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STATEMENT OF
BALTAS E. BIRKLE, DEPUTY DIRECTOR
COMMUNITY AND ECONOMIC DEVELOPMENT DIVISION

BEFORE THE
HOUSE SUBCOMMITTEE ON TRANSPORTATION AND COMMERCE
OF THE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE 2306
ON
[CONRAIL'S REDUCED CAPITAL SPENDING PROGRAM]

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

WE ARE HERE TODAY TO DISCUSS OUR REVIEW OF CONRAIL'S
OPERATIONAL AND FINANCIAL PROJECTIONS FOR 1980-1984, AND THE
RISKS INHERENT IN ITS STRATEGY FOR LIMITING ITS USE OF
FEDERAL FUNDING. CONRAIL'S 5-YEAR BUSINESS PLAN DATED
AUGUST 1, 1979, CALLED FOR REDUCED CAPITAL EXPENDITURES DUR-
ING 1980 AND 1981, AND CATCH-UP SPENDING IN THE LATER YEARS.
CONRAIL DECIDED ON THIS STRATEGY IN ORDER TO STAY WITHIN THE
CURRENT FEDERAL INVESTMENT LIMIT OF \$3.3 BILLION DOLLARS.
THE KEY ASSUMPTION IN CONRAIL'S PLAN IS THAT REGULATORY RE-
FORMS WILL MAKE IT POSSIBLE FOR CONRAIL TO EARN SUFFICIENT
REVENUES TO REJUVENATE ITS CAPITAL PROGRAMS IN 1982. IN ITS
AUGUST PLAN, CONRAIL ASSUMED IT WOULD BE COMPLETELY DEREGU-
LATED, AND ALLOWED TO FUNCTION AS THOUGH IN A FREE MARKET
SUBJECT ONLY TO LIMITATIONS SPECIFICALLY NEEDED TO PROVIDE
PROTECTION AGAINST MARKET ABUSES.

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CONRAIL BEGAN OPERATIONS ON APRIL 1, 1976, WITH A FEDERAL COMMITMENT OF \$2.1 BILLION TO COVER EARLY OPERATING LOSSES AND TO SUPPORT REHABILITATION AND IMPROVEMENT PROJECTS. HOWEVER, CONRAIL'S FIRST FEW YEARS OF OPERATION SHOWED THAT MORE FEDERAL FUNDING WOULD BE NEEDED, AND IN 1978 CONGRESS AUTHORIZED AN ADDITIONAL \$1.2 BILLION BRINGING THE TOTAL AVAILABLE FEDERAL COMMITMENT TO \$3.3 BILLION. IN ITS 1979 PLANNING PROCESS, CONRAIL FACED THE FACT THAT AUTHORIZED FEDERAL FUNDING WOULD RUN OUT IN 1981 IF IT MAINTAINED ITS EXISTING RATE OF SPENDING, AND HAD TO CHOOSE BETWEEN CONSERVING THE FEDERAL FUNDING BY CUTTING BACK ITS CAPITAL SPENDING FOR IMPROVEMENTS, REHABILITATION, AND MAINTENANCE, OR REQUESTING ADDITIONAL FEDERAL FUNDING.

CONRAIL'S PLANNING PREMISES

ON MARCH 15, 1979, CONRAIL SUBMITTED A 5-YEAR BUSINESS PLAN TO THE UNITED STATES RAILWAY ASSOCIATION, WHICH PROJECTED A CUMULATIVE FEDERAL FUNDING NEED OF \$4.082 BILLION THROUGH 1983, \$782 MILLION MORE THAN THE \$3.3 BILLION AUTHORIZED BY CONGRESS. THE MARCH PLAN ASSUMED THERE WOULD BE LITTLE REGULATORY CHANGE DURING THE 5 YEARS, AND CONRAIL PLANNED TO SPEND \$1.936 BILLION FOR TRACK REHABILITATION AND \$728 MILLION FOR ADDITIONS AND IMPROVEMENTS.

HOWEVER, LESS THAN 5 MONTHS LATER, ON AUGUST 1, 1979, CONRAIL MODIFIED ITS PLANS, MAINLY BY ASSUMING THAT REGULATORY CHANGES WOULD BE ACHIEVED EARLY IN THE 5-YEAR PERIOD. ALSO, IN ORDER TO STAY WITHIN THE AUTHORIZED FEDERAL FUNDING

LIMIT, CONRAIL REDUCED ITS CAPITAL SPENDING PROGRAM FOR TRACK REHABILITATION AND ADDITIONS AND IMPROVEMENTS IN 1980 AND 1981 BY ABOUT \$379 MILLION. CONRAIL BELIEVED THAT ESTIMATED TRAFFIC LEVELS AND PRICES UNDER A CHANGED REGULATORY ENVIRONMENT WOULD PROVIDE SUFFICIENT REVENUES TO ALLOW THE CAPITAL PROGRAM TO BE RESTORED IN 1982.

