CHAPTER 1
SUMMARY

PURPOSE AND APPROACH

This report examines the financial outlook for ConRail, the railroad entity proposed by the United States Railway Association (USRA) to acquire the bulk of the railroad assets and operating responsibilities of the bankrupt Northeast railroads. On July 26, 1975, USRA dispatched to the Congress its Final Systems Plan (FSP), or "blueprint", for reorganizing the bankrupt railroads now responsible for 22,200 miles of track. Early in 1975, in accordance with the 1973 Regional Rail Reorganization Act, USRA published a Preliminary Systems Plan (PSP) to which the public, creditors, shippers, ICC and other interested parties responded.

The approach of this report is to examine the critical assumptions affecting ConRail's financial viability using background data developed by USRA, the views of the key parties and independent analysis. Not surprisingly, ConRail's financial future depends on (a) how fast its revenues can grow, (b) whether it can reduce its operating expenses per ton mile of freight carried by improving efficiency, and (c) how much it must pay to acquire capital assets from the bankrupts and upgrade such track and equipment to give better and lower cost service. This report provides an independent assessment of how the decisive factors in each of these areas might be expected to develop between now and 1985. It concludes with an analysis of what these outcomes may mean in terms of the three critical financial questions facing the Congress as it weighs the ConRail proposal in reaching its November 1975 decision:

- What is the size of the Federal government's subsidy to start and sustain ConRail?
- Is it realistic to plan on an "income-based" reorganization? That is, can ConRail be expected, in 1979 as projected by USRA, or ever, to make profits adequate to shift it from public to private ownership?
- Finally, if the forecast shows that ConRail will encounter financial problems more serious than contemplated by USRA, are there superior alternative approaches? Can these be implemented now or can acceptance of the USRA ConRail proposal be viewed as the first step toward such options?

THE BASIC FINANCIAL PROJECTION

USRA'S report to the Congress projects modest increases in revenue and dramatic improvements in operating efficiency. These outcomes together with the low estimated cost of acquiring the bankrupt railroads' assets, and the use of favorable depreciation accounting methods lead to USRA'S conclusion that ConRail can be launched at a cost of $1.85 billion, plus another $650 million in contingency funds.

During the planning period, USRA projects that ConRail will collect $43.7 billion in revenues (current dollars) and generate $1.5 billion in income. This represents a dramatic turnaround from a $332 million loss in 1976 to a profit of $397 million in 1985. The first profitable year of operation is expected to be 1979.

REVENUES

USRA estimates that the tonnage of freight shipped on ConRail will increase by 15.4 percent from 317.1 million tons in 1973 to 366.3 million tons in 1985. Tonnage shipped by the Penn-Central has been dropping for the last decade. ConRail is projected to experience a 1.20 percent per annum tonnage growth rate. Revenues (in 1973 dollars) are projected to grow by 15.7 percent, or 1.22 percent per year, to $2.090 billion by 1985. The GNP growth rate through 1985 of at least 3.5 percent is more than twice the revenue growth rate.

This projection is not optimistic in light of the projected growth in coal shipments. It assumes increased coal tonnage will constitute 62.2 percent of the total increase in freight shipped from 1973 to 1985. Even accounting for the declining share of Eastern coal in U.S. production, the absolute amount of coal produced in the U.S. is expected to grow so dramatically that major new ConRail shipments can be expected.

A pessimistic factor that could lower the USRA revenue projection results from the operation of the ICC-managed regulatory system for railroads. Railroads seek rate increases based on cost increases. At projected inflation rates of six percent or more, if the railroads are not quick to document cost increases and seek ICC actions, and the ICC does not rule expeditiously and responsively, then revenues will be eaten up by costs with no margin for profits. The magnitude of revenue losses due to unplanned lags could be $100 million or more over the 1976-1985 period. For ConRail, the situation is even worse because the ICC grants rate increases on an industry-wide average cost basis. ConRail's costs will exceed, at least into the early 1980's if not beyond, the costs experienced by other railroads. Thus, rate increases granted are likely to fall short of ConRail's requirements.

