

## CHAPTER VI

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# THE VIABILITY OF CONRAIL

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# AND ITS POLICY IMPLICATIONS

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The projections of Conrail's operating and financial results suggest that Conrail is viable as an ongoing company. This viability depends, however, on the assumptions made about the macroeconomic and operating environments that Conrail will face over the next decade. Conrail's viability under a range of assumptions is examined in this chapter.

This chapter first reviews the estimates from Chapters II through V of Conrail's traffic, net operating income, capital program, net income, and cash flow under current (baseline) policy and compares those projections with Conrail's performance in 1984 and 1985. Second, while maintaining the same macroeconomic and baseline assumptions, alternative assumptions for the levels of the tariff recovery rate and the rate of productivity growth are examined for their effects on Conrail's income and cash flow. Third, the baseline assumptions concerning the legal and financial structure of the corporation are changed to reflect Conrail's performance on a stand-alone basis, and the resulting effects on Conrail's net income, cash flow, and potential viability are projected. Finally, the policy options available to the Congress in returning Conrail to the private sector in light of the viability analysis, and a discussion of what the Conrail system is worth, conclude the chapter.

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### VIABILITY UNDER CURRENT POLICY

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According to the criteria for viability established at the outset of this study, Conrail will remain viable over the next decade whether the base or low macroeconomic case occurs. Those criteria are that (1) 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, (2) net operating income should remain positive and at a level consistent with the size of the railroad and the traffic it carries, (3) capital investment levels should be sufficient to maintain the quality of the track and equipment at current levels, and (4) net income and cash flow from operations should be sufficient to meet the firm's capital, debt, and dividend requirements.

The only area in which this conclusion might be qualified is the dividend payment required under the current financing agreement, since part of the dividend payment in both cases is paid out of cash balances and not entirely from current operations. However, both the level of dividends paid and the contribution of current income to those payments are substantial. In light of the very stringent cash dividends required by the financing agreement, Conrail is certainly viable in the baseline scenario.

The benchmarks for comparison of the forecast results are the years 1984 and 1985. Conrail's strong performance in these years indicates the company's capabilities in years of both high (1984) and moderate (1985) traffic. If Conrail can continue to produce, on average, operating and financial results comparable to these years, it should be able to survive as an independent railroad. Therefore, the projections in each of the categories above are compared with this recent experience to gauge the potential for Conrail's viability. Table 19 provides a summary of CBO's projections. Dollar amounts in the table are given in current dollars, while the text discussion also includes those amounts in real dollars to depict more accurately the trend in these variables.

The base-case forecast is the principal basis for the finding of Conrail's viability. The low-case scenario indicates the sensitivity of the forecast to a recession in the economy and the decline in demand for Conrail's services. The low case, while reducing Conrail's traffic, does not severely diminish it. It does diminish the profitability of the corporation, but would not threaten the viability of Conrail as an independent railroad over the next decade and beyond.

### Traffic

In the base case, Conrail is projected to haul an average of about 192 million tons annually over the forecast period. This is the level of traffic Conrail carried in 1984. The peak tonnage over the period is 195 million tons and the lowest is 185 million tons at the start of the period. This level of traffic would be sufficient to use efficiently Conrail's available capacity.

In the low case, the traffic forecast predicts an average of 178 million tons a year over the forecast period. Traffic ranges from a peak of 184 million tons in 1986 to a low of 170 million tons in 1988 at the trough of the recession, recovering to 180 million tons in 1995. While the level of traffic averages 14 million tons per year less than in the base case, it is approximately the level actually carried in 1982, 1983, and 1985. The 1987-1988 recession would reduce Conrail's traffic significantly from the base-case

level, but, at the trough, traffic would be only 6 percent lower than in 1985. Traffic would be reduced in this case, but would not decline below levels of recent, profitable years.

### Net Operating Income

Net operating income in the base case (in current dollars) rises from \$418 million in 1986 to \$643 million in 1995, compared with \$450 million and \$388 million in the benchmark years of 1984 and 1985. Real net operating income ranges from a low of \$403 million in 1986 to a peak of \$493 million in 1991, declining to \$432 million in 1995. These values are comparable to real levels of \$465 million in 1984 and \$388 million in 1985. The level of net operating income, therefore, remains positive throughout the forecast period and is comparable to Conrail's recent income levels.