TRACK REHABILITATION

TO IMPROVE ITS OPERATIONS, CONRAIL HAS BEEN COMMITTED TO A MASSIVE TRACK REHABILITATION PROGRAM. SINCE IT WAS CREATED, CONRAIL HAS LAID ABOUT 3,800 MILES OF RAIL AND INSTALLED ABOUT 16 MILLION TIES, A PROGRAM DESIGNED TO PREVENT FURTHER DETERIORATION AND REDUCE DEFERRED MAINTENANCE. IN MARCH 1979, WHEN CONRAIL PLANNED TO SUSTAIN ITS CAPITAL SPENDING PROGRAMS, IT EXPECTED TO LAY 876 MILES OF TRACK AND 3.2 MILLION TIES ANNUALLY DURING 1980-1983. HOWEVER IN ITS AUGUST PLAN, CONRAIL CUT BACK ITS PROGRAMS FOR 1980 AND 1981 TO 240 MILES OF RAIL AND AN AVERAGE OF 1.4 MILLION TIES FOR THE 2 YEARS. CONRAIL'S RECORDS SHOW THAT TO MAINTAIN ITS EXISTING TRACK CONDITION, IT WOULD NEED TO REPLACE ABOUT 725 MILES OF RAIL AND 2.8 MILLION TIES ANNUALLY.

IN ITS AUGUST PLAN, CONRAIL PROJECTED THAT IT WOULD BE ABLE TO INCREASE ITS SPENDING ON CAPITAL PROJECTS IN 1982 AND 1983, BUT THAT THE NET CUTBACK DURING 1980-1983 RELATIVE TO ITS MARCH PLAN WOULD STILL BE 1,576 MILES OF RAIL AND 4 MILLION TIE REPLACEMENTS. CONRAIL INTENDS TO SOFTEN THE

IMPACT OF THE RAIL AND TIE PROGRAM CUTBACKS BY INCREASING EXPENDITURES FOR OTHER KINDS OF MAINTENANCE SUCH AS SURFACING.

ADDITIONS AND IMPROVEMENTS PROGRAM

THE ADDITIONS AND IMPROVEMENTS PROGRAM, PARTICULARLY FOR YARDS AND TERMINALS, HOLDS GREAT POTENTIAL FOR OPERATING IMPROVEMENTS AND BETTER PRODUCTIVITY. ON OCTOBER 6, 1978, WE RELEASED A REPORT ENTITLED "CONRAIL FACES CONTINUING PROBLEMS" EMPHASIZING THAT YARD AND TERMINAL REHABILITATION AND MODERNIZATION PROJECTS WERE CRITICAL AND THAT THESE PROGRAMS WERE FALLING FAR SHORT OF GOALS. WE CONCLUDED THAT UPGRADING YARDS AND TERMINALS WAS IMPORTANT TO EXPEDITING FREIGHT CAR HANDLING AND IMPROVING CUSTOMER SERVICE, BOTH CRUCIAL TO CONRAIL'S LONG-TERM VIABILITY. DURING 1978, CONRAIL ATTRIBUTED ITS SLOW-STARTING YARD AND TERMINAL PROGRAM TO PROBLEMS ASSOCIATED WITH ORGANIZING A LARGE CAPITAL PROGRAM AND OVERCOMING INERTIA AS WELL AS MANAGEMENT'S DECISION TO SPEND MORE TIME ON ANALYSIS TO ASSURE MONEYS WERE SPENT WISELY. TOWARD THE END OF 1978, WE FELT THE PROGRAM WAS BEGINNING TO SHOW SOME VITALITY, AND CONRAIL NEARLY MET ITS PROGRAM EXPENDITURE GOAL FOR THE FIRST TIME IN 1979.

CONRAIL'S AUGUST PLAN PROPOSED A \$90 MILLION ADDITIONS AND IMPROVEMENTS PROGRAM FOR 1980, A 36 PERCENT REDUCTION FROM ITS MARCH PLAN, AND CONSIDERABLY LESS THAN IT SHOULD BE INVESTING. CONRAIL ESTIMATES THAT A MORE APPROPRIATE

LEVEL WOULD BE ABOUT \$123 MILLION. THE UNITED STATES RAILWAY ASSOCIATION STAFF ESTIMATES CONRAIL SHOULD BE SPENDING FROM \$130 MILLION TO \$150 MILLION FOR ADDITIONS AND IMPROVEMENTS. AS WITH THE TRACK PROGRAMS, CONRAIL PLANNED TO INCREASE ADDITIONS AND IMPROVEMENTS EXPENDITURES IN 1982 AND 1983 TO OFFSET THE REDUCTIONS.

