CHAPTER 5

FINANCING: ACQUISITION COSTS, REHABILITATION EXPENSES, AND ACCOUNTING METHODS

The principal role of the Federal government in the reorganization of the bankrupt railroads will be to inject massive amounts of Federal funds. Because the return on investment (ROI) in the railroad industry is so low, it cannot attract private capital. In fact, the collapse of the Penn Central was precipitated by the inability of the railroad to "roll over" its existing debt and obtain new debt to finance future operations. Given the low return on investment in the industry and the dismal profit performance of the bankrupts, creditors prefer to invest money elsewhere. Table 17 compares the average ROI for Class I Railroads and alternative investments. The railroads' lack of attractiveness is striking.

The magnitude of Federal funding will be contingent on two variables besides railroad operating performance: the cost of the properties to be acquired from the bankrupts, and the cost of rehabilitating those properties for ConRail's use. USRA has estimated that $1.85 billion of Federal funds will be required for rehabilitation and operating expenses. Another $1.05 billion will guarantee that the former owners of the bankrupt railroads are adequately compensated for the properties conveyed to ConRail. Other guarantees, subsidies, loans, etc. are included under the plan to insure the financial viability of the system.

The form of Federal funding is a key to creating a profitable railroad. The proposed mechanism allows ConRail to initially use Federal funds without paying interest in cash. Much later (the process is not completed until the year 2016 when the railroad will presumably be strong enough to support the Federal debt), interest is paid in cash and the outstanding debt and stock are redeemed.

INCOME BASED REORGANIZATION

The greatest potential liability for taxpayers may be hidden in the form of deficiency judgments against the government for failing to adequately compensate creditors for the properties conveyed to ConRail. Two key questions are: Can ConRail produce a profit to support an income based reorganization? Is $422 million adequate compensation for the creditors? Because of the laws of bankruptcy, answering the second question may be contingent on a positive answer to the first.

TABLE 17

RATE OF RETURN ON NET WORTH

LEADING CORPORATIONS

Calendar Year 1972

Industrial group	Percent return on net worth
1. Soft drinks	22.4
2. Soups and cosmetics	20.4
3. Drugs and medicines	19.7
4. Common carrier trucking	19.4
5. Autos and trucks	17.2
6. Instruments, photo goods, etc.	16.8
7. Tobacco products	16.2
8. Hardware and tools	15.9
9. Restaurants and hotels	15.7
10. Household appliances	15.4
11. Baking	14.8
12. Brewing	14.7
13. Mail order	14.0
14. Lumber and wood products	13.9
15. Office computing equipment	13.8
16. Printing and publishing	13.7
17. Other food products	13.1
18. Automotive parts	13.1
19. Electric equipment and electronics	13.0
20. Other business services	13.0
21. TOTAL SERVICES	12.9
22. Real estate	12.8
23. Commercial bank holding companies	12.8
24. Dairy products	12.6
25. Miscellaneous manufacturing	12.6
26. Glass products	12.5
27. Chain stores - variety, etc.	12.3
28. Farm construction, material-handling eqpt	12.1
29. TOTAL MANUFACTURING	12.1
30. Property and liability insurance	12.0
31. Rubber and allied products	11.7
32. Building, heating, plumbing equipment	11.6
33. Furniture and fixtures	11.6
34. Department and specialty	11.6
35. Construction	11.3
36. Chemical products	11.3
37. TOTAL TRADE	11.3
38. Electric power, gas, etc.	11.2
39. Amusements	11.2
40. Clothing and apparel	11.1
41. Other machinery	10.9
42. Petroleum production and refining	10.8
43. Wholesale and miscellaneous	10.7
44. Distilling	10.7
45. Shoes, leather, etc.	10.6
46. TOTAL PUBLIC UTILITIES	10.6
47. Other stone and clay products	10.6
48. Paint and allied products	10.6
49. Miscellaneous transportation	10.5
50. GRAND TOTAL	10.5
51. Metal mining	10.4
52. Sales finance	10.3
53. Other metal products	10.2
54. Telephone and telegraph	9.8
55. TOTAL MINING	9.6
56. Sugar	8.8
57. Aerospace	8.8
58. Cement	8.8
59. Paper and allied products	8.7
60. Other mining, quarrying	8.7
61. Textile products	7.8
62. Food chains	7.3
63. Nonferrous metals	7.2
64. Meatpacking	7.1
65. TOTAL FINANCE	6.7
66. Air transport	6.6
67. Iron and steel	6.2
68. TOTAL TRANSPORTATION	4.8
69. CLASS 1 RAILROADS,	3.0
70. Investment funds	1.5

Source: First National City Bank of New York, Monthly letter, April 1973.

