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Report to Rep. John L. Burton, Chairman, House Committee on Government Operations: Government Activities and Transportation Subcommittee; by Elmer B. Staats, Comptroller General.

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Federal legislation establishing the Consolidated Rail Corporation (Conrail) authorized Federal assistance of $2.1 billion to enable the company to become profitable by the end of 1979. Conrail, in its latest business forecast, stated that this amount was not enough and that it will need an additional $1.3 billion through 1982 to achieve financial self-sufficiency. The United States Railway Association (USRA), in its report to the Congress, identified problems which indicated Conrail's poor prospects for achieving self-sufficiency. Findings/Conclusions: Conrail's forecast of profits by 1980 was based on assumptions that contradict its past and current performance trends. It could require substantially more than the amount appropriated plus the additional $1.3 billion to become self-sufficient. Although Conrail recognized that additional moneys will be needed for its contributions to the railroad retirement system and to replenish the employee protection fund, its business plan makes no specific provision for these funds. Conrail made substantial investment in track and equipment rehabilitation, but its improvements program for modernizing yards and terminals lagged because of time-consuming planning processes. It has taken some steps to expedite improvements. Among problems experienced by Conrail were: a decline in traffic, primarily because of poor customer service; inadequate amounts and poor condition of equipment received from bankrupt railroads; and a high incidence of breakdowns, partly because of inadequate maintenance practices. Conrail expects to achieve labor savings as a result of a new labor agreement. The USRA found errors in the final system plan estimate of potential car utilization

improvements; however, GAO believes that needed improvements emphasized in the plan should remain as a guide for Conrail performance. Recommendations: The Conrail Chairman and Chief Executive Officer should take actions necessary to ensure that Conrail requests adequate Federal investment for all improvements contemplated in the final system plan and moves ahead aggressively in planning and implementing them and that Conrail includes the full costs it assumes the Federal Government will bear in requests for Federal funding. (Author/HTW)

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REPORT BY THE Comptroller General OF THE UNITED STATES

Conrail Faces Continuing Problems

Conrail predicts it will become profitable by 1980, but needs $1.3 billion more than the $2.1 billion current Federal authorization. GAO doubts that Conrail will be profitable by 1980, and believes Conrail could require substantially more than the appropriated $2.1 billion and the additional $1.3 billion. To reverse its deterioration Conrail must improve customer service, increase labor productivity, and modernize its yards and terminals.

Conrail made substantial investment in track and equipment rehabilitation, but Conrail's improvements program for modernizing yards and terminals lagged because of time-consuming planning processes and only now is beginning to show some vitality.

Conrail assumes that other Federal monies amounting to $680 million over the next 5 years will be appropriated to replenish the title V employee protection fund and pay its share of Railroad Retirement Fund assessments.

CED-78-174
OCTOBER 6, 1978

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-164497(5)

The Honorable John L. Burton, Chairman
Subcommittee on Government Activities and
Transportation
Committee on Government Operations

Dear Mr. Chairman:

Pursuant to your request of December 28, 1977 (also signed by Congressmen Evans, Maguire and Moffett), and our subsequent meetings with your office, this is our report on the Consolidated Rail Corporation's (Conrail) prospects for success as a private, for-profit corporation, and the United States Railway Association's (USRA) effectiveness as a monitor of Conrail's performance. Since you asked us to do this audit, USRA and the Interstate Commerce Commission have both reported that Conrail's prospects for achieving self-sufficiency by 1982 are questionable even with substantially more Federal funding than the $2.1 billion the Congress originally provided. We agree. We believe it is doubtful Conrail will achieve profitability by its revised target date of 1980, and that Conrail could require Federal funding substantially in excess of the $2.1 billion already appropriated and the additional $1.3 billion Conrail says it needs.

We also found that Conrail assumes Federal monies will be appropriated to replenish the Title V Employee Protection Fund and to pay its share of additional Railroad Retirement Fund assessments. These programs could cost as much as an additional $680 million over the next 5 years.

We obtained comments on this report from Conrail and USRA. Conrail did not respond in writing, but their oral comments are included where appropriate in the text. USRA's written comments are included as appendix I and are also discussed in the text where appropriate.

We are also sending copies of this report to Congressmen Evans, Maguire and Moffett. As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of the report until 30 days from its date. At that time we will send copies to interested parties and make copies available to others upon request.

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE SUBCOMMITTEE ON GOVERNMENT ACTIVITIES AND TRANSPORTATION, HOUSE COMMITTEE ON GOVERNMENT OPERATIONS

CONRAIL FACES CONTINUING PROBLEMS

D I G E S T

Federal legislation establishing the Consolidated Rail Corporation (Conrail), a private corporation, authorized Federal assistance of $2.1 billion to enable the company to become profitable by the end of 1979. Conrail, in its latest business forecast, stated that the $2.1 billion is not enough and that it will need an additional $1.3 billion in Federal funds through 1982 in order to achieve financial self-sufficiency.

Conrail bases its forecast of profits by 1980 on favorable assumptions that contradict its past and current performance trend. GAO doubts the forecast. Conrail could require Federal funding substantially in excess of the $2.1 billion that has already been appropriated and the additional $1.3 billion that Conrail has said it needs to become self-sufficient. (See Ch. 3.)

GAO's findings were similar to those reported to the Congress by USRA in its annual report of May 31, 1978.

GAO also found that neither the Conrail nor the U.S. Railway Association (USRA) financial projections include two contingencies which could increase the projected need for additional Federal funds by as much as $680 million through 1982. Conrail recognizes that additional monies will be needed for its contributions to the railroad retirement system and to replenish the title V employee protection fund, but its business plan makes no specific provision for these funds. (See p. 37.)

One of the Government's primary goals in investing in Conrail was to rehabilitate the properties. Conrail installed more rail and acquired more equipment than the final system plan projected. However, because of delays in the engineering planning and design processes, Conrail has not started some of the additions and improvement projects on such facilities as yards and terminals that were considered important to its success. Conrail has taken steps to expedite its corporate approval process and to begin a catch up program on additions and improvements in 1978. Conrail's overall financial operating results for the first 21-months of operation were very close to the final system plan projections, but the trend was directly opposite the trend forecasted by the final system plan. Instead of improving as predicted by the final system plan, Conrail's performance gradually deteriorated. The deterioration in performance has continued into 1978. (See ch. 2.)

One of the primary reasons for Conrail's declining traffic was a continuing degradation in the quality of service the company provided its customers. The poor quality of service was attributable to (1) an insufficient quantity of serviceable locomotives and (2) delays in moving freight trains through certain yards and terminals because of deteriorated or obsolete facilities. These and other factors prevented Conrail from halting a continuing decline in car utilization. (See pp. 16, 30.) Conrail's deteriorating service adversely affected revenues because some customers switched to other railroads or other modes of transportation, such as trucks and barges, and it has also hampered Conrail in attracting new customers. (See p. 10.)

Conrail has experienced equipment problems since it was formed because it received fewer serviceable freight cars and locomotives from the bankrupt railroads than expected and because the equipment was in worse condition than anticipated. (see p. 8)

Beginning in the winter of 1976-1977, Conrail's locomotive fleet began experiencing a high incidence of breakdowns. This continued into 1977, when on an average day about 19 percent of Conrail's locomotive fleet was out of service, and into early 1978 when almost one-quarter of its locomotives were out of service. USRA believes that the locomotive shortage was partly due to Conrail's inadequate maintenance practices. (See p. 8.)

USRA found serious errors in the final system plan estimate of potential car utilization improvements and has stated that Conrail can reasonably be expected to achieve only half the improvement projected in the final system plan. Conrail's expenses for equipment rentals were about $78 million more than the final system plan projected because the final system plan overstated car utilization levels of the bankrupt railroads when Conrail was formed. (See p. 16)

To reverse its deteriorating performance, Conrail must improve customer service, increase labor productivity, modernize its yards and terminals, and rationalize its physical plant. On the labor issue, Conrail recently announced that it has completed a new labor agreement with the United Transportation Union. Conrail expects to achieve considerable labor savings as a result of these agreements. (See p. 32)

GAO concluded that USRA is capable of providing the Congress reasonable and well-supported judgments about Conrail's performance and future prospects and that USRA's most recent annual report to the Congress properly identified Conrail's poor prospects. USRA has recommended that the final system plan be dropped as a measuring stick for Conrail's performance and that Conrail's own business plans be used instead, but GAO believes that the Congress created Conrail with the understanding that improvements outlined by the final system plan and made possible by Federal funding would result in a self-sustaining entity. Therefore, GAO believes the areas of needed improvement emphasized in the final system plan should

remain as a guide for Conrail performance.
(see p. 50)

USRA and Conrail reviewed and commented on a draft of this report. Their comments were considered and are reflected throughout the report. In addition, portions of USRA's written comments are discussed in detail in Chapter 4. (See pp. 51 - 54.)

RECOMMENDATIONS

GAO is recommending that the Conrail Chairman and Chief Executive Officer take actions necessary to ensure that:

--Conrail requests adequate Federal investment for all improvements contemplated in the final system plan and moves ahead aggressively in planning and implementing them.

--Conrail include the full costs they are assuming the Federal Government will bear in requests for Federal funding.

Contents

ABBREVIATIONS

Conrail	Consolidated Rail Corporation
FSP	Final system plan
GAO	General Accounting Office
ICC	Interstate Commerce Commission
USRA	United States Railway Association

CHAPTER 1

INTRODUCTION

On December 28, 1977, the Chairman, Subcommittee on Government Activities and Transportation, House Committee on Government Operations asked us to undertake a comprehensive audit to determine whether the Consolidated Rail Corporation (Conrail) can meet the congressional goal of financial self-sufficiency.

In a subsequent meeting with the Subcommittee staff we agreed to review:

--Actual operating experience to determine deviations from plans.

--Earnings and operating projections as outlined in the Conrail 1978 5-year plan.

--The U.S. Railway Association (USRA) monitoring of Conrail.

An additional Subcommittee concern--delays in payments to railroad employees who were laid off or employed in lesser paying jobs as a result of the merger of bankrupt railroads into Conrail--was addressed in a separate report (CED-78-138; July 31, 1978).

WHAT IS CONRAIL?

Conrail is the product of a merger of several bankrupt railroads in the Northeast United States. When Conrail began operating on April 1, 1976, it assumed major portions of six railroads: Penn Central, Central of New Jersey, Lehigh Valley, Lehigh and Hudson River, Erie-Lackawanna, and Reading. With the creation of Conrail, the Congress established a 17,000 route mile system serving 16 Northeastern and Midwestern States, the District of Columbia, and two Canadian Provinces. Conrail is a for-profit corporation chartered in Delaware and headquartered in Philadelphia, Pennsylvania.

WHY WAS CONRAIL FORMED?

The railroads evolving into Conrail were characterized as bankrupt and unable to be reorganized within the existing framework of section 77 of the Bankruptcy Act (11 U.S.C. 205). Authoritative sources generally agreed that the bankrupt railroads' economic situation was attributed to many complex and interrelated factors including:

--The rapid development of competitive forms of transportation (particularly trucking) versus the slow development of the railroad industry.

--The shift in the Northeast from heavy industry and agriculture to a service-oriented high-technology economy.

--The inability of the railroad industry to adapt to changing market conditions because facilities are in place.

Given the bankrupt railroads inability to reorganize under the existing statutes, the Congress passed the Regional Rail Reorganization Act of 1973 (45 U.S.C. 701), which was subsequently amended by the Railroad Revitalization and Regulatory Reform Act of 1976 (45 U.S.C. 801). Its main objective was to restructure bankrupt Northeast railroads into an economically workable rail system. Conrail emerged from this legislation.

HOW WAS CONRAIL FORMED?

The Regional Rail Reorganization Act of 1973 established USRA as a Government corporation. The USRA congressional mandate was to reorganize bankrupt Northeast railroads and restore them to the profitable, self-sufficient status necessary to provide efficient and essential rail services. USRA is a Government corporation subject to Section 201 of the Government Corporation Control Act, directed by an 11-member Board of Directors consisting of a Chairman, three Federal Government ex-officio members and seven non-Federal Government members from rail industry management, railroad unions, the financial community, shippers, state and local governments, all appointed by the President of the United States. After extensive study, USRA proposed a preliminary system plan which outlined recommendations on how rail service should be restructured. After detailed review--including public hearings--USRA prepared a final system plan (FSP) setting forth Conrail detailed operational and financial goals. Congress approved that FSP on November 9, 1975, and legislation implementing the reorganization was made in the Railroad Revitalization and Regulatory Reform Act of 1976. The act also gave USRA continuing responsibilities to:

--Monitor and annually report to the Congress on Conrail performance.

--Control the flow of Government investment and loan funds to Conrail.

USRA has issued two annual reports on Conrail progress; the first on May 31, 1977, and the latest on May 31, 1978.

NEED FOR GOVERNMENT FINANCING

USRA anticipated that Conrail would not generate sufficient funds to meet operational goals during its early years. The FSP proposed that Federal funds be made available to Conrail until Conrail would generate sufficient funds from its own operations. The funding finally approved by the Congress was $2.026 billion, which would be invested in Conrail through the purchase by USRA of two types of financial securities: debentures and series A preferred stock. The Congress also authorized an additional $74 million as a safety margin, thus increasing the potential Federal investment in Conrail to $2.1 billion; $1 billion earmarked for debentures and $1.1 billion for series A prefered stock. The FSP intended that this funding would cover early operating losses and would also support Conrail's capital improvements program. The FSP expected that such funding would support Conrail operations until 1979, after which time no new funding would be required.

The terms and conditions of the Federal investments are covered in a financing agreement between USRA and Conrail. This agreement also requires Conrail to provide USRA, on or before November 15 of each year, a business plan for the following 5 years detailing financial and operational projections. The first 5-year plan was issued December 31, 1976, 1/ but the second plan was delayed, with USRA approval, until February 15, 1978.

FINAL SYSTEM PLAN PROJECTIONS

USRA noted in the FSP that the railroads in bankruptcy had not reduced the size of their physical plants as fast as their traffic declined. Thus, the operating plan for Conrail focused on reducing the plant to the reduced traffic levels and on improving operating efficiencies of the restructured rail system.

1/According to the financing agreement, the first 5-year plan was scheduled for release on December 31, 1976, but for each succeeding year, the plans would be released on November 15.

The FSP, as adjusted for accounting changes on January 10, 1978, projected a loss in 1976 amounting to $296 million on total revenues of $2,437 million. Losses were expected to continue until 1979, when Conrail would generate a profit of $111 million. After that, profits were expected to grow, reaching $591 million during 1985 on revenues of $6,981 million.

To realize the financial improvements projected in the FSP, Conrail was expected to improve (1) car loadings, (2) physical plant, (3) rolling stock utilization, (4) road and terminal utilization, (5) revenue yield, and (6) management effectiveness.

CONRAIL EFFORTS TO DATE

In 1976 and 1977 Conrail lost $572 million, which was close to FSP and business plan projections. But the greater loss occurred in 1977 while the FSP had anticipated better financial performance with each succeeding year. The net loss for the 9 months of 1976 was $205 million and the net loss for 1977 was $367 million. The 1976 loss was $91 million less than the FSP projected, but the 1977 loss was $96 million greater. Deteriorating financial performance continued through the first 6 months of 1978 with the railroad reporting a $277 million loss.

