CHAPTER 7

FINANCIAL ASSESSMENT AND CONSEQUENCES FOR THE FEDERAL GOVERNMENT

Based on the sensitivity analysis in Chapter 6, it is possible to project the impact of changes in some basic assumptions on the financial viability of ConRail and the required Federal commitment.

To factor the results of the sensitivity analysis into the FSP financial projections a pro forma income statement and sources and uses of funds statement were prepared. The income statement (Table 25) aggregates all of ConRail's revenues and expenses for the planning period (1976-1985) and computes an aggregate income. Figures are expressed in current dollars. USRA projects that ConRail will generage $43.7 billion in operating revenues and $1.5 billion in income during the planning period. Over 34% of the expenses are attributable to transportation costs. Income represents only 3% of revenue indicating how quickly an increase in operating costs or a revenue decline could eliminate profits. Ninety-seven cents of every revenue dollars is devoted to expenses, many of which are not variable with volume. Trucks, for example or barges can ease operations during slack periods. This decreases their tolls or taxes because the government owns the right of way. Railroads however, must continue to pay property taxes and maintain their own right of way. Assuming that one-third of ConRail's costs are variable, a 45 percent drop in revenue would eliminate all profits during the planning period. Similarly, a 4.5 percent increase in revenue would more than double profits.

The sources and uses of funds statement (Table 26) indicates that during the planning period, ConRail will take in and disburse $8.96 billion in funds. The largest sources of funds will be Federally financed debentures and Series A Preferred Stock (27%). Income will generate only 13 percent of the funds requirements. Seventy-five percent of the funds will be used for addition to road, facilities and transportation equipment. The Table obviates the need for ConRail to draw on funds other than those generated internally (i.e., depreciation and income) to replace its physical plant.

The $1.85 billion figure used to represent the Federal commitment includes the $1,000 million of 7.5 percent debentures and $850 million of the $1392 million of Series A Preferred Stock shown in Table 26. The remaining $542 million in Series A Preferred Stock represents additional stock accepted by the tax-payers in lieu of cash interest payments. The Federally guaranteed Certificates of Value worth $1.05 billion in 1987 do not represent a source of funds for ConRail but only a guarantee to the creditors.

These two tables provide the baseline data from the FSP necessary to apply the results of the sensitivity analysis.

TABLE 25

INCOME STATEMENT (1976-1985)
(Current dollars)

REVENUES :		
Freight & Other Revenue	36,326	83%
Passenger Revenue	5,694	13%
Passenger Subsidy	1,650	4%
Total Railway Operating Revenues	43,670	100%
OPERATING EXPENSES:		
Maintenance of Way	4,710	10%
Maintenance of Equipment	5,346	12%
Transportation	15,222	35%
Gen. & Admin. & Other Expenses	2,119	5%
Passenger Operating Expenses	7,344	17%
Total Railway Operating Expenses	(34,741)	79%
OTHER INCOME (EXPENSES):		
Net Car Hire	2,735	6%
Payroll Taxes	2,560	6%
Other Taxes	704	2%
Other Income and Expenses	99	>1%
Total Other Expenses	(6,098)	14%
Interest Expenses	(784)	2%
Net Tax (After Extraordinary Item)	(520)	1%
INCOME	1,527	3%

Source: Final System Plan pp. 51

TABLE 26

SOURCES AND USES OF FUNDS (1976-1985)

SOURCES OF FUNDS	(Inflated $M)	Percentage of Total
Income	1,156	13%
Depreciation	1,357	15%
Deferred Taxes & Tax Credits	891	10%
Series A Preferred Stock	1,392	16%
Series B Preferred Stock	400	4%
Common Stock	21	>1%
7.5% Debentures	1,000	11%
Equipment Obligations	1,502	17%
Passenger Assets & Reimbursements	677	8%
Salvage Value for Retired Assets	162	2%
Increase in Noncurrent Liabilities	402	4%
TOTAL	8,960	100%

USES OF FUNDS	(Inflated $M)	Percentage of Total
Dividends	569	6%
Accretion of Series A Preferred	86	1%
Additions to Road & Facilities	4,582	51%
Addition to Transportation Equip.	2,121	24%
Increase in Net Passenger Assets	488	5%
Repayment of Equipment Obligations	414	5%
Increase in Other Assets	121	1%
Increase in Working Capital	579	7%
TOTAL	8,960	100%

Source: Final System Plan pp. 54-55

IMPACT OF SENSITIVITY ANALYSIS

The analysis in Chapter 6 calculated the impact of alternative assumptions on revenues, expenses and the required Federal investment. Table 27 summarizes the results.