OPERATING COST

Today, the bankrupt Penn-Central loses 9.9¢ on every dollar of revenue. ConRail is expected to make a profit of 13.5¢ by 1985. This is to be accomplished primarily by reducing operating expenses. The most dramatic cost saving is to occur in the cost of transporting freight. Transport costs will, according to USRA, drop from about 40¢ on the revenue dollar to about 30¢.

USRA projects that such savings will result from improved yard efficiencies, car utilization, and better traffic densities (tons per mile of track) which can reduce costs. Many USRA FSP critics doubt ConRail will do so well. USRA correctly identifies yards as the chief delay point in car movements. Only 14.6 percent of car time is spent moving whereas 61.8 percent is spent in yards. If yards can be bypassed and if yard efficiencies improve, the average time a car spends on a trip (through 5-6 yards per trip) will decline. Cost per trip will drop, and because more time per car and per locomotive will be available, less new equipment will need to be purchased to handle new tonnage. USRA anticipates an investment savings of $1.2 billion due to car utilization improvements.

USRA expects these gains to result from the implementation of a computerized car management system. “Blocks” of cars will bypass yards. However, USRA’S projections will not be easily attained. The primary reason is the structural characteristics of the Northeast railroads. There is an inverse correlation between railroad operating ratios (operating costs + revenues) and the percentage of railroad mileage devoted to mainlines as opposed to yards and light density lines. Thirty-one percent of Penn-Central line is mainline and its operating ratio is 84.4 percent. This compares with the N&W’s operating ratio of 71.1 percent and mainline proportion of total track of more than 70 percent. Even the divestiture of 5,700 miles of light density lines from the bankrupts as recommended by USRA will not free ConRail of this disadvantage.

Other characteristics of the Northeast bankrupts will impede improvements in efficiency. Generally, greater traffic per mile of track (called density) allows better recovery of fixed costs. But, the Penn-Central’s density is near the bottom of the top ten railroads (measured in terms of revenue). ConRail’s average haul length is shorter than most major railroads, making trip simplifications and yard avoidance more difficult. Finally, the nature of the Northeast economy leads inevitably to more rail car terminations on ConRail than other railroads which enjoy more through traffic. Because a railroad pays other lines when their cars are on its tracks, this characteristic works to ConRail’s disadvantage.

A prudent forecast would not assume that these structural limits of Northeast railroads can be easily overcome by sophisticated computer-based planning. Most likely, the operating improvements ConRail will experience will fall substantially short of those assumed by USRA.

SENSITIVITY ANALYSIS

Adjusting USRA'S estimates for possible outcomes that are more pessimistic or optimistic than the FSP forecast serves to illustrate how much worse or how much better ConRail's financial outlook might be over the period to 1985.

Coal Revenues Could Be Higher - The FSP assumed that coal tonnage shipped by ConRail will grow 36 percent by 1985. But, growth of 58 percent is possible if national coal production doubles in accordance with current plans. This adjustment would increase ConRail revenues by $752 million. Profits would rise by $150 million. In addition, a 50¢ per ton rate increase for coal shipments is possible in 1976. If implemented, ConRail's coal revenues would jump $375 million and profits would increase by the same amount.

Operating Improvements Will Fall Short of USRA Expectations - If the efficiency gains anticipated by USRA in the FSP occur later and fall short of USRA projections, the investment required by ConRail would increase $1 billion and operating costs would grow by $1.85 billion. Illustrative of the failures that would produce this result are: only 50 percent of the equipment utilization savings are achieved and not until two years after the USRA schedule, yard rehabilitation fails to reduce yard operating expenses, and only 75 percent of blocking improvements are achieved (see Chapter 6 for complete details).

The Federal Government May be Burdened with a Higher Initial Cost of Acquiring Bankrupt Assets - The creditors and stockholders of the bankrupt railroads are to be offered $422 million according to the FSP. The U.S. Supreme Court has held that the creditors may sue the U.S. Government for damages if they can prove the USRA offer is less than the "constitutional minimum" they deserve. Other estimates of the value of the bankrupts' properties are $7.4 billion (by Penn-Central creditors assuming continued operation) and $3.5 billion (by Penn-Central creditors assuming liquidation). If any outcome above $422 million is reached, the Federal guarantee to the creditors and stockholders would increase proportionally.