The Conrail projected financial performance over the next 5 years shows that it expects a cumulative loss of $35 million. This is based on revenue expectations of $21,612 million. Analysis of annual projections shows that Conrail is projecting continuing losses in 1978 and 1979, with a small margin of profit beginning in 1980. However, the later year profits are not sufficient to fully offset the losses expected in the earlier years. Comparison of the Conrail projected loss of $35 million with FSP goals shows that Conrail is anticipating $1,490 million less total income than the FSP. According to Conrail, the combination of higher capital expenditures and lower cash generated creates the need for additional Federal funding. Conrail projects this need at $1,283 million, which is in addition to the $2,026 million authorized under existing legislation.

SCOPE OF REVIEW

Our review was primarily conducted at Conrail headquarters in Philadelphia, Pennsylvania. We reviewed the Conrail actual financial and operating results for the first 21 months of operations and compared it with corresponding business plans and FSP goals. We reviewed the latest Conrail 5-year operational and financial forecasts, released on February 15, 1978. To a limited extent, we also evaluated the economic criteria and other assumptions used to develop the 5-year revenue forecast. When applicable, we utilized analyses and reports prepared by USRA. Conrail and USRA reviewed and commented on a draft of this report--USRA in writing and Conrail orally. We considered their comments in preparing this report. The USRA written comments are attached as appendix I.

The details and results of our review are presented in the following chapters. In chapter 2, we analyze performance for the first 21 months of operation. In chapter 3, we present an analysis of Conrail operating and financial projections for the 5-year period beginning in 1978. The report concludes with chapter 4 which presents data on USRA's monitoring of Conrail.

CHAPTER 2
CONRAIL'S FIRST 21 MONTHS: SOME PROGRESS BUT MANY PROBLEMS

Although the Conrail financial operating results for the first 21 months of operation were very close in overall terms to the FSP projections, its performance trend was directly opposite the performance forecasted by the FSP. For example, the FSP projected that Conrail would sustain a loss in each of its first 2 years of operation; a larger loss would occur in the first year than in the second. During the 21-month period, Conrail performance, instead of improving as predicted by the FSP, gradually deteriorated as evidenced by a steady decline in revenues in relation to the FSP projection and an increase in certain operating expenses. The deterioration in performance has continued into 1978.

Conrail traffic declined because of several factors, but of primary importance is that the railroad has not yet stemmed the degradation in the quality of service which the predecessor railroads provided their customers. For example, service quality when measured as a percentage of freight cars arriving within 1 day of schedule continued to decline from conveyance into 1978. Although there were peaks and valleys in the data, our straight line trend analysis of this service quality measure shows a decline from 75 percent in April 1976 to 55 percent in May 1978. Unreliable service caused some customers to switch to other railroads and other modes of transportation and hampered Conrail in attracting new customers.

During the first 21 months, unreliable service has resulted from a number of factors including an insufficient quantity of serviceable locomotives and delays in moving trains through certain deteriorated and obsolete yards and terminals. These factors prevented Conrail from halting a continuing decline in car utilization. 1/

Other factors which caused traffic declines were strikes, adverse weather, and economic sluggishness in certain industries. Strikes and adverse weather also affected the other railroads which service Conrail's region, but those railroads had sufficient equipment

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1/ Conrail car utilization figures for July and August 1978 were better than the comparable figures for 1977. This improvement, however, has not been of sufficient duration for us to conclude that the long-term downward trend in car utilization has been halted or reversed.

to handle the traffic surge which occurs at the end of such events. Conrail equipment problems caused it to forfeit traffic because it could not effectively handle these peak traffic loads. Such events do not seem to lessen the total demand for transportation services; they only cause it to be more variable. A slowdown in the steel industry affected demand in coal, coke, and iron ore commodities, major segments of Conrail business.

Despite these problems, Conrail reported that it made substantial progress in rehabilitating tracks and equipment, two objectives of the Federal investment in Conrail. Conrail laid 1,745 miles of rail, resurfaced 14,009 miles of track and installed over 9 million ties. Conrail also made major repairs to 1,845 locomotives and heavy repairs to 24,652 freight cars. All these accomplishments exceeded FSP objectives. However, the rehabilitation work cost more than predicted by the FSP.

Even though Conrail exceeded FSP goals to rehabilitate the railbed and equipment, its program to rehabilitate and modernize yards and terminals was behind schedule. Such modernization projects are crucial to the long-term efficiency of the railroad and were one of the objectives of the Federal investment in Conrail. Several important projects have yet to be started or are just being started more than 2 years after conveyance. Conrail has taken steps to improve its corporate planning and engineering capability and to begin a catch-up program in 1978.

CONRAIL REVENUES HAVE BEEN BELOW EXPECTATIONS

Conrail revenues in 1976 and 1977 totaled $5.62 billion. This was about 7 percent less than the FSP-forecasted revenues of $6.04 billion and about 4 percent less than the Conrail revenue estimate of $5.85 billion, as contained in its business plans. The shortfall in actual revenues from the projections occurred primarily in 1977 and has continued in 1978.

About 80 percent of Conrail revenues come from freight operations, with the remainder from passenger operations and the operation of light-density lines. Since passenger and light-density line operations are conducted for the most part on a break-even basis through the use of subsidies, we concentrated on determining why Conrail freight revenues were smaller than expected.

In general, Conrail freight revenues have been less than forecasted because freight volume was lower than forecasted. The reduced volume was caused by equipment problems, strikes, adverse weather, and economic sluggishness in certain industries. In addition to volume shortfalls, freight rate increases were smaller than forecasted. Commenting on a draft of this report, USRA said that each of these factors exerted a negative influence on Conrail revenue in 1977. They added, however, Conrail also lost business because of its failure to provide a competitive level of service on a consistent basis and its inability to implement the strategies developed in its lines of business analysis in a timely fashion as well as to develop and implement a car utilization and distribution system to get the proper equipment to customers promptly. USRA's staff believes the shortfall in revenue was due to a combination of all the factors mentioned above and that the failure to provide competitive service on a consistent basis was the major negative influence.

Conrail could not supply all its customers because of equipment problems

Conrail estimated it lost revenues of $6 million and $33.6 million, in 1976 and 1977, respectively, because equipment shortages kept it from serving all potential customers. These equipment shortages resulted primarily from the lack of serviceable locomotives to move empty and loaded cars to and from shippers.

Equipment problems began because Conrail was conveyed fewer serviceable freight cars and locomotives from the bankrupt railroads than the FSP projected. These problems worsened through 1977. Specifically, Conrail identified shortages of locomotives, open-top hopper cars (used for coal and ore), automotive parts cars, covered hopper cars (used for bulk commodities), gondolas (used for steel and scrap), and coil steel cars. In recognition of the car problem, the railroad reduced its 1977 revenue forecast by 5.7 percent. It did not reduce its revenue forecasts because of locomotive shortages, but the lack of serviceable locomotives became an increasingly critical problem through 1977. USRA believes that the locomotive shortage was partly due to Conrail's inadequate maintenance practices.

Beginning in the winter of 1976, the Conrail locomotive fleet began to experience a high incidence of breakdowns. This continued into 1977, when on an average day about 19 percent of Conrail's locomotive fleet was out of service. In early 1978, the out-of-service ratio had worsened to a point where almost one-quarter of Conrail's locomotives were out of service.

Early in 1978, USRA identified a number of problems with Conrail's locomotive fleet.

--Some classes of locomotives, after overhaul, did not perform any better than unoverhauled units.

--Some locomotive repair shops appeared to be performing inadequate routine maintenance on locomotives.

--Some locomotive units were not subjected to required periodic inspections on a timely basis.

--Overhaul and maintenance instructions needed review, updating, and modification.

--Training for some supervisory and maintenance personnel was needed.

--A better system for reporting locomotive failure and performance data for use by management was needed.

USRA indicated that Conrail was taking action to review and modify repair and maintenance specifications; to develop an equipment information system to identify the performance of individual locomotives and failures, as well as repairs made; to increase inspections of locomotives before and after repairs are made; and to develop training programs for shop employees. USRA now believes that Conrail's level of service problems and trains delayed waiting for locomotive power are more related to locomotive distribution practices than to poor maintenance practices and that the coming winter will provide a much clearer answer to the adequacy of Conrail's accelerated locomotive maintenance program.

To alleviate the shortage of serviceable locomotives, Conrail repaired and is planning to repair more locomotives than envisioned by the FSP. In 1976 and 1977 major repairs were made to 1,845 locomotives, about 400 more than planned by the FSP. In 1978 Conrail originally had planned to overhaul 874 locomotives and make heavy repairs on another 170, but revised goals were established to overhaul an additional 20 locomotives and make heavy repairs to about 330 units.

Also, Conrail is buying more new locomotives than planned for in the FSP. In 1977, Conrail decided to acquire 175 locomotives, whereas the FSP had planned for 163. For 1978, Conrail plans to buy 217 new units compared to 120 planned for in the FSP.

Conrail also leased locomotives from other railroads to help alleviate short-term locomotive shortages. During 1976 Conrail leased an average of 66 locomotives a month, reaching a high in November and December of 128 and a low in May of 12. Locomotive leases increased in 1977 to an average of 73 per month with a high in March of 97 and a low in January of 43. Through mid-1978 locomotive leases continued at about 31 per month.

Despite the accelerated repair and acquisition programs, as well as the leasing of locomotives, shortages of locomotives continued in 1978, reaching critical levels during the winter months. In September 1978 Conrail officials said that the locomotive situation had improved. The out of service ratio, always better in the summer, averaged about 16 percent in July and August.

Service quality declines

As Conrail equipment shortages worsened, particularly for locomotives, service quality continued to decline, which caused some customers to switch to alternative modes of transportation. Service quality, when measured as the percentage of freight cars arriving within 1 day of schedule, continued to decline from April 1976 into 1978. Although there were peaks and valleys, a straight-line trend of this service quality measure shows a decline from 75 percent in April 1976 to 55 percent in May 1978.

Even though the business plan forecasted a dramatic service turnaround in 1978, this year's performance is behind the level achieved in 1977, primarily for the same reasons that caused the decline last year. Preliminary data to the end of June 1978 indicates that volume is down 9 percent and revenues are down 1 percent over 1977, because Conrail did not have sufficient equipment to handle the traffic surge that occurred when the winter weather improved and the coal miners' strike ended. Car shortages were particularly acute through April and were affecting most of the major commodity groups. These car shortages caused poor service and continued to be the major deterrent to an increase in Conrail's revenue. Through April 30, 1978, equipment shortages caused the loss of about 37,000 carloads and $20 million in revenues.

The short-term effect of equipment shortages and the decline in service quality has been the loss of revenues, which Conrail estimates to be about $60 million. However, the long-term effect could be more serious because Conrail is losing current and potential customers.

These problems caused criticism from several major shippers and, consequently, some shippers have switched to alternative modes of transportation as well as to other railroads. For example, USRA found that several corporations had diverted business from Conrail because of the level of service quality, rates, and equipment shortages.

Revenue forecasts did not accurately reflect the effect of adverse conditions

Conrail estimates that $26.6 million in revenues were lost in 1976 because of strikes. In 1977, about $119.4 million in revenues were lost because of weather and strikes. The Conrail estimate of the amount of freight it would carry during these years was higher than actually occurred. Other railroads were also affected, but they had enough equipment to take advantage of the traffic resurgence which follows the end of a strike or winter. The following table from the Conrail business plan highlights the business lost by Conrail in 1977 due to winter and strikes.

Table 2-1
Estimated Negative Effect on 1977 Demand

	Carloads	Revenues (millions)
Severe winter	101,600	$ 48.9
Johnstown flood	15,200	6.5
United Mine Workers strike	51,700	22.7
Wildcat coal strikes	42,500	15.5
Iron ore strike	23,500	8.8
Longshoreman's strike	10,500	4.0
Miscellaneous strikes	19,600	13.0
Total	264,600	$119.4

Apparently, the Conrail 1978 business plan also overestimated demand, in part, even though the ongoing coal strike and the harsh weather in early 1978 were explicitly considered in revenue projections. USRA said this overestimate may be partially offset by the $48 million dollar management reserve included in the Conrail plan.

The coal strike, which was ongoing when the new business plan was released, caused Conrail to lose an estimated $73 million in business in many commodity groups. As of the end of April, revenue in the coal, coke, and iron ore commodity groups was down an estimated $35 million

--16 percent from the same period in 1977. The severe weather, especially in February, aggravated the railroad equipment shortages by making it difficult to move cars to locations where they were needed.

Economic sluggishness in certain industries

Conrail estimates that demand for its services in 1977 was reduced by about 31.6 thousand carloads because of less production in certain industries than forecast. In particular, steel production did not match Conrail's predictions, which also affected demand for transportation of coal, coke, and iron ore. Further, several plants on the Conrail system closed or reduced production contributing to lost carloads.

However, Conrail expects to offset these losses. For example, Conrail reports that several new or expanded industries will be located on Conrail lines. When these industries are fully operational, Conrail believes that they will produce 125,000 carloads and trailers with gross revenues of $76.8 million annually.

Rate increases were less than forecasted

Generally, Conrail has not obtained the annual freight rate increases that were forecasted although the impact has been modest relative to revenues for the period. Both the amount and timing of increases have been different than forecast reducing revenue Conrail received by $7.8 million for the 21 months. The 1978 freight rate increase, which was also less than forecast but took effect earlier, is expected to result in a shortfall of $11 million in 1978. Conrail relies on general rate increases to recover the cost of inflation and on selective rate actions to increase revenue from particular commodities. Historically, however, railroad general rate increases have been less than the cost rise due to inflation.

The following table shows the forecasted and actual rate actions for Conrail.

Table 2-2
Forecasted and Actual Rate Actions

Year	Forecast Amount (percent)	Forecast Effective date	Actual Amount (percent)	Actual Effective date	Revenue increase (decrease) (millions)
1976	4.9	4-18-76	4.9	4-18-76	-
	-	-	0.4	10-07-76	$ 7.2
1977	3.9	1-07-77	3.9	1-07-77	-
	5.6	11-01-77	5.0	11-30-77	(15.0)
1978	6.5	9-01-78	3.58	6-17-78	(11.1)
Net shortfall.					$(18.9)

According to a Conrail official, other railroads are the primary obstacles to Conrail obtaining the rate increases it feels it needs because the other railroads will not agree to proposing higher rate increases. An USRA staff member stated that other railroads will not agree to proposed rate increases because it would put them at a competitive disadvantage in their regions.

CONRAIL'S TOTAL OPERATING EXPENSES WERE LOWER THAN EXPECTED ALTHOUGH SOME WERE HIGHER

In total, Conrail's operating expenses during its first 2 years of operation were lower than forecasted by the FSP and the Conrail business plan. However, some categories of expenses exceeded these projections. Total expenses did not decline at the same rate as revenues, so that expenses represented a higher proportion of revenues than forecasted and operating losses were higher.

