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CONRAIL:

Government Creation

&

Privatization of an American

Railroad

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CONRAIL:
Government Creation And Privatization
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Three major railway institutional reforms have been achieved in the United States in the past 20 years--the formation of Amtrak, the formation and eventual privatization of Conrail, and rail rate deregulation. Taken together, they represent the outcome of a series of major initiatives which are necessary if "public enterprises" are to bridge the gap between purely private competition and the provision of a public service. This paper chronicles the Conrail experience.

Conrail has its roots in a myriad of privately-owned railroads formed in the nineteenth century. In this earlier era, the Northeastern region of the US was a thriving, industrialized economy, almost totally dependant on rail transport. The consequent power and wealth of the Northeastern railroads resulted first in a veritable thicket of competing railway lines, next in a period of monopoly creation and financial exploitation which gave new meaning to the phrase "Robber Barons", and culminated in an environment of political hostility and harmful regulatory intervention which continued unabated for nearly 90 years until the early seventies. This process is, in fact, a clear illustration of the ways in which political myths and current realities can diverge to the detriment of society. In a very real sense, the last 20 years of rail transportation policy development in the US, including the formation of Conrail and Amtrak, can be seen simply as the problems arising from the need to reconcile fact versus myth. The adjustment was not easy, and it is not over.

The long decline in market share of the US railway industry, both for passengers and for freight, began with the emergence of competition--at first trucks, buses and private automobiles, and later air. World War II intervened to arrest this trend; but afterwards, the return to a more normal economy, followed by the Interstate Highway program in the fifties, produced a dramatic erosion in rail's competitive position for passengers and for merchandise traffic. This trend was nowhere more serious than the Northeast because demographic and economic forces were shifting the locus of growth elsewhere in the nation. As a result, most of the railroad companies serving the Northeast/Midwest region grew progressively weaker in the two decades after the War. Some companies, such as the New Haven and the Boston and Maine, failed and operated under the protection of bankruptcy proceedings. Others, notably the Pennsylvania Railroad and the New York Central Railroad chose to merge (forming the Penn Central Railroad), hoping that the economies of line abandonment and eventual labor force rationalization would aid in their survival.

Unfortunately, the myth of the fabulously wealthy railroad, able to bear without compensation any "public service" obligation imposed on it by the Congress, the Interstate Commerce Commission, the labor unions, or State legislatures, was simply too powerful. Only a major financial "train wreck", involving the Penn Central along with most of the other Northeastern railroads, could create the circumstances under which the myth could be seriously questioned.

In 1971, when the Penn Central first entered bankruptcy, very little changed. The assumption was, as had always been true in major rail reorganizations, that a capital restructuring would solve the problem. Only after three years of struggle did the Penn Central trustees and the bankruptcy judge reach the conclusion that the Penn Central was so burdened by uneconomic services, irrational rates and excess labor that revenues would not--could not--even cover cash operating costs. Even this inconvenient conclusion would not have had much result under prevailing law and transport policy except for the fact that, once the judge reached this stage, he had the power and the responsibility under the US Constitution to halt operations and liquidate the railroad in order to pay the creditors. From today's perspective, it seems almost incredible that, just at the time that the judge was preparing to close the railroad because it was impossibly uneconomic, the labor unions were preparing to strike in an intransigent defense of their right to "featherbed". The resulting crisis at last posed the unavoidable choice: "do something, or lose the railroad".

At first, typically, the Congress chose to do as little as possible: it provided some money to the railroad to keep going, refused to let the labor practices be changed as the trustees were demanding, ordered the Secretary of Transportation to study the situation, and hoped the problem would go away. Only when this approach proved ineffective did the Congress and the President agree on passage of the first of three major pieces of legislation, the "Railroad Revitalization and Regulatory Reform Act of 1976", popularly called the "4R" Act.

The 4R Act is the foundation for the process which followed. First, it acknowledged that change was necessary (although it was vague as to the nature of that change). It created the United States Railway Association (USRA) as an independent agency with the authority to develop comprehensive strategic business and financial plans (called the Preliminary and Final System Plans) for the reorganization of the bankrupt railroads and, after public comment and Congressional acceptance, to implement the final plan. Finally the Act provided that the Penn Central and six other Northeastern bankrupt carriers could be merged into a new entity called Conrail, and that the Federal government would guarantee that the creditors would be fairly compensated for the taking of their property.

The Final System Plan was only partly successful. It did succeed in establishing Conrail. Some unprofitable branchlines were abandoned, and the long and expensive program of rebuilding the properties which had suffered years of deferred maintenance was begun. As a start it was crucial. Even so, many of the clearly critical

problems of redundant labor and uneconomic commuter services (Amtrak had essentially resolved the intercity passenger deficits) were not adequately addressed. To some extent this was because the forecasts of USRA were sufficiently (and erroneously) favorable that painful change for Conrail was not yet clearly necessary. More important, the broader political consensus needed to support a change in the national policy towards rate and service regulation did not yet exist. Four more years of unprofitable performance by Conrail, two more rail bankruptcies in the Midwest, and continuing deterioration in financial performance by all of the railroads were required before the final two steps could be taken.

The first, and the most important from the industry's point of view, was the "Staggers Act" of 1980, which substantially relaxed the regime of rate and service regulation under which the railroads had suffered for so long. Railroads were allowed to sign confidential and essentially unregulated contracts with their customers and, except where a railroad is shown to be earning an adequate rate of return on its overall operation (which has not happened yet), were allowed to set all other rates without ICC interference unless the proposed rate in question could be shown to be unduly high (which has rarely happened). The Staggers Act started a financial renaissance for the entire rail industry which continues until the present. While Conrail was one of the primary beneficiaries, Conrail was also the reason why the underlying irrationality of regulation came to be recognized: when faced with the unavoidable choice of subsidizing Conrail or letting the rail shipper pay more reasonable rates, Congress chose the latter.

The next major step arrived when, with Conrail offering no real promise of ending its requirements for continuing Federal operating subsidy, Congress and the President faced the issue of what Conrail's future should be. Three factors were important: the election of Ronald Reagan and the appointment of Drew Lewis as Secretary of Transportation meant that there would be unrelenting pressure from the Executive branch to cease all financial support for Conrail; the Senate was, for the first time in many years, controlled by the Republican Party which meant that the threat of a Presidential veto was of overriding importance in ruling out the most comfortable solution of simply continuing to subsidize Conrail's losses; and, Conrail's leadership changed, with the new President having exactly the qualities needed to lead the rebuilt railroad into the new regulatory environment. The result, embodied in the Northeast Rail Services Act of 1981 (NERSA), was enormous pressure on the two remaining impediments to Conrail's survival, the labor unions and the local commuter authorities. The labor unions, in return for generous buyout provisions, finally accepted wage restraint and changes in work rules. The local commuter authorities took over the operation of commuter services, along with their associated labor forces and operating deficits. Finally launched properly, Conrail began to fly, leading to its successful return to the private sector in early 1987, more than 16 years after the Penn Central bankruptcy.

CHANGES IN CONRAIL: 1977-1987

	Net Income ($ Millions)	Operating Ratio (percent)	Freight Ton-Miles (billions)	Miles Of Road	Employees	Ton-Miles Per Employee (000)
1977	-367	111	92.4	19,222	81,843	1,129
1978	-385	111	92.9	19,013	78,332	1,186
1979	-221	105	93.1	19,046	74,383	1,252
1980	-244	105	83.3	18,902	65,691	1,268
1981	39	98	79.0	18,420	57,065	1,384
1982	174	99	68.0	17,103	45,405	1,498
1983	313	91	70.3	16,233	38,497	1,826
1984	500	86	76.8	15,468	37,911	2,026
1985	442	88	74.1	14,025	35,134	2,109
1986	431	87	74.6	13,739	33,768	2,209.
1987	299	87	81.1	13,341	31,428	2,581

In retrospect, the outcome of a major political struggle always acquires an air of "success" and inevitability which is far beyond that apparent to the participants at the time. What can be fairly said about the "success" of the Conrail exercise, and what were the essential ingredients of the achievement?

Was the Conrail Process Successful?

From one point of view, that of the beneficiaries of the status quo, the Process had a distinctly unhappy outcome. Today, Conrail has only about 31,000 employees compared with over 91,000 at the beginning. By the same token, it operates only 13,300 miles of track as compared with the 19,000 miles it started with. Its ton-miles are down by (only) 12 percent from the levels it handled in 1978, and its tons handled are down by more than 22 percent. From a purely financial point of view, it is also relevant to note that the entire process cost almost US $8 billion in order to create an entity which was eventually sold for under US $2 billion.

This is too narrow a perspective, however. Conrail, today, while not a rapidly growing enterprise, certainly has an opportunity for continued existence as a private sector enterprise. It has become one of the innovative forces in the industry, both technically and commercially. The rail industry, of which it is a part, is stronger than it has been for many years, largely because of the regulatory reform which would not have been possible without the Conrail struggle. Overall, there are very few observers of the process who would make significant changes in the outcome, and most believe that real progress (albeit at a price) was achieved.

What Were The Ingredients Of "Success"?