TABLE 27

THE IMPACT OF ALTERNATIVE ASSUMPTIONS ON REVENUE, INCOME AND INVESTMENT REQUIREMENTS (1976-1983)

Alternative	Revenue	Income	Investment
Final System Plan	$43.7B	$1.5B	$1.85 B Federal investment
1 Increased Coal Revenue	$44.8B	$2.OB	More rapid repayment of Federal debt
2 Lags in Operating Improvements	$43.7B	$-.3B	Require increased Federal investment Of $lB
3 Deficiency judgement (assume assets valued at $7.4B)	$43.7B	$ .5B	Increased Federal payments directly to creditors of $6.7B deficiency
4 Unified ComRail	$51.lB	$2.5B	$1.2 B Federal

The results in Table 27 illustrate that the financial viability of ConRail may be jeopardized by failure to achieve the operating improvements projected in the FSP. The Federal commitment could be increased substantially by an adverse deficiency judgement or failure to meet operating goals. The latter case could eliminate the possibility of ConRail ever returning to private ownership. Coal provides the most optimistic possibility but an increase in coal rates would require a decision by the entire railroad industry, not only ConRail. Unified ConRail requires further analysis to examine the adverse impacts which could result from a monopolistic rail system. In addition to the in-depth sensitivity analyses, several other aspects of ConRail's financial projections deserve consideration.

The $1.5B profit is in part an accounting fiction= If ConRail were to depreciate rehabilitation expenditures using normal ICC betterment accounting, a $900 million loss would have been reported rather than a $1.5 billion profit.

Failure of ConRail to achieve the average industry operating ratio will mean that rate increases will not cover cost increases and profits would decline. The losses predicted under the “operating failure” assumption would be magnified.

USRA assumed that ConRail would receive $1.65 billion in subsidies primarily from the Federal government. Failure to receive this subsidy would convert the $1.5 billion profit to a $100 million loss ($50 million of the subsidy is for capital replacement) .

If ConRail is required to continue operating light density lines without a subsidy after the initial two year "reexmination" period losses could increase substantially.

Numerous additional variables could be cited reconfirming Conrail’s susceptibility to changes in the operating environment. On balance, however, the FSP seems to be optimistic with a considerable downside risk for the taxpayers should ConRail fail to meet operating expectations.

CONSEQUENCES FOR THE FEDERAL GOVERNMENT

The Final System Plan requests $1.85 billion in Federal funds to be invested in ConRail during the first 5 years. $1.0 billion will be injected as debt in the form of debentures earning 7.5% interest annually. In case ConRail fails they are the first securities to be repaid except for secured debt (i.e., equipment mortgages) .85 billion will be invested as equity in the form of Series A Preferred Stock, which earns dividends at 7.5% annually. If there is not sufficient “cash available” (as defined by USRA) to pay dividends in cash then ConRail will issue more Series A Preferred Stock.

In fact, the Federal investment exceeds $7 billion rather than $1.85 billion because guarantees and subsidies are also expected to be provided during the planning period. By 1985, the U.S. will have invested about $7.3 billion in the reorganization, including loans, grants and guarantees. Potential deficiency judgments against the government could more than double that amount. Table 28 details other Federal costs implied by the Plan. These calculations assume that the FSP profitability projections are achieved. A poorer performance could increase the need for Federal assistance.

There are five basic types of financial commitments which the Federal government will incur in support of ConRail. (Table 28).

Direct Investment: The Federal government could potentially invest $3.4 billion in ConRail by 1985. $2.7 billion will definitely be invested in the form of cash $1.85 billion and postponed interest ($880 M). The remainder are discretionary funds which could be used if ConRail fails to meet FSP projections. The government may forgive interest payments if ConRail requests it and the Government Investment Committee approves.

TABLE 28

Type of Commitment	Form of Funds	Value ($M)	Total ($M)
Direct Investment	7.50 % debentures	1000	
	Series A Preferred Stock	850	
	accrued interest (1985	880	
	Secretary of Transportation Discretionary Funds	400	
	Government Investment Committee Discretionary Funds	250	
			3380
Subsidies	Passenger Subsidies	1650	
	Light Density Lines	180	
	Reimbursement for Northeast Corridor conversion	211	
			2041
Grants and Loans	Section 215 interim assistance	300	
	Section 213 emergency assistance	282	
			582
Guarantees	Certificates of Value (1987)	1050	
	Labor Protection Costs	250	
			1300
TOTAL			7303
POTENTIAL DEFICIENCY JUDGEMENT			0-6800
POTENTIAL TOTAL			7303-14103

Subsidies: The government will provide over $2 billion in subsidies primarily to support passenger operations. Table 29 outlines the uses of the $1.65 billion requested for subsidies. USRA concluded that freight traffic should not subsidize passenger service and that local or federal authorities would have to provide the necessary subsidies.

