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GIVING CONRAIL A GREEN LIGHT

INTRODUCTION

FOR SALE: one used railrd., several prev. owners. As is. $1.2 billion or best offer. Call E. Dole, 426-4000.

Although Transportation Secretary Elizabeth Dole has not actually placed such a want ad, for the past three and one-half years the Department of Transportation (DOT) has been trying to sell the Consolidated Rail Corporation (Conrail), the federally owned freight railroad. Last week, after an exhaustive search for buyers and a complex negotiating process, the Department recommended that the railroad be sold to the Norfolk-Southern Corporation for $1.2 billion.

Pursuant to legislation passed last year, Congress must approve the deal before the sale can take place. In reviewing this sale, lawmakers should resist the temptation to second-guess or tinker with the deal struck by DOT. By all standards, the Department has made a well-reasoned decision as to the method of sale and the purchaser. The proposed buyer is financially strong, experienced in the industry, and will pay a good price. Delay or restrictions imposed by Congress may threaten consummation of the deal or endanger the future viability of the soon-to-be private enterprise. Congress thus should take this opportunity to speed the federal government's long-awaited exit from the freight railroad industry. It makes good business sense for the taxpayers to pocket $1.2 billion now from Norfolk-Southern in exchange for Conrail.

THE METHOD OF SALE

The federal government's involvement in Conrail began in 1973 as an effort to preserve rail freight service in the northeastern United States after the Penn Central Railroad bankruptcy.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

As authorized under the Rail Reorganization Act of 1973, and put into effect by the Railroad Revitalization and Regulatory Reform Act of 1976, the federal government purchased most of the assets of the Penn Central and six other bankrupt eastern roads and transferred them to Conrail, a newly created corporation owned by the federal government. Fifteen percent of Conrail's stock later was conveyed to the company's employees.

It was expected that Conrail soon would be able to pay back the entire investment of the government. Yet it suffered enormous losses during its early years of operation and required approximately $3.3 billion in federal aid. Recognizing that federal ownership had not solved, and would not solve, the northeastern railroad problem, Congress in 1981 enacted the Northeast Railroad Service Act (NERSA), calling for the sale of Conrail to the private sector. Under this act, DOT was required to sell Conrail as a single entity if the railroad became profitable, and piecemeal if it were not making a profit. If Conrail were sold as a unit, the act required that DOT's plan for the sale assure continued rail service, promote competitive bidding, and maximize return to the taxpayer. Although not specifically required by NERSA, congressional approval of the final plan must be obtained in order to cancel the debt owed by Conrail to the federal government.

After passage of NERSA, the fortunes of Conrail took a startling turn for the better. After losing billions of dollars in its first five years, it posted a surprising profit of $39 million in 1981. The following year, this figure jumped to $174 million and rose again to $313 million in 1983. It is expected that Conrail will net close to $500 million for 1984. Although Conrail's overall financial position may not be as sound as these figures indicate, the company's performance has improved markedly.

There are several reasons for this. Among them: good management by L. Stanley Crane, head of Conrail since 1981; the Staggers Act of 1980, which substantially deregulated the railroad industry, enabling Conrail to set its own rates and thus compete more effectively; and Conrail's unions, which accepted pay cuts and other labor cost cutting actions.

Thanks to this turnaround, the Department of Transportation has been able to offer Conrail as a single enterprise, rather than trying to sell it in pieces. In 1982, DOT and Goldman Sachs and Co., the New York investment banking firm retained for the purpose, began looking for a suitable buyer. In reviewing prospective bidders, DOT stated that it would favor bidders who:

1) left Conrail in the best financial position after the sale;

2) best guaranteed continued service to Conrail shippers; and

3) offered the best price.

The search has been not easy. There are only a few qualified buyers with resources sufficient to purchase the company. Federal Railroad Administrator John Riley personally contacted the presidents of every Class I railroad that interconnects with Conrail. Goldman Sachs and DOT, meanwhile, approached some 100 individuals, companies, and partnerships that had the financial means to make the purchase. A June 18, 1984, deadline was set for submission of formal bids by interested parties. DOT received fifteen bids--more than had been anticipated.