In the low case, net operating income ranges in current dollars from a low of \$308 million in 1988 to a peak of \$515 million in 1995. In real terms, net operating income ranges from \$276 million in 1988 to \$396 million in 1995. While net operating income remains positive throughout the period, the average real level is \$354 million a year, slightly below the 1985 level. At the end of the forecast period, however, Conrail's real net operating income would be above the 1985 level.

### Capital Program and Net Income

The capital programs are designed to maintain the Conrail system at its current standards of quality and scale given its expected traffic in each case. Conrail should have the resources to maintain its capital stock at these levels. The charges flowing from the capital program affect both net income and cash flow, and whether Conrail can carry these charges annually is important to its viability.

In the base case, Conrail's net income in current dollars ranges from a low of \$448 million in 1986 to a peak of \$604 million in 1992, declining slightly to \$588 million in 1995. Real net income peaks at \$492 million in 1987, ranges between \$440 million and \$468 million through 1993, and then declines to \$395 million in 1995. These levels of real net income are commensurate with the levels in the benchmark years (\$517 million in 1984 and \$442 million in 1985) and appear to be within a reasonable range for the size of the corporation and the traffic carried.

In the low case, net income in current dollars ranges from a low of \$279 million in 1988 to a high of \$468 million in 1995. Real net income

declines from \$421 million in 1986 to a low of \$266 million in 1988 and rises steadily to \$359 million in 1995. These values are below the level of recent experience and indicate the effect of the recession on Conrail's profitability. But while net income is reduced in this case, it remains substantial throughout the recession and early recovery period. Nevertheless, the reduced level of income produced in this case may be indicative of problems for Conrail should the low-case scenario occur.

The analysis in both cases indicates that Conrail will produce strong financial results over the forecast period, although there is the risk of some weakness in Conrail's net income in the low case. Whether these projected levels of net income are sufficient will depend on the cash requirements of the firm as reflected in the cash flow statement.

TABLE 19. SUMMARY OF CBO'S PROJECTIONS FOR CONRAIL

	Actual		1986	1987	1988
	1984	1985			
<b>Base Case</b>					
Tons	192	181	185	188	190
Net Operating Income	450	388	418	489	529
Capital Investment	555	574	501	592	638
Net Income	500	442	448	530	512
Ending Cash Balance	846	910	1,097	1,280	1,220
<b>Low Case</b>					
Tons	192	181	184	179	170
Net Operating Income	450	388	400	369	308
Capital Investment	555	574	501	532	516
Net Income	500	442	437	416	279
Ending Cash Balance	846	910	1,086	1,201	1,052

NOTE: Tons are in millions of tons; all other numbers are in millions of current dollars. Total tons and net operating income do not include subsidiaries. All other numbers include subsidiaries.

Cash Flow

In the base case, Conrail's cash flow is strong throughout the forecast period. Cash on hand rises to a peak of nearly \$1.3 billion at the end of 1987. While the change in cash becomes negative in 1988 and thereafter, Conrail's annual change in cash is positive and large before the interest and dividend payments to the government are made. This change in cash ranges from a high of \$224 million in 1991 to a low of \$148 million in 1995, and averages \$195 million over the 1988-1995 period.

The payments to the government must be subtracted from the initial annual change in cash, however, and they are a severe drain on Conrail's cash resources. These payments include \$64 million a year for interest on

TABLE 19. (Continued)

1989	1990	1991	1992	1993	1994	1995
<b>Base Case</b>						
191	194	194	195	195	193	192
537	596	625	640	643	642	643
681	727	775	817	862	902	942
515	569	592	604	603	596	588
1,120	1,051	959	840	699	538	356
<b>Low Case</b>						
176	177	177	179	180	179	180
348	401	430	458	476	495	515
585	612	643	664	684	698	712
314	360	384	412	432	449	468
923	815	702	587	467	354	243

SOURCE: For 1984 and 1985, Conrail; for 1986 to 1995, Congressional Budget Office. Total capital investment is from Conrail for 1986.

debentures and a yearly average of \$247 million for dividends. This average annual payment of \$311 million over the 1988-1995 period results in an average cash drain of \$195 million per year from current income and \$116 million per year from existing cash balances. This drain on existing cash balances results entirely from the high cash dividend requirements in each year. Despite these payments, however, Conrail's cash balance remains above \$500 million until 1995.