USRA argues that $422M is a reasonable value for the assets converged given the risks being taken by the government to salvage the bankrupt railroads. USRA assumes that the reorganization will be successful and that ConRail will operate as a profitable entity. If the creditors can prove that ConRail is not financially viable, then the mandatory conveyance requirements in the Act make the acquisition a "taking" of private property under the governments right of eminent domain. Under these circumstances a much higher valuation may be awarded by the courts.

An "income based reorganization" requires proof that the bankrupt railroads can be restructured so as to produce a profit. The return to creditors then includes not only the $422 million offered initially for the property but also the stream of earnings which follows. USRA claims to have proven that the reorganization is income based through the FSP projections that ConRail will generate enough profit to raise the value of ConRail Common and Series B Preferred Stock to $1.575 billion by 1985. This value is in excess of the Certificate of Value based on the $422 million valuation plus 8 percent annual interest. Critics of this approach argue that the machinations required to make the system appear profitable (including use of depreciation accounting, Federal debt that pays interest by distributing stock rather than cash, and remarkable projected operating efficiencies) make profitability an "accounting fiction." These critics argue that normal Section 77 bankruptcy can represent an income based reorganization because the same entity continues in operation with a revamped capital structure. ConRail is a new entity with less assurance of producing any income, and to offer a minimum valuation in the hope that this untried new rail system will produce a profit is inconsistent with the Section 77 principles of reorganization. Precedents do exist, however, for operating railroads at a marginal rate of return even where creditors might prefer liquidation and investment in higher yielding ventures. This stems from the concept that railroads are "public service enterprises" which have received special considerations such as land grants in return for a necessary public service. Under this definition, ConRail can produce a marginal profit and still be considered a successful income based reorganization.

If ConRail fails to produce a profit and the assets of the creditors erode (i.e., rails and ties deteriorate as cash generated by the railroad is used to pay off operating expenses instead of for rehabilitation), then it may still be argued that the reorganization was not income based. Under this scenario, the government has appropriated the creditors' properties at a low value based on expected future income. However, since they did not produce an income the Court could consider that conveyance constituted "taking" private property under the right of eminent domain. The valuation would then be the cost of reassembling these properties at market value or perhaps their value on the open market if sold for purposes other than railroading. In any event,

ConRailcs profit producing potential remains the critical issue.

VALUATION

The creditors and stockholders of the bankrupt railroads are being offered $422 million for their properties. Table 18 indicates the manner in which value has been assigned to the various properties and the liabilities that will be assumed by ConRail. The valuation was determined by examining the assets of the various line (some by actual site visits) and assuming that the railroad was to be dismantled and sold piecemeal. Costs were assigned for managing the system's liquidation. In addition, some economic factors were included to determine how the sharp increase in supply coupled with the limited demand for many of the assets being sold might depress prices. The returns to creditors were discounted at a 15% rate back from the presumed date of sale to the date of conveyance.

TABLE 18

ASSETS AND LIABILITIES CONVEYED TO CONRAIL

Assets Acquired:	$M
Road & Facilities	290
Transportation equipment	340
Land	44
Net Passenger Assets	22
Other Assets	71
TOTAL ASSETS	767
Liabilities Acquired:	
Equipment Obligations	250
Unfunded Pension Benefits	31
Section 215 Government Loans	64
TOTAL LIABILITIES	345
TOTAL NET ASSETS	422

SOURCE: FSP, p. 57

The Supreme Court, in upholding the constitutionality of the Act, held that creditors have a right to sue the U.S. government for damages under the Tucker Act if they can prove that $422 million is less than the "constitutional minimum" to which they are entitled. The argument turns on the resolution of three issues: 1) the valuation method used to determine the value of the assets conveyed (i.e., liquidation value if the assets are sold piecemeal; assemblage value, meaning the price of repurchasing the bankrupt's properties on the open market minus depreciation; or book value meaning the depreciated value which the bankrupts used in their accounts for the assets); 2) the basis of the reorganization (i.e., will the new ConRail be profitable and provide the creditors with a stream of earnings implying an "income based reorganization"or will the new Conrail lose money continuing to dissolve the assets of the old creditors); 3) value of the securities conveyed depends on the type of securities issued (i.e., USRA has suggested using stock with a minimum value guaranteed by the U.S. government) . The Act allows ConRail to take control of the bankrupts' assets before a final conveyance price has been determined. If the final price is significantly different than $422 million, two principal effects occur. First, if the value is more than $422 million the assets conveyed to ConRail may be increased in value which would increase the depreciation charges. For example, if the value of transportation equipment conveyed is assessed to be $700 million instead of $340 million, and the depreciation rate is 5 percent annually, the depreciation deductions from income would increase from $17 million to $35 million annually. Second, the U.S. Government investment in Conrail could increase indirectly under the proposed financing scheme through Federal "Certificates of Value" guaranteeing the value of stock issued to the creditors. Presently the Government would guarantee $1.05 billion worth of securities issued to the creditors (this is the $422 million plus 8 percent annual interest because the certificates are redeemable on or before November 1, 1987).[1]