Bidders represented a wide variety of interests, from competing railroads and trucking companies to a banking company and even the owner of a hotel chain. The field was narrowed first to six and then to three: the Norfolk-Southern; a group headed by J.W. Marriott; and the Allegheny Corporation. Finally, after further investigation by DOT, the Treasury, and the Justice Department, Secretary Dole announced on February 8 that she would recommend to Congress that the bid from Norfolk-Southern be accepted.

The principal terms of the agreement with Norfolk-Southern are that the buyer will:

1) pay the United States Treasury $1.2 billion for Conrail;

2) not take advantage of accrued tax benefits resulting from Conrail's years of massive deficits, including $275 million in investment tax credits and $2.1 billion in loss carry-forwards;

3) be forgiven $3.3 billion in debt now technically owed to the federal government by Conrail stemming from the years of government subsidy; and

4) accept specified "public interest" covenants to protect Conrail employees and customers. These covenants require the new owner, for five years after the sale, to: (a) continue Conrail's business substantially as it is now being conducted; (b) maintain a controlling interest in Conrail; (c) make "adequate" capital investments over the next five years; (d) maintain the maximum amount of rail service that is economically justifiable, subject to Interstate Commerce Commission standards; (e) refrain from paying dividends unless a minimum cash balance of $500 million remained; (f) relinquish Conrail's special authority to abandon lines on an expedited basis; and (g) offer any lines that are abandoned to short line railroads and shippers at 75 percent of liquidation value.

In addition, Norfolk-Southern is now negotiating for the 15 percent interest in Conrail now held by Conrail's employees.

ANALYSIS OF THE PROPOSED SALE

DOT has done remarkably well in finding a qualified buyer and negotiating fair terms for the sale of Conrail. While some may claim that a more qualified buyer could have been found or that a different method of sale would have been preferable, the Department has achieved each of its three major goals:

Financial Strength of Conrail

Financial soundness was a major factor in DOT's selection of a buyer for the company. After the turmoil that had surrounded Conrail and its predecessor, the Penn Central, DOT was determined to ensure that Conrail was put on the kind of financial footing that would avoid the previous difficulties. DOT did not want to sell Conrail only to watch it go through a second bankruptcy--or worse, return to the public trough looking for more subsidies.

An examination of Conrail's finances reveals that, while its performance has improved markedly, it is still a marginal enterprise. Much of its recent "profit" in fact has resulted from its enviable exemption from federal and state income taxes, the employee protection benefits funded by the federal government, and the temporary wage concessions by the unions. According to Federal Railroad Administration calculations, if Conrail had paid state taxes and employee protection benefits and not received wage concessions, it would have lost $55 million in 1981 and $146 million in 1982, and made profits of only $37 million in 1983 and $312 million in 1984. Had federal income taxes also been paid, these figures would have been even lower.

The railroad business in the northeast, moreover, long has been cyclical with several years of very high returns followed by years of very low returns. Conrail itself predicts a downturn in profits in 1985, 1986, and 1987. Based on available information on Conrail's financial plans, profits in 1986 and 1987 are expected to be several hundred million dollars less than the current level. Thus, there is reason for concern about Conrail's future and insistence that its buyer be financially strong.

The selection of Norfolk-Southern helps to alleviate these concerns. It is an established company with substantial cash reserves, estimated at over $1 billion. With such a stable parent company, Conrail should be able to weather a financial storm. Such support would not be available if a weaker purchaser were to buy the railroad. Nor, obviously, would there be such support if Conrail were to be made into a fully independent firm, and its shares sold directly to the public.

Continued Level of Service

The sale to Norfolk-Southern ensures continuation of an adequate level of freight railroad service in the northeast. A recurring fear of DOT and Conrail's customers has been that the

line would be sold to an investor who immediately would resell Conrail's assets piecemeal for a quick profit. Sale of Conrail to Norfolk-Southern helps alleviate these concerns. Norfolk-Southern has clear plans to integrate Conrail into its existing operations to create a larger and more efficient railroad. It thus is unlikely that Norfolk-Southern views Conrail as a temporary investment to be dismembered and resold as soon as possible.