In the low case, Conrail's cash flow reflects the recession and the resulting reduction in net income. The annual increase in cash before interest and dividend payments ranges from a low of \$43 million in 1989 to a high of \$145 million in 1995. Over the 1988-1995 period, the average annual payment to the government is \$218 million, including \$64 million in interest on debentures and \$154 million in dividends. In 1988 and 1989, a portion of the interest payment and the entire dividend payment come from existing cash balances. In subsequent years, the entire interest payment and a continuously increasing percentage of the dividend payment come from current income. On average, over the 1988-1995 period, \$98 million per year in payments to the government comes from current income and \$120 million per year comes from existing cash balances. As a result, cash balances that peaked at \$1.2 billion in 1987 decline to \$243 million by 1995.

Conrail's profitability is much lower and the cash drain for dividend payments is higher in this case than in the base case, but the company's viability would not be in question. Though the years 1987 through 1989 include a recession and the early recovery period, Conrail still maintains a positive net cash flow of \$89 million after interest payments but before dividends. Net cash flow after interest and before dividends totals \$283 million from 1986 to 1990 and \$285 million over the next five years, giving Conrail \$568 million in current income to apply to dividend payments in the low-case scenario.

#### ALTERING THE OPERATING ASSUMPTIONS

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The operating assumptions developed in Chapter III are key elements in determining Conrail's viability. The level of the tariff recovery rate and the rate of productivity growth have a much greater effect on the income and cash flow forecasts in each case than do changes in macroeconomic assumptions. Variation in these two rates can have significant effects on Conrail's prospective profitability and viability.

These effects can be demonstrated by comparing the tariff recovery rates and rates of productivity growth selected for the base case and low case in the baseline analysis with different operating variables under alternative scenarios. In Table 20, the CBO baseline is compared with Conrail's own projections, which represent a more optimistic situation, and with a more pessimistic scenario reflecting lower rates for the operating variables.

In the base case, Conrail's assumption of a tariff recovery rate of 80 percent accompanied by annual efficiency increases of 2.0 percent yield much higher levels of net income and cash flow than in the baseline. By 1995, cash balances have risen to \$1.6 billion, and total payments to the government over the forecast period equal nearly \$3.3 billion. The total effect on Conrail's prospects is to improve income and cash flow by approximately \$2 billion over the 10-year period. Values of 60 percent for the tariff recovery rate and 1.0 percent for efficiencies--levels substantially below historical experience--have just the opposite effect and drastically impair Conrail's ability to meet its obligations by 1993. Beginning in 1992, current operations would not provide sufficient cash to meet capital and debt requirements, let alone dividend payments to the government. Cash balances would turn negative in 1993, and Conrail would have to borrow over \$100 million to meet that year's dividend payment. Under these operating assumptions, Conrail's viability would come into question in the mid-1990s.

In the low case, the effects are very similar. Values of 80 percent for the tariff recovery rate and 2.0 percent for productivity growth yield an increase in income and cash flow over the period of more than \$1.8 billion. Cash at the end of the period is \$1.1 billion higher than in the baseline, while cumulative payments to the government are \$755 million higher and equal \$2.5 billion for the period. Under a more pessimistic scenario with a 40 percent tariff recovery rate and a 1.5 percent rate of productivity growth, cash balances would become negative in 1993. In this scenario, current operations do not provide sufficient cash flow to finance capital and debt requirements after 1987. As a result, all dividend payments and some current capital charges come from existing cash balances in the years 1988 through 1995.