In 1976 and 1977 Conrail operating expenses totaled $6.14 billion. This total was about $444 million less than the $6.59 billion in operating expenses forecasted by the FSP, and $203 million less than the $6.34 billion in operating expenses forecasted by Conrail in its business plans for 1976 and 1977. Although the total of Conrail's operating expenses was less than forecasted, some individual categories of expense did exceed projections.

Our review concentrated on those areas of operating expenses 1/ that were running at greater than forecasted levels. These were maintenance of way, maintenance of equipment, and equipment rents expense. Transportation expenses which are directly related to train operations such as fuel and crew costs, were less than planned because the volume of train operation was less than planned. Transportation expenses constitutes the largest single operating expense category.

Overall for 1976 and 1977, Conrail transportation expenses were 12.7 percent lower than the FSP estimate. Compared to its business plan forecasts, the Conrail transportation expenses were 2.7 percent less than anticipated while volume was 8.2 percent lower. Consequently, although Conrail transportation expenses were less than projected by both the FSP and the business plan, the cost to transport freight on a per-ton basis has been more than expected because transportation expenses did not decrease as much as did freight traffic.

<u>Conrail replaced more track than planned but it cost more</u>

During the first 21 months of operations, Conrail replaced more track than planned by the FSP. The FSP anticipated shortages of rail for replacement but these shortages did not occur so Conrail was able to accelerate the rail, tie and surfacing projects. Conrail laid 1,745 miles of rail, which exceeded FSP forecasts by about 200 miles. It also resurfaced 14,009 miles of track exceeding the FSP estimate by about 200 miles and installed about 1 million more ties than planned.

Conrail spent $854 million on these projects, which was $88 million more than predicted by the FSP but only $16 million more than its own forecasts. In 1976 Conrail actually spent about $11 million less on rail replacement costs than it estimated, but in 1977 it spent $27 million more. A major portion of the cost increase in 1977 was attributable to severe winter weather and the flooding in Johnstown, Pennsylvania.

1/There are six major categories of operating expenses: maintenance of way; maintenance of equipment; transportation; general and administrative; equipment and joint facility rent; and payroll, property, and other taxes.

Conrail reduced replacement personnel below planned levels, in an attempt to control rail replacement costs, resulting in labor savings of $17 million in 1977. Since the 1977 plans did not identify specific production goals, we were not able to determine whether the manpower reductions adversely affected replacement projects.

Commenting on the rail replacement program, USRA said that Conrail is proceeding in a generally effective manner even though completion of the miscellaneous work has lagged. However, it noted a number of deficiencies in Conrail's budgeting and cost control measures. USRA also noted that Conrail had not achieved any significant improvements in productivity and believed that this is an area that also needs management attention.

<u>Conrail repaired more equipment than planned but costs per unit were higher</u>

Conrail repaired more locomotives and freight cars than planned by the FSP during 1976 and 1977, but fell slightly short of its own, more ambitious goals. Major repairs were made to 1,845 locomotives, about 400 more than planned for by the FSP, but about 100 less than its own goals. Heavy repairs were made to 24,652 freight cars, which was about 4,000 more than planned by the FSP and slightly less than the Conrail goals.

In general, Conrail spent more on equipment repairs than planned because the equipment was in worse condition than anticipated by the FSP. Not only did Conrail have to repair more cars and locomotives, it also spent more per unit, particularly for repair parts. In 1976 and 1977, equipment maintenance cost about $1.1 billion which was about $40 million more than planned by the FSP. Most of the cost overrun occurred in 1977.

USRA agrees that equipment conveyed to Conrail was in worse condition than originally anticipated and that the FSP had underestimated the cost to repair each locomotive. USRA told us that the equipment to be conveyed was inspected in 1974, and that the actual condition at conveyance in 1976 was not accurately portrayed. Also, repair costs were underestimated because historical data of the bankrupt railroads was used to project Conrail's maintenance of equipment expenses. Subsequently, USRA found that this historical cost data did not accurately portray Conrail costs.

Equipment rents have been higher due to the level of car utilization

Through the end of 1977 Conrail equipment rents expenses totaled $651 million--about $78 million more than the FSP projected. The reasons for the higher costs were that the FSP overstated Conrail's level of car utilization at conveyance and assumed Conrail would start operations with a level of car utilization equal to the 1973 level experienced by the Penn Central Railroad. However, utilization actually declined approximately 10 percent between 1973 and 1976.

Car-hire expenses are significantly affected by the overall level of car utilization. If the railroad is not able to use its own freight cars efficiently, it must rely more on other railroads' cars to service its customers. In addition, inefficient car use means that the other railroad cars will be on Conrail's system longer, thereby driving up rent expenses without an associated increase in venues.

The consultant who studied car utilization for the FSP projected that Conrail would be able to improve its car utilization by 28 percent over the 1973 level within 6 years after conveyance, but an improvement of only 3.2 percent was estimated as coming in 1976 and 1977. Utilization was not expected to decline between 1973 and conveyance in 1976, but it did by approximately 10 percent.

In March 1978 USRA revised the car utilization projections made by the consultant. USRA said the factors which led to the reassessment of the consultant's work were the considerable changes in the business mix in Conrail's territory since 1973 and the larger percentage of traffic terminating on Conrail since 1973. The USRA reassessment confirmed that the situation had changed and some of the original assumptions were invalid. USRA then stated that the original methodology with these assumptions properly restated would now result in a forecast that Conrail would achieve by 1982 only half of the 28-percent improvement, 14 percent over the 1973 base. USRA still believes that utilization improvements of 28 percent are attainable at some point. USRA did not recalculate the resultant effect on 1976 and 1977 car-hire expenses, but estimated that rent expenses would be $487 million higher than originally estimated for 1978 to 1982. This amount was not reflected in the FSP financial projections and represents, therefore, an understatement of Conrail's original financial need.

During its first 21 months, Conrail was not able to halt the decline in car utilization begun under the predecessor railroads. Conrail stated that car utilization for the last 9 months of 1977 was 3 percent below the corresponding period a year earlier. Conrail believes that the poor condition of its locomotives and freight cars contributed to lower utilization and reduced traffic. For example, in 1977 Conrail held an average of 65 trains per day for lack of locomotive power. Further, shippers rejected about 6,000 cars per month for loading because they were considered unsuitable.

Conrail officials also stated that the disruption of schedules caused by the track rehabilitation program caused lower car utilization, as did the further deterioration of tracks, yards, and terminals.

Car utilization has continued to decline in 1978. A Conrail official said car utilization in the first half of the year ran about 2 to 7 percent behind the mid-1977 level. The Interstate Commerce Commission (ICC) recently fined Conrail, as well as other major railroads, because of their car use practices.

In 1976, Conrail commissioned a task force composed of representatives from other railroads and its own to study the car utilization problem. In October, the task force recommended that an improved car control system was necessary, as the FSP had recommended, and that the system would likely cost about $60 million and would provide annual savings of at least $37.5 million. It also stated a more effective organization and greater field discipline were needed.

USRA felt that Conrail management was sluggish in that it did not fully respond to these recommendations until March 1978. At that time, Conrail launched a program to enhance the existing computer system, which is primarily an automated accounting system, and improve field discipline. Conrail does not intend to install a new operating car control system until 1981 at the earliest. Conrail officials stated that they delayed implementing the new system because it will not produce car utilization improvements early enough to get needed near-term improvements and because the system will cost more than originally planned. See our report "Conrail's Attempts to Improve Its Use of Freight Cars," (CED-78-23, Jan. 24, 1978).

USRA's report to the Congress, in discussing Conrail's program to improve car utilization by enhancing the existing computer system and by achieving rigorous discipline, states

"Given these considerations, the conservative approach by Conrail--enhancement of the existing system and emphasis on field discipline before introducing major innovation--is probably wise." The USRA report goes on to note that, nonetheless, immediate action for improvement is imperative and that the 2-year delay was extremely regrettable.

SOME CAPITAL EXPENDITURE PROGRAMS CRITICAL TO CONRAIL SUCCESS WERE DELAYED

In 1976 and 1977, Conrail spent more on its track and equipment programs than planned and is ahead of the FSP goals for these rehabilitation areas. However, the progress to rehabilitate other facilities, categorized as additions and improvements (A&I) lagged in 1976 and 1977. One of the Government's goals in investing in Conrail was to rehabilitate the physical properties acquired from bankrupt railroads. Accordingly, more rail has been installed, and more equipment has been acquired than the FSP projected, but the A&I program to rehabilitate and modernize yards and terminals appears to be slow in getting started. In an effort to enhance the A&I program areas in 1978, Conrail is programming $144 million in new A&I projects which would substantially exceed the 1978 FSP estimate of $106 million. Should Conrail complete its 1978 programs as planned, it will spend $277 million on A&I projects by the end of 1978 as compared with an FSP estimate of $285 million.

Capital spending for additions and improvements behind schedule

In 1976 and 1977, Conrail's A&I expenditures were less than forecasted by either the FSP or Conrail's business plans. The following table summarizes Conrail's spending on A&I projects by project category for 1976 and 1977.

Table 2-3
Comparison of A&I Expenditures with Projections

Project category	Actual expenditure	FSP projection	Variance	Business plan forecast	Variance
	(millions)				
Yards and terminals	$ 6.0	$ 50.7	$(44.7)	$ 17.8	$(11.8)
Communications and signals	7.3	9.8	(2.5)	17.7	(10.4)
Safety and environmental	15.1	10.8	4.3	28.7	(13.6)
Service and operating	2.0	22.3	(20.3)	10.4	(8.4)
Workshops and machinery	35.6	42.1	(6.5)	71.8	(36.2)
Intermodal facilities	0.2	11.4	(11.2)	4.6	(4.4)
Bridges and tunnels	7.2	6.9	0.3	14.9	(7.7)
Track investment	44.3	25.0	19.3	41.9	2.4
Miscellaneous	15.2	8.0	7.2	12.2	3.0
Total	$132.9	$187.0	$(54.1)	$220.0	$(87.1)

As shown by this table, Conrail spent $54 million less than envisioned by the FSP and $87 million less than Conrail envisioned in its business plans on A&I projects. More importantly, because of the track rehabilitation program, Conrail's expenditures were concentrated in the areas of track investment and workshops/machinery and were substantially less than projected for yard and terminal improvements and for service and operating improvements.

It should be noted that the FSP contained no specific project plans or estimates for A&I work on yards and terminals, rather, it included only a listing of projects which the planners felt were important to Conrail's success. According to Conrail, as it began its review of these and other projects, it found that the funds included in the FSP for these projects were far below what the total investment might have to be. Conrail, therefore, concluded that a program of project design, cost estimating, and prioritization was essential.

In discussing A&I spending during the first 21 months, we were told by Conrail that the lower spending level could be attributed to:

--Problems associated with organizing a large capital investment program and overcoming the inertia of the bankrupt railroads which had allowed capital planning functions to atrophy.

--Management's decision to spend more time on analyses to assure that funds expended on critical projects were allocated properly.

For many of the same reasons, Conrail will spend less on A&I projects in 1978 than planned. At the beginning of the year, Conrail estimated it would spend $165 million on A&I projects, as compared to an FSP estimate of $106 million. About $65 million of the Conrail planned expenditures was for projects carried over from previous years. In June 1978 Conrail estimated that $144 million of the $165 million would actually be spent on projects originally budgeted in 1978.

Yard and terminal projects critical to improved service and efficiency

The physical plant Conrail inherited was in such poor condition that expenditures could only keep even with continuing deterioration and not provide for future enhancements or operating efficiencies. As a result, the deteriorated plant which plagued the bankrupt railroads, continues to adversely affect Conrail performance. In particular, upgrading yard and terminal operations is critical for expediting car handling and customer service as well as for improving car and locomotive utilization. Conrail's Allentown, Pennsylvania, yard is a case in point. When constructed in the early 1930's by the Central Railroad of New Jersey, it was to serve as an interchange point with the Reading Railroad. At that time, traffic through the yard was directional--cars received from the west continued eastbound and vice versa. In later years, the Lehigh Valley Railroad took over operation of the yard. The Lehigh Valley brought more local traffic into the yard for classification. Traffic which was directional under the Central Railroad of New Jersey became multidirectional. Traffic received from the west was to be dispatched to the west and southwest; traffic from the east was to be dispatched to the east and southeast. Thus, cars first had to be switched in one side of the yard, then transferred and reswitched in the other.

With conveyance to Conrail, traffic that had moved over former Penn Central and Erie-Lackawanna Railroad lines was added. Today, this double switching is still required; but with larger trains the additional cross-yard volume generated from intermediate switching has magnified the interference and added to the delays.

Because of the critically deteriorated condition of the eastbound yard, Conrail cannot move freight through the yards as efficiently as possible. In addition to derailments and damage to goods and equipment, the present average time for all cars to move through these yards is about 29 hours. Conrail estimates that rehabilitation of the yard could reduce this time to 15.6 hours. Conrail recently authorized funding this project, with construction scheduled to start shortly.

Because of the length of time needed by Conrail to plan and approve A&I projects, delays have occurred relative to the schedule Conrail would like to have met. Following are two examples:

--Elkhart, Indiana, yard. Conrail considers Elkhart to be one of its most important yards, both economically and strategically. It is Conrail's primary yard for moving traffic to and from the Chicago Gateway. Redesign and modernization of this yard, which could cost over $20 million, could produce annual cost savings of $4.6 million, according to Conrail. These savings would be from reduced switching requirements at other yards and from greater consolidation of traffic from Cincinnati and Indianapolis for movement through Chicago. Originally planned for 1976, Conrail has delayed starting this project because it wanted to make a further review of traffic, capacity, and profitability and because it feels it needs to examine the impact of the planned changes on its entire system. According to Conrail, the Elkhart facility conveyed to Conrail was in good condition. Therefore, rehabilitation was not a problem. Rather, Conrail said that the primary effort centered on the design of a switching operation to consolidate and organize the westward traffic flows on the Conrail system. It is unlikely that management will approve the project in time for significant construction to begin in 1978. Therefore, anticipated savings in switching charges, labor, locomotive, and car-hire cost will be delayed.

--Oak Island, New Jersey, yard. This yard is in northern New Jersey and serves the New York City metropolitan area. Expansion and modernization of this facility would consolidate the switching operations of five separate northern New Jersey locations. The physical separation of these yards often causes work to be duplicated, and an improved facility would allow three other yards to be closed and will reduce staffing at another. Construction was originally planned to begin during 1977 at an estimated cost of $29 million. When complete, Conrail expects the project to provide savings of almost $8 million yearly. The project was delayed pending the study of a new investment strategy involving less improvements and less capital. According to Conrail, the Oak Island project approved by Conrail's management in September 1978, has a much reduced capital requirement and provides facilities sized adequately for the projected traffic to be served.

Conrail has begun to speed up its additions and improvements planning and decisionmaking processes

Weaknesses in capital planning and appraisal have limited Conrail progress in completing A&I projects. The weaknesses involve planning, approval, control, and implementation. Although Conrail recognized these problems at conveyance, their immediate correction was not possible because the bankrupt railroads allowed their investment management and control processes, including staff, to atrophy.

To improve its capital investment process, Conrail has reorganized the evaluation, approval, and implementation process by concentrating more authority for each function at the corporate level. Conrail believes this should emphasize system priorities and optimize the efficient use of system resources. Because the changes have been made only recently, it will take time to assess their effect. Some of the actions taken were:

--Conrail launched an investment planning study to assess capital investments and develop an approach to review and approve capital investments.