In any case, DOT has guaranteed that appropriate service will be provided Conrail's customers by including binding public interest covenants in the sale agreement. These oblige the new owner to maintain substantially current service. But even though these covenants may protect service, they also may tie the hands of Conrail's new management, to the detriment of the company and the public. Much of Conrail's current success can be attributed to its ability to eliminate unprofitable lines and services when necessary. By denying Norfolk-Southern this flexibility, the restrictive public interest covenants may prevent Norfolk-Southern from keeping Conrail profitable.

Fair Price to the Taxpayer

The agreed price for Conrail is reasonable. While the "book" value of Conrail's assets is approximately $4 billion, such valuations are rarely a reliable guide to the market value of a company. Many of Conrail's assets are in old or unprofitable lines or tied up in properties without much value to a potential buyer. The value of the assets, moreover, could not be realized without long and expensive liquidation. Employee termination costs alone could be substantial.

Nor is the amount of federal investment in Conrail a reliable guide to its value. Of the approximately $7.7 billion that Washington has pumped into Conrail, approximately $1.5 billion went toward non-rail expenditures for Conrail, its predecessors, and Conrail's supervisory agency, the U.S. Railway Administration. These expenditures are of no real value to a prospective buyer. An estimated $2.8 billion of the federal investment is attributable to the original purchase of the railroad from the estates of the bankrupt railroads. This amount, however, includes the cost of many assets that are no longer part of Conrail, such as the Northeast Rail Corridor between Boston and Washington. Only $3.3 billion of federal money went directly to Conrail. Of this, approximately $600 million funded Conrail's operating deficits--an expenditure of no value to a potential buyer. The remainder of the federal investment, $2.7 billion, went toward remedying deferred maintenance.

Of more importance to determining the value of Conrail is the income it is expected to produce. A buyer bases the price he will pay for an asset on the amount of income he can expect to obtain from it--not on what a previous owner has spent on it in the past. Conrail has been only marginally profitable in the past, and a downturn in profits is expected in the coming years. These factors have decreased the market value of the railroad.

The purchase price offered by Norfolk-Southern is consistent with the estimates of DOT's financial advisers. Goldman Sachs

originally valued the railway at $1.4 billion. As the federal government now owns 85 percent of it, the federal share would be about $1.2 billion. In its plan for the sale, Conrail's management estimated a total selling price of $1.4 billion.

Further, in addition to the cash sales price, Norfolk-Southern will surrender over $2 billion in tax advantages, an action that will benefit the U.S. Treasury directly.

Another factor in determining the market price of Conrail concerns the public interest covenants required by DOT. Attaching these "strings" to the sale reduces Conrail's value to a potential buyer. While no dollar amount can be put on these covenants, their impact on the final cash price was undoubtedly substantial.

In light of all these factors, it would appear that the taxpayers are selling Conrail for a very good price.

EFFECTS ON COMPETITION

One concern raised by the sale of Conrail to Norfolk-Southern is the effect the merger will have on competition among railroads. Currently, only three major railroad companies operate along the Eastern seaboard: Norfolk-Southern, Conrail, and CSX Corporation. Some fear that merger of two of these lines would provide the resulting company with undue control over the market.

A study of this issue by the Antitrust Division of the Justice Department, however, alleviates much of this concern.[1] If certain divestitures are made by Norfolk-Southern, concludes the study, the merger would not violate the antitrust laws.

While Norfolk-Southern and Conrail are both large railroads, they do not compete against each other in every area of the country. Conrail is limited to the northeast and midwestern regions, while Norfolk-Southern operates mostly in the South. In addition, in many areas where both Conrail and Norfolk-Southern do operate, there is significant competition from smaller railroads and other forms of transportation. With this in mind, the Antitrust Division found that the merger would hurt competition substantially in only 39 counties, located in 21 states. Were there to be no divestiture of assets by Norfolk-Southern in these markets, the Division said, it would oppose the sale. But Norfolk-Southern has fully agreed to divestiture, and will sell the assets subject to the approval of the Antitrust Division. Moreover, the railroads acquiring these assets will be given rights to use certain track and switching services of Norfolk-Southern.

