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UNITED STATES
GENERAL ACCOUNTING OFFICE

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Better Information Needed In Railroad Abandonments

Interstate Commerce Commission

The Interstate Commerce Commission's abandonment process relies on some outdated precedents which treat railroads unfairly.

GAO found that:

- The Commission has not established a uniform accounting system for determining branch line costs; instead, potential abandonments are evaluated on the basis of criteria established from an unrepresentative abandonment case decided in 1939.

- Since 1972 the Commission has allowed railroads to file less detailed abandonment applications for lines annually handling less than the Commission's breakeven criteria of 34 carloads per mile, which is also unrepresentative.

Also, the Commission does not consider return on net salvage value as an avoidable cost and depreciation of track structures as a cost. As a result, potential losses from lines seeking abandonment may be understated.

CED-76-125

JULY 23, 1976

UNITED STATES GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

COMMUNITY AND ECONOMIC
DEVELOPMENT DIVISION

B-139052

The Honorable George M. Stafford
Chairman, Interstate Commerce Commission

Dear Mr. Stafford:

The General Accounting Office has surveyed various aspects of the Interstate Commerce Commission's railroad abandonment process to identify areas where improvements should be made. These improvements were recently addressed in the Railroad Revitalization and Regulatory Reform Act of 1976 (Public Law 94-210), which requires the Commission to make changes in its abandonment process. The results of our survey should be helpful to you in meeting the requirements of the act.

We made our survey at the Commission headquarters in Washington, D.C., and at various railroads' headquarters. We reviewed (1) abandonment cases selected statistically at random from the past 15 years, (2) the Commission's abandonment procedures, and (3) applicable laws and regulations. We also held discussions with Commission and railroad officials involved in the abandonment process.

Our observations cover the following areas:

--Need for a uniform accounting system for determining branch line profitability.

--Need for a more representative and reliable breakeven standard for use in the abandonment process.

--Need to include return on net salvage value and depreciation of track structure in deciding abandonments.

THE ABANDONMENT ISSUE

The Interstate Commerce Act (49 U.S.C. 1) requires common carrier railroads to request Commission certificates which permit them to abandon rail lines. The Commission must decide whether present or future public convenience and necessity permits the abandonment.

Total railroad mileage decreased from a peak of almost 260,000 miles in 1920 to about 200,000 in 1973 1/ as the Commission authorized abandonment of about 23 percent of the Nation's rail lines. While abandonments averaged about 1,250 miles per year, the rate has increased in recent years. For example, from 1959 to 1969, the annual average was about 1,300 miles, but from 1969 to 1973 the average increased to about 2,100 miles.

Abandonment cases often cause local controversy because of their direct impact on the public involved. Recently, however, when some of the major northeast and midwest railroads were experiencing severe financial difficulty, the questionable need for unprofitable lines and the possibility of massive abandonment became a national issue. Railroads have lost much of their original importance to the Nation as competition from alternative transportation modes has grown. Between 1939 and 1973, when trucks began to effectively compete with railroads, the railroads' share of freight shipping decreased from 62 to 39 percent.

In 1974 Congress passed the Regional Rail Reorganization Act of 1973 (Public Law 93-236) primarily to reorganize eight bankrupt northeastern railroads. The act allows for abandonment of some rail service and provides for a subsidy for these rail lines which are not to be included in the new Government supported railroad, Consolidated Rail Corporation (ConRail).

Under the Reorganization Act, the Department of Transportation published an initial report in February 1974, which analyzed rail service provided by the northeastern railroads. The report identified 15,575 miles of potentially excess rail lines--approximately 25 percent of the analyzed area's 1972 route mileage. The Department estimated that less than 4 percent of the area's 1972 rail traffic originated or terminated on these lines. 29

1/Data is shown only through 1973 because two events caused a temporary moratorium on abandonments: (1) the 1973 Regional Rail Reorganization Act and (2) an environmental ruling causing the Commission to cease abandonments until it established an environmental review panel (Harlem Valley Transportation Association, et al. v. George M. Stafford, et al., 73-Civ.1330 [S.D.N.Y.]).

The large quantity of lines affected by the act and questions about how to measure the unprofitability of some lines helped bring abandonment to importance as a national issue. The Commission's Rail Services Planning Office held hearings on the United States Railway Association's February 1975 Preliminary System Plan, which reflected public concern about the possibility of abandonment of so many lines. Over 1,900 witnesses testified in 27 cities during these hearings.

When the Association issued its Final System Plan in July 1975, it identified 10,692 miles of active rail lines as requiring detailed analysis. Of these, 5,757 miles were eligible for abandonment or subsidy. The remainder were recommended for inclusion in ConRail.