--Conrail has expanded its industrial engineering organization to improve evaluation procedures.

--Conrail established a new project management department to improve project implementation.

--Conrail developed new procedures to monitor A&I expenditures.

--Conrail organized a new planning and control group to independently review capital investment programs.

USRA believes that Conrail actions to strengthen the overall A&I process should enhance their ability to implement its projects over the next several years. However, USRA also believes that Conrail can no longer afford to permit delays in planning, approving, and constructing capital projects that are critical to improving operations and realizing efficiency savings. We agree with this assessment.

CONCLUSIONS

In contrast to the FSP expectations, Conrail performance deteriorated in 1977 and 1978 as evidenced by a steady decline in traffic and an increase in certain operating expenses. A primary reason for the traffic decline was the degradation of service provided by Conrail to its customers. Key factors which caused Conrail service to decline were (1) a shortage of serviceable cars and locomotives and (2) antiquated yard and terminal facilities. These factors have prevented Conrail from halting a continuing decline in car utilization.

Conrail has not moved as quickly to improve car utilization as the FSP anticipated. Specifically, Conrail decided to delay implementation of a new car control system that was recommended by the FSP as essential to improving car utilization because it will not yield near-term improvements and because it costs more than anticipated. Currently, implementation of this system is not expected to occur until 1981.

Conrail's A&I program has also lagged behind expectations because of time-consuming engineering planning and design processes. Conrail has taken some action to streamline its procedures, but this area needs particular attention by Conrail and USRA to prevent further delays which would adversely affect service and efficiency improvements. In particular, yard and terminal improvements are needed.

Conrail is aggressively attacking its equipment problems and is meeting goals for the rehabilitation of track and roadbed.

RECOMMENDATION

We recommend that the Conrail Chairman and Chief Executive Officer take the necessary action to assure that Conrail management moves ahead agressively to implement those improvements contemplated by the FSP.

CHAPTER 3
ADDITIONAL FEDERAL INVESTMENT MAY NOT ASSURE CONRAIL PROFITABILITY

Conrail will require additional funding beyond the $2.1 billion already appropriated; however, further Federal funding may not assure profitability. If current negative trends continue, Conrail will need more than the additional $1.283 billion in Federal funding now forecasted by Conrail's 1978 to 1982 business plan. The Conrail business plan estimates that the railroad will become marginally profitable in 1980, but will incur an overall loss of $35 million for the 5-year period 1978-1982. USRA, in evaluating Conrail's forecast, developed a range of forecasts. But only the most optimistic, which closely approximated the Conrail business plan, indicated a profit for Conrail by 1982. The USRA more pessimistic forecasts showed needs for increasing amounts of Federal funding over the period up to $3.8 billion, with Conrail still losing money at the end of the period.

The Conrail forecast is optimistic due to certain methodologies used to construct the economic estimates and because favorable assumptions, which are contrary to current trends, were made about key variables, such as rate increases, customer service, and increases in labor productivity. Apparently, Conrail will not achieve the amount of forecasted rate increases for 1978. Assuming Conrail gets all the future rate increases it is projecting, the difference between the rate increase the ICC granted this year and the increase Conrail anticipated could lower Conrail's revenues through 1982 by about $442 million.

Decisive and innovative management action is needed for Conrail to reverse the negative trends and make positive gains in the other key variables. The Conrail business plan included these gains in estimating that Conrail would show a net loss of $35 million by 1982. In order to measure the magnitude of this predicted turnaround, we conducted a sensitivity analysis of forecasted traffic using three simplified alternative assumptions. These analyses show that (1) if past traffic trends continue, Conrail's net loss through 1982 could increase to about $3 billion; (2) if traffic is maintained at the 1978 level, the net loss through 1982 is an estimated $1.9 billion; and (3) if 93 percent of Conrail's forecasted tonnage is achieved, the net loss estimate is about $800 million. Note that these extrapolations are merely an analytic technique and not our forecast for Conrail.

The Conrail business plan does not make any financial allowances for two issues which could increase the projected need for additional Federal funding by as much as $680 million for the 5 years. Conrail recognizes that additional monies will be needed for its contributions to the railroad retirement system and to replenish the title V employee protection fund; however, its business plan makes no specific provision for these funds, but assumes that Conrail will not be required to pay for these programs.

The Conrail projected financial statements do not recognize total interest owed to the Federal Government by Conrail because of an accounting procedure that discounts the interest. This accounting procedure will understate interest expenses by about $184 million for the 5 years and is under review by the ICC. If Conrail is required to state interest at its full value, the Conrail net income projections would be overstated, but the overstatement would not impact on the Conrail funding needs.

CONRAIL AND USRA FINANCIAL FORECASTS FOR 1978 TO 1982

In February 1978--less than 2 years after beginning operations--Conrail stated that it would incur substantial losses in 1978 and 1979, and would not achieve profitability until 1980--1 year later than the FSP had forecast. Conrail estimated that the profit in 1980 would be small and that it would incur an overall loss of $35 million for the 5-year period in contrast to the $1.5 billion profit envisioned by the FSP. Moreover, Conrail estimated it would need additional Federal financing of $1.283 billion through 1982 in order to rehabilitate physical assets, provide adequate working capital, and offset operating losses.

USRA made independent forecasts of Conrail revenue, net income, and Government funding needs. USRA projected optimistic and pessimistic outcomes. It believes that there is only a small possibility that Conrail funding needs would be greater or lesser than this range.

USRA projections show that Conrail may require as little as $1.1 billion in Federal assistance under optimistic assumptions. However, the pessimistic projection indicates a potential requirement of $3.8 billion through 1982. Conrail's funding need of $1.283 billion falls within the range of the possible extremes, but USRA believes that it has a low probability of being achieved because it is so close to the optimistic end of the range. Further, only the estimates in the optimistic end of the range indicate Conrail beginning to earn a profit during the 5-year period.

The USRA analysis indicated a significantly greater likelihood that Conrail will require substantial funding beyond the $1.283 billion requested, perhaps as soon as 1980.

Conrail and USRA forecasts of revenues, net income, and additional Government funding required are summarized below:

Table 3-1
Summary of Conrail and USRA Forecasts
For 1978 Through 1982

	Conrail business plan	USRA optimistic (millions)	USRA pessimistic
Revenue	$21,612	$21,926	$19,697
Net income (loss)	(35)	239	(2,380)
Additional Government funding	1,283	1,086	3,793

ECONOMIC FORECASTS NEED IMPROVEMENT

Both Conrail and USRA forecasts of the Conrail 1978 to 1982 performance are susceptible to errors and the methods and data used need improvement. However, any economic forecast of revenues and costs up to 5 years in the future is subject to some degree of error. Such an error, even when small, can have a large impact on the estimate of Conrail profitability and the associated need for Federal funds.

Conrail does not have much data to base forecasts on, because it has been operating for only 2 years. Historical data is available from several railroads that were combined to form Conrail, but such data is believed to be inaccurate.

Conrail developed a single forecast for 1978 to 1982 which was presented in its 1978 business plan. USRA used a different forecasting technique and developed forecasts ranging from optimistic to pessimistic which were presented in its 1978 annual report to the Congress.

Evaluation of Conrail methodology

For most commodity groups, Conrail estimated its business volume (expressed in tonnage hauled) using a statistical methodology which explains tonnage by five main variables: national production by commodity imports and exports, manufacturing employment or personal income for Conrail's region, relative truck/rail rates; and time. The statistical methodology is evaluated in this section.

For the remaining commodity groups, including coal, Conrail used other approaches for estimating business volume. The tonnage estimates for all commodities were then adjusted by Conrail for a variety of reasons to develop forecasts contained in the 5-year plan.

Conrail used the tonnage forecasts to calculate costs and revenues by incorporating various assumptions about labor rate changes, freight rate changes and so on. Conrail methodology has several limitations which make its estimates susceptible to errors.

Lack of measure for service quality

Conrail is requesting Federal funding to improve its quality of service, on the assumption that better service will enhance profitability. However, the forecasting methodology Conrail used does not include service quality measures. Because service is not included, the forecast for 1978-82 may be optimistic since Conrail has actually been losing business to other carriers as its service has been getting worse. Although the quality of service is difficult to measure, some statistics are available and should be included in the methodology, to demonstrate how additional investment will affect tonnage and profitability.

Lack of regional data

Tonnage estimates may also be inaccurate because Conrail forecasts were made with limited data applicable to the the Conrail service region. For one-half of the commodity forecasts, the methodology uses national data. We doubt that national data approximates the economic outlook for these commodities in the Conrail region. For the remaining commodities, the only variable representing the Conrail service area is the Northeast's share of manufacturing employment (or personal income). Thus, the methodology generally assumes that the Conrail commodity forecasts reflect, to a degree, trends in national commodity forecasts. Conrail forecasts that national production will increase for most commodities with the tendency that the Conrail traffic will also increase.

Questionable use of time variable

Time is a questionable forecasting variable because it is passive and often masks the influence of more relevant factors, such as relative truck/rail rates. In addition to producing a forecast, economic analysis of this type should provide insights into the business environment which are useful for management decisions. When time is used as the forecasting variable, as it is for several Conrail commodities, these insights are often forfeited.

Single equations used for dissimilar products

Some of the commodity groups include dissimilar products but are estimated by one equation. For example, rubber and plastics are different types of products and not amenable to joint economic demand analysis, but the Conrail analysis contains one equation for both. Inaccuracies are built in by this procedure. In this type of analysis, each distinct product should be forecasted alone.

Evaluation of USRA forecast methodology

USRA applied a different forecasting technique than used by Conrail. USRA questioned the Conrail forecast because it was constructed by using historical tonnage data which, USRA believed, likely contained duplications even after adjustment. USRA also questioned the availability of serviceable locomotives needed to move the 1978 forecasted volume, planned car utilization improvements, and overall service capabilities. USRA forecasts were based primarily on the assumption that the tonnage handled in any year is related to tonnage in the previous year multiplied by a growth factor. The growth factors were taken primarily from a major macroeconomic forecasting service and, in those cases where Conrail marketing strategies were involved, from the Conrail 5-year plan. Using this data, USRA produced three forecasts--optimistic, most probable, and pessimistic. USRA did not list the 1979-82 most probable forecast in its 1978 annual report to the Congress because it wanted to emphasize the range of estimates rather than any single forecast.

Although developed differently, USRA forecasts have some of the limitations discussed as applicable to Conrail forecasts including aggregation of diverse commodities, limited use of regional data, and limited use of service quality measures.

Because of the USRA assumption that tonnage handled in any year is related to tonnage in the previous year, any error in forecasted tonnage for 1 year is likely to have a compounding effect in subsequent years.

THE CONRAIL FORECAST IS BASED ON FAVORABLE ASSUMPTIONS CONCERNING SEVERAL KEY ISSUES

The Conrail forecast that it will return to profitability in 1980 was based on favorable assumptions, contrary to current trends, concerning four key issues. If actual performance is less than forecasted in any one area, profitability could be jeopardized. Conrail must achieve the forecasted level of rate increases, vastly improve its customer service (mainly by using its existing equipment more effectively), increase labor productivity by successfully negotiating work rule changes, and rehabilitate its deteriorated and inefficient yards and terminals. A turnaround in the latter three areas, followed by positive gains, will require decisive and innovative management action.

Freight rate increases

Conrail estimated that most of its revenue growth over the 5 years would result from freight rate increases that will generate $2.8 billion in additional revenues. These estimates were developed from a set of inflation forecasts, since Conrail assumes that such increases will be granted to partially offset rising costs. However, general rate increases for the rail industry have historically fallen short of compensating the railroads for the full impact of inflationary cost growth. USRA compared general rate increases for the Eastern Rail District over the last 10 years to the rate of inflation and found general rate increases averaged about 86 percent of the rail cost increase.

A rate increase less than Conrail predicts in any given year affects the current year's revenues but has a more significant effect on future years' revenues because the rates are compounded as new ones are enacted each year. For example, Conrail forecasted a 6.5-percent general rate increase for September 1978 but a new general rate increase averaging 3.58 percent took effect on June 17, 1978. If Conrail receives all future forecasted rate increases in the amount and at the times predicted in the business plan, this percentage shortfall could reduce revenues by about $442 million through 1982. However a Conrail official stated that the railroad expects the 1979 rate increase to be earlier than forecast, offsetting some of the revenue shortfall.

USRA believes the Conrail rate increases will be lower in 1978 and 1979 than Conrail estimated. USRA based its estimates on historical performance of the Eastern railroads and its judgment of future occurrences. USRA calculated that the lower rate increases would mean Conrail will need $300 million more in Federal funding than the $1.3 billion Conrail estimated.

Customer service

Conrail must improve its customer service to increase its business. Conrail adjusted tonnage forecasts upward to reflect its assumption that service will improve, even though its service has been deteriorating since conveyance and currently is not adequate to hold, let alone expand its market share.

USRA reported the situation was so serious in February 1978 that Conrail service affected the entire Nation's car supply. Although weather and the inability of customers to receive goods aggravated the crisis, USRA felt that Conrail's inadequate locomotive maintenance practices and the lack of forceful corrective action were major causes. At one time, Conrail had 21.4 percent of the Nation's 50-foot box cars on its lines; normally this figure is about 17 percent. This situation was not alleviated until the end of April.

Sufficient equipment

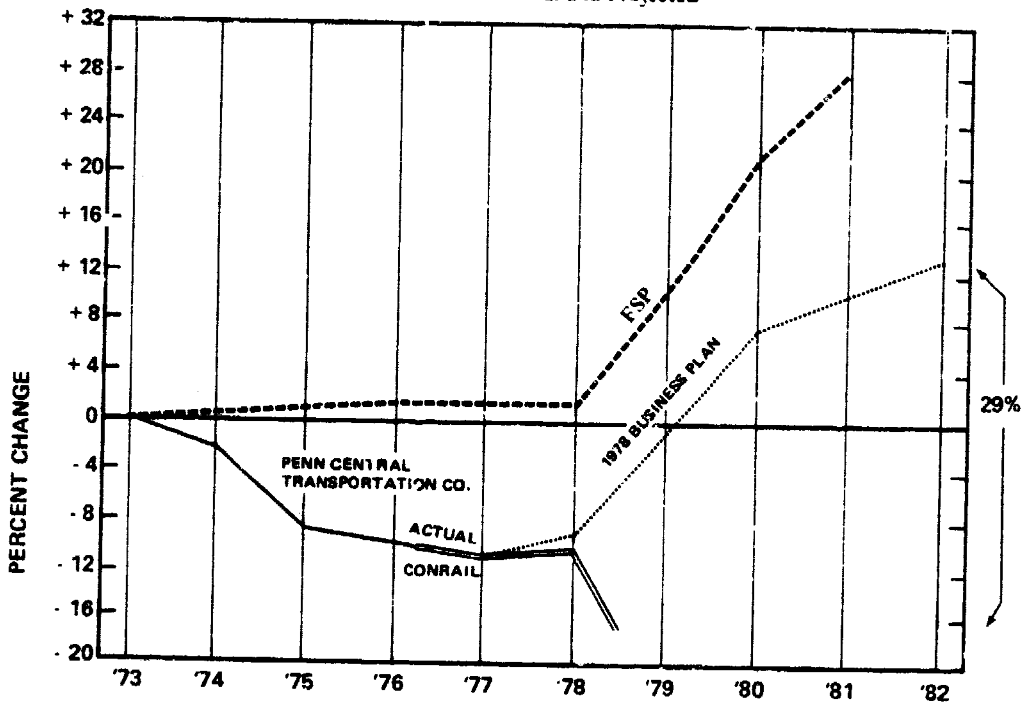
One aspect of good service is to deliver an acceptable freight car to the customer when needed; the Conrail 1978 forecast has apparently overestimated its ability to do this. Equipment shortages causing lost business were a factor in the Conrail failure to achieve 1977 business plan goals and this trend seems to be continuing. For example, Conrail reported that it experienced freight car shortages during the first 5 months of 1978 of about 100,000 cars--about 400 percent worse than the same period a year earlier. Although Conrail is purchasing more new freight cars and locomotives than envisioned by the FSP, and is overhauling and repairing existing equipment, a Conrail official believes one of the keys to alleviating the problem is better utilization of existing equipment.