It should also be remembered that the merger will result in important economic efficiencies or cost reductions that will benefit consumers. In addition to reductions in general administrative and overhead costs, the larger railroad will be able to

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1 See, letter from J. Paul McGrath to Elizabeth Dole, January 29, 1985.

provide direct service on more routes. Traffic for the first time will be able to move directly from the South to Northeast, without having to switch railroads along the way. These savings, according to the Antitrust Division, will offset the small adverse competition effects that will remain after divestiture.

ALTERNATIVES TO THE PROPOSED SALE

The sale to Norfolk-Southern, of course, is not perfect; no sale could have been. But each of the other sale alternatives had similar or more serious drawbacks. While the Allegheny Corporation was a well-qualified bidder, from 1954 to 1968 it owned a controlling interest in the New York Central, until it was later merged with the Pennsylvania Railroad to form the Penn Central. Fred Kirby, the chairman of Allegheny, served on the Board of Directors of the Penn Central. Because of this involvement in the Penn Central, critics have claimed that a sale to Allegheny would, in effect, return the line to the same people who helped precipitate its bankruptcy.

On the other hand, selling Conrail to the investment group led by J.W. Marriott would have created a different set of problems. Marriott has no experience or prior interest in the railroad industry. This legitimately raised the question of whether Marriott was looking for a long-term investment or for a quick, profitable resale of Conrail. Again, this is not to say that Norfolk-Southern was the best choice of a purchaser for Conrail, but merely to state that each of the other finalists also had serious drawbacks.

Another proposed alternatve would have been to sell Conrail by offering shares to the public via the stock market. On its face, this would have had several advantages. First, Conrail could have remained an independent entity and likely retained the present successful management team. Second, much of the concern as to the new ownership's intentions would have been muted, since the management almost surely would keep the railroad intact. Third, a higher sales price possibly could have been realized.

The public offering option was studied seriously by DOT. It was rejected because many problems emerged on close inspection, including:

1) Only one other public stock offering of such a magnitude has been attempted in U.S. history--the Ford Motor Company offering in 1956. The results of such an offering thus would be hard to predict. Setting the offering price is no easy task. Given these uncertainties, it is difficult to say whether a public stock offering would raise more or less money for the taxpayers than would the deal already in hand.

2) To ensure that Conrail does not seek federal help in the future, a private Conrail needs a sturdy financial base. A public offering would give Conrail independence but no additional access to funds. In fact, if a "leveraged" buy-out were used (that is an offering supplemented by the assumption of debt by the company), Conrail's financial reserves actually would be decreased.

3) If the public did not purchase all Conrail shares at the offered price, the government could end up as a minority shareholder with little or no control over management.

4) A public sale could take up to a year to organize, thus delaying substantially Washington's exit from the railroad business.

5) The public interest covenants included in the present deal would be difficult to impose on individual purchasers of stock in a public offering.

As such, a public offering seems no better than selling Conrail to a financially sound firm. It could, in fact, leave the company, its customers, and the taxpayers in a worse situation.

CONCLUSION

The Department of Transportation has negotiated a fair sale of Conrail to a well-qualified buyer. All that is now needed to return this enterprise to the private sector is congressional approval.

For Congress to delay presents two dangers. First, congressional committees probably would alter or "tinker" with the negotiated deal by adding new or increased restrictions under pressure from the myriad special interests involved in the issue. Burdening Conrail with such politically motivated restrictions would hinder the company's ability to compete with transportation companies not thus restricted. This would endanger the future profitability of the private firm--and possibly even undermine the deal itself.

The second danger is that of potential congressional inertia. The proposed buyer cannot wait indefinitely to find out if its offer is accepted. As would any investor, the buyer needs a decision in order to move forward with its plans. Should congressional approval be delayed, the purchase could fall through.

The agreement with Norfolk-Southern gives Congress a rare opportunity to return an important component of the economy to private control. Even if Congress has some reservations about specific items of the sale, lawmakers should recognize that market pressures would soon mold the new, private Conrail into a railroad that efficiently meets the needs of its customers. A delay in the sale would threaten the long-term future of the railroad--and another collapse would jeopardize the pocketbook of the American taxpayer.

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