The foregoing examples suggest that the selection of operating variables for estimating Conrail's future operating results will play a crucial role in predictions of its viability. For this reason, the conservative values of 70 percent for the tariff recovery rate and 1.5 percent for the rate of productivity growth were selected for the baseline analysis. Conrail has exceeded both of these values in each year since passage of the Northeast Rail Service Act of 1981. Furthermore, it is unlikely that Conrail would

TABLE 20. PROJECTED EFFECTS OF ALTERNATIVE VALUES FOR  
OPERATING VARIABLES UNDER BASELINE  
ASSUMPTIONS (In millions of current dollars)

	Conrail's Forecast		CBO Baseline		Pessimistic Scenario	
<b>Base Case</b>						
Tariff Recovery Rate	80		70		60	
Efficiency Rate	2.0		1.5		1.0	
	<u>1990</u>	<u>1995</u>	<u>1990</u>	<u>1995</u>	<u>1990</u>	<u>1995</u>
Net Income	741	1,000	569	588	396	172
Change in Cash	38	51	-69	-182	-176	-417
Ending Cash Balance	1,393	1,596	1,051	356	708	-889 <sup>a/</sup>
Payments to Government	355	509	290	330	224	149
Cumulative Payments to Government	3,285		2,480		1,680	
<b>Low Case</b>						
Tariff Recovery Rate	80		50		40	
Efficiency Rate	2.0		2.0		1.5	
	<u>1990</u>	<u>1995</u>	<u>1990</u>	<u>1995</u>	<u>1990</u>	<u>1995</u>
Net Income	538	794	360	468	221	190
Change in Cash	-4	68	-107	-111	-190	-265
Ending Cash Balance	1,203	1,366	815	243	520	-673 <sup>a/</sup>
Payments to Government	263	403	189	256	132	132
Cumulative Payments to Government	2,505		1,750		1,135	

SOURCE: Congressional Budget Office.

NOTE: Includes Conrail and subsidiaries. Tariff recovery and efficiency rates are percentages.

a. Turns negative in 1993.

continue to seek out and carry traffic that could sustain, on average, rate increases equal to only 60 percent or less of the inflation in its costs. Similarly, if productivity improvements are not forthcoming, the relatively high average cost of Conrail's transportation services would result in the abandonment of some traffic and lines, and their acquisition by a lower-cost competitor or short-line operator. At some point, therefore, the least profitable traffic would have to be forgone, thereby reducing operating costs and capital costs, and commensurately improving net income and cash flow. Conrail has the operating freedom to make these decisions, has not hesitated to make them in the past, and will probably continue to do so. Under reasonable operating assumptions, Conrail is a viable, independent railroad company.

### STAND-ALONE VIABILITY

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The assumptions made concerning the legal structure of the corporation are based on current law. The baseline scenario assumes that existing legislation remains in force and that no changes are made. The proposals for returning Conrail to private ownership would restructure the corporation financially and maintain it as an independent, or stand-alone, firm. Since this restructuring to a stand-alone configuration would affect Conrail's performance, a stand-alone scenario is examined to compare Conrail under this scenario with that of the baseline.

Conrail could be restructured in a number of ways. The stand-alone scenario adopted here attempts to make the fewest assumptions while preserving the intent of the various proposals currently being considered by the Congress. The following changes from the baseline scenario are assumed:

1. Conrail would be responsible for paying both state taxes and labor protection payments.
2. The federal government would terminate the 1979 financing agreement with Conrail.
3. The federal government would cancel all of Conrail's subordinated debentures, Series A preferred stock, and Series B preferred stock and contribute them to the capital of the corporation while retaining its ownership of 85 percent of Conrail's common stock.
4. Conrail would surrender the use of its existing net operating loss and investment tax credit carryforwards.

The first assumption ends Conrail's exemption from state taxes and the federal payment of labor protection payments, both of which were adopted in NERSA. With this change, the structure of Conrail's operations becomes essentially the same as other major railroads--that is, Conrail benefits from no special operating considerations.

The second and third assumptions eliminate the conditions placed on Conrail's financial operations in the financing agreement and recapitalize the corporation. By eliminating the liabilities of the corporation that are superior to the common stock, the value claimed by the liabilities is added to the value of the common shares.