RISKS ASSOCIATED WITH A
DEFERRED CAPITAL PROGRAM

WE BELIEVE THAT CURTAILING CAPITAL PROGRAMS IN 1980 AND 1981 TO STAY WITHIN THE CURRENT \$3.3 BILLION FEDERAL FUNDING CREATES AN UNACCEPTABLE RISK. REDUCED CAPITAL INVESTMENTS COULD RESULT IN PLANT DETERIORATION AND A RETURN TO DECLINING SERVICE QUALITY, THEREBY ERODING THE BENEFITS GAINED FROM THE ALREADY SIGNIFICANT FEDERAL INVESTMENT. CONRAIL ASSUMED IN ITS PLANS THAT REGULATORY REFORM WOULD ENABLE IT TO MAKE PRICING AND PLANT RATIONALIZATION CHANGES THAT WOULD PRODUCE REVENUES IT COULD USE TO REJUVENATE ITS CAPITAL PROGRAMS. BUT REGULATORY REFORM MAY NOT ALLOW THE FREEDOMS CONRAIL ANTICIPATED. FURTHER, REVISED CONRAIL ESTIMATES FOR REDUCED TRAFFIC AND NET INCOME IN 1980 CAUSE US TO DOUBT WHETHER CONRAIL CAN GENERATE SUFFICIENT REVENUE TO SUPPORT INCREASED INVESTMENT PROGRAMS IN 1982.

BECAUSE OF ITS CONCERN OVER THE CAPITAL DEFERMENTS ISSUE AND THE UNCERTAIN STATUS OF REGULATORY REFORM, THE UNITED STATES RAILWAY ASSOCIATION REQUESTED CONRAIL TO SUBMIT ALTERNATIVE BUDGETS AND PLANS REFLECTING CAPITAL

PROGRAMS AT MORE APPROPRIATE SPENDING LEVELS. CONRAIL THEN ESTIMATED THAT IF THERE IS NO FEDERAL REGULATORY REFORM, AN ADDITIONAL \$587 MILLION IN FEDERAL FUNDING WOULD BE NEEDED IN 1981 TO FINANCE CAPITAL PROGRAMS AT MORE APPROPRIATE LEVELS AND TO COVER HIGHER PROJECTED OPERATING LOSSES IN 1980 AND 1981. FOR THESE 2 YEARS, CAPITAL INVESTMENT IN TRACK, AND ADDITIONS AND IMPROVEMENTS WOULD BE INCREASED BY \$326 MILLION. CONRAIL ESTIMATES IT COULD CARRY OUT THE HIGHER CAPITAL PROGRAM IN 1980 WITH AUTHORIZED FUNDING BUT THAT FEDERAL FUNDING WOULD BE EXHAUSTED BY THE YEAR END.

OUR CONCLUSION THAT CONRAIL'S CAPITAL SPENDING PLANS ARE UNACCEPTABLY RISKY IS BASED ON CONRAIL'S TECHNICAL JUDGMENT ABOUT THE SPENDING LEVELS NEEDED TO PREVENT ITS TRACK SYSTEM FROM DETERIORATING AND OUR UNCERTAINTY ABOUT THE OUTCOME OF REGULATORY REFORM. IN ITS AUGUST PLAN, CONRAIL SAID THAT DURING 1980 AND 1981 IT WILL SPEND CONSIDERABLY LESS ON TRACK REHABILITATION AND ADDITIONS AND IMPROVEMENTS THAN WOULD BE APPROPRIATE TO SYSTEM SIZE AND VOLUME. IT SAID THAT THESE PROGRAM CUTBACKS WILL RESULT IN A CERTAIN AMOUNT OF DEFERRED MAINTENANCE AND A REDUCTION IN EFFICIENCIES ASSOCIATED WITH ASSET IMPROVEMENT. CONRAIL INTENDS TO HAVE HIGHER-THAN-NORMAL SPENDING IN 1982 AND FUTURE YEARS AND IT EXPECTS TO PAY FOR THE CATCH-UP COSTS WITH INCREASED REVENUES THAT WILL BE MADE POSSIBLE BY REGULATORY REFORM.

WE THINK THE LOGIC OF THE SITUATION ARGUES FOR CONTINUED CAPITAL SPENDING AT LEAST AT THE LEVEL NEEDED TO KEEP THE SYSTEM IN ITS CURRENT CONDITION. THIS IS NOT A TECHNICAL JUDGMENT, BUT INSTEAD WAS REASONED OUT AS FOLLOWS. IF CONRAIL FOLLOWS ITS CURRENT PLAN AND DEFERS CAPITAL SPENDING, TWO THINGS COULD HAPPEN: IT MIGHT BE ABLE TO INCREASE ITS REVENUES ENOUGH TO PROVIDE THE FUNDS NEEDED TO REJUVENATE ITS REHABILITATION AND MAINTENANCE PROGRAMS, OR IT COULD CONTINUE TO LOSE MONEY, AND WOULD EITHER HAVE TO SEEK ADDITIONAL FUNDING FROM THE GOVERNMENT OR CONTINUE DEFERRING ITS CAPITAL PROGRAMS.