Conrail has made favorable assumptions about its ability to improve car utilization even though car utilization has been declining in recent years. These assumptions are less optimistic than those made by USRA in the FSP. The Conrail assumptions are incorporated into the business plan forecasts and have significant effects on projected financial performance. USRA has some concerns about whether Conrail can attain these increases. Conrail overestimated its ability to improve car utilization in the past and fell considerably behind its improvement goals in the first half of of 1978. Conrail stated that its car utilization has begun to exceed 1977 performance, based on July and August results.

The following graph illustrates some of the above points: continued decline in car utilization, and the significant increase forecasted by the 1978 business plan.

Graph 3-1

Freight Car Utilization
FSP versus Actual and Projected



If car utilization fails to improve as forecast, Conrail will need to buy significantly more freight cars to haul the freight volume forecast in the 1978 business plan. Conrail estimates that about 11,500 more freight cars will be needed if only one-half of the projected improvement in car utilization can be achieved. About 26,300 more cars will be needed if no improvement can be made.

Conrail marketing officials stated that more cars are needed to meet customer demand than are currently budgeted, even if the utilization improvements occur. Other Conrail officials stress the need to balance customer desires for equipment with the financial returns that can be earned from such investments.

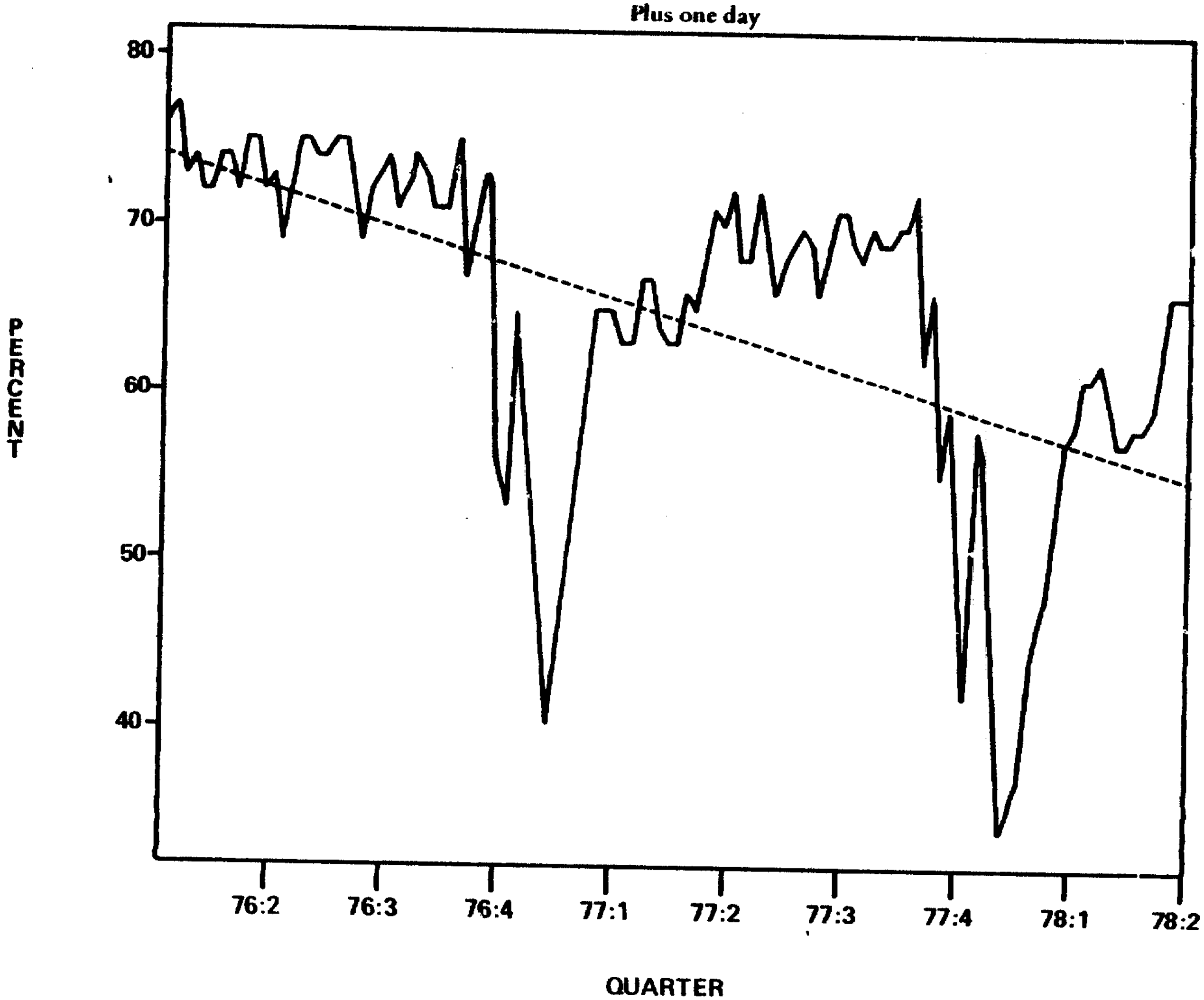
On-time deliveries

Another aspect of customer service is delivering loaded cars on schedule. Conrail's on-time performance has been deteriorating since conveyance, a problem which has caused disruptions of its customers' businesses and caused Conrail to lose business.

The following graph shows the downward trend of freight cars arriving within 1 day of the scheduled time.

Graph 3-2

Conrail Service Quality and Trend Analysis
Percentage of shipments arriving on-time
Plus one day



In an effort to increase reliability, shipment time schedules were recently lengthened. A Conrail official stated that the new time schedules could also lead to reduced total transit time for freight cars because of the more efficient operations. USRA commented that lengthening schedules to increase reliability and provide better service is a questionable tactic. USRA stated that Conrail will still be required to report to them under the old schedules as well as the new ones.

USRA was critical of the Conrail delay in emphasizing the importance of service in its planning efforts and daily operations. Although Conrail has now implemented a program to improve on-time performance, USRA is concerned that the program is not properly coordinated with all concerned departments.

Labor negotiations

Conrail predicts that it will reduce labor costs and increase productivity over the next 5 years. Conrail anticipates that it will be able to realize labor savings totaling $569 million in the 1978-82 period. $342.8 million of these savings is expected to be realized through improvements in Conrail labor agreements, which include work rule changes, terminal labor consolidations, and the early retirement of enginemen. Another $226.2 million in savings is expected to result from efficiencies realized from Conrail capital and managerial improvement programs, such as the discretionary track rehabilitation program, the additions and improvements capital program, and the program to improve the management of its yards and terminals.

In 1977, Conrail labor costs represented 66.6 percent of its revenues. This is significantly higher than any other major railroad and the industry average, which was about 52.6 percent in 1976. Conrail recognizes that the size of its labor costs is critical to its drive for self-sufficiency. According to its 5-year plan, Conrail expects that significant work rule improvements will be achieved with an expected benefit of more than $300 million in the 5-year period. Basically, Conrail negotiating objectives with operating craft unions (such as the United Transportation Union and the Brotherhood of Locomotive Engineers) and with nonoperating employee unions are to seek work rule changes which increase labor productivity, allow greater flexibility in work assignments and provide more uniform pay scales. In addition to negotiating work rule changes, Conrail is also negotiating terminal labor consolidation agreements.

These agreements basically involve setting up new consolidated labor agreements in terminal areas that were formerly served by more than one of Conrail's predecessor railroads. Conrail has executed 45 terminal consolidation agreements out of a potential of about 65. Conrail expects that these consolidations will enable it to reduce its yard labor costs by $4 million in the 1979-82 period.

Conrail also expects that savings of $38.5 million will be generated between 1978 and 1982 through the early retirement of enginemen. According to Conrail, it has more engine service employees at certain locations than are needed. Accordingly, Conrail has initiated a program to induce enginemen to retire early. Through this program, 417 enginemen have accepted separation, according to Conrail.

During our review, we were told that the labor negotiations were expected to be completed by late spring 1978. At the time our fieldwork was completed in mid-September, Conrail announced that new labor agreements had been signed with the United Transportation Union and the Brotherhood of Locomotive Engineers. According to Conrail, the new agreement with the United Transportation Union, when fully implemented, provides for a reduction in train crew size on almost every freight train operated by Conrail. It also assures the establishment, by July 1, 1979, of a single contract with uniform work rules, to replace the 43 separate contracts with the United Transportation Union which Conrail inherited from its bankrupt predecessors. Conrail believes that the agreements will enable it to substantially achieve its goal of $500 million savings over the next 5 years as a result of collective bargaining negotiations and the consolidation of bargaining agreements. Because of time limitations, we were unable to review the agreements or the validity of the savings projected by Conrail.

Finally, it should be noted that if Conrail negotiates labor contracts that result in the displacement of a number of employees, an additional burden could be placed on funds authorized under Title V of the Regional Rail Reorganization Act of 1973 as amended. Title V provides payments to employees of predecessor railroads whose compensation is reduced by the Conrail solution to the Northeast rail crisis. If Conrail obtains work rule efficiencies, many employees may take early retirement in exchange for separation allowances or will claim their rights under title V to make up for lost earnings. This could lead to depletion of the title V funds before 1982. The Conrail plan assumes that a shortfall in the fund would be replenished through Federal legislation and that protection payments would not have to be made by the railroad. USRA estimates that the additional title V funding required for payments to employees who would be displaced because of work rule changes could exceed $250 million. See p. 38 for a further discussion of the effect of these assumptions by Conrail in its forecasted financial performance.

<u>Revitalization of yards and terminals</u>

Conrail physical improvements to its yards and terminals will directly influence its ability to improve service and reduce expenses. Over the next 5 years Conrail plans to spend about $816 million on improvements, which it projects will achieve efficiency savings of $212 million per year. According to a Conrail official, the projects cited as support for business plan forecasts are firm for the early years of the business plan, but projects to be carried out in later years cannot be considered as firm because they have not undergone appropriate analysis or corporate review.

Several important lines of business (such as coal, metallic ores, and trailer-on-flat-cars) base predictions of increased business on capital projects which are still being developed. Specifically, one line of business forecasts a 50-percent growth in tonnage based on improving an existing facility, but details of the improvement project are still being developed. For another line of business, Conrail states that the only means of retaining a significant market share is through investment in a new facility; again, the decision to build the facility is awaiting completion of necessary design studies. Further, expenditures for the first 21 months were generally for keeping even with ongoing deterioration and not necessarily for future enhancements or operating efficiencies. Expenditures as of July 30, 1978 are currently about $12 million1/ behind schedule and Conrail is estimating it will not spend about $15 to $34 million of this year's planned improvements budget. Also, Conrail continues to study and review the benefits and costs of major projects for which it bases improved service, higher revenues, and efficiency savings.

1/USRA, in its comments on a draft of this report, stated that Conrail's historical financial statements included two nonoperating expenditures totaling $8 million which were not included in Conrail's business plan: a $3 million capitalized computer lease and a $5 million legal settlement with the Lehigh and Susquehanna Railroad. Thus USRA believes Conrail is $8 million further behind in additions and improvements than our figures show.

Conrail spends more than $1 billion annually to operate its urban yards and terminals, where over half of Conrail's labor force is employed. Efficiency projections of $179.2 million shown in the business plan are based on several transportation improvement programs. The savings are composed of reduced labor costs of $78.1 million and reduced loss and damage liability of $101.1 million.

Labor cost reductions, Conrail believes, can be achieved by implementing five programs--the largest being the transportation terminal improvement project which accounts for $50.9 million of the projected labor savings. Savings from other programs will not occur before 1979.

USRA believes, and Conrail studies have confirmed, that savings projections are probably conservative and substantial benefits are possible and achievable. USRA foresees difficulties in changing past work habits and practices. Successful implementation of the terminal improvement project is necessary because it not only affects labor cost but is one of the main factors in increasing car and locomotive utilization and improved customer service, on which Conrail's ability to increase tonnages and revenue is based.

Conrail estimates the remaining terminal-related efficiency savings of $101.1 million will occur from reducing its loss and damage freight liability by increasing inspections, improving customer service, reducing theft, and improving management.

Conrail has reorganized its damage prevention and risk management operations and steps have been taken to reduce liability. Our analysis of projected savings show some programs have fallen behind schedule. Loss and damage efficiencies will probably not meet the 1978 projections; some savings for 1979 also appear overstated, based on current plans. Though the potential for signficant savings exists, it appears that initially, at least, the projections in the business plan will not be met because of Conrail's delay in initiating projects.

ANALYSIS OF CONRAIL FORECASTS USING ALTERNATIVE TRAFFIC PROJECTIONS

Conrail forecasts an appreciable increase in freight traffic over the next 5 years. Historically, freight traffic hauled by its predecessor railroads and Conrail itself has declined. We developed three alternative traffic projections for the same 5-year period and compared Conrail traffic forecasts to them. These alternative traffic projections are presented for analytical purposes only; however, we do feel that each provides a plausible scenario for future traffic trends.

Conrail currently estimates that actual freight traffic for 1978 will be about 258 million tons, which is about 93 percent of what was forecast in the 1978 business plan. We used this updated traffic estimate for 1978 in all three of our alternative projections, but varied assumptions as to what trends the subsequent 4 years traffic would follow.

The assumptions as to future traffic trends were:

--Trend extrapolation assumes that past trends will continue into the future. This assumption caused the analysis to show Conrail traffic continuing to decline for the next 5 years at about the same rate as in the past.

--The constant 1978 level assumes that traffic will remain constant at 258 million tons for the next 5 years.