The final assumption eliminates potential assets of the corporation that correspond directly to the liabilities canceled by the third assumption. Conrail's debentures and preferred stock were received by the government as compensation for the capital contributed to cover Conrail's operating losses and to finance capital acquisitions. The net operating loss carry-forwards and investment tax credits provide tax benefits in recognition of these same losses and investments.

The net effect of canceling both the liabilities and the tax benefits will be reflected in the value of the common stock. Under this stand-alone configuration, Conrail has external long-term liabilities of common stock and collateralized debt. In this scenario, the government would receive tax payments and common stock dividends, whereas in the baseline it received interest payments and preferred stock dividends. This change transfers the value and consideration to be paid from the debentures and preferred stock to the common stock and makes Conrail liable for federal taxes. All of the changes from the baseline to the stand-alone configuration are assumed to begin on January 1, 1987, at the start of Conrail's next fiscal and tax year.

### Base Case

The net income and cash flow statements for the stand-alone base case are shown in Table 21. The elements that remain the same between the baseline and stand-alone scenarios are the noncash items, property sales, changes in working capital, capital net of financing, and debt installments. Entries that are new or have changed include labor protection payments, state taxes, net operating income, net income, federal income tax, and dividends.

Labor protection payments are assumed to be \$12 million in 1987 and \$10 million thereafter. State taxes are projected to be \$30 million per year starting in 1987. Since operating expenses and therefore net operating in-

come do not include allowances for these expenses, they must be subtracted from baseline operating income. In addition, net interest no longer includes interest on debentures, so that nonoperating income is higher than that in the baseline. Net income before federal income tax, therefore, now includes labor protection payments and state taxes as expenses and excludes interest on debentures.

Federal income taxes are assumed to be required in this scenario, because the net operating loss and investment tax credit carryforwards are no longer available. CBO estimates that Conrail will book taxes at a rate between 20 percent and 30 percent of net income. Since taxes will be owed, it is assumed that Conrail will attempt to reduce its tax liability by adjusting its financial transactions--for example, by purchasing rather than leasing equipment and by shortening depreciation periods. Rather than calculating these adjustments and Conrail's estimated tax liability, CBO assumed that from an approximate book tax of 25 percent a year, Conrail would pay half of that amount in actual cash tax payments. Annual tax payments are calculated by applying this effective tax rate of 12.5 percent to each year's net income. The resulting tax payments rise steadily from a low of \$61 million in 1987 to a high of \$81 million in the years 1993-1995.

After-tax net income rises from a low of \$426 million in 1987 to a high of \$568 million in 1993, and then dips slightly to \$564 million in 1995. This compares with a range of \$512 million to \$604 million and 1995 net income of \$588 million in the baseline scenario. The difference occurs because the increase in expenses from labor protection payments and federal and state taxes more than offsets the decrease in expenses from the elimination of interest on debentures.

Dividend payments in the base case are assumed to be \$100 million per year in the 1987-1990 period and then rise to \$125 million per year in the 1991-1995 period. The resulting change in cash and the effect on cash balances can be seen in the cash flow section of Table 21. The ending cash balance in 1995 is only \$15 million below the level at the start of the forecast period, \$895 million versus \$910 million. The change in cash is becoming increasingly negative, however, so that over half of the dividend payment is coming from existing cash balances at the end of the period.

### Low Case

Changes to net income and cash flow in the low case, shown in Table 22, are the same as in the base case except for the level of the dividend payments. Labor protection payments, state taxes, and the effective federal

TABLE 21. STAND-ALONE SCENARIO: BASE CASE  
(In millions of current dollars)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Net Income</b>											
Net Operating Income	397	418	447	489	497	556	585	600	603	602	603
Operating income	397	418	489	529	537	596	625	640	643	642	643
Labor protection	0	0	12	10	10	10	10	10	10	10	10
State taxes	0	0	30	30	30	30	30	30	30	30	30
Nonoperating Income	45	31	40	44	43	42	42	44	46	44	42
Capital Gains <sup>a/</sup>	38	14	17	18	18	19	20	20	21	22	23
Net Interest	-21	-14	-8	-9	-12	-15	-17	-18	-18	-23	-28
Interest earned	64	66	76	72	68	64	61	60	59	57	54
Interest paid	85	80	84	81	79	78	78	78	78	80	82
Other	29	30	31	35	37	38	40	42	43	45	47
Net Income Before Federal Income Tax	442	448	487	533	540	599	627	644	649	647	645
Federal Income Tax	0	0	61	67	68	75	78	80	81	81	81
Net Income After Federal Income Tax	442	448	426	466	473	524	549	563	568	566	564

(Continued)

a. Capital gains on property sales.