Although the Commission's normal role in the abandonment decisionmaking process was altered for those lines affected by the Association's plan, the Commission will continue to function, as usual, for future abandonment applications. The Congress, concerned about transportation regulation, has considered various proposals to change the Commission's role. The Railroad Revitalization and Regulatory Reform Act of 1976, among other things, required certain changes in the Commission's abandonment decisionmaking procedures, with a timetable to be followed in making the changes.

The results of our survey cover the following requirements of the act:

--That the Commission shall, not later than June 30, 1977, issue regulations and procedures prescribing a uniform cost and revenue accounting and reporting system for all railroad common carriers which shall include indirect cost accounts for determining fixed, common, joint, and constant costs, including the cost of capital, and the method for the assignment of such costs to various functions, services, or activities (Sec. 307).

--That the Commission shall study, develop, and submit to the Congress an initial proposal setting forth rules of practice that include receiving evidence so as to facilitate the timely execution of the functions of the Commission [Sec. 305(a)(2)].

Also, the act requires the Commission to establish an abandonment proceeding to publish standards for determining the "avoidable cost of providing rail service" over a line to be abandoned.

NEED FOR A UNIFORM ACCOUNTING SYSTEM FOR DETERMINING BRANCH LINE PROFITABILITY

The Interstate Commerce Act requires the Commission to determine whether public convenience and necessity permit a line or a service to be abandoned. In early cases the Commission interpreted public to mean those people served by the rail line. In other words, if shippers who required the railroad's service were on the line, the line could not be abandoned.

Now the tendency is to take a much broader perspective, considering the public as a whole. This is based on the theory that continued operation of unprofitable lines might adversely affect the strength of an entire rail system, thereby directly affecting a railroad's ability to render adequate service in interstate commerce. Potential adverse effects to affected shippers or communities resulting from abandonment, therefore, are weighed against the burden imposed on interstate commerce by continued operation of the line. This burden is the amount of historical losses incurred by the railroad in operating the unprofitable line. The railroads must submit this information on their applications for abandonment.

Railroads are required to keep financial records in accordance with the Commission's standards and forms. These records show the financial results of railroad systems' operations as a whole. The Commission, however, does not require railroads to keep financial records for each branch line segment. As a result the railroad must estimate costs and revenues associated with a branch line which it desires to abandon.

The Commission has developed its own "rule of thumb" formula to determine the admissibility of railroad cost estimates, but there is no regulation requiring railroads to use this formula. As a result, railroad estimates of branch line costs may conflict with the Commission's estimates.

We found 6 cases in our sample of 72 where railroad estimates of branch costs differed from the Commission's. The difference in these cases ranged from $1,479 to

$254,680. Those differences, expressed as percentages of total estimated branch line costs, ranged from 8.3 to 23.3 percent. In one case, a railroad estimate showed a branch line loss of $162,851 for 1 year, while the Commission's estimate showed a profit of $91,829 for the same year.

The major difference appears to be in the method of estimating indirect branch line costs. Direct costs are attributable to the line and include such items as maintenance, wages, and fuel costs. Indirect branch costs include all variable costs associated with handling the branch line traffic on other parts of the rail system.

In 1939 the Chicago and North Western Railroad submitted DLG0491 cost information showing that a fair approximation of indirect branch costs could be made on the basis of revenues from its main lines. The Chicago and North Western used 50 percent of its main line revenues as the cost of handling branch line traffic. The Commission accepted this 50-percent estimate as reasonable and still uses it as a "rule of thumb" in evaluating abandonment applications.

From 1960 to May 1975, the Commission decided 1,650 abandonment cases for 298 railroads. Of these cases, 1,098, about 67 percent, were filed by 61 class I railroads (railroads having annual revenues of $5 million or more). The 1973 freight operating ratios (freight operating expenses to freight operating revenues) for these 61 railroads ranged from a low of 56 percent to a high of 191 percent.

Considering this variability, it does not appear that the Commission should be using the 50-percent rule to evaluate abandonment applications. The percentage, based on the 37-year-old cost experience of one midwestern railroad, cannot be considered representative of all railroads filing for abandonment. A 1972 consultant report 1/ stated that the 50-percent rule tends to understate indirect branch costs. The report recommended that the Commission use a railroad's freight operating ratio in computing indirect branch costs. The Commission believed, however, that the freight operating ratio includes certain costs which are not avoidable when a line is abandoned.

1/"Evaluation of Proposed Interstate Commerce Commission Railroad Line Abandonment Standards" August 8, 1972, prepared for Department of Transportation by Simat, Hellieson and Eichner, Inc.