TABLE 29

PASSENGER OPERATIONS

	1976 - 1985 ($ billion inflated)
Operating Revenue	$6.07
Operating Expenses	($7.34)
Operating Loss	($1.27)
Government Subsidies:	
Operating Loss Reimbursement	$1.27
Additional Depreciation (betterment accounting)	$ .33
Additional Working Capital Needs	$ .05
	$1.65

In the FSP, USRA estimated that passenger subsidies and revenue would increase from a 1973 level of $322M to a 1976 level of $377M (1973 dollars). This 14 percent increase will result from a renegotiation of contracts with passenger authorities. After 1976, USRA predicts that subsidies and revenues will rise to cover the inflated cost of passenger operations. Reimbursements would cover the allocated cost of passenger service which includes all those costs attributable to passenger operations.

Penn-Central, in reviewing the FSP, noted that historically railroads have not succeeded in recovering inflationary cost increases. In 1976 ConRail may be able to negotiate contracts with passenger authorities such that all passenger costs are covered. However, beyond 1976 if passenger authorities fail to raise rates sufficiently to cover inflationary cost increases, ConRail will be forced to cover the shortfall. Historically, this has been the experience of the railroads.

Once ConRail agrees to provide passenger service, an ICC ruling will be required before service can be terminated. In the past, the ICC has not even allowed abandonment when a passenger authority failed to pay a bankrupt railroad for inflationary cost increases beyond avoidable costs (less than fully allocated costs). It is even less likely that the ICC would allow abandonment if passenger authorities do not raise rates to pay ConRail for inflationary cost increases. Penn-Central estimated that the $1.5B in profits projected for ConRail would be reduced by $1.3B or 87% if relationships with passenger authorities follow existing patterns.

Grants and Loans: The government has already provided the bankrupt railroads with $582 million in loans to meet current operating and maintenance deficits. USRA expects that $236 million of this will be converted to a grant.

Guarantees: $1050 million will be authorized to guarantee creditors the value of their assets ($422 million plus 8 Percent annual interest to 1987). The FSP projects that if operating projections are achieved, these funds will not have to be expended. An additional $250 million of labor protection guarantees are provided but ConRail expects to use only $200 million.

Deficiency Judgement: The Federal government will be liable for any deficiency judgement entered against ConRail. Because ConRail will not be able to issue more stock to pay off these claims, they will probably be paid directly from the Federal treasury. Payments could range from zero to nearly $7 billion.

Table 30 summarizes the potential Federal costs under each of the alternatives discussed in the sensitivity analysis. Improving profitability through higher coal revenues will not decrease the Federal investment although the payback period would be shortened. On the other hand, operating failures could increase the Federal commitment by more than 30%. A large deficiency judgement could do the most to increase the Federal contribution. Unified ConRail could decrease the Federal investment by more than 17 percent.

TABLE 30

Alternative	Direct Investment	Subsidies	Grants and Loans	Guarantees	Deficiency Judgment Payments	Total
FSP	**$2.7B**	**$2.OB**	**$ .6B**	**$ .2B**	**O**	**$5.5B**
Increased Coal Revenue	**2.7**	**2.O**	.6	**.2**	**0**	**5.5**
Operating Failures	>3.4	2.0	.6	103	0	)7.3
Deficiency Judgment	2.7	2.0	.6	1.3	6.8	13.4
Unified ConRail	1.8	2.0	.6	.2	0	4.6

In every case, the taxpayers investment far exceeds the publicized $1.85B figure. The government could further protect their investment by adding indenture agreements and restricting ConRail activity. For example, if FSP projections are not achieved further loans could be restricted. The opposite " reaction, however, is more likely. Once taxpayer's funds are invested, the government **may** feel committed to infuse more capital to salvage the existing investments. In addition, because ROI in the railroad industry is so low, few railroads **will** be able to obtain long term financing. ConRail sets a precedent for substituting Federal funds for conventional sources of long term debt and over the next ten years as $1.3 billion in debt comes due, the US may have to supply funds to other railroads.[1] The Federal investment in ConRail may signify the beginning of a new Pattern in relationships between the Federal government and the railroad industry.

A Financial Analysis of the Preliminary System Plan as proposed by the USRA, First National City Bank 5/15/75.