1. Probably most important, the decision-makers faced (or thought they faced) situations in which the "do-nothing" alternative was unavailable. Even so, most decisions were made more slowly than appeared possible at every stage of the game, and only after ample opportunity for discussion and debate. In many cases, even though the rationale for painful decisions was clear, it was necessary to allow events to prove, conclusively and expensively, that the old myths were no longer operable and that some pain was unavoidable.

2. Even though pain was eventually imposed, every reasonable effort was made to cushion the blows. Labor was eventually bought out, after several false starts. Local and State agencies wanting continued rail service were given generous opportunities either to subsidize continued service or to acquire the rail facilities and operate the service themselves. The bankrupt creditors received a fair price for the assets taken from them. Largely because the process was seen to be fair, it became more difficult for several of the parties, especially labor, to retain all of their past privileges.

3. Conrail's situation both provoked and benefitted from a long-delayed clarification in US transport regulatory and promotional policy. The burden of intercity passenger services was, via the creation of Amtrak, shifted to the Federal Government and State Governments where it belonged. The burden of commuter services, both financial and managerial, was transferred to State and local agencies who were better equipped to define and pay for the services actually required. These changes permitted Conrail management to focus on potentially profitable freight. Most important, all of the railroads were given the freedom, within certain broad limits, to deal freely and flexibly with their customers, just as their major commercial competitors have long been able to do. The result has been both enhanced rail profits <u>and</u> lower rail rates.

4. The agency (USRA) established to carry out the planning process and administer the funding, was seen to be expert, independent of existing institutional biases and partisan pressures, and of limited life. USRA employees were not civil servants, making them free of civil service pay scales and tenure restrictions. While they were convenient targets of public criticism, their work was also generally accepted privately as being worthy of respect. Also because of its independence and stature, USRA was a useful vehicle of both compromise and communication between the Congress and the Executive

branch. When USRA's job was over, it was, in fact, possible to abolish it.

5. The plans developed by USRA constituted a very meticulous statement of strategic options and alternative costs. They were an excellent basis on which to have an informed debate as to the public choices to be made. Though not often thought of in this sense, they were also the basis of a kind of Contract-Plan relationship between Conrail and USRA, with the US DOT and the Congress as interested observers.

CHAPTER I

THE BACKGROUND
THE MYTH OF THE MIRACULOUS RAILROAD

Among the more pleasant tales in Greek mythology is that of Philemon and Baucis. These two were an elderly couple, devoted to each other, poor, honest, and hospitable to strangers. They lived in a small house on the edge of a village whose inhabitants were notorious for their hostility to strangers, at least to those who could not afford to pay well for food and lodging. Most of the village was in a valley that, in older times, had been a lake. The house of Philemon and Baucis was on the high ground where the road came up from the valley. One day, Zeus and Hermes came walking through the village, disguised as poor travellers. The villagers threw stones at them, jeered at them, and set their dogs on them. Philemon and Baucis took them in and offered to share their simple supper, apologizing because they had already used most of the milk in the house and supplies, generally, were short. As one might expect, the old couple's provender of grapes, brown bread, and honey took on astonishing qualities of goodness of taste and did not give out, no matter how much their guests ate. It turned out that the milk pitcher always refilled itself whenever it was emptied. Zeus and Hermes spent the night, and, in the morning, Zeus put the lake back in the valley and turned all the mean people in the village into fishes. The two gods departed, leaving the old couple with a number of blessings, one of which was the miraculous pitcher. It kept on refilling itself with milk for the rest of the lives of Philemon and Baucis.

The point of the tale is simple. It is often said that the French are a worldly-wise and sophisticated people. When confronted with a situation or episode where events do not, at first glance, appear to have a rational explanation, they say, "cherchez la femme". In American politics, when an observer or historian is trying to puzzle out why some seemingly irrational way of doing things persists for some time, he is well advised to look for the "myth". Political myths are built around a set of supposed facts or principles, fervently believed to be true, that once were true, or never were true, but are certainly not true now. These facts or principles take on mythic force, and people believe them. Then people make decisions and continue policies which are not rational, in light of the facts, but make perfectly good sense according to the myth. For the topic of this paper, the relevant myth is the myth of the miraculous railroad.

The first thirty-five years after the Second World War were a period of steady decline for the railroad industry in the United States. For the railroad firms that operated in the Midwestern and Northeastern part of the country, the decline, especially the decline in profitability, was greater than that for the firms whose operations were in the West and South. The economic causes of the decline were, to some degree, the straightforward result of the rise of the railroads' competitors: trucks and barges for freight traffic; automobiles and airplanes for passenger

traffic. Rapid advances in aviation technology after World War II soon made the airplane the mode of choice for the business traveler or the high-income traveler in a hurry. The construction of a vast network of restricted access, dual lane highways made the private automobile an attractive and inexpensive alternative to rail travel for those whose time was not so valuable. The drop in aircraft operating costs that came with the introduction of the jet engine made non-business air travel a feasible option across a much wider range of incomes than had been the case before. Because of this growth in competition, the carriage of passengers ceased to be a profitable business for the railroads.

Improved technology for long-haul, heavy trucks and growth in traffic suited for pipeline movement had somewhat similar effects on railroads' freight traffic. The freight traffic did not melt away nearly in toto as passenger traffic did, but the rail share of freight traffic fell markedly. This can be seen from Table I-1 which shows that, from 1950 to 1985, the railroads' share of intercity freight movements dropped by twenty percentage points, with the lost share going to trucks and pipelines in roughly equal portions. Total ton-miles were rising substantially as the railroad share fell, so that ton-miles of freight hauled by railroads did increase. In the period in question, ton-miles moved by rail rose by 43 percent, while total freight movements went up by 121 percent. As a consequence of these changes, the railroads experienced an unfavorable change in the composition of their traffic as well as a loss of growth.

Trucks hurt railroad profits, for they tended to take the cargo with high values per ton: the cargo whose owners are most likely to be willing to pay a high rate per ton. Because of that high value, the same owners are likely to place a premium on speed and reliability of movement, and a truck can easily move goods faster and more reliably than a train. The truck is not burdened by the train's requirement to spend time assembling a large amount of cargo in many cars and then spend more time along its route of travel dropping off some cars and picking up others. Thus, the competition from trucks made the railroads more dependent on bulk commodities: grain, coal and ores, and bulk chemicals. Virtually all of the traffic growth for another major group of bulk commodities, crude and refined petroleum, was taken by pipelines.

For several reasons, the effects of these changes were especially severe for the railroads in the Northeast. In general, these railroads had little coal or grain traffic and, thus, were particularly hard hit by the loss of their higher-valued traffic (often referred to in the American railroad industry as "merchandise" traffic). In particular, the Penn Central (PC) railroad carried a significant amount of coal traffic, but it was not nearly as large a proportion of its total as it was for some of the carriers to the south of the PC and, thus, bulk traffic did not give the PC the same base of "safe" revenue that stronger railroads outside the Northeast. Growth in manufacturing was shifting away from America's traditional "manufacturing belt" which lay in the Northeast and Midwest. Because that part of the country was the

TABLE I-1

U.S. DOMESTIC FREIGHT MOVEMENTS: 1950-1985

MODAL SHARES: PERCENTAGES OF TON-MILES

	RAIL	TRUCK	WATER	PIPE	AIR	TOTAL
1950	57.44	15.80	14.93	11.81	0.03	100
1955	50.43	17.20	16.58	15.66	0.04	100
1960	44.73	21.46	16.56	17.19	0.06	100
1965	43.67	21.76	15.89	18.56	0.12	100
1970	39.83	21.28	16.46	22.26	0.17	100
1975	36.74	21.97	16.55	24.54	0.19	100
1980	37.47	22.32	16.37	23.64	0.19	100
1985	37.20	24.86	14.42	23.28	0.26	100

BILLIONS OF TON-MILES

	RAIL	TRUCK	WATER	PIPE	AIR	TOTAL
1950	628	173	163	129	0.3	1,094
1955	655	223	217	203	0.6	1,298
1960	595	285	220	229	0.8	1,330
1965	721	359	262	306	1.9	1,651
1970	771	412	319	431	3.3	1,936
1975	759	454	342	507	3.9	2,066
1980	932	555	407	588	4.8	2,487
1985	898	600	348	562	6.4	2,414

SOURCE: Statistical Abstract of the United States

cradle of American manufacturing, the railroad network had been built in the nineteenth century as manufacturing and populations were growing together, and when, for both people and goods, the railroad was the only viable mode of transportation between towns. The tracks were not laid out on any grand design, but were originally built in small pieces to serve a few towns. Later, as a few railroad firms grew and took over their rivals, the pieces were stuck together so that the growing firms could offer rail service over wider areas. As a consequence, the rail network in the Northeast was not particularly efficient in design, and the network was much too dense for the second half of the twentieth century in which railroads had strong competitors for passenger and freight traffic. Again because of the age of the cities in the region, the larger cities, New York, Philadelphia, Boston, and Chicago, had extensive commuter rail operations that were carried out by the railroad firms.