ON THE OTHER HAND, IF CONRAIL CONTINUED CAPITAL SPENDING AT THE LEVEL NEEDED TO MAINTAIN THE SYSTEM IN ITS CURRENT CONDITION, IT WOULD REQUIRE ADDITIONAL FEDERAL FUNDING IN 1982. IF IT IS ABLE TO INCREASE REVENUES ENOUGH TO PROVIDE FUNDS FOR CAPITAL PROGRAMS, THE NEED FOR ADDITIONAL FEDERAL FUNDING WOULD BE MINIMIZED BECAUSE CATCH-UP MAINTENANCE AND REHABILITATION WOULD NOT BE NEEDED AND CONRAIL WOULD BE ABLE TO PAY FOR ITS OWN CAPITAL PROGRAMS SOONER. EVEN IF CONRAIL CONTINUED TO LOSE MONEY, THE NEED FOR ADDITIONAL FEDERAL FUNDING WOULD STILL BE MINIMIZED BECAUSE CATCH-UP MAINTENANCE WOULD NOT BE NEEDED.

IN OUR MARCH 10 REPORT WE SUGGESTED THAT THE CONGRESS HAS SEVERAL OPTIONS FOR RESPONDING TO CONRAIL'S SITUATION. THESE OPTIONS ARE NOT MUTUALLY EXCLUSIVE AND THE OPTIMUM

RESPONSE MAY VERY WELL BE SOME COMBINATION OF TWO OR MORE
OPTIONS. THE CONGRESS CAN

- DEFER ANY ACTION;
- PLEDGE ADDITIONAL FUNDS;
- ENACT REGULATORY REFORMS; OR
- SEEK AN ALTERNATIVE SOLUTION TO RAIL PROBLEMS
IN THE NORTHEAST.

WE ARE NOT RECOMMENDING THAT THE CONGRESS DIRECT CONRAIL TO
MAINTAIN APPROPRIATE CAPITAL SPENDING PROGRAMS AND PLEDGE
ADDITIONAL SUPPORT IF NEEDED, ONLY BECAUSE WE RECOGNIZE THE
NEED TO CONSTRAIN FEDERAL OUTLAYS, AND THAT THE CONGRESS
MUST CHOOSE BETWEEN THIS AND MANY OTHER POSSIBLE USES FOR
SCARCE FEDERAL FUNDS. AS WE STATE IN OUR REPORT, THE PRE-
PONDERANCE OF OUR WORK RELATING TO THE RAILROAD INDUSTRY
SUGGESTS THAT SUBSTANTIAL REGULATORY REFORMS ARE NEEDED.
WE ARE NOT ENDORSING A PARTICULAR APPROACH TO REGULATORY
REFORM, BUT ENCOURAGE RESOLUTION OF THE MATTER AS SOON
AS PRACTICABLE.

CONRAIL DISAGREES WITH OUR CONCLUSION THAT REDUCED
CAPITAL SPENDING CREATES AN UNACCEPTABLE RISK. IT BE-
LIEVES REGULATORY REFORM AND OPERATIONAL IMPROVEMENTS WILL
PERMIT REJUVENATION OF CAPITAL SPENDING BEFORE ANY SERIOUS
DETERIORATION OCCURS.

THE DEPARTMENT OF TRANSPORTATION ALSO DISAGREED WITH
OUR CONCLUSION THAT A 2-YEAR REDUCTION IN CAPITAL SPENDING
WOULD CREATE AN UNACCEPTABLE RISK TO THE FEDERAL INVESTMENT

AND CONRAIL'S FUTURE PROFITABILITY. IT NOTED THAT CONRAIL AND THE UNITED STATES RAILWAY ASSOCIATION AGREE THAT REDUCING MAINTENANCE PROGRAMS FOR 2 YEARS WILL NOT CAUSE SERIOUS PROBLEMS IF CATCH-UP FUNDS ARE AVAILABLE AT THE END OF THAT PERIOD. WE AGREE THAT A SHORT-TERM REDUCTION IN CAPITAL PROGRAMS MAY NOT BE CRITICAL, BUT THINK THAT REDUCED CAPITAL SPENDING BEYOND 2 YEARS COULD RISK A RETURN TO AN INADEQUATE RAIL FREIGHT SYSTEM IN THE NORTHEAST.