Many industry members and USRA staff members believe that a court case to settle the value of the properties conveyed is inevitable. Table 19 indicates the results of some alternative evaluation methods. The USRA valuation is the lowest, with alternative methods producing values 3 to 30 times higher. Further payments by the Federal government, however, would be contingent on resolution of the court case which USRA staff members indicated would take years to reach a judgment. USRA argues that $422 million is more than adequate because creditors are continuing to lose money on these assets, giving them no real earning power, only a liquidation value. The increased government investment will be responsible for the turnaround in the bankrupts' earnings, yet the taxpayers will not share in the appreciation of the assets since their investment will carry fixed returns. Additional federal grants and subsidies above the $422 million will protect creditors' assets for example by

[1] Final system plan p. 95.

TABLE19

ALTERNATIVE VALUATION TECHNIQUES

	Total Value ($B)	
USRA net liquidation value	.6	
Book value 12/31/75	4.4	
Cost of Reconstruction New (less depreciation)	17.9	(excludes LH, AA, CNJ)
Gross proceeds from Liquidation	3.6	(includes only PC)
Net Proceeds from Liquidation	1.8	(excludes L&H)
Penn-Central Creditors assuming continued rail use	7.4	(Penn-Central only)
Penn-Central Creditors minimum value assuming liquidation	3.5	(Penn-Central only)
RANGE	$ .6 - 17.9B	

SOURCE: FSP, p. 142-43, 155.

[2] Washington Post 7/17/75, p. '14

subsidizing passenger service. The taxpayer is exposed to substantial losses and potential deficiency judgments while even the most successful outcome would be a return of the initial capital over a very long period of time at an interest rate that scarcely justifies the risk. Allowing the government to participate directly in the proceeds from ConRail, for example by reviewing dividends, would use up cash that will now be used to pay the creditors and increase the value of their stock. It is the government's willingness to postpone cash interest payments during the startup period that makes the venture viable. In sum, the taxpayers are taking substantial and unrewarded risks in addition to the initial $422 million that more than compensates the creditors.

The creditors argue that they would receive more than $422 million for their properties if they could liquidate now. USRA'S valuation technique reduces the asset valuation unreasonably. For example, the 15 percent after tax discount rate is too

high, reducing the net present value of the assets below the proper rate. Without discounting, net proceeds from liquidation equal $1.8 billion and gross proceeds (i.e., before the administrative costs of liquidation) are $3.6 billion.[3] Common sense would dictate a higher value for the land owned by the Penn Central than $422 million.

Resolution of the valuation question will probably require court action and USRA staff members expressed considerable doubt about the probable outcome. Any increase in the $422 M figure, however, will come directly from the taxpayers and could materially increase the cost of the ConRail venture.

REHABILITATION EXPENSES

As shown in Table 20 ConRail will spend $4.2 billion for rehabilitation of road property and $1.78 billion for additional freight equipment during the planning period. To calculate roadway rehabilitation costs, USRA determined which tracks were to be upgraded and to what level. Contractors developed engineering estimates of anticipated rehabilitation expenses.

The rate of rehabilitation increases markedly to accomodate for previously deferred expenditures. Between 1976 and 1985 ConRail will more than double the number of ties and triple the miles of rail replaced by the bankrupts in the previous ten year period (1965-1974).[4] The increase results from the infusion of Federal cash which may be used for rehabilitation of roadway and structures. Railroads nationally have had problems financing capital expenditures. In the ten year period, 1965-1974, the railroads spent $14.4 billion for equipment, roadway and structure additions and betterments. Cash generated in the railroads during that period covered only 63 percent of the cost with the remainder borrowed against equipment because loans for roadway improvements are generally not available. At the same time, the AAR estimated that as of November 1974, $7.2 billion in maintenance and capital improvements had been delayed.[5]

Because rehabilitation expenditures are a significant use of Federal funds and because there are no alternative external sources for those funds, the accuracy of the estimates are a critical factor in determining the sufficiency of the $1.85 billion request.

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[3] FSP p. 155

4A Final System Plan p. 87

[5] A Financial Analysis of the Preliminary System Plan as proposed by the USRA, First National City Bank, 5/15/75 p. 59-60.

