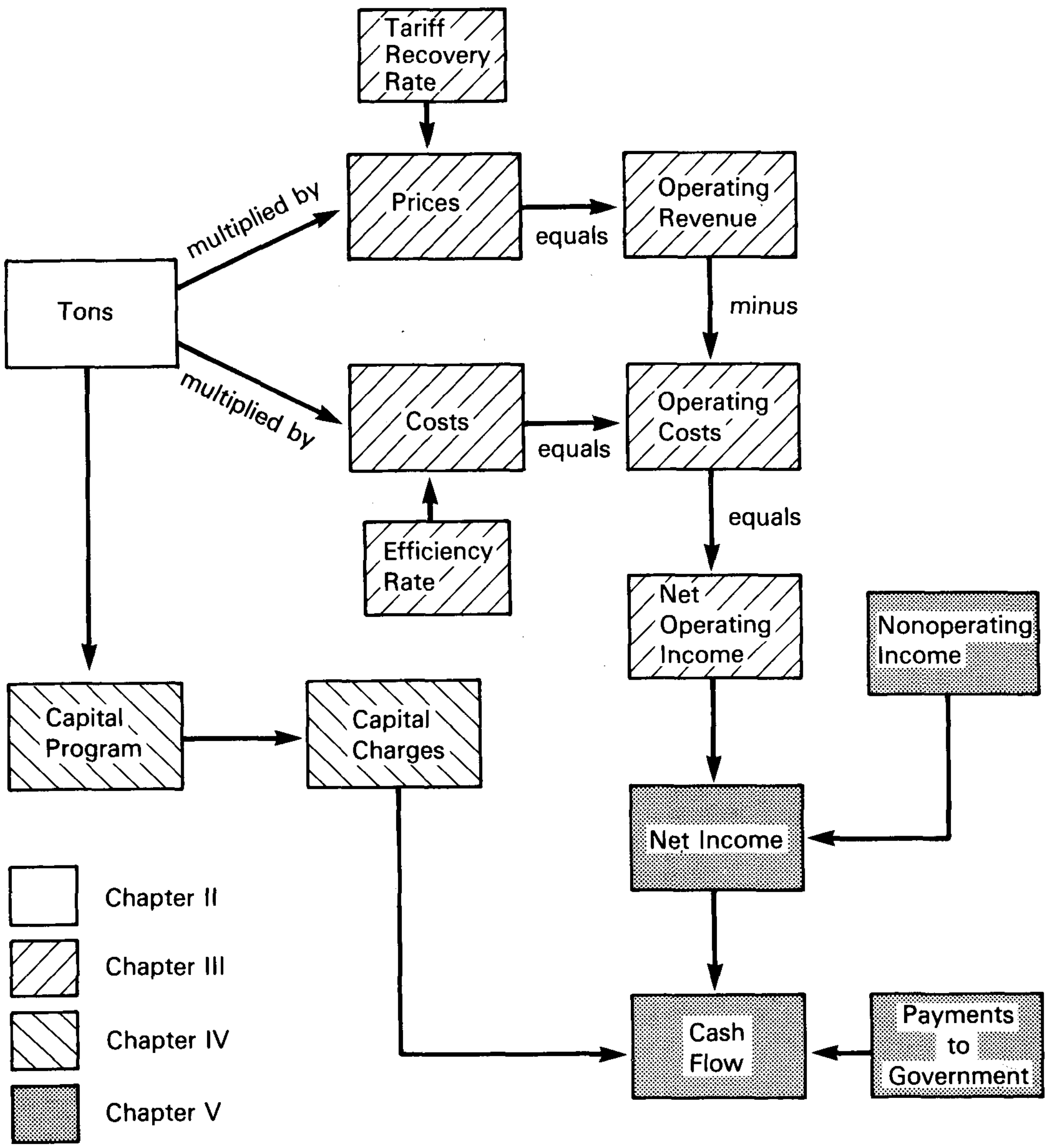
- The government holds 85 percent of the common stock of the corporation.

- Conrail retains the use of its net operating loss carryforwards.

- Conrail retains the use of its investment tax credits.

- Conrail is exempt from paying state taxes.

Figure 1.
Organization of the Analysis



SOURCE: Congressional Budget Office.

- o Conrail's labor protection payments are the responsibility of the federal government.

- o The 1979 financing agreement between Conrail and the USRA remains in force.