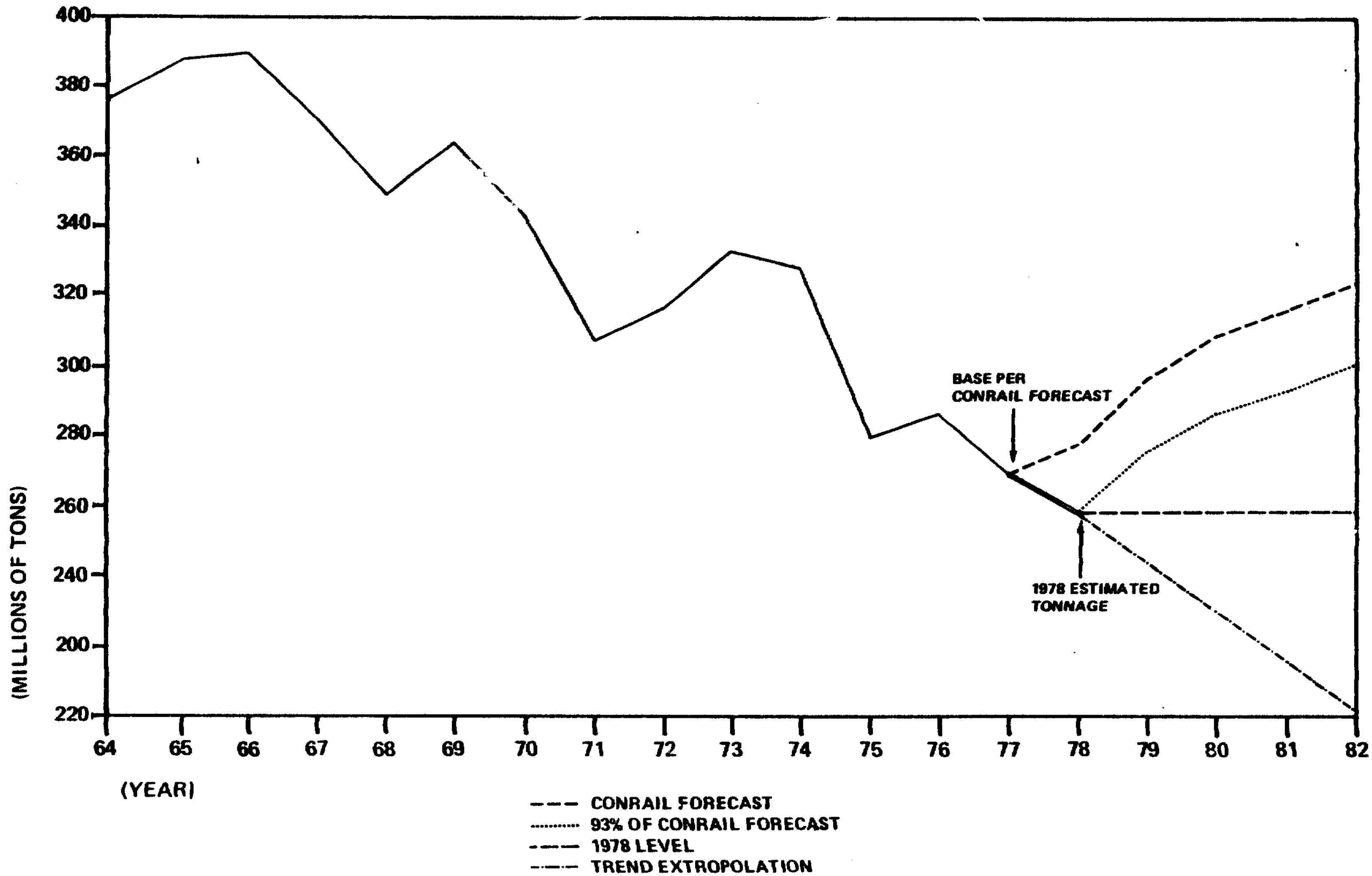
--Traffic was assumed to increase at about 93 percent of the Conrail forecast. This assumption is based on Conrail's 1978 performance through mid-year.

Graph 3-3 shows the historical traffic decline since 1964, the Conrail 1978 business plan tonnage forecast, and our three alternative traffic projections. This graph illustrates that all three alternative projections generate tonnages below those forecast by Conrail. The sharp turn-around in tonnage forecast by Conrail for 1978 is not being achieved and, in fact, Conrail estimates that its traffic is off 8 percent as of July over the same period last year.

We used the tonnage figures illustrated in graph 3-3 and Conrail's own methodology to project alternative levels of net income (loss) of Conrail. The three alternative net income (loss) projections are presented and compared to the Conrail business plan forecast in the following table.

Graph 3-3

Conrail Forecast
versus
Alternative Projections



Notice that the three alternatives all indicate a net loss in 1978 of $499 million since each used the latest Conrail 1978 traffic estimate.

Table 3-2
Net Income (Loss) Resulting From
Alternative Traffic Projections

Year	Conrail business plan	Trend extrapolation	Constant 1978 level	93 percent of Conrail forecast
		---------------(millions)---------------		
1978	$(379)	$(499)	$(499)	$(499)
1979	(119)	(493)	(395)	(266)
1980	68	(534)	(320)	(96)
1981	142	(683)	(334)	(38)
1982	253	(828)	(324)	61
Total	$(35)	$(3,037)	$(1,872)	$(838)

The 5-year total loss of $35 million forecasted by Conrail is significantly less than the total losses ranging from $838 million to $3,037 million generated by the alternative traffic projections. However, note that the projection which uses 93 percent of Conrail forecast (a level of performance now being approximated in mid-1978) does forecast a small profit in 1982.

OTHER FINANCIAL UNCERTAINTIES WHICH MAY AFFECT THE NEED FOR FEDERAL FUNDS

Two financial contingencies could increase the projected need for additional Federal investment by as much as $680 million. USRA and Conrail recognized these contingencies but made no specific provision for funds. These two issues are: railroad retirement funding and employee income protection under Title V of the Regional Rail Reorganization Act of 1973.

Railroad retirement fund

During the forecast period, Conrail may be required to contribute between $330 million and $590 million to the railroad retirement system to fund its share of an estimated shortfall for the entire rail industry. However, Conrail assumed that it would not be obligated to pay these additional costs and, therefore, did not include funds for this purpose in its estimate of additional Federal funding requirements.

The railroad retirement system provides railroad workers with benefits equivalent to Social Security benefits (tier 1) and also provides extra benefits based solely on railroad service (tier 2). For tier 1 benefits, employees' contributions to the retirement fund are matched by Conrail. For tier 2, Conrail (as well as any other railroad) is the sole contributor to the railroad retirement fund. This is in accordance with collective bargaining agreements negotiated with railroad workers' unions.

In its 5-year business plan for the 1978-82 period, Conrail assumes that tier 1 employer contributions would be offset by tariff increases, and that no costs would be assessed against them for tier 2 increases. The business plan does not show how shortfalls would be funded, but the presumption is that the Federal Government will deal with the problem as part of its industrywide consideration of railroad retirement benefits.

A Railroad Retirement Board analysis of retirement funding shows that benefits received by railroad workers have increased almost every year since 1970, and that the cumulative effect from 1970 through 1977 has been to more than double the benefits. While benefits and beneficiaries have increased, the number of employees contributing to the plan has been declining leading to a depletion of the fund. The latest actuarial valuation of the railroad retirement fund shows that employer contributions to the tier 2 portion of the fund were insufficient to cover payments to retired employees. The actuaries estimate that without corrective action the fund will be depleted by 1986.

Maintaining the financial soundness of the tier 2 fund is an industrywide problem. We estimate that the tier 2 shortfall for the railroad industry for the 1978-82 period ranges from $2 billion to $3.6 billion. 1/ We also estimate that Conrail's share of the tier 2 fund ranges from $330 million to $590 million. 1/ Costs of at least these magnitudes could be required for each 5-year period after 1982.

Employee income protection funding (title V)

When Conrail was formed, the Congress included a provision in the legislation which was intended to protect railroad workers' income when adversely effected by the

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1/The lower range is based on the assumption that the fund would not be allowed to fall below its present level for the next decade. The high range assumes that the fund would be placed on an actuarially sound basis over the next 40-year period.

restructuring of bankrupt railroads into Conrail. This income guarantee was provided for in Title V of the Regional Rail Reorganization Act of 1973, as amended, and the Congress authorized $250 million for this purpose.

Funding for title V payments may be depleted by about 1980, and Conrail assumes that additional funds will be made available by the Congress. If additional funding is not made available, Conrail costs could increase by about $90 million for the 1978 business plan period. This amount could increase appreciably as a result of labor negotiations now ongoing between Conrail and the labor unions. Conrail has stated that its estimate for $1.283 billion in additional funding does not include funds for additional title V payments.

The Conrail 5-year business plan states that anticipated labor productivity gains will reduce its number of employees by about 11,500 and that many employees will claim their rights under title V. Thus, Conrail assumes the $250 million fund will be depleted during 1978-82 period and that the fund will be replenished through congressional action. A precise evaluation of the amount of additional Federal funds that will be needed for title V payments cannot be made. However, it appears likely that the existing $250 million fund for title V may de depleted in 1980. We estimate that approximately $90 million in additional funds would be needed to extend this fund through 1982. However, our estimate could change considerably depending on the labor agreements Conrail negotiates.

Should the Congress fund this shortfall, Conrail's income statements for the 1978 to 1982 period will not be affected. If Congress does not elect to continue funding, Conrail may have to provide it. This could affect Conrail's financial statements for as long as 35 years if payments are made in the current manner.

INTEREST OWED THE FEDERAL GOVERNMENT IS UNDERSTATED

Conrail owes interest to the Federal Government for its loans, but does not accrue the expense at its full value in its financial statements. If the accounting procedure was changed and interest recorded at full value, the Conrail projected loss of $35 million for the period would increase to about $219 million. However, the need for Federal funding would be unchanged since Conrail pays interest to the Federal Government in series A stock instead of cash.

Legislation creating Conrail provides for Federal loans up to $1 billion, secured by debenture bonds. Conrail has received all funds authorized under the legislation. In return for these loans, Conrail is required to pay interest at an annual rate of 7.5 percent on bonds outstanding on December 31 of each year. Interest is payable in cash, if available; otherwise in shares of series "A" preferred stock at the rate of one share for each $100 of interest payable. To date, all interest payable on debentures has been paid by issuing series A preferred stock to USRA. The Conrail method of valuing series A preferred stock issued in lieu of cash is currently under review by the ICC. USRA, the recipient of the preferred stock, is recording on its books the face value of each share at $100, whereas Conrail currently records the value at about $4.77 1/ a share. The difference between USRA's and Conrail's treatment is not reflected as an expense on Conrail profit and loss statements.

ICC is currently studying this accounting treatment to determine whether the Conrail treatment is in accordance with generally accepted accounting principles. Should Conrail be required to record such interest at the redemption price of $100 a share, the effect on the Conrail income statements could be significant. We estimate that over the next 5 years such unrecorded interest expense could total about $184 million.

CONCLUSIONS

Conrail will require additional Federal funding beyond the $2.1 billion already appropriated. If current negative trends continue, Conrail will also need more than the additional $1.283 billion forecast by its 1978 business plan. USRA believes that the additional Federal investment needed by Conrail for the period could be as high as $3.8 billion through 1982, with Conrail still being unprofitable at the end of the period. Both Conrail and USRA economic predictions are susceptible to errors because of their forecasting procedures and uncertainties about the validity of historical data they used.

Although Conrail predicts it will begin to make a profit in 1980, 1 year later than estimated by the FSP, the profit is expected to be small for the remaining 2 years of the forecast period. Whereas the FSP predicted a $1.5 billion profit for the 5 years, Conrail now forecasts a net loss of $35 million because of the relatively larger losses in 1978

1/This value will progressively increase during future years.

and 1979. Even this forecast is optimistic since it is based on favorable assumptions concerning several key issues which historically and currently are exhibiting negative trends.

For the forecasted turnaround to happen, Conrail management must take decisive and innovative action to reverse negative trends and make significant positive gains. Specifically, management must improve a deteriorating level of customer service by using available equipment more effectively; increase labor productivity by negotiating necessary work rule changes; make the railroad more efficient by renovating its deteriorated and obsolete yards and terminals; and rationalize its physical plant in order to eliminate non-essential and redundant facilities.

Not everything that needs to be done is within Conrail control, but many things are. Customer service, equipment utilization, and renovation projects are matters management should be able to control and improve.

Since increased contributions to the railroad retirement fund or payments to employees protected under the title V employee protection fund provisions are costs that will most likely have to be borne by the Federal Government if Conrail does not pay for them, we think they should have been included as part of the Conrail estimate of increased Federal funding needed.

RECOMMENDATIONS

We recommend that the Conrail Chairman and Chief Executive Officer take actions necessary to assure that Conrail management (1) expedites its engineering planning and design to firm up projects which are important to turning around Conrail operations, including those needed to improve customer service, equipment utilization, and yards and terminal operations; (2) requests Federal funding in amounts large enough to make the needed improvements; and (3) includes in its requests the full cost they are assuming the Federal Government will bear in estimates of Federal funding needs.

CHAPTER 4
USRA MONITORING OF CONRAIL PERFORMANCE

USRA monitoring has increased in response to Conrail's deteriorating performance and is presently adequate to provide the Congress reasonable and well-supported judgments about Conrail's performance and prospects. In its first report to the Congress on Conrail's operation, USRA did not mention Conrail's reluctance to certify its future profitability, but did caution that it was too early to judge Conrail's future financial self-sufficiency conclusively. In its latest annual report, USRA was specific about Conrail's operational and management problems.

The Regional Rail Reorganization Act of 1973, as amended by the Railroad Revitalization and Regulatory Reform Act of 1976, requires USRA to

--control the flow of Government investment and loan funds to Conrail and

--monitor Conrail performance.

USRA CONTROL OVER CONRAIL REQUESTS FOR FEDERAL FUNDS

A March 12, 1976, financing agreement between USRA and Conrail details the performance reporting, financial management, and recordkeeping requirements Conrail must comply with. A finance committee, consisting of the USRA Chairman and the Secretaries of Transportation and Treasury, has authority to cease or limit USRA investments in Conrail and to waive compliance with or modify conditions governing the purchase of Conrail securities.

The finance committee, upon recommendations of the USRA board has waived several provisions of the financing agreement. This enabled Conrail to

--submit modified certificates accompanying projections which contained no reference to achievement of a "net positive funds position,"

--submit its business plan on February 15, 1978, instead of November 15, 1977; and

--continue receiving Federal funds until June 30, 1978.

The finance committee said the waivers were necessary to achieve the purposes of the acts and the FSP goals.

Modifications to certificates accompanying projections

Pursuant to the financing agreement, Conrail must attach and sign a certificate accompanying projections to its business plan and any other projections submitted to USRA, attesting to the reasonableness of the projections and assumptions and to the likelihood that Conrail will not need Federal financial assistance substantially above amounts already provided for by law of $2.1 billion.

As early as November 1976 Conrail began including an attachment to its certificates accompanying projections which served to further clarify and qualify Conrail's position. According to a USRA official, subsequent attachments to the certificates became more qualified. Conrail officials stated that the attachments were submitted primarily because Conrail questioned whether it could achieve a "net positive funds po tion," which is defined as a situation where cumulative sources of funds equal or exceed the cumulative uses of funds. USRA officials also stated that Conrail meant it was not sure whether it could certify that it would not need any additional Government investment substantially above the $2.1 billion already appropriated or any additional outside financing other than for equipment.