For all these reasons, then, the financial performance of American railroad firms, especially those in the Northeast, was diminishing through the post-war decades and reached a nadir in the 1970's. This trend is shown clearly in the figures in Tables I-2 and I-3. The picture cannot be fully appreciated, however, without a clear understanding of the institutional and political setting that the railroads operated in. As ordinary private firms, the railroads need not have found any of the circumstances cited above to be crushing burdens. They could have cut back their track and other fixed plant as traffic was falling, adjusted their prices to take account of the presence of strong competitors, and abandoned whole classes of service, especially passenger service, that were no longer profitable. Labor that was no longer needed could have been laid off, and the remaining labor used more efficiently in new operating patterns. American railroads were not, however, ordinary private firms. These ways of dealing with their situation were not open to them, or were available in such a restricted fashion as to make their use slow and difficult.

State ownership of the railroads has not normally been part of the pattern of the development of transportation in the United States. In 1971, The Congress established the National Railroad Passenger Corporation (Amtrak) and thereby created a de facto state-owned passenger service; the creation of the Consolidated Rail Corporation (Conrail) in 1976 did the same thing for freight service in the Northeast. The only other occurrence of federal management was a brief period during the First World War, when it was deemed that the emergency made government direction of the railroads appropriate. It took a crisis in the fortunes of the railroad industry to drive the United States Congress to choose state ownership, albeit in a somewhat disguised form (and, in the case of Conrail, a temporary form), as a solution. The roots of that crisis lay in the way that American policy had treated the railroads since the third quarter of the nineteenth century.

Although the United States government generally avoided public ownership of the railroad entities, and turned to federalization only under crisis conditions, the government never hesitated to use the railroads as

TABLE I-2

EARNINGS OF U.S. RAILROADS 1950-1984

	NET RAILROAD OPERATING INCOME (millions of 1982 dollars)	RETURN ON INVESTMENT
1950	4343	4.28%
1951	3757	3.76%
1952	4227	4.16%
1953	4282	4.19%
1954	3323	3.28%
1955	4147	4.22%
1956	3801	3.95%
1957	3168	3.36%
1958	2566	2.76%
1959	2461	2.72%
1960	1890	2.13%
1961	1724	1.97%
1962	2276	2.74%
1963	2488	3.12%
1964	2486	3.16%
1965	2846	3.69%
1966	2989	3.90%
1967	1883	2.46%
1968	1798	2.44%
1969	1646	2.36%
1970	1157	1.73%
1971	1340	2.12%
1972	1406	2.34%
1973	1313	2.33%
1974	1422	2.70%
1975	592	1.20%
1976	716	3.57%
1977	510	3.71%
1978	591	4.22%
1979	1065	4.38%
1980	1531	5.56%
1981	1448	4.18%
1982	742	2.65%
1983	1769	NA
1984	2351	NA

NOTE: Return on investment omitted for 1983 and 1984, because accounting changes that took effect after 1982 render later years not comparable.

SOURCE: Association of American Railroads
U.S. Department of Commerce GNP deflator

TABLE I-3

EARNINGS OF U.S. EASTERN RAILROADS 1950-1984

	NET RAILROAD OPERATING INCOME (millions of 1982 dollars)	RETURN ON INVESTMENT
1950	1635	3.63%
1951	1523	3.47%
1952	1722	3.86%
1953	1797	4.01%
1954	1272	2.89%
1955	1770	4.19%
1956	1661	4.05%
1957	1324	3.29%
1958	790	2.00%
1959	863	2.27%
1960	572	1.55%
1961	319	0.89%
1962	616	1.80%
1963	768	2.28%
1964	822	2.54%
1965	1039	3.32%
1966	1099	3.55%
1967	486	1.58%
1968	371	1.27%
1969	122	1.10%
1970	-242	-
1971	-127	-
1972	25	0.11%
1973	15	0.07%
1974	87	0.46%
1975	-378	-
1976	-77	-
1977	-289	-
1978	-278	-
1979	203	1.32%
1980	464	2.78%
1981	663	3.76%
1982	263	1.54%
1983	837	NA
1984	1224	NA

NOTE: Return on investment omitted for 1983 and 1984, because accounting changes that took effect after 1982 render later years not comparable.

SOURCE: Association of American Railroads
U.S. Department of Commerce GNP deflator

instruments of social and economic policy, occasionally to the advantage of, more generally to the disadvantage of, the railroads' shareholders. In the nineteenth century, when the Federal government wanted to encourage the development of the West, Congress made large grants of land to the railroad firms that were willing to lay tracks in that region. For the most part, however, Congress took the view that the railroads were powerful and wealthy monopolists and that some portion of their profits could be diverted to serve public goals without doing undue injury to the shareholders.

It is an open question as to whether the railroads were ever as profitable as the belief that held sway in the political arena; in any event, as we have seen, their profitability declined steadily after the Second World War. Nonetheless, the image of railroads as private firms that could well afford to serve public goals took on mythic force. The railroads were, indeed, viewed as so many miraculous pitchers of money, always having some for those that Congress might find to be deserving. It was not until Congress was presented with a large railroad that was about to cease operation for lack of money that the myth began to lose its currency.

Who were the followers and beneficiaries of the myth? These fall into two groups: certain users of rail service and rail labor. With respect to the first group, the government required the railroads to provide service at unremunerative rates to various classes of shippers. These included shippers located on lightly used lines, and shippers that belonged to classes which the Federal government, for whatever reason, deemed worthy of special assistance (a class which included the federal government, itself, under certain circumstances), but at the expense of railroad shareholders, not of taxpayers. These classes included shippers of a variety of types of freight, and, prominently, passengers. There is not space in the compass of this paper to review fully the history of railroad regulation in America. The point to be made clear is that railroads were required to carry significant amounts of freight and passengers at rates that did not cover the railroads' costs of moving those goods and people. The consensus in the body politic was that the railroads ought to be able to do earn enough profit on their other traffic to cover the costs of these subsidies and still provide a decent return on capital; and, if there were not a decent return to capital, so be it, these groups of cargo shippers and passengers were all deserving of support. This latter point of view prevailed in the Congress, in the Interstate Commerce Commission (the ICC, the independent government agency that administers railroad regulation), and, to a large degree, in the Federal courts. It was also, of course, exceedingly popular with the beneficiary groups which had no difficulty in convincing themselves that they were entirely deserving of special treatment.

As with the other followers of the myth, railroad labor occupied a special position. Partly because of a widespread belief that the country could not endure a rail strike, American law and political practice made it virtually impossible that there could be a nationwide railroad strike. Railroad labor matters are covered by a special body

of law, unique to the railroads. The law provides for lengthy procedures to be followed in the event of industrial dispute, requiring several months before either the firms have the right to shut down or the unions have the right to strike. Both sides know that, when this point is reached, Congress will intervene and impose a settlement rather than see a strike occur and, given the large size and political cohesiveness of rail unions, and imposed settlement was usually in favor of the unions. As a consequence, not only high rates of pay but significant overmanning were characteristic of American railroad operations, and, to a large degree, still are. In the period under discussion, the railroads, especially the eastern railroads, had work forces vastly larger than those required for efficient operation. For example, ton-miles of freight carried by American railroads in 1984 were greater than those carried in 1970 by 21 percent, but employees had dropped from 566,000 to 323,000, a decline of 43 percent. Ton-miles carried per worker slightly better than doubled. These trends are continuing, and they largely reflect that, with time, the railroads are working off staff through attrition and making gradual gains in labor agreements to permit more efficient use of labor. It is clear, though, that in 1970 the railroads had far more people than they needed, and railroad managements were not going to be allowed the luxury of a rapid reduction. Again, the ruling presumption in the political arena was that railroads could afford this burden easily, or, if not easily, they could at least sustain it, and, in any event, a confrontation with the railroad unions would have been very undesirable.

The strength of the myth of the miraculous railroads may be gauged by the fact that it persisted well into a time when the railroads were clearly not doing well financially. It is only by understanding the strength of the myth, however, that one can understand how the American government was able, for so long, to let the railroads be a source of subsidy while not perceiving any conflict with principles of the primacy of private enterprise and of economic efficiency in transport.

Finally, reality forced itself on the government and Congress found that it had to act. Its actions took three principal forms. In 1971, Congress, at the behest of the Nixon Administration, created Amtrak and relieved the railroads of the burden of inter-city passenger service. A fear that long-distance rail passenger service might actually disappear was a driving force behind this measure, as well as the realization that the railroads were not financially robust and it was no longer reasonable to ask them to subsidize these services. Notably, the commuter services operated by some of the large eastern carriers were not affected by Amtrak and continued to drain those railroads. The bankruptcy of the Penn Central, the dominant northeastern railroad, and the largest railroad in the nation, followed by the threat, in early 1973, that it might stop operating altogether, forced Congress into the series of actions that created, and ultimately privatized, Conrail. As the 1970's drew to a close, Congress saw that Conrail was not succeeding and that other railroads in the Midwest were going bankrupt or on the verge of going bankrupt. The result was significant reform of the regulatory system, which finally allowed the railroads to move toward a regime of pricing based on the interplay of costs and market demands.