SUMMARY IMPACT

The impact of alternative assumptions on the projected revenue and income of the system is summarized below.

The Impact of Alternative Assumptions on Revenue and Income (1976-1983)

	Alternative	Revenue	Income
1.	Final System Plan	$43.7 billion	$1.5 billion
2.	Increased Coal Revenue	44.8 billion	2.0 billion
3.	Lags in Operating Improvements	43.7 billion	- .3 billion
4.	Deficiency Judgment (Assume assets valued at $7.4 billion)	43.7 billion	.5 billion
5.	Unified ConRail	51.1 billion	2.5 billion

THE FEDERAL COMMITMENT

Under the proposed restructuring, the Federal government replaces private investors as the primary source of capital. As a result, a majority of the ConRail board members will be government appointees until long after the year 2000. The federal investment will vary depending upon ConRail's success in achieving the projections set forth in the FSP. In all cases however, it is in excess of the publicized $1.85 billion investment. Better performance will probably speed up repayment of the Federal debt but worse performance would substantially increase the Federal liability. The level of required Federal commitment is summarized below for alternative assumptions:

Alternative	Direct Investment	Other Assistance	Deficiency Judgement Payments	Total
FSP	$ 2.7B	$ 2.8B	0	$ 5.5B
Increased Coal Revenue	2.7	2.8	0	5.5
Operating Failures	>3.4	3.9	0	>7,3
Deficiency Judgement	2.7	3.9	6.8	13.4
Unified ConRail	1.8	2.8	0	4.6

ISSUES AND QUESTIONS

In the short time available to complete this report, many questions were left unanswered or, to speed the analysis, simplifying assumptions were employed. Nonetheless, conclusions were reached that merit serious consideration. Other questions need more investigation.

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#1 On balance, the downside risks for ConRail from the basic USRA forecast are greater than the upside profit potential. This means it is likely that the cost to the Federal government of the ConRail package will exceed that anticipated in the USRA forecast, perhaps by billions of dollars.

#2 The choice between a Unified ConRail and a ConRail/Chessie solution in the Northeast has very significant financial consequences. The public is being asked to pay possibly $650 million or more for the additional rail-to-rail competition resulting from the USRA preferred solution versus Unified ConRail. It would be helpful to have more insight into the value of this competition, taking into account the role of trucks and other presently viable railways in the Penn-Central area of operations.

#3 It may be appropriate to explore further the financial consequences of some of the findings herein. USRA relies on a computer model for financial forecasting. The authors of this report did not have access to that model. Thus, the report’s ability to incorporate the results of the model is limited by the requirement that the analysis consists solely of adjustments to published projections. For example, the scale of the projected coal tonnage increase may exceed the amounts assumed in the USRA sensitivity analysis, especially in the early years, to such a degree that different cost factors, capital requirements, etc. may need to be employed.

#4 The USRA analysis of coal has become dated. This report finds that the coal tonnage and revenue forecasts in the FSP are probably too low. Moreover, USRA’S proposal that Chessie rather than ConRail acquire the only Penn-Central line into the lucrative West Virginia coal area raises questions about how thoroughly coal was considered in USRA's plans for restructuring the bankrupt railroads. Recently available information from government and private sources could be used to considerably strengthen the coal projections in the FSP. As the most important commodity in ConRail’s future, it would appear desirable to understand more fully how more up-to-date projections will impact on the key issues raised in the FSP.

#5 Both USRA and industry personnel recognized that a deficiency judgment was likely to be entered against the government. Since the cost of these claims could exceed all other government investments, it deserves further consideration.

#6 Once agreement is reached to invest Federal funds in ConRail, contingency plans should be made to minimize losses. Otherwise, the taxpayer could continue indefinitely to subsidize the railroad with no hope of ever recovering public capital.