Even though USRA had accepted the Conrail attachments to its certificates since November 1976, it was not until September 28, 1977, that USRA officially and publicly expressed doubts that Conrail could continue to make the representations required in the certificates accompanying projections--particularly concerning Conrail's ability to become self-sustaining within the available $2.1 billion limit. In accordance with the financing agreement, USRA notified the Conrail Chairman and Chief Executive Officer, by letter dated September 28, 1977, of five areas in which doubts existed. USRA stated out that Conrail faced

--lost revenues and increased maintenance and capital expenditures because of the severely deteriorated condition of the equipment fleet,

--lost revenue because of severe winter,

--the possibility of increased labor costs,

--regulatory developments not anticipated in the FSP, and

--a less favorable current economic forecast than anticipated in the FSP.

In a letter dated October 26, 1977, Conrail requested the finance committee and USRA to allow it to submit modified forms of certificates which contain no reference to net positive funds. The Conrail request was discussed at the October 1977 USRA board meeting and rejected. Despite the rejection, USRA, with the concurrence of the finance committee, decided to continue to make funds available to Conrail until February 15, 1978. Subsequently, on February 14, 1978, the finance committee issued a waiver which permitted USRA to accept modified Conrail certificates during the period February 15, 1978, to June 30, 1978. These exclude representations relating to projected achievements of a net positive funds position.

Business plan submission date extended

Because it was experiencing difficulties in achieving its financial goals for 1977, Conrail requested in September that it be permitted to depart from the provisions of the agreement which required Conrail to furnish its 5-year business plan on November 15 for review by USRA. Conrail stated that it would prefer submitting its business plan in two parts: a business plan with projections limited to calendar year 1978 on November 15, 1977, and the balance of the plan, including projections through 1982, to be furnished on February 15, 1978. Conrail and USRA agreed that the 2-part submission would provide Conrail with the time necessary to analyze the problems facing it and to propose the most effective resolutions to those problems.

In view of the above circumstances and upon recommendation of the USRA board, the USRA finance committee issued a waiver on October 12, 1977, authorizing Conrail to submit its plan in two parts. In addition, the finance committee authorized USRA to continue to purchase Conrail securities until February 14, 1978. On February 14, 1978, the finance committee issued another waiver allowing USRA to continue to make investments in Conrail from February 15, 1978, to June 30, 1978.

Finance committee affirmative finding

On February 22, 1978, the finance committee notified Conrail that it had made an affirmative finding that it is not reasonably likely, taking into consideration all relevant factors, that Conrail will be able to become financially self-sustaining without requiring Federal financial assistance substantially in excess of the amounts authorized in section 216 of the Rail Act. As required by the Rail Act, the affirmative finding and related USRA comments were sent to the Congress on March 3, 1978.

Conrail funding recommended by USRA

USRA endorsed the release of Federal funds to Conrail through the conclusion of fiscal year 1979. In its annual report dated May 31, 1978, USRA stated that it supports the additional authorization request by Conrail and a fiscal year 1979 appropriation of $600 million. Beyond 1979, the amount of Federal funding USRA endorses is contingent upon Conrail's ability to solve and turn around its unprofitable trends. USRA has several studies of other options for Conrail underway and will present alternatives for congressional consideration should Conrail not adequately demonstrate resolution of problem areas.

USRA MONITORING HAS INCREASED

USRA monitoring efforts include review and analysis of various monthly and quarterly reports required by a financing agreement between USRA and Conrail, plus data in the Conrail 5-year business plan. USRA aso studies critical problems and assesses operating and financial results. USRA reports Conrail progress to the Congress annually within 150 days after the end of the Conrail fiscal year. These annual reports, mandated by the Law, must include, among other things, evaluations of

--the degree to which the Act is being met,

--variances from financial projections in the FSP,

--Federal funds made available to Conrail and its use of such funds,

--the projected financial needs of Conrail,

--the projected sources of funds, and

--the Conrail ability to become financially self-sufficient.

USRA submitted its first report on May 31, 1977, covering Conrail's first 9 months of operation. USRA concluded that Conrail had achieved or surpassed FSP goals and was meeting regional rail transportation needs and service requirements. USRA did not mention Conrail's certification qualification regarding its ability to achieve self-sufficiency without further Government investment, but did caution that it was too early to judge Conrail's future financial self-sufficiency conclusively.

In its second annual report, released May 31, 1978, USRA reported that Conrail's promising 1976 performance had seriously deteriorated and projected that Conrail would need at least $1.1 billion of additional Federal funds by 1982 under favorable circumstances and up to as much as $3.8 billion additional Federal funds by 1982 assuming less favorable circumstances (Federal funding beyond 1982 would also be needed according to the latter forecast). USRA further stated in its annual report that Conrail's own projection that it will need $1.3 billion more in Federal funding is so close to USRA's optimistic projection that USRA must conclude that there is only a small chance that Conrail's plan will be realized. Given the high probability that Conrail's Government investment requirements will substantially exceed its stated expectations, USRA has begun to examine other options for Conrail that would increase its prospects for attaining financial self-sufficiency or reduce its needs for additional Federal funding. Before requesting funds for Conrail beyond the $1.3 billion now under consideration, USRA will present to the Congress the results of these studies.

The USRA report compared Conrail performance with FSP projections as required, but stated that the FSP is no longer a useful measuring stick and that USRA intends, in the future, to report on Conrail performance and prospects as compared to the Conrail business plans.

The USRA monitoring program, as it now exists, is the product of an evolutionary process. During its first 9 months, when Conrail appeared to be successfully meeting regional rail transportation needs and the FSP goals, USRA stated that it monitored Conrail in a manner that would assure protection for the Government investment and at the same time, afford Conrail the managerial flexibility necessary to become a profitable railroad.

As Conrail began to fall behind its schedule and increase its funding drawdowns and as questions about Conrail prospects surfaced (see our report "Conrail's Attempts to Improve Its Use of Freight Cars," CED-78-23, Jan. 24, 1978, and our staff study "Conrail's Profitability: Framework for Analysis," PAD-78-52, Apr. 10, 1978), USRA enhanced its monitoring program by separating it into two functions (operations and finance), by increasing its staff, and by becoming much more closely involved with Conrail. USRA's board now meets informally with the Conrail board to discuss plans and progress.

Financial monitoring program

The USRA Office of Financial Analysis was required by the financing agreement to monitor the Conrail financial position by reviewing the following reports:

--Monthly, quarterly, and annual financial statements.

--Conrail business plans.

--Conrail interim projections in tracking its business plan.

--Quarterly maintenance reports.

--Comparison and variance analyses explaining differences between actual results and the business plan.

--Conrail reports to the Securities and Exchange Commission, security exchanges, lenders, ICC and shareholders.

--Daily cash receipts and disbursements and 2-week forecasts of the same.

During September 1977, the USRA Office of Audits reported that with respect to its financial monitoring of Conrail

--USRA had not formalized or implemented a comprehensive monitoring program and

--the USRA monitoring program had been limited mainly to the comparison of the actual and forecasted data with similar FSP data or Conrail's prior submissions.

In response to the audit report, USRA formally defined objectives and responsibilities for monitoring Conrail performance and designed a financial analysis program to insure that financial analyses and conclusions were adequately documented. Responsibilities of the Office of Financial Analysis included

--monitoring Conrail financial performance;

--determining the reasonableness of Conrail indicated need for Government investment;

--making independent determinations concerning Conrail's ability to become financially self-sustaining; and

--reporting its findings to the USRA board.

USRA has supplemented its comparisons of actual and forecasted data with similar FSP and business plan projections by including evaluations and interpretations of the data. USRA has also broadened its financial analyses to include reviews on matters such as the Conrail inventory system and claims for loss and damage and personal injury expenses.

Operational monitoring program

The USRA Office of Operations is responsible for

--highlighting differences between the FSP and actual performance;

--analyzing the reasons for the differences; and

--identifying factors that have changed since the FSP.

The Office of Operations had not outlined in writing its monitoring activity in the form of a work program to insure that analyses were adequately documented, and had not prepared a plan for future monitoring efforts. Organizationally the Office of Operations is set up to review (1) local rail service and manpower, (2) operations and cost analyses, (3) marketing, and (4) facilities and equipment.

Some of the activities being pursued are summarized as follows:

Table 4-1
Operational Staff Work Activities

Functional area	Work scope
Local Rail Service and Manpower Group	- Passenger reports and commuter activities, - Abandonments and light-density lines, - Labor agreements,
Operations and Cost Analysis Group	- Actual costs of running trains, - Operational reports,
Marketing Group	- Marketing strategies and sales reports, - Overall economic outlook, - Commodity revenue groups,
Facilities and equipment	- Conrail service, - Onsite inspections, - Maintenance expenses, - Production data

USRA staff emphasizes that its primary responsibility is to present analyses and evaluations to the USRA Board of Directors, which it does through detailed discussions, presentations, and written reports. USRA's only publicly released reports so far have been its annual reports.

USRA staff members said they have a close working relationship with Conrail. They noted that many of their ideas for improving operations have been implemented. USRA staff members emphasized that their recommendations are only advisory even though they control the funding to Conrail. USRA staff members state that they voice their opinions and make suggestions but cannot direct Conrail to take certain action. They maintain that decisions affecting Conrail operations are Conrail management's responsibility.

CONCLUSIONS

Our review of USRA annual reports, board meeting minutes, and documentation provided by USRA staff, lead us to conclude that USRA is capable of providing the Congress reasonable and well-supported judgments about Conrail performance and future prospects.

USRA's most recent annual report to the Congress, dated May 31, 1978, in our judgment, properly identified Conrail problems and poor prospects for achieving self-sufficiency within the original Federal funding level. The report recognized achievements in track rehabilitation and initiatives taken in marketing as well as areas where Conrail has not attained performance goals contemplated in the FSP. Our observations in this report are similar to those reported by USRA.

Although the USRA report is technically adequate, its conclusions, coupled with related finance committee actions, lead us to conclude that USRA has not always provided the Congress complete reports on Conrail performance. As outlined earlier in this chapter, in November 1976 Conrail began qualifying its certification that it would achieve a net positive funds position as planned. USRA did not alert the Congress to this situation in its May 1977 report.

In its presentations to the USRA Board of Directors, the USRA staff outlined its forecast that the most probable outcome of Conrail's next 5 years would requir[illegible] 2.444 billion in Federal funding. However, in its report to the Congress, USRA mentioned only the range of possible funding forecasts and pointed out that the Conrail request for an additional $1.3 billion was so near USRA's optimistic forecast that there was only a small chance Conrail could get by on that amount. Nonetheless, USRA endorsed the Conrail request with a note that it will probably require more than $1.3 billion.

In our opinion, Congress should have been alerted to Conrail problems as soon as possible, and should base any decision it makes on what to do about further funding on the most probable cost, not the cost that would occur if everything goes right.

USRA has also recommended that the FSP be dropped as a measuring stick for Conrail performance, and that Conrail business plans be used instead. We agree that the FSP projections are based on old and sometimes faulty data, and that revised targets based on current knowledge are more reasonable. However, the Congress created Conrail with the understanding that improvements outlined by the FSP and made possible by Federal funding would result in a self-sustaining entity. While the specific quantities forecasted may have been inaccurate, the areas of needed improvement emphasized in the FSP should remain as a guide unless Conrail or USRA can convincingly demonstrate that circumstances have changed or that the FSP was wrong in the first place. As we pointed out in our staff study "Conrail's Profitability: Framework For Analysis"(PAD-78-52 April 1978) it is appropriate to use the most recent plan as a basis for developing reports to the Congress, but it is also important that the framework for evaluating performance does not change frequently.

USRA COMMENTS AND GAO EVALUATION

Commenting on a draft of this report, USRA stated that our conclusion that USRA delayed informing the Congress about Conrail's reluctance to certify its future profitability misconstrues Conrail's certification requirements and implies that USRA failed to carry out part of its monitoring responsibilities.

USRA commented that, in the interests of technical accuracy, we should have noted that the Conrail financing agreement requires Conrail to certify, at various times, only that:

> "It is reasonably likely that Conrail will be able, in compliance with applicable laws, to perform Conrail's Rail Service obligations on a long-term basis while achieving a net positive funds position * * *"

and that there is no requirement that Conrail "certify its future profitability."

They also suggested we note that the certification relating to achievement of a net positive funds position by Conrail is an USRA requirement imposed on Conrail under the terms of the financing agreement, not one imposed by statute, and that there is no requirement either in the Rail Act or elsewhere that USRA immediately inform the Congress about "Conrail's reluctance to certify its future profitability."

USRA commented that Conrail's initial statements were submitted in late 1976, when Conrail was performing markedly better than any of the projections developed by USRA or others. USRA said Conrail's need for Federal funding in 1976 was considerably less than the financing agreement provided, and Conrail's operating results for that year were considerably better (i.e., the loss was less) than projected in the FSP. They also said Conrail's initial statement of clarification and qualification of the certification, submitted in late 1976, definitely did not indicate that Conrail expected future operating performance or financial results to deteriorate. USRA commented that its report on Conrail's performance during 1976, published in May 1977, fully reflected these circumstances.

We have not stated that USRA is required by law to immediately inform the Congress of events such as Conrail's reluctance to certify its future. However, we think an agency responsible for monitoring Conrail and objectively reporting its progress to the Congress would want to do so or at least mention the situation in its annual report. A November 10, 1976, Conrail communication to USRA stated, in part, that preliminary results from Conrail's 5-year planning effort suggested that Conrail's equipment needs may be larger than the FSP projected, and that

> "without further management of capital expenditures or in investments for inventories and receivables, it appears that Conrail's financing requirements still moderately exceed the currently appropriated funds."

While Conrail's statement is not entirely clear, USRA's definite statement in its May 31, 1977 report to the Congress that "Conrail management projects that the company will become self-sustaining within the funding limit of $2.1 billion" seems inconsistent with Conrail's message.

USRA also commented that Conrail should be measured against the financial goals contained in its own business plan once USRA accepts those plans. Nevertheless, USRA said it will continue to monitor Conrail's operational performance and will pay particular attention to operating programs which the FSP identified as being critical to Conrail's turnaround, so that the FSP operating goals or modified goals which USRA believes are most attainable, will continue to be kept. However USRA said the actual timing of operating improvements, as well as Conrail's financial performance, will be measured against Conrail's business plan objectives, rather than the FSP timetable, which has become obsolete after 2-1/2 years of Conrail operation.

USRA commented that it will continue to provide comparisons of Conrail's performance with the FSP as long as the statutory requirements exists. However, USRA said the credibility and usefulness of such comparisons are questionable, particularly in light of drastically lower revenue levels, increasingly divergent underlying economic factors, and Conrail's additional funding requirements.

Commenting on our draft, USRA also pointed out that while it is true that its only publicly-released report so far have been its annual reports, much information USRA has developed has become public through the continuing process of informing the Congress. As examples, they said that in at least four hearings early this year USRA officials answered detailed questions concerning Conrail and responded to additional questions in writing for the record. USRA also briefed concerned members and committee staffs--for example, on December 19, 1977, USRA's president conducted a special briefing for Senate and House staff members on the potential magnitude of Conrail's funding needs based on the preliminary figures furnished by Conrail. USRA said a great deal of information has been made available at each of their Board of Directors meetings during the sessions open to the public under the Sunshine Act, and that USRA's president personally delivered a number of speeches and answered the questions of interested audiences, and has been interviewed several times by the press. USRA cited interviews in September 1977 regarding Conrail's apparent need for additional funds: the Wall Street Journal of September 15 story headlined, "Conrail to require Much More Financing From U.S. Government, USRA Aide Says;" and a September 14 New York Journal of Commerce article pointing out that Conrail would be needing substantially more Federal funding. USRA thinks the evidence is clear that considerably more of their work has been made available to the Congress and the public than our report indicates.