A thorough history and analysis of these events would fill many volumes. The balance of this paper will be concerned with a brief review of the government's reaction to the bankruptcy of the Penn Central and how it sought to solve the problem through the creation of new institutions.

CHAPTER II

CRISIS
THE PENN CENTRAL IS BANKRUPT AND THREATENS TO SHUT DOWN

The myth of the railroads as an unending source of subsidy endured as long as it did largely because it suited many people to keep on believing it. If the myth were taken away, the body politic would have to make some difficult and painful decisions, decisions that hardly anyone wanted to confront. That is why it required the threatened closure of the nation's largest railroad to draw the government's attention to the problem that had been growing for many years.

The bankruptcy of the Penn Central (PC) was a shock to most observers, although not to a handful of analysts, including some in the U.S. Department of Transportation (DOT). The Penn Central was created on February 1, 1968, by the merger of two long-standing rivals, the Pennsylvania Railroad and the New York Central Railroad. The Pennsylvania was already the largest railroad in America, and its merger with the New York Central made a behemoth among railroads. It was the sixth largest firm in the United States with $6.5 billion in assets, almost 100,000 employees and over 20,000 miles of line.

The impetus for the merger came from the senior management of the Pennsylvania, who, it seems in retrospect, believed the myth themselves. Certainly, they exaggerated the savings to be gained by consolidating two large, and more or less parallel, railroads. The management of the New York Central was somewhat reluctant to merge, but allowed themselves to be persuaded. There was substantial opposition to the merger from some political groups in Pennsylvania and from the rail labor unions who feared a loss of jobs. Under the terms of the Interstate Commerce Act, management was obliged to negotiate with the unions on the issue of job protection. That the management of the Pennsylvania believed the myth is best evidenced by the conditions that they agreed to in order to overcome labor opposition. The president of the Pennsylvania promised that no worker on either railroad would lose his job as a consequence of the merger. The Interstate Commerce Commission (ICC) which functions as a sort of court with respect to rail, and some other transport, matters, had to approve the merger. As a condition of its approval, the ICC required the merged railroads to incorporate the then-bankrupt, but still operating, New York, New Haven, and Hartford Railroad (known as the New Haven). The New Haven received a high proportion of its revenue from passengers and commuters, and it operated in a part of the country, New England, where short distances between towns made trucks especially formidable competitors for railroads. At the time of the merger, the New Haven was losing approximately $24 million a year, no small burden for the new rail firm to carry.

The consummation of the merger was widely hailed in the financial community as creating a powerful and profitable firm. In the first year after the merger, the price of Penn Central stock rose from 55 1/8 to 86

1/2. Despite this excitement on Wall Street, the reality was otherwise, and the Penn Central was in difficulty, both in its operations and its finances, from the first day of its life. No one had planned for, or even considered very much, the practical problems of integrating the management and operations of two large, complicated, and very different institutions. Not only did the expected savings fail to materialize, it was found that the new railroad was barely able to operate; business was lost as disgusted customers found other ways of moving their goods. At the start, the Penn Central lost about $250,000 per day; by the time of the bankruptcy, the firm was losing in excess of $1,000,000 per day.

Early in 1970, the Penn Central management were no longer able to sustain optimism, and they made private overtures to the Federal government for financial assistance to avert the disaster they could no longer avoid. There was concern in the government, for no one wanted the bankruptcy to occur, but it proved to be impossible to arrange substantial help (a minimum of $200 million was needed) in a short time. Word of the Penn Central's difficulties began to get about due to the many meetings and discussions that had been held in Washington. The Board of Directors of the Penn Central, feeling pressure from the firm's creditors and from the government, fired the three highest officers of the firm on June 8, 1970. The price of PC stock had fallen to 2. The Penn Central filed bankruptcy papers with the courts on June 21, 1970, less than 18 months after it had come into existence. There was a cry of dismay from those who had loaned money to Penn Central (and from those who had bought the stock). Their sense of alarm was heightened by the fact that seven other, smaller, railroads in the Northeast had also gone, or were soon to go, into bankruptcy.

There was little or no immediate response from the government, other than the issuance of reports commenting on what had transpired. There was no immediate need for any response, because the Penn Central and the other railroads continued to operate, just as they had before. The labor force continued to be paid, goods and commuters continued to move, and those who had been receiving railroad services at subsidized rates continued to do so. The railroads were able to do this because their creditors were held at bay by the courts. The continued payments to those whom public policy had designated as recipients of railroad largess were made, in effect, at the expense of the creditors. The miraculous pitcher went right on pouring. This allowed the government to avoid taking any action. To understand how this could be, it is necessary to know something about how U.S. law relating to railroad bankruptcies had been traditionally applied by the courts.

As with American labor law, there is a separate body of bankruptcy law for railroads. The key difference between railroads and other firms is that a railroad cannot close down and go out of business of its own volition; it needs the permission of a judge to do so. In ordinary American bankruptcy law, a firm has the option of continuing its operations in the hope of being able to reestablish its fortunes, or of liquidating, selling off the assets and using the proceeds for at least partial satisfaction of the firm's debts. The court will be mindful of the creditors' interests and will allow the bankrupt firm to continue

operation only if the judge believes that such continued operation will leave the creditors better off than a liquidation would. If the bankrupt firm chooses liquidation as its preferred path, the court will not ordinarily prevent that.

In the case of a railroad, the interests of the creditors and the shareholders must be balanced against the interests of the public served by the railroad. Once people become accustomed to drinking from the miraculous pitcher, it must not be taken from them lightly. At the time of the Penn Central bankruptcy, a major railroad had never been liquidated. When a railroad went into bankruptcy, the Federal judge in charge of the case would seek an "income-based" reorganization. The underlying presumption was that the railroad was generating enough revenue to cover its operating expenses and that the only difficulty was that it was temporarily unable to cover all of its capital charges. The bankruptcy judge would appoint trustees and direct them to develop a plan for reorganization, the notion being that some sort of rescheduling or postponement of the railroad's debt would allow it to meet its obligations and restore itself to good financial performance. (The technical definition of an "income-based" reorganization is roughly as follows: The railroad's future income stream is estimated, and the present value of that stream is added to the value of the railroad's net assets when the court fixes the amount of debt that the railroad in reorganization is obligated to service.) Again, we see the myth in operation. That a railroad's revenues might actually be insufficient for it to meet its running costs was not an admissible possibility.

When the Penn Central filed for bankruptcy, the Federal judge who was assigned to the case appointed four trustees, following established custom, and asked them to bring him a plan for reorganization. In time, it became clear to the trustees that an ordinary, income-based reorganization was simply not possible, unless the railroad were relieved of the subsidy burdens and excessive labor force that it had to sustain. Early on, the trustees had advised the judge that the Penn Central could not operate at all without some financial help from the government. In December of 1970, six months after the bankruptcy, Congress had enacted the Emergency Rail Services Act, under which railroads in distress could issue loans guaranteed by the government. The Penn Central borrowed $100 million under this authority. Repeatedly, the trustees asked for, and the judge granted, extensions of time in which to file their reorganization plan. On April 1, 1972, not quite two years after the bankruptcy, they filed a report with the bankruptcy judge. That report stated that reorganization of the railroad was not possible unless the following three conditions were met:

> The railroad were relieved of the burden of intercity passenger operations, the commuter operations and the uncompensated costs borne by the railroad as a result of Amtrak trains running over its tracks;
>
> The railroad were allowed to terminate service on lightly used freight lines whose operation was unremunerative; and

> The railroad were allowed to dispense with the services of employees that were not required for its "safe and efficient operation".

These requirements were, of course, quite beyond the power of the judge to meet; indeed, they were beyond the power of the Federal government, in the absence of radical, new legislation by the Congress. This was not to be forthcoming, because, as yet, nothing had happened that would cause Congress to do anything very much out of the ordinary.

The trustees proposed that they would work for a year to bring these changes about and then file a reorganization plan on April 1, 1973. It soon became clear that there were no realistic prospects that the trustees would succeed. Further, the time in bankruptcy had grown so long that the court could no longer put the rights of the creditors second to the railroad's public service obligations. There was Constitutional protection for the creditors' rights, and, while the judge could balance the rights of the creditors against the damage that might be done if the railroad were to cease to function, the court would have to honor the creditors' rights and turn to liquidation if it were clear that an income-based reorganization were impossible.

The role of the Constitution in this matter must be clearly seen if one is to understand the balance of power among the various interests concerned with the Penn Central and the other bankrupts. The Fifth Amendment to the Constitution flatly prohibits the Federal government from taking a citizen's property for public purposes without just compensation. To keep the railroad operating when reorganization was clearly hopeless would be a clear "taking" of the creditors' property. Every day the railroad operated it was worse off financially than it was the day before, and the value of whatever assets might be available to satisfy the creditors' claims was further eroded. The courts could ignore the creditors for a time, but not indefinitely. This fact is critical, because it meant that the possibility of the railroad firm ceasing operations and liquidating its assets could no longer be dismissed.