Chicago and North Western itself criticized the 50-percent rule in a 1973 abandonment proceeding involving a Wisconsin branch line. The railroad argued that a rule which makes costs a function of revenue tends to underestimate costs when a line ships commodities with low freight rates. In this particular case 85 percent of the line's traffic was pulpwood, an extremely low-rated commodity.

The United States Railway Association and the Commission's Rail Services Planning Office have developed alternative methods for estimating indirect branch costs. The Association's plans for reorganizing the bankrupt northeast railroads used specific cost factors to determine indirect branch costs. The Rail Services Planning Office, in its development of rail service continuation subsidy standards for lines omitted from the Con-Rail system, also used specific cost factors to determine indirect branch costs.

NEED FOR A MORE REPRESENTATIVE AND RELIABLE BREAKEVEN STANDARD FOR USE IN THE ABANDONMENT PROCESS

Railroads have complained about the cost and delay involved in the filing and processing of abandonment applications. Because of this problem the Commission revised its regulations to allow railroads to file less detailed applications for some lines. These are lines, according to Commission criteria, where revenues did not at least equal costs. In other words, the lines had not reached the breakeven point.

Before 1972 railroads were required to include detailed cost information with all abandonment applications. The revised regulations allow railroads to file less detailed applications for lines annually handling less than the Commission's breakeven criterion of 34 carloads per mile. Potentially, abandonment applications for lines meeting this criterion could be processed easier and quicker.

The Commission established the 34-car rule on the basis of 39 cases decided during 1969-70. Revenue and cost data for each of the 39 cases was obtained, and a breakeven formula was applied. The average of the breakeven carload figures for the 39 cases was 34.42 annual carloads per mile.

The continued use of the 34 carload breakeven amount is technically deficient because (1) it is not based on a representative sample of cases and (2) the wide variance of breakeven carload figures from one railroad line to another prevents the 34-car rule from being a reliable indication of branch line profitability.

The Commission based its criteria on all the 39 orally heard cases decided during 1969-70. Two-thirds of these cases were western rail lines, and one-third were eastern. Since 1960, however, eastern rail lines have accounted for 60 percent of abandonments and western rail lines about 34 percent.

The use of the Commission's 34-carload rule does not consider inherent differences between east and west rail lines Eastern rail lines may have higher carload breakeven amounts because there is more congestion in the east. Therefore, eastern lines do more switching, more terminal handling and more interchanging between roads, causing certain operating costs to be higher.

The apparent bias in the Commission's sample seems to have resulted in a breakeven figure more suitable to western rather than eastern rail lines. For example, representatives of two western railroads, Chicago, Rock Island and Pacific, and Chicago and North Western, were satisfied with the 34-car rule. Chicago and North Western told us the 34-car rule was very satisfactory for their railroad since it was structured on traffic flows similar to theirs.

A representative from an eastern railroad, the Chessie System, said that in May 1975 the railroad filed to abandon 18 lines. All 18 lines handled more than 34 carloads per mile annually, and he believes the 34-car rule may be too low.

Besides being based on an unrepresentative sample, the 34-car rule is unreliable as an indicator of branch line profitability, because the breakeven carload figures from the Commission's 39 case sample varied widely around the average The range was from 1.38 to 144.55 carloads, and only 17 of the 39 cases varied less than 50 percent from the 34-car breakeven average. The breakeven points of the remaining 22, about 56 percent of the sample, varied more than 50 percent above or below 34.

The Director of the Commission's Office of Proceedings informed us that future use of the breakeven standard will be dependent on the results of implementing Section 802(a)(5) of the Revitalization Act. This requires each railroad to file with the Commission a diagram of its transportation system which includes a detailed description of lines potentially subject to abandonment.

NEED TO INCLUDE RETURN ON NET SALVAGE VALUE AND DEPRECIATION OF TRACK STRUCTURES IN DECIDING ABANDONMENTS

In deciding whether or not to allow an abandonment, the Commission has not considered:

--Return on net salvage value from an abandoned line as a cost of the continued operation of the line.

--Depreciation of track structures as a cost when determining the profitability of a line to be abandoned.

Return on net salvage value

Abandonments usually allow removing the track. Therefore, when a railroad is allowed to abandon a line, it can reinvest the net salvage value from the line (from ties, rails, bridges, trestles, etc.) in more productive assets, such as its other profitable lines or Government securities. For example, in July 1973, the Commission denied an abandonment application in which the New York and Harlem Railroad Company claimed it could have saved $25,943 annually, representing 6 percent interest on net salvage value of $432,386, from the abandoned line. DLG 01192

Therefore, the railroad incurred a cost that could have been avoided if the line was abandoned. This cost is the lost opportunity to earn a return on the capital invested in the abandoned line.