TABLE 21. (Continued)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Cash Flow</b>											
Net Income	442	448	426	466	473	524	549	563	568	566	564
Noncash Items	227	224	221	220	229	241	254	267	282	299	319
Funds from Operations	669	672	647	686	702	765	802	830	850	865	883
Property Sales	65	45	41	41	41	43	44	46	48	50	52
Changes in Working Capital	-95	-21	-25	-30	-35	-40	-45	-47	-49	-51	-53
Total Sources	639	696	663	697	708	767	802	829	849	864	882
Capital Net of Financing	449	383	468	488	508	529	550	573	596	621	646
Debt Installments	126	126	116	113	119	126	135	151	160	163	176
Dividends	0	0	100	100	100	100	125	125	125	125	125
Total Uses	575	509	684	701	727	755	810	849	881	909	947
Change in Cash	64	187	-21	-4	-19	12	-9	-20	-32	-45	-64
Beginning Cash Balance	846	910	1,097	1,075	1,072	1,053	1,065	1,056	1,037	1,004	959
Ending Cash Balance	910	1,097	1,075	1,072	1,053	1,065	1,056	1,037	1,004	959	895

SOURCE: For 1985 Conrail; for 1986-1995, Congressional Budget Office. Capital net of financing and debt installments are from Conrail for 1986.

NOTE: Includes Conrail and subsidiaries. Historical data for 1985.

TABLE 22. STAND-ALONE SCENARIO: LOW CASE  
(In millions of current dollars)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Net Income</b>											
Net Operating Income	397	400	327	268	308	361	390	418	436	455	475
Operating income	397	400	369	308	348	401	430	458	476	495	515
Labor protection	0	0	12	10	10	10	10	10	10	10	10
State taxes	0	0	30	30	30	30	30	30	30	30	30
Nonoperating Income	45	38	46	33	31	24	20	21	24	25	27
Capital Gains <sup>a/</sup>	38	14	17	18	18	18	19	19	20	20	20
Net Interest	-21	-7	-2	-19	-22	-30	-36	-36	-34	-34	-34
Interest earned	64	73	83	61	54	42	33	29	26	23	21
Interest paid	85	80	85	80	76	72	69	65	60	58	55
Other	29	30	31	34	35	36	37	38	39	39	40
Net Income Before Federal Income Tax	442	437	373	302	339	386	410	440	461	480	502
Federal Income Tax	0	0	47	38	42	48	51	55	58	60	63
Net Income After Federal Income Tax	442	437	326	264	297	337	359	385	403	420	439

(Continued)

a. Capital gains on property sales.

TABLE 22. (Continued)

	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
<b>Cash Flow</b>											
Net Income	442	437	326	264	297	337	359	385	403	420	439
Noncash Items	227	224	219	215	219	226	234	242	251	262	274
Funds from Operations	669	661	545	479	516	564	593	627	654	682	713
Property Sales	65	45	41	41	41	42	43	44	45	46	46
Changes in Working Capital	-95	-21	-22	-23	-23	-24	-25	-30	-35	-40	-45
Total Sources	639	685	565	497	534	581	611	641	664	688	715
Capital Net of Financing	449	383	425	406	459	469	479	489	500	510	521
Debt Installments	126	126	115	111	114	117	123	134	138	135	141
Dividends	0	0	50	50	100	100	100	100	100	100	100
Total Uses	575	509	590	567	673	686	702	723	738	745	762
Change in Cash	64	176	-26	-69	-139	-105	-91	-82	-74	-58	-47
Beginning Cash Balance	846	910	1,086	1,060	991	852	747	657	574	500	443
Ending Cash Balance	910	1,086	1,060	991	852	747	657	574	500	443	396

SOURCE: For 1985 Conrail; for 1986-1995, Congressional Budget Office. Capital net of financing and debt installments are from Conrail for 1986.