Among the interests involved, the preponderance of the political power lay with those interests that were served by the continuation of Penn Central operations, regardless of the cost that might be borne by others. All the railroad's customers including some of the largest industrial firms in the country, wanted it to keep operating. Of course, those customers that were receiving service at less than its full cost were particularly anxious that the railroad should continue to operate with no significant changes in the subsidy system. Large, solvent railroads that exchanged traffic with the PC wanted it to keep operating, else they would lose substantial revenue. The people that commuted to work daily on the railroad wanted it to keep operating. The railroad's workers wanted it to keep operating. The political leadership in all the communities where the railroad provided service and paid taxes wanted it to keep operating. The creditors very much wanted it to stop operating, unless someone else could be found to pay

the bills. It is an interesting point that, now that the time had come when the myth was clearly no longer true, its beneficiaries seemed unconcerned: as long as somebody could be found to pay for the railroads' operation, what difference did it make?

As events turned out, the circumstances that nearly brought on the stopping of the railroad came about in an unexpected way. Since the submission of the April, 1972, report to the court, the Trustees had pressed the plan for eliminating redundant labor, meeting intransigent resistance from the union. They had carefully followed the slow and tortuous path marked out by the Railway Labor Act. Finally, the Penn Central issued orders requiring that the crew consists, the number of people required to operate a train, be substantially reduced. The rail unions struck immediately, and, on February 8, 1973, the Penn Central stopped running. The Federal government could no longer look the other way. Congress immediately (within hours) approved a resolution that overrode the cut in the crew sizes and required the railroad to keep operating for another 90 days. In the same resolution, Congress required the Department of Transportation to issue a report on the situation. Congress knew that the status quo could no longer be maintained. The Federal government had to find a way to keep rail service in place in the Northeast, a way that did not involve indefinite bleeding of the creditors. As it became apparent that the government was going to do something, the bankruptcy judge, who had begun to issue orders contemplating liquidation in the fall of 1973, put off the date for liquidation until early in 1974. Thus, it was the bankruptcy court that forced the government to act, because the government could not accept the liquidation of the Penn Central. By the end of 1973, Congress and the Administration had agreed on a plan of action.

CHAPTER III

THE GOVERNMENT CHOOSES A COURSE OF ACTION (BUT FINDS A WAY TO POSTPONE MANY DECISIONS)

The government of the United States, and especially Congress, can move slowly enough, if that helps avoid a difficult decision, especially a decision that entails withdrawal of government-ordained benefits from groups that have long enjoyed them. On the other hand, Congress can move quickly enough if it has to, and this time Congress, as well as the Administration, recognized that action was unavoidable. If the government did not act, the bankruptcy judge was ready to force the liquidation that nobody could accept.

It was one thing for the government to realize that it had to do something; quite another thing to decide what to do. The situation was without precedent in American history; the past offered no guides. What form the government's intervention should take, what should be its ultimate objective, how much of a financial commitment the government should make to northeastern rail service: these, and many more, were the open questions. All participants in the debate were starting with blank tablets, though not necessarily with open minds. Indeed, it is somewhat surprising that broad agreement on the approach to the problem was reached fairly quickly. Before entering into the discussion of what was actually decided, it is useful, first, to establish the political landscape and the identities of the principal participants.

President Nixon, a Republican, had just been re-elected for his second term with an overwhelming vote. Despite the extent of the Republican victory in the presidential election, the Democrats had retained control of both houses of the Congress, the House of Representatives and the Senate. Shortly after the Penn Central strike, the Watergate scandal began to emerge as the dominant episode in the national political arena, with the effect of preoccupying the White House and leaving the Secretary of Transportation and his people on their own to carry the Administration's side of the argument. In view of the poor relations between the Nixon White House and the Democratic leadership in the Congress, the distance of the White House from the discussions may actually have been quite helpful.

In any event, the Department of Transportation (DOT) was the principal body involved from the Executive Branch. In addition to Congress, there was one other body of the Federal government to reckon with: the Interstate Commerce Commission (ICC). The ICC, as an independent agency, is governed by seven commissioners appointed by the President but not answerable to him or removable by him. As has been noted, it has the responsibility for carrying out the Federal government's regulation of the railroads, which, at that time, was quite extensive. Also at that time, the ICC was dominated by the view that the myth had been, still was, entirely correct, and that it was the right role of government to make sure that the railroads fulfilled their public service obligations without worrying about how they were to meet the

costs. The ICC functioned (to a degree, still does) as a court to which the railroads had to apply to eliminate or alter services, to set their rates, to merge with, or sell properties to, one another, or do any of a number of other things. In addition, it considered itself as an appropriate font of Federal policy on any railroad matter. Generally speaking, the ICC of that time was politically close to Congress, where the followers of the myth were also well represented, and distant from the Administration.

Railroad labor was very influential in Congress, and the extent of this strength was acknowledged by all parties to the discussions. At the same time, the view that the railroads should be relieved of much of their public service obligations and that the burden of those obligations should not be permanently transferred to the Federal treasury had some representation in Congress and was strongly held in the White House and in DOT. A solution to the problem that depended on simply spending large sums of Federal money so that all could carry on as before might well have been supported by a majority in both houses of Congress, but would certainly have met with a veto from the President. It requires a two-thirds vote in each house of Congress to over-ride a Presidential veto, and those who benefitted from the myth knew that they could not muster that much support.

At the outset, the formal position of the Administration was that there could be no solution which required the expenditure of any money by the Federal government. The leadership at DOT knew that that was politically unrealistic, that eventually they would have to agree to a solution that required Federal spending, perhaps substantial spending, but they were determined to strike the best bargain they could. DOT was viewed with deep distrust in Congress, both as part of President Nixon's domain and as an institution. The Department had only been in existence for six years, but had already shown that it had no sympathy for the principle of using government regulation of transportation to provide services and prices that a free market-place would not provide. Many in Congress felt comfortable with the ICC and (rightfully) viewed it as an ally, but recognized that its standing as an impartial participant was doubtful, and that it had no credibility whatever with the Administration or with DOT.

As a matter of history, it should be noted that, while DOT was only six years old at the time of the Penn Central crisis, the ICC had been in existence since Congress first tried to regulate the railroads with the Interstate Commerce Act of 1887. It is no great exaggeration to say that, in the ICC view of the world, DOT was an unneeded and dangerous interloper, while DOT viewed the ICC as a political fossil engaged in functions which had long ceased to be useful. Indeed, many at DOT viewed the ICC as being one of the major sources of the problems highlighted in the Penn Central collapse.

In any event, these were the parties that had to deal with one another:

> Congress: generally sympathetic to the interests that would suffer directly from any reduction in the services provided by the Penn Central and subject to strong influence from labor.

> DOT: strongly desirous of a solution with minimal Federal money or other involvement and a solution that would lead to a level of rail service that the marketplace could support.
>
> ICC: very sympathetic to the interests at risk and also anxious to show that it should still be listened to on a matter of railroad policy.

These were the governmental players in the game that began with the strike on the Penn Central. The preponderance of political power lay with Congress, but the Members that took the lead recognized that they were subject to three important constraints:

> A solution had to be acceptable to the railroad union leaders.
>
> The threat of a veto by the President had to be taken seriously, so that a solution had to be at least minimally acceptable to DOT.
>
> Congress could not avoid the need to bargain with DOT by temporizing, because the bankruptcy judge was ready to liquidate the Penn Central if the government did not act with reasonable promptness.

This last point bears considerable emphasis. The judge's known willingness and, after having exhausted all opportunities for an income-based reorganization, authority to liquidate the bankrupt firms put an urgency in the process that simply would not have been there otherwise.

Despite the sharp difference of viewpoint between the Administration and Congress, as well as the lack of precedent for a government response to the situation, agreement on the major elements of a strategy was reached relatively quickly. There were probably two reasons for this. One reason was the awareness of all parties of the constraints listed above. It is fair to note that, along with that awareness, the relevant political leaders in both Congress and DOT genuinely sought a resolution and were not inclined to adopt intransigent positions for the sake of public posturing. The other reason was that a way was found to put off some of the most difficult questions.

The strike occurred on February 8, 1973. DOT issued the report called for by Congress on March 26, 1973, the first version of the bill was voted out of a House of Representatives sub-committee in July, and the final bill was passed by both houses of Congress before the end of the year. This is rapid work. Early in the process, a consensus emerged that a planning effort should be undertaken to select those properties of the bankrupt railroads that should be transferred to a new corporation that was to take over the operation of the bankrupts' facilities. The planners, acting with a due regard for the public interest and with the notion that they were to avoid abrupt or severe disruption in existing patterns of service, were to choose the tracks and other facilities for the new corporation with the objective of creating an enterprise that could, after a period of interim support

from the government, stand on its own and be returned to the private sector. Because of the Administration's reluctance to commit money, it was some time before DOT openly agreed to interim support from the government, but all involved recognized that this was inevitable. All sides recognized that the planning involved would be complex and lengthy, so that the best that could be done immediately was to provide interim financial assistance for the continued operation of the bankrupt railroads and cause the planning to be done.