USRA also commented on our statement that it did not mention its forecast of the most probable outcome of Conrail's next 5 years in its May 31, 1978, report to the Congress. USRA said it thought that giving the precise figure would have been and still would be misleading. It said it provides the range from optimistic to pessimistic as a reasonable representation of what is likely to happen, assuming the current ground rules remain unchanged through 1982 (which they almost certainly will not if Conrail's results begin to approach the pessimistic extreme), and knowing also that a simple averaging of the two extremes would give a reasonably accurate estimate of the most probable result. USRA said it had been properly criticized for using point forecasts in the FSP and wanted to avoid putting undue emphasis on one now. USRA also said it thought that a point forecast for Conrail during the 1979-82 period with all of the factors which must be assessed--from the state of the economy to the quality of Conrail's service to the severity of the winters--could encourage Conrail's management to beat the projection, which would be detrimental to Conrail's meeting some of the goals (such as that for service) listed in the Act.

We think USRA clearly stated in its report that Conrail's estimate of $1.3 billion was optimistic and that Federal funding needs were likely to be higher. But we believe the Congress should be as well informed as possible in a situation where final funding requirements will probably be larger than the initial request. The Congress' willingness to provide $2.4 billion in additional funds to Conrail may be different than its willingness to provide $1.3 billion. The USRA forecast indicated that the Congress' approval of the $1.3 billion request will very likely lead to a need for another $1.1 billion, and that by not saying so, USRA may be providing the Congress less information than it needs to properly consider Conrail's request.

United States Railway Association

955 L'Enfant Plaza North, S.W.
Washington, D.C. 20595
(202) 426-1991

Donald C. Cole
President

September 19, 1978

Mr. Henry Eschwege
Director, Community and Economic
Development Division
United States General Accounting Office
Washington, D.C. 20548

Dear Mr. Eschwege:

Thank you for your letter of September 1 and the opportunity to comment on your draft report entitled, "Conrail Faces Continuing Problems." This letter deals with those issues which I consider most substantive. A listing of less substantive changes, typographical errors and editorial changes is attached for your consideration.

The Report (on page 70) alleges that "USRA delayed in informing Congress about Conrail's reluctance to certify its future profitability..." This assertion misconstrues Conrail's certification requirements and implies that the Association failed to carry out part of its monitoring responsibilities.

In the interests of technical accuracy, you should note that the Conrail Financing Agreement requires Conrail to certify, at various times, only that "It is reasonably likely that Conrail will be able, in compliance with applicable laws, to perform Conrail's Rail Service obligations on a long-term basis while achieving a net positive funds position." There is no requirement that Conrail "certify its future profitability."

It should also be noted that the certification relating to achievement of a net positive funds position by Conrail is a requirement imposed by the Association on Conrail under the terms of the Financing Agreement, not one imposed by statute. There is no requirement either in the Rail Act or elsewhere that the Association immediately inform Congress about "Conrail's reluctance to certify its future profitability."

To put the issue of the qualifications to Conrail's certification requirements into perspective, it should be noted that Conrail's initial statements were submitted in late 1976, when Conrail was performing markedly better than any of the projections developed by the Association or others. Conrail's need for federal funding in 1976 was considerably less than the Financing Agreement provided, and Conrail's operating results for

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that year were considerably better (i.e., the loss was less) than projected in the Final System Plan. Conrail's initial statement of clarification and qualification of the certification, submitted in late 1976 definitely did not indicate that Conrail expected future operating performance or financial results to deteriorate. Our report on Conrail's performance during 1976, publishing in May 1977, fully reflected these circumstances.

Conrail formally advised the Association in February, 1977, of the adverse effects the severe winter weather was having on Conrail's operations and financial performance. A more elaborate statement describing the winter difficulties was made in May, 1977. The modifications that signified material reservations to the certification itself were made by Conrail in August, 1977. These modifications led the Association to issue the "substantial doubt" letter of September 28, 1977, informing Congress as well as Conrail that the Association was seriously concerned about the likelihood of Conrail achieving the major projections of the Final System Plan.

(See GAO note 1, p. 65.)

The Association believes that Conrail should be measured against the financial goals contained in its own business plans once those plans are accepted by the Association. Nevertheless, the Association will continue to monitor Conrail's operational performance and will pay particular attention to operating programs which the FSP identified as being critical to Conrail's turnaround. Thus, the operating goals of the FSP, or modified goals which USRA believes are most attainable, will continue to be kept. However, the actual timing of operating improvements, as well as Conrail's financial performance, will be measured against Conrail's Business Plan objectives, rather than the FSP timetable, which has become obsolete after 2-1/2 years of Conrail operation.

USRA will continue to provide comparisons of Conrail' performance with the FSP as long as the statutory requirements exists. However, the credibility and usefulness of comparisons are questionable, particularly in light of drastically lower revenue levels, increasingly divergent underlying economic factors, and Conrail's additional funding requirements.

Changes in the overall level of economic activity in Conrail's service

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area may affect dramatically the carrier's ability to realize FSP revenue levels. Additionally, USRA anticipates greater levels of inflation and lower levels of real growth than those contemplated in the FSP, both of which will have a detrimental impact on the railroad's ability to become financially self-sustaining. Finally, required accounting changes make comparisons of Conrail's actual data to the FSP increasingly more difficult and less precise. While the Association has been able to restate the FSP for changes in certain accounting methods (most significantly, the capitalization of long-term leases), Conrail has begun using the new ICC Uniform System of Accounts, which segregates data in categories previously not required. While many of the changes in the new ICC System of Accounts can easily be restated, a few will require very crude estimations to obtain previously unsegregated data. The Association questions the usefulness of comparisons to an FSP data base that is subject to such potential distortions.

While it is true that USRA's only publicly-released reports so far have been its annual reports (page 80), much information developed by our staff has become public through the continuing process of informing Congress of our work. For example, in at least four hearings early this year, we answered detailed questions concerning Conrail and responded to additional questions in writing for the record. We have also briefed concerned members and committee staffs. In fact, on December 19, 1977, I conducted a special briefing for Senate and House staff members on the potential magnitude of Conrail's funding needs based on the preliminary figures furnished by Conrail. A great deal of information has been made available at each of our Board of Directors meetings during the sessions open to the public under the Sunshine Act. In addition, I have personally delivered a number of speeches and answered the questions of interested audiences, and have been interviewed several times in the press. For example, there were key interviews in September, 1977, regarding Conrail's apparent need for additional funds. The Wall Street Journal of September 15 carried a story headlined, "Conrail to Require Much More Financing From U. S. Government, USRA Aide Says." On September 14, the New York Journal of Commerce pointed out that Conrail would be needing substantially more federal funding. This story was picked up and carried by many other newspapers and trade publications at the time. The evidence is clear, I think, that considerably more of our work has been made available to Congress and the public than indicated in your Report.

There are two pieces of information included in your draft report that, though we had the information, we elected not to include in our Report to Congress. The first of these is the precise figure of $2.444 billion as our most probable estimate of Conrail's need for Federal Funding under existing circumstances. We thought that giving the precise figure would have been, and still would be, misleading. We provided the range from optimistic to pessimistic as a reasonable representation of what is likely to happen, assuming the current ground rules remain unchanged

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through 1982 (which they almost certainly will not if Conrail's results begin to approach the pessimistic extreme), knowing also that a simple averaging of the two extremes would give a reasonably accurate estimate of the most probable result. We had been criticized, properly in our opinion, for using point forecasts in the FSP. We wanted to avoid putting undue emphasis on one here. We also thought that a point forecast for Conrail during the 1979-82 period with all of the factors which must be assessed - from the state of the economy to the quality of Conrail's service to the severity of the winters - could encourage Conrail's management to beat the projection which would be detrimental to Conrail's meeting some of the goals, such as that for service, listed in the 3R Act.

The second piece of information is a listing of Conrail's locomotive fleet problems during the first quarter of 1978 which was presented to our Board of Directors. We did not include this specific material in our Report to Congress because we had evidence that Conrail was constructively dealing with the situation. While we are still not satisfied by Conrail's level of service, we think that deficiencies in this case and in those of trains delayed waiting for power are more related to locomotive distribution practices than to poor maintenance practices. Winter will provide a much clearer answer to the adequacy of Conrail's accelerated locomotive maintenance program.

(See GAO note 1, p. 65.)

In general, when publishing utilization figures, one should define the measure used and the time period involved. There is no single undisputed "utilization" statistic.

It should be pointed out that there has been a considerable change in the mix in business in Conrail's territory since 1973 and a much larger percentage of its traffic terminates on Conrail than did on the Penn Central in 1973. This was one of the factors which led to the reassessment of our consultant's work in calculating the original forecast of 28% improvement in car utilization (car days on line per originated load) by 1981.

We would characterize the results of the reassessment as follows: In March, 1978, USRA reviewed the estimate and found the situation had changed. Some of the original assumptions were invalid. USRA then stated that the original methodology with these assumptions properly restated would now result in a forecast that Conrail would achieve by 1982 only half of the 28% improvement, 14% over the 1973 base. USRA still believes that utilization improvements of 28% are attainable at some point.

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We did not recalculate the resulting effect in 1976 and 1977 car-hire expenses because the difference between the FSP and the actual results reflects the 10% decrease in the rate of car utilization (car days on line per originated load) between 1973 and March 31, 1976. (There were almost no decreases in car days on line per originated load forecast in the FSP for the period April 1, 1976 - December 31, 1977).

There is no reference in the FSP to the cost for installing a new operating control system. The consultant's report (June 1975) estimates the cost for development and implementation of a new OCS at $4.7 million, with incremental annual costs of $3.2 million. However, it should also be noted that the FSP included a large inefficiency factor in General and Administrative expenses. Over the first 21 months of operation, Conrail spent $141 million less in this category than projected in the FSP. This trend has continued in 1978.

On page 11, the draft report deals with the deviation between Conrail's revenue and its forecast. Our analysis indicates that reduced volume was mainly due to external conditions rather than to equipment problems. Lost revenues attributed to external events amounted to $118.7 million while those attributed to equipment shortages amounted to $33.6 million.

The report mentions revenue is affected by equipment problems, strikes, adverse weather, a depressed economy in certain industries, and lower general rate increases than expected. There is no doubt that each of these factors exerted a negative influence on Conrail's revenue in 1977. However, Conrail also lost business because of its failure to provide a competitive level of service on a consistent basis and its inability to implement the strategies developed in its Lines of Business analysis in a timely fashion, as well as to develop and implement a car utilization and distribution system to get the proper equipment to customers promptly.

The report appears to indicate that equipment shortage was the major factor causing Conrail to lose traffic. It states that the lack of serviceable locomotives was one factor which prohibited Conrail from attaining better utilization of the available car fleet. However, the lack of equipment was only one of the negative influences depressing Conrail's revenue during 1977. USRA's staff believes the shortfall in revenue occurred due to a combination of all the factors mentioned above and that the failure to provide competitive service on a consistent basis was the major negative influence.

We share your concern about Conrail's performance in completing capital projects designed to yield sizeable rates of return. We would urge the cover summary be revised to state that "only now is this need beginning to be addressed."

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Further, on page 57, your report states "Expenditures for 1978 are currently about $8 million behind schedule." Conrail's historical financial statements include two non-operating expenditures totaling $8 million which were not included in Conrail's Business Plan: a $3 million capitalized computer lease and a $5 million legal settlement with the Lehigh and Susquehanna Railroad. Thus, while Conrail's additions and improvements appear to be $9 million below, they are actually $17 million below Business Plan levels through June 30, 1978.

We have three suggestions concerning the Digest. First, on page v we would suggest the inclusion of the sentence from page 81 concerning our 1978 Report to Congress, as well as reference to the similarity of the Conrail operational issues covered in our reports. I appreciate the fact that Chairman O'Neal of the ICC recently did this in a cover letter to his staff's "Early Warning Report."

Finally, concerning the reasons for the poor quality of Conrail's service, the discussion on iv and 9 is not inconsistent with our explanation but is an oversimplification. The Report discussion excludes, for example, car shortages, misroutings and an effective car control system. These factors should be included.

(See GAO note 1, p. 65.)

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(See GAO note 1, p. 65.)

Conrail's forecasted and actual volume for the year 1977 follows:

	1977	
	Carloads[1]	Freight Revenue (Millions $)[2]
A. Forecasted	5,402,200	$ 2,915.9
B. Actual	4,838,483	2,718.0
C. Change		
1. Absolute	(563,717)	(197.9)
2. Percent	(10.4%)	(6.8%)

[1]Actual carloads for 1977 determined by dividing actual TOFC/COFC units handled by 1.8 units per carload and adding to actual units handled for remaining commodity groups.

[2]Gross Freight Revenue. Forecasted revenue at Ex-Parte 336 level.

USRA is of the opinion that, while Conrail's forecast for 1977 could have been somewhat optimistic, the demand identified in the forecasting process was more indicative of the traffic available to Conrail than actual results indicate. Conrail's volume in 1977 was constrained by the negative factors mentioned as the reasons for reduced volume on page 11.

The first sentence on page 40 indicates that "Conrail's projected financial statements do not recognize total interest owed to the Federal Government by Conrail because of an accounting procedure that discounts the interest." Without further clarification this sentence is misleading. Under the "cash available" formula set forth in the Financing Agreement, interest owed to the Federal Government may be paid in Series A stock and is not considered a cash cost until either $500 million in retained earnings has been achieved (excluding consideration of interest on debentures or deferred income tax) or 1982

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whichever occurs later. Thus, inclusion of "total interest owed to the Federal Government" in a discussion of cash needs is inappropriate at this time since current interest is properly carried by Conrail as a non-cash item.

In discussing the reasons for the bankruptcy of the railroads which later formed Conrail (page 2), the subsidy relationships between the Federal Government and the modes competing with the railroads in the East should be mentioned since the timing of major improvements, such as the completion of major stretches of I-80, had marked and measureable impacts on the railroads' traffic base.

As a matter of historical information, the Allentown yard constructed by the Central Railroad of New Jersey in the early 1930's was not the western terminus of that road. It separated westward traffic on its own line from that going to the Reading Company. The Central Railroad of New Jersey continued to go westward as far as Scranton, Pennsylvania, even after its bankruptcy in 1967.

We wish to express our deepest thanks for your kind attention to the matters raised in this lengthy letter. It is our purpose and our desire to assist Conrail in solving the serious problems it faces. A full understanding of these problems on the part of Congress and the public can only help in the achievement of this goal.

Very truly yours,

Donald C. Cole
President

GAO note 1: Portions of this letter have been deleted because they are no longer relevent to the matters discussed in this report.

GAO note 2: Page references in this appendix refer to the draft report and do not necessarily agree with the page numbers in the final report.

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