TABLE 20

REHABILITATION

	Road Property Expenditures
Additions & Improvements	$1.lB
Deferred Work	1.4B
Current Maintenance	1.7B
	$4.2B

	Freight Equipment Additions
Locomotives	.74
Freight Cars	1.00
Misc. Equipment	. 0 4
	1.78

SOURCE: FSP, p. 61

The USRA estimate was based on information from four independent sources. USRA integrated the results and eliminated gross errors. Rehabilitation costs for track vary widely depending on the traffic which the rail must bear and the funds available for rehabilitation. For example, funds may be allowed for upgrading a stretch of track from 10 mph to only 30 mph because the savings from increased train speeds would not justify the cost of upgrading it further. Rehabilitation estimates were revised downward from the PSP to the FSP because USRA carefully specified the level to which each line would be upgraded. All track must be upgraded to a level which ensures safety, prevents derailments and reduces equipment operating and repair costs. USRA and outside commenters generally felt that the $4.2 billion for road property rehabilitation allowed management sufficient flexibility to perform necessary repairs and cover potential cost overruns.

The major criticism on the subject of rehabilitation is the fear that ConRail management cannot resist pressures to “gold plate the rail.” Once the precedent is set of providing rehabilitation funds from the Federal Treasury, political pressure may be applied to ensure that one community’s branch

line is upgraded to as high a level as another's. Rehabilitation costs could spiral if ConRail attempts to achieve equity among jurisdictions. Minimizing road rehabilitation costs is essential because costs are hiqh and returns in terms of increased system efficiency may be very low. Under normal private enterprise incentives the profit motive will force management to reuse old materials and replace only the necessary rail. Whether these incentives will function for ConRail remains to be seen.

In summary, the rehabilitation estimates seem reasonable, but managements ability to stay within those estimates by resisting political pressures and rehabilitating only where necessary remains unproven.

CHOICE OF DEPRECIATION METHOD

USRA tried to choose a method of depreciation which accurately reflected the real cost incurred by ConRail. Depreciation should reflect the decrease in the value of ConRail's assets resulting from use, decay and obsolescence. Three depreciation methods were considered:

- Betterment accounting is used by almost all railroads for depreciating track structures. Under betterment accounting all track structure replacement expenditures (i.e., replacement of rails, ties, etc.) are subtracted directly from income. Consequently, the value of track structures on the balance sheet is low because some items may be 100 years old. Another consequence of betterment accounting is that higher rehabilitation expenditures result in lower reported income. Thus, railroads hoping to report higher profits over the short term simply reduce rehabilitation expenditures. The ICC accepts betterment accounting as standard practice partly because record keeping is easier. Under normal depreciation procedures, it would be necessary to record the date of installation of all ties, ballast and track and to depreciate them at various rates depending upon the degree of wear. Betterment accounting eliminates the need for such calculations.
- Modified betterment accounting was developed by USRA and used in the PSP to depreciate track structures. USRA argued that expenditures for replacement of track structures resulting from the previous managements' failure to perform timely maintenance should not be subtracted from income (as under betterment accounting), Instead those expenditures related to such deferred maintenance would simply be added to the balance sheet. This method was ultimately rejected by USRA for the FSP because it was impossible to separate expenditures

related to deferred maintenance existing prior to ConRail from other maintenance expenditures, and more importantly because the accounting profession would probably have refused to certify it as a valid means of public reporting.

- Depreciation accounting was chosen as the basis for reporting the FSP results. Under depreciation accounting, only 3.33 to 6.66 percent of the rehabilitation expenditure is subtracted from income in a single year.[6] Thus, rather than subtracting all rehabilitation expenses from income in a single year as in normal betterment accounting, the expenses are spread over 15 to 30 years, ConRail's reported income is much higher than would be reported by other railroads using betterment accounting. While depreciation accounting requires record keeping similar to that required under modified betterment accounting, it eliminates the necessity of making arbitrary decisions about which expenditures stem from pre-ConRail deferred maintenance.

Using depreciation accounting, ConRail profits are considerably higher than would be reported by railroads using normal ICC accounting procedures. Table 21 illustrates the impact of depreciation accounting on reported income. Using betterment accounting, income would be reduced by $2.4 billion. Rather than producing a $2.0 billion profit in the planning period, ConRail would have reported a $400 million loss. This loss will be reported for tax purposes because the IRS uses the betterment approach.

The choice of depreciation method only affects ConRail's profits on paper. Cash flow would remain the same regardless of the accounting method chosen, however, the attitude of investors towards the railroad may be improved by the choice of an accounting method which reports a $2 billion profit rather than a $400 million loss. Unfortunately, ConRail's operating results will no longer be comparable to other railroads.

[6] FSP, p. 58.

TABLE 21- PROFIT IMPACT OF DEPRECIATION ACCOUNTING

INCOME (inflated $M)

		ConRail Depreciation Accounting ($M)	ICC Betterment Accounting ($M)
1976		(332)	(464)
1977		(220)	(375)
1978		(79)	(271)
1979		36	(192)
1980		259	(2)
1981		354	81
1982		413	129
1983		475	180
1984		544	237
1985		597	275
TOTAL	Profit (Loss)	$2,000M	($400M)

SOURCE: Final System Plan, p.66.