The goal of a self-sufficient, private enterprise was readily accepted by the serious participants in the debate. Both in the 1973 discussions and later, various concepts of public ownership were raised, but these ideas never gained wide acceptance. Nobody wanted nationalization (at least not in name), and liquidation was unacceptable.

In light of the failure of the private corporations already on the scene, one might wonder if any of the interests involved, and particularly the Administration, genuinely believed that a successful private firm was a possibility. It is worth noting that DOT, which might well have been skeptical, had received assurances from the accounting firm of Price, Waterhouse & Company that the Penn Central could be cut down to a profitable network. For those whose major concern was continuation of existing service, it was easy to accept a self-sustaining operation as a distant goal, if there were sufficient government support in the interim. This was especially so since the hard decisions were to be put off until the end of the planning process.

Again very early in the process, a consensus arose that a new body, independent of both Congress and Administration, should be established to carry out the planning task. This was an essential requirement for the successful completion of the planning work and the eventual establishment of the Consolidated Railroad Corporation (Conrail). DOT could have done the work, but did not want to. It would have been a useless effort, so deep was the distrust of the Department among the interests that were at risk and in Congress. The ICC could have done the job, but its work would have had no credibility with DOT. A new face, not identified with any side of the argument, was needed, and, thus, the United States Railway Association (USRA) came into being.

Labor protection provisions were negotiated between the railroad labor leaders and representatives of the rail industry. The arrangement was a little odd, since neither the government nor the railroad (Conrail) that was going to be the employer of the workers was a party to the agreement. Nonetheless, once agreed to in this arena, these provisions became an inviolable element of the agreement. DOT objected to the agreement, noting that the government, which would have to use taxpayers' money to pay for the provisions, was not in the negotiation. Although DOT maintained opposition to the labor protection provisions until near the end of the legislative negotiations, all knew that labor's requirements would be accommodated without change. Briefly, the heart of the labor provision was that any worker, with more than five years' service, on any bankrupt railroad that was to be part of the process, would receive lifetime indemnification for loss of any or all of his income due to the restructuring process. Each such worker would receive a monthly payment, funded by the government, until he reached

sixty-five years of age and could start drawing his pension (based on his railroad earnings including the supplemental payments). Workers with less service would receive lump-sum payments. The bill that Congress passed included $250 million for this purpose. DOT, as well as a number of other parties to the bargain, believed that, although the price was high, Conrail was being given the opportunity to trim its payroll of unneeded workers. As will be discussed further in Chapter V of this paper, the reality was to be otherwise.

Thus, the legislation that was enacted gave USRA a relatively free hand in the planning process, but provided ironclad protection for the labor force, whatever the outcome of that planning process might be.

USRA was to be under the control of a board of eleven directors. The composition of that board was a notable feature of the basic design of USRA, for Congress sought to protect the various interest groups by making sure of their representation on the board. Three of the directors were to be Federal officials: the Secretary of the Treasury, the Secretary of Transportation, and the Chairman of the Interstate Commerce Commission. The other eight were to be appointed by the President, but in no way under his control. Of these eight, one would be the Chairman, whom the President (in effect, the Secretary of Transportation) would be free to select as he thought best. The other seven were to be the representatives of specified interest groups, as follows:

The non-bankrupt railroads;

Railroad labor;

State governments;

City governments;

Shippers (two directors from this group, one to be representative of small firms using the railroads); and

The financial community.

The law required that the directors be selected from lists of names submitted by these groups. Many observers might think at first glance that this mode of selection of the board would have guaranteed a group riven by dissension and incapable of agreeing on any significant decisions. This did not turn out to be the case. The directors from the designated groups were responsible people who worked earnestly with one another toward the resolution of a difficult problem. The board supported the work of the staff and never made an effort to politicize the planning process. In the end, the plan developed by USRA was unanimously adopted by the board, and the diverse composition of the board made the plan all the more acceptable to Congress and to the interest groups at risk.

Both houses of Congress acted on the legislation to set up this process just before the end of 1973, and the President signed it early in the

new year. The formal name of the bill was the "Regional Rail Reorganization Act of 1973", known ever after as the "3R Act". It embodied the following main points:

> The government would create and finance a corporation, Conrail, to take over and operate designated portions of the properties of the bankrupts.
>
> An independent planning body, USRA, was to designate the properties to be conveyed to Conrail. Once accepted by Congress, such conveyance would be mandatory. The shareholders and creditors of the bankrupt railroads would have no right to object.
>
> There would be interim financial support from the government to permit the bankrupt railroads to continue to operate until the designated properties were transferred to Conrail.
>
> Once that transfer, or "conveyance", was effected, the estates of the bankrupt railroad firms were to be relieved of their obligations as railroads and be free to use or dispose of their remaining assets as best suited the creditors and the shareholders. Thus, rail service on lines not conveyed to Conrail could be abandoned without any further legal procedures.
>
> The government would guarantee settlement, at appropriate amounts, with the creditors for the properties taken from the bankrupts. It would be part of USRA's task to put a value on those properties, and the ultimate settlement with the creditors would be made in court and through negotiation.
>
> There would be ironclad protection of the workers.
>
> A Special Court was established, because of the legal complexities of the whole affair, to have jurisdiction over all the matters involving the bankrupt railroads and the government's program to establish a new railroad using their properties.

Having done all that, and having set the planning process in motion, Congress was now able to step back and let USRA do its work, a process that would take the next two years.

CHAPTER IV

THE PLANNING PROCESS

At the beginning of the process, there was a flurry of legal challenges to the constitutionality of the 3R Act, filed by groups of creditors arguing that they were being unfairly used. These were overcome, and USRA went on its way unimpeded by legal obstacles. Of particular significance was the Supreme Court ruling, late in 1974, that upheld the constitutionality of the mandatory conveyance to Conrail of the properties specified in the Final System Plan. Creditors had claimed that this was an unconstitutional "taking" by the government of private property. The Court held the contrary, stating that the creditors would have recourse under the "Tucker Act" if they thought their compensation inadequate. The Tucker Act provides a vehicle under which persons can sue the United States for redress in such a matter.

Congress had charged USRA with the goal of establishing a new rail firm that could stand on its own in the marketplace, but Congress had also charged USRA with other goals. Not surprisingly, a number of these goals conflicted with the goal of self-sufficient rail service.

It is not unusual for Congress to do this when giving policy direction for a study or planning effort. A list of nice-sounding goals is an easy way of making a gesture towards various interests, and the point that the goals may be in conflict with one another is not a troubling one for Congress. The agency charged with the planning assignment is expected to make due obeisance to each of the goals, but make its own decision as to the ones to which to give real weight. Following is the list of goals for the Final System Plan that were set out in the 3R act:

A self supporting rail service;

A rail system adequate to meet "transportation needs and service requirements" in the region;

High-speed rail passenger service in the Northeast Corridor;

Preserve existing patterns of rail service (consistent with other goals), maximize retention of service in coal-producing areas and maximize the use of modes which are fuel-efficient (Congress believed that this latter meant railroads);

Preserve competition;

Be good to the environment (another way of saying maximize rail service);

Generally, do something for passenger service; and

Minimize job losses in places now served by rail.

No constituent reading this list could accuse the United States Congress of being hard-hearted with any deserving group; here was something for everyone.

As well as a list of goals and some other instructions, the 3R Act provided USRA with a schedule, one that had to be taken seriously. As passed, the Act required that the Preliminary System Plan (PSP) had to be completed by October 29, 1974. Given that the President signed the bill on January 2, 1974, and that some time would be required to assemble a staff and get organized, USRA had little enough time for this job. In the event, with predictable delays in selecting board members and other problems associated with the creation of a new institution, the original statutory deadline became hopelessly unrealistic, and Congress approved a 120-day extension, moving the deadline to February 26, 1975. The PSP was the critical document that USRA would produce. The label of "preliminary" is a little misleading. The PSP was not to be an early stage of a report that would then entail considerable further time and work. It was to be a finished piece of work, called "preliminary" only because it was to be exposed for public comment before USRA issued the Final System Plan (FSP). Between the PSP and the FSP, USRA would accommodate the political reaction as it thought best and then send the FSP to Congress as the final word on what properties would be conveyed to Conrail and what the shape of the railroad system in the Northeast would be. The Final System Plan would be deemed approved by Congress and take effect with the force of law unless either house of Congress adopted a resolution rejecting it within 60 days of its submission to Congress.

Both USRA leadership and the staff were, from the start, fully committed to the goal of a self-sufficient railroad system in the Northeast. They dealt with their list of statutory goals by concentrating their limited time and resources on the first one, a self-supporting rail firm, and on that of maintaining competition. The one other goal to which USRA did give some serious attention was high-speed rail service in the Northeast Corridor (NEC). They knew that Congress genuinely wanted this service, and they did develop a recommendation for taking freight traffic off the Penn Central line that would become a segment of the NEC main line.