Baseline Forecast. The assumptions made concerning the future level of macroeconomic activity are the same as the baseline forecast in CBO's *The Economic and Budget Outlook: Fiscal Years 1987-1991* released in February 1986. This baseline forecast is called the base case in this study. All of the forecasts and projections of Conrail's traffic and finances are predicated on and consistent with this base-case forecast. In order to observe the sensitivity of the Conrail projections to the macroeconomic assumptions used in the base case, a "low case" incorporating a recession in 1987 and 1988 is also examined.

The relevant macroeconomic variables for each case are real gross national product (real GNP), the GNP deflator, and the interest rate on three-month Treasury bills (see Table 3). The CBO baseline and low forecasts are made only through 1991 and must be extended through the 1992-1995 period for this study. In both cases, real GNP and the GNP deflator are increased over this period at annual rates equal to those projected from the fourth quarter of 1990 to the fourth quarter of 1991. The T-bill rate for the 1992-1995 period in each case is the rate projected for 1991.

In the base case, sustained real growth in output is accompanied by moderate inflation for the forecast period. Real GNP grows at an average annual rate of 3.3 percent through 1991 and then declines slightly to the assumed annual rate of increase in the economy's growth potential, or 2.7 percent, for the remainder of the period. The inflation rate, as measured by the GNP deflator, is 3.6 percent in 1986 and increases to 4.1 percent per year thereafter. The rate on T-bills declines slowly from 6.8 percent in 1986 to 5.4 percent in 1991.

In the low case, a recession is assumed to begin in 1987 and to extend through 1988. Real GNP drops by 0.7 percent in 1987 and by 0.8 percent in 1988. Real GNP growth recovers at a moderate rate after the recession and levels off at 3.2 percent for the 1991-1995 period. The GNP deflator increases slightly before the recession and then drops with the decline in output and the slack in the economy to 2.1 percent by 1991 and remains at that level. The rate on T-bills rises before the recession to a high of 7.7 percent in 1987 and then drops steadily to 4.3 percent by 1991.

TABLE 3. CBO MACROECONOMIC VARIABLES
(Base year 1982)

	Actual 1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
					Base Case						
Real GNP (billions of 1982 dollars)	3,570.9	3,689.0	3,804.8	3,930.9	4,068.5	4,210.9	4,346.1	4,463.4	4,583.9	4,707.7	4,834.8
Percent Change	2.3	3.2	3.1	3.3	3.5	3.5	3.2	2.7	2.7	2.7	2.7
GNP Deflator	1.117	1.157	1.204	1.254	1.306	1.360	1.415	1.473	1.533	1.596	1.662
Percent Change	3.3	3.6	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1	4.1
Three-Month Treasury Bill Rate (percent)	7.5	6.8	6.7	6.4	6.1	5.7	5.4	5.4	5.4	5.4	5.4
					Low Case						
Real GNP (billions of 1982 dollars)	3,570.9	3,679.4	3,654.4	3,624.7	3,821.1	3,950.6	4,078.2	4,208.8	4,343.4	4,482.4	4,625.9
Percent Change	2.3	3.0	-0.7	-0.8	5.4	3.4	3.2	3.2	3.2	3.2	3.2
GNP Deflator	1.117	1.159	1.211	1.246	1.283	1.311	1.339	1.367	1.396	1.425	1.455
Percent Change	3.3	3.7	4.5	2.9	3.0	2.2	2.1	2.1	2.1	2.1	2.1
Three-Month Treasury Bill Rate (percent)	7.5	7.6	7.7	5.9	5.6	4.9	4.3	4.3	4.3	4.3	4.3

SOURCE: Congressional Budget Office, *The Economic and Budget Outlook: Fiscal Years 1987-1991*, extended by CBO for the years 1992-1995 for this analysis.

These macroeconomic cases are not in any sense actual forecasts of future economic events. Rather, they are stylized paths that represent two ways in which the economy might grow. In the later years of the forecast period, growth is actually higher under the low case than under the base case. This anomaly occurs because, under the base case, the economy grows so consistently in the late 1980s that, by 1992, the economy is producing at a level equal to its productive potential, and further growth is limited by the rate at which productivity increases and the rate at which new resources--particularly growth of the labor force--are introduced into the economy. The average annual rate of growth under the base case, however, is 3.2 percent, compared with 2.6 percent under the low case, over the entire 10-year forecast period.