The United States Railway Association, in its Final System Plan for the bankrupt railroads, and the Commission's Rail Services Planning Office, in its rail service continuation subsidy standards, both recognized return on net salvage value as a branch line cost. In both cases the rate of return used was based on U. S. Treasury bonds or notes.

Depreciation of track structures

The Commission requires the use of betterment accounting procedures by the railroad industry. This requires track structure expenses to be charged against revenues only when repair or replacement occurs; additions or betterments are capitalized, not charged against revenues. Railroads' income statements can be adjusted from year to year because of the scheduling of track maintenance. For example, in a year with good revenues, money can be spent on the tracks to offset the revenues, while in lean years, maintenance expenses can be deferred.

Railroads gradually eliminate excess and unprofitable lines through a program of deferred maintenance. Rather than spending money to upgrade and rehabilitate the ballast, ties, and rails of these lines, the railroads defer these expenditures and spend their money on their profitable lines. As a result, when lines are filed for abandonment, they are often badly worn and must be repaired and upgraded if they are to continue operating.

When the Commission attempts to determine the profitability of a line proposed for abandonment, it looks at the historical profit or loss figures. If the line accumulated deferred maintenance in those years, the profitability figures may be too high because they do not account for the needed maintenance to keep the line operating in good condition. Although estimates of future rehabilitation and maintenance expenses are included in the abandonment proceedings, no attempt is made to incorporate these estimates into the Commission's consideration of branch line profitability.

The alternative to betterment accounting is depreciation accounting. This method allows expenses for track repair and replacement to be capitalized and depreciated over time, as all other railroad equipment is now treated. This would give railroads consistent income statements and provide truer measurements of line profitability to be used in the abandonment process. While this accounting method would not prevent railroads from deferring maintenance, it does provide for consistent reporting of expenses and revenues.

The United States Railway Association and the Commission's Rail Services Planning Office both recognized the problems of betterment accounting and included estimates of rehabilitation and maintenance costs for track structures in their costing formulas for reorganizing the bankrupt railroads and rail subsidy plans, respectively. The Association recommended the adoption of depreciation accounting to be used for track structures in its northeast reorganization plans for ConRail.

CONCLUSIONS

The Commission's abandonment process relies on some outdated precedents which treat those railroads applying for abandonments unfairly. Also, in deciding abandonments, the Commission does not recognize all costs associated with the continued operation of the line to be abandoned.

The Commission has not established a uniform accounting system for determining branch line costs. Instead the Commission evaluates potential abandonments using an estimate for branch line costs determined on the basis of an abandonment decided in 1939. The estimate from that case--50 percent of main line revenues as the cost of handling branch line traffic--is not representative of all railroads filing for abandonments.

Since 1972 the Commission has allowed railroads to file less detailed abandonment applications for lines annually handling less than the Commission's breakeven criterion of 34 carloads per mile. This breakeven figure was determined by the Commission from 39 abandonments decided during 1969-70. The sample is not representative of all railroads filing for abandonments.

The Commisssion, in its abandonment decisionmaking process, does not consider return on net salvage value as an avoidable cost and depreciation of track structures as a cost. As a result, potential losses from lines seeking abandonment may be understated. Both the United States Railway Association and the Commission's Rail Services Planning Office recognized the need for considering these costs and included them in their respective plans.

RECOMMENDATIONS

We recommend that, in responding to the requirements of the Railroad Revitalization and Regulatory Reform Act of 1976, the Commission:

--Establish a uniform accounting system that will show costs allocable to branch lines so that applications for abandonment can be treated fairly.

--Use a breakeven standard or other criteria that treats railroads fairly in determining the amount of detail required in abandonment applications. This might require establishing different standards by region or by railroad.

--Include in the abandonment decisionmaking process the effect that return on net salvage value and depreciation of track structures have on the future profitability of the line applying for abandonment.

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We appreciate the cooperation received during our survey and would like to be informed of any action taken on our recommendations. We would be glad to discuss this report with you or your staff.

We are sending copies of this report to the Director, Office of Management and Budget, and to appropriate congressional committees.

As you know, section 236 of the Legislative Reorganization Act of 1970 requires the head of a Federal agency to submit a written statement on actions taken on our recommendations to the House and Senate Committees on Government Operations no later than 60 days after the date of the report and to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of the report.

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Sincerely yours,

Henry Eschwege

Henry Eschwege
Director