The question of the level of competition and how to provide it was an issue that the USRA staff and leadership wrestled with grimly throughout the process. Clearly, the more competition for Conrail, the lower its level of profit and the longer it would take it to reach the point of profitability and cease to become the ward of the government. On the other hand, there was strong political pressure for competition, and USRA's people feared that, if they gave competition short shrift in their work, they would produce an unacceptable plan. In the end, the goal of increasing the degree of competition eluded them, but not for their lack of effort. The process that USRA went through was somewhat more complex than sorting through all the lines and yards of bankrupts and choosing which to retain and which to abandon (although that was difficult enough). The 3R Act gave USRA the option of designating lines for sale to solvent railroads operating in the region. Further, the USRA board came to understand, early in the game, that they were not

necessarily bound to create a single Conrail; they could try to make two new railroad firms if they wished. They also had the option of not creating Conrail at all, if they could succeed in selling off most of the bankrupts' lines to solvent railroads.

Although the idea of setting up two new corporations with government financing attracted some significant political support, especially in Pennsylvania, it never gained much ground inside USRA. As the USRA staff worked to estimate the cost of restoring the bankrupts' deteriorated lines, they became more and more alarmed at the sums that were to be needed to set Conrail on its feet. The notion of creating two government-sponsored firms to compete against one another seemed not in keeping with common sense.

The idea of selling off the bankrupts' properties to solvent carriers and having no government-sponsored firm at all had enormous appeal in principle, but USRA found what it regarded as two insuperable obstacles. One was a lack of buyers. Some carriers showed interest in some of the lines, provided the government were to rehabilitate them and take responsibility for displaced labor, but there were no buyers in sight who would take enough of the property to let the government get away without setting up a new corporation. The other obstacle was a political one. Many of the interests at risk would have perceived a recommendation that did not include a Conrail as an attempt by the government to abandon the responsibilities that they thought the government had taken on with the enactment of the 3R Act.

Nonetheless, USRA did try, throughout the process, to sell some lines to solvent carriers in the hope of making Conrail a little smaller and its competitors a little bigger. Up almost to the eve of conveyance, USRA thought it had a deal with the Chessie System (a large, solvent railroad) to buy some lines, but this bargain finally came apart on labor problems, and the Conrail that came into being was the maximum-sized one that USRA had tried hard to avoid. In the event, there was little political cost from this, in part, no doubt, because USRA had tried so conspicuously to achieve a different outcome.

USRA's biggest analytical tasks had to do with the basic questions of which lines were to be excluded from Conrail because of light usage and how large would be the investment required to rehabilitate the lines and facilities of the bankrupts and carry the new firm to the point where it could stand on its own in the marketplace. Both issues involved political problems for USRA. On the costs, the principal problem was with the Administration. The Administration had started with the position that no Federal money at all would be committed to the Northeast rail crisis. Then, after protracted struggle, it had accepted the 3R Act with provision for up to one billion dollars for government investment in Conrail. This figure did not include the funds authorized for labor protection, for transitional subsidies to lightly-used lines excluded from Conrail, or for the funds necessary for the interim operation of the bankrupts until Conrail could come into existence. Now, as USRA staff worked on their cost estimates and financial projections, it became apparent that the likely figure could

be in the neighborhood of two or three times the one billion dollars authorized in the Act. When the time came for the submission of the FSP to Congress, the Administration would have to be petitioned anew for a far larger financial commitment than it had already agreed to.

A much thornier matter was that of the lines to be excluded from Conrail. The idea that a profitable railroad could not afford to operate track with light traffic density was one of the unpleasant possibilities exposed when the myth was shattered by the strike on the Penn Central. In their 1972 report to the bankruptcy judge, the PC trustees had set out the conditions for profitable operation: shedding the excess labor burden; relieving the railroad of the cost of passenger operations; and allowing the railroad to stop operation on unprofitable lines. These conditions were still valid, and there was a fourth, and very important, one, that the trustees had omitted from their report to the judge, although they had included it in other statements. The system of railroad rate regulation, which forced the railroads to subsidize certain classes of traffic (and also forced them to overprice on some services) had to go. USRA made these points, time and again, in the PSP, but the issue of the light-density lines was the single one with which it could deal directly.

The labor protection issue had been taken out of the discussion by the acceptance by all parties of the earlier agreement. Such was the political strength of rail labor, that the difficult issues of railway labor practices and work rules, the whole question of the more efficient use of labor, was deemed to be untouchable.

On the regulatory and passenger issues, USRA could, and did, make recommendations, and, in an echo of the trustees' report, it made clear that the financial projections of profitability were conditioned on rate increases on non-remunerative traffic and on relief from all passenger costs. On the light-density lines, largely branch lines, USRA had the power to take direct action, and its people realized that if they did not try to deal with the issue, an opportunity would be lost that might not come again for some time.

USRA's analysts went at the problem in a straightforward fashion, and, when the PSP was issued, USRA recommended elimination of 6,200 miles of line out of the nearly 9,600 miles of light-density lines studied. In the PSP, USRA noted that, sharp though this cut appeared, 75 percent of the branch-line traffic, and 95 percent of the total traffic, of the bankrupts would be retained. This impact of this blow would be cushioned by a provision in the 3R Act for two years of subsidy. The Act authorized $90 million a year for two years for Federal subsidies of up to 70 percent of the cost of branch-line operation, the rest to be made up by state or local government or by shippers. The Act also required Conrail to operate any excluded branch line, as long as a subsidy sufficient to cover operating costs was offered by a "financially responsible person". It fell to The ICC's Rail Services Planning Office (RSPO) to calculate the amount of subsidy actually required.

USRA also stated in the PSP that the capital required for Conrail would be "substantially in excess" of the one billion dollars authorized in the 3R Act. On the matter of competition, USRA expressed the hope that the two large, solvent carriers that operated in the southern parts of the Northeast, the Chessie System and the Norfolk and Western (as they were then known), would buy some of the lines of the bankrupts.

All this was reasonable enough, but USRA quickly found itself under attack from two sides. The followers of the myth were distressed by the branch-line cuts and by what they perceived as insufficient competition. The Administration was alarmed by the escalating cost estimates and by the prospect of Conrail as a very expensive, and long-term, ward of the government.

The fiercer public attacks came from the followers of the myth. The 3R Act required public hearings on the PSP and had created a new office at the ICC, the RSPO whose primary mission, in the short run, was to organize hearings in the communities affected by the branch-line cuts and, in general, whip up opposition to the PSP and attack it with all the vigor it could muster. This it did, with great energy and spirit. Indeed, just in case the affected public failed to yell loud enough on its own, the RSPO sent staff members into the field to scout out and organize the injured so their voices could be added to the chorus of complaints. The RSPO was required by the Act to publish comments on the PSP, once the hearings had been held. This too, it did, and the comments are what one would expect. RSPO explicitly made the point that USRA had subordinated the social goals enumerated in the Act to the goal of profitability. How these goals could be treated equally without sacrificing profitability was a point that the followers of the myth did not trouble themselves with. They were beginning to perceive that the myth might be kept alive, after all, in a new form: organize a government corporation that has self-sufficiency as a distant goal, provide it with plenty of Federal money, and make sure that excess labor and subsidized shippers and passengers continue to get their accustomed benefits.

On the other side, the Administration saw this threat clearly enough. Indeed, from the point of view of many inside DOT the PSP appeared to lead directly to what the followers of the myth wanted. There had been a change of Secretaries at DOT (there had also been a change of Presidents - by the time the PSP appeared, President Nixon had resigned and been succeeded by President Ford). Claude Brinegar had been Secretary of Transportation from the time of the strike on the PC until just before the PSP was issued. His successor was William Coleman. Both were very able secretaries, but with very different personal styles. Brinegar was an analytical man who preferred quiet negotiation to public confrontation. Coleman was comfortable with confrontation as a working tool. He let it be known at once that the sell-off of the bankrupts' assets to solvent carriers would be the only solution acceptable to him. As we have already noted, this approach, which came to be known as "controlled transfer", had been considered and put aside by USRA. USRA people felt that the lack of buyers and the political difficulties, not to mention additional legal and procedural

complexities, were good enough reasons for discarding controlled transfer as a real option.

It was the view of many in DOT, not just of the new Secretary, that USRA had put controlled transfer aside because the people at USRA were reluctant to take on a hard political fight. The new Secretary had no such reluctance and threw himself into the struggle. DOT changed from being quietly cooperative with USRA to a public adversary.

Thus, USRA went into the last stretch of the process under heavy fire from both right and left. The difficulties in this last stage were heightened by the fact that it was clear that Congress would have to take further action. Because of the need for authorization of additional capital for Conrail, and for other reasons, new legislation was needed. It was not going to be sufficient for USRA just to submit the Final System Plan and wait for Congress to refrain from disapproving it. There was going to be a messy struggle at the finish.

At the end, when the dust had settled after what was, indeed, a messy struggle, what emerged in the FSP and was then confirmed by an Act of Congress was not too different from what was in the PSP. This legislation was called the Railroad Revitalization and Reform Act of 1976, popularly known as the "4R Act".