NOTE: Includes Conrail and subsidiaries. Historical data for 1985.

a. Capital gains on property sales.

tax rate of 12.5 percent are the same. The dividend payments in the low case are assumed to be \$100 million a year except in the recession years of 1987 and 1988 in which they are reduced by half.

Federal income taxes vary between \$38 million in 1988 at the trough of the recession and \$63 million in 1995. Net income after federal income tax ranges from a low of \$264 million in 1988 to a high of \$439 million in 1995, slightly higher than the level in 1986. Compared with the low case in the baseline scenario, net income is \$90 million lower in 1987 and between \$15 million and \$29 million a year lower in the rest of the period. The difference is again the result of the net effect of labor protection, interest, and tax changes.

The ending cash balance in 1995 in this case is \$396 million, or \$514 million below the level at the start of the period. The negative change in cash in 1988 through 1990 exceeds the dividend payment, indicating that some of Conrail's cash requirements must be paid from existing cash balances even before making dividend payments to its owners. For the forecast period as a whole, however, current operations provide sufficient cash flow to cover all current expenses, including taxes, and to produce a total of \$285 million for dividend payments.

### Viability

Altering the structure of the corporation would not change its viability in either the base or the low case. In the base case, the analysis indicates that Conrail would be capable of paying a nominal dividend in each year of the forecast period while maintaining the real value of the corporation and capital stock, paying full industry wages and taxes, and maintaining its current level of cash holdings. Higher dividend payments could be made in each year by drawing further on cash reserves. With the dip in traffic in the final two years of the forecast period, greater use would be made of existing cash balances to finance dividend payments, which could be of concern in the years beyond the forecast period. Nonetheless, Conrail would pay the federal government, as a common stockholder and taxpayer of the corporation, over \$1.5 billion from current income over the period, including \$672 million in tax payments and \$871 million in dividends.

In the low case, Conrail's ability to pay dividends from current income is greatly reduced from that in the base case. Though the dividend payment is lower in response to lower output and income, the consumption of cash balances is required to finance 65 percent of total dividend payments in the forecast period. Whereas the trend at the end of the period in the base case

indicated the potential for problems beyond the forecast period, the trend at the end of the period in the low case indicates that the drawing down of cash reserves is abating and that all dividends might be payable soon from current income flows. In this case, then, existing cash balances permit the payment of dividends during the period of reduced traffic in the recession and recovery; and they permit Conrail to rebuild its traffic and financial ability to pay dividends while maintaining such payments in the interim.

This analysis indicates that it is the degree to which the corporation is profitable and the level of dividends it is able to pay that are at issue for Conrail, not whether the company can survive. The viability of Conrail is not in question under either the base case or low case. Conrail would be able to meet all of its current expenses, capital requirements, and tax obligations even if a recession occurred as in the low case. In addition, current operations would provide income to pay dividends in both cases.

The uncertainty associated with Conrail's earning potential and its prospective ability to pay a dividend would affect the value associated with ownership of Conrail stock. These issues of risk and value will be examined in the options section below.

#### IMPLICATIONS FOR POLICY

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The Northeast Rail Service Act of 1981 expressed the intent of the Congress that the freight service provided by Conrail should be returned to the private sector, and that Conrail should be sold as an independent company if it could be made profitable by employing the provisions and reforms contained in the act. As noted previously, Conrail met the two profitability tests contained in NERSA, and the Department of Transportation therefore proposed a plan for returning Conrail to private ownership. This section examines DOT's proposal and several options for selling the government's interest in Conrail in light of the viability analysis above.

In order to simplify analysis of the various options, CBO assumed that Conrail would be restructured in accordance with the stand-alone scenario described above. This assumption would cancel all of Conrail's preferred shares and subordinated debentures and contribute their value to the corporation. As a result, the government's ownership interest in the corporation would be consolidated to 85 percent of the common stock outstanding. The remaining 15 percent would be held by an employee stock ownership plan (ESOP).