The major changes were in the capital for Conrail and the level of competition. With regard to the latter, none of the hoped-for sales to solvent railroads materialized (although this was not to be finally clear until after Congress had acted), and all the bankrupts' lines, facilities, and equipment (except the branch lines excluded by the FSP) were conveyed to Conrail. One of the seven smaller bankrupt carriers, the Boston and Maine, had managed to find a feasible path to reorganization. Thus, on conveyance day, April 1, 1976, the rail assets (the non-rail assets stayed with the bankrupt estates) of the Penn Central and six other small-to-middle-sized railroads were turned over to Conrail.

USRA stood its ground on the light-density lines. After the hearings, the lines were re-analyzed, in some cases with new data, and a few lines were put back in. Nonetheless, the FSP provided for exclusion of 5,757 miles of branch line, not a great reduction from the 6,200 miles proposed in the PSP. Virtually all of the mileage excluded continued in operation, at least for a time, under the subsidy provided by the 3R Act. The 4R Act, in a politically necessary compromise, extended the coverage of the subsidy program to the whole nation. This considerably increased the cost of softening the blow to shippers on lightly-used lines, for, in the upshot, some 43 percent of the subsidy money went to states outside the region originally designated in the 3R Act. The subsidy program proved popular and was extended by Congress. In 1981, Congress terminated the operating subsidies, but a program of very modest (less than $10 million per year) Federal aid to the states for rail planning and for capital expenditures on lightly used lines continues.

Despite the Administration's discomfort, the capital for Conrail was doubled when Congress acted on the matter. The 4R Act provided $2.1 billion in capital for Conrail, with USRA to have the responsibility of doling it out. Conrail was required to develop a business plan showing how it would use the government capital to make its way to profitability. The business plan was required to show a projection of Conrail's progress, year by year, towards this goal. As a concession to the Administration, the 4R Act gave the Executive Branch the power to veto disbursements to Conrail if its actual performance fell short of the projections in the business plan.

There was one other concession to the Administration. Controlled transfer had gotten nowhere, but the 4R Act provided a procedure for something called "supplemental transactions". This meant that, should the circumstances arise under which a sale of some part of Conrail were feasible, a legal procedure was in place for that purpose. DOT's obstinacy in the closing struggle had not gone entirely unrewarded. Aside from these two concessions, DOT's opposition was very helpful to USRA in holding firm on the branch lines and, generally, in holding off schemes for more expansive Federal support to railroads. (It is not central to the theme of this paper, but it should be noted that the 4R Act contained provision for some aid (other than branch-line subsidy) to ailing railroads in the rest of the country.) In this way, the idea of an independent planning body was again vindicated. With DOT scowling and threatening on the right, USRA was perceived as being in the moderate middle and thereby strengthened in the final negotiations.

Conrail was thus launched, a nominally private corporation with only the government to look to for capital. USRA had made some headway on getting rid of branch lines, but the other fundamental problems were untouched. Despite the generous labor protection arrangements, nothing had even been attempted with regard to the highly inefficient work rules of the railroad labor agreements. The problem of the costs of passenger service for commuters had not been resolved. The 4R Act made a modest start on regulatory reform, but Conrail, in common with other railroads, still carried heavy requirements to subsidize various classes of users. The conditions for profitability, set out by the Penn Central trustees and echoed by USRA, had not been met. There were many observers, inside DOT and elsewhere, who felt that the fight for self-sufficient rail service in the Northeast had been decisively lost. On the other hand, an institutional mechanism for coping with the crisis had been found, and there was at least a nominal commitment to the goal of independence from the government's purse. It was certainly a better arrangement than an explicit commitment to indefinite government support.

CHAPTER V

A BAD START FOLLOWED BY A RECOVERY: THE MIRACULOUS RAILROAD FINALLY RUNS DRY

In both the Preliminary System Plan and the Final System Plan, the USRA staff had been careful to stress that Conrail's ultimate profitability required action on labor productivity, light-density lines, passenger service, and rate regulation. The Penn Central trustees said much the same thing in their 1972 report. In the process that lead up to the birth of Conrail, some action, as we have seen, was taken with respect to branch lines. No action was taken in any of the other critical areas. The truth of what both USRA and the trustees said is borne out in the figures in Table V-1. From inception through 1980, Conrail lost substantial amounts of money and did only a little better than breaking even in 1981. The USRA forecast had shown Conrail making rapid progress towards profitability, showing a substantial positive net income in 1979. Table V-2 brings out the difference between the forecast performance and the actual results more sharply, since it focuses on earnings from rail operations in isolation from the effects of non-rail income or fluctuations in interest and tax payments.

In Table V-2, we see that USRA forecast a significant amount of operating income from the very beginning. In the event, Conrail ran substantial operating losses from the start, got positive, but modest, results in 1981 and 1982, and did not see significant cash from rail operations until 1983. Conrail had been expected to behave as railroads once did in income-based reorganizations, generating income from operations, but not enough to cover fixed charges. Instead, the financial performance of early Conrail was not all that different from the financial performance of the Penn Central.

In the first four-and-three-quarters years of its life, Conrail's operations simply gulped government money. The original $2.1 billion authorized by the 4R Act ran out and more had to be provided. Progress on rehabilitation of the plant was slowed, because the rail operations were consuming the capital intended for upgrading track and other facilities. The skeptics were vindicated. Conrail showed every sign of becoming a permanent ward of the government. Nationalization had been avoided in name, but the prospects for rail service in the Northeast without government support seemed dark. Yet subsequent events have followed a very different course.

When Congress was finally confronted with the facts of Conrail's condition, it chose to inflict pain on the followers of the myth, rather than take on Conrail as a permanent ward. In order to look at how this came about, it is first useful to look at what had, and what had not, happened in the process that culminated in the 4R Act and the establishment of Conrail. A new entity had been created, but none of the fundamental problems had been addressed. In effect, Congress had chosen to give the myth another chance: perhaps a generous injection of government money would restore the miraculous powers of the railroad.

TABLE V-1

CONRAIL NET INCOME 1977-1985
MILLIONS OF CURRENT DOLLARS

	FORECAST	ACTUAL
1977	-238	-367
1978	-71	-385
1979	151	-221
1980	440	-244
1981	594	39
1982	733	174
1983	831	313
1984	922	500
1985	1009	442

NOTE: 1976 figures are not shown, because Conrail did not operate for all of that year.

SOURCES: Final System Plan Supplemental Report

TABLE V-2

CONRAIL OPERATING RESULTS 1977-1985 --- ACTUAL AND FORECAST
MILLIONS OF CURRENT DOLLARS

	1977	1978	1979	1980	1981	1982	1983	1984	1985
ACTUAL									
OPERATING REVENUES	3292	3510	3951	3982	4201	3617	3076	3379	3208
of which:									
freight	NA	3043	3422	3358	3551	2999	3076	3379	3208
passenger	NA	467	529	624	650	618	0	0	0
OPERATING EXPENSES	3644	3887	4129	4169	4135	3568	2788	2913	2811
of which:									
way maintenance	NA	520	579	627	632	619	473	491	456
equipment maintenance	NA	1142	1124	1086	1075	911	771	776	735
transportation	NA	1916	2105	2119	2087	1746	1274	1358	1218
other	NA	309	321	336	342	292	270	289	332
ACTUAL OPERATING INCOME	-352	-377	-178	-187	66	49	288	466	397
FORECAST									
OPERATING REVENUES	3734	3898	4266	4865	5317	5753	6210	6705	7250
of which:									
freight	3167	3287	3608	4158	4561	4952	5359	5801	6286
passenger	567	611	658	707	756	801	851	904	964
OPERATING EXPENSES	3283	3303	3461	3739	4032	4275	4567	4899	5267
FORECAST OPERATING INCOME	451	595	805	1126	1285	1478	1643	1806	1983
OPERATING INCOME									
ACTUAL LESS FORECAST	-803	-972	-983	-1313	-1219	-1429	-1355	-1340	-1586
FREIGHT REVENUE									
ACTUAL LESS FORECAST	NA	-244	-186	-800	-1010	-1953	-2283	-2422	-3078
OPERATING EXPENSES									
ACTUAL LESS FORECAST	361	584	668	430	103	-707	-1779	-1986	-2456

SOURCES: Final System Plan Supplemental Report
Conrail financial statements

NOTE: 1976 not shown, because there was not a full year of operation.
Some 1977 detail not shown, because of an accounting change.

Thus, it is not surprising that the financial results of early Conrail are much like those of the Penn Central; very little had changed.

Yet it is not true to say that nothing had changed. The political environment of the railroad industry was changing rapidly in the late 1970's.

The PC bankruptcy and the other northeastern bankruptcies had much to do with starting that change. By the latter part of the 1970's, it was becoming clear that railroad financial catastrophe was not a problem restricted to the eastern part of the country. A group of grain-hauling rail carriers in the upper Midwest (generally known in U.S. rail circles as the "grangers" or the "granger roads") was beginning to get into serious difficulty. Two in particular, the Chicago, Rock Island, and Pacific (the Rock Island) and the Chicago, Milwaukee, St. Paul, and Pacific (the Milwaukee), went into bankruptcy in this period. In the 4R Act, Congress had made some provision for financial aid to these railroads, but both Congress and the Executive (now the Carter Administration) were making it plain that the Federal government would not spend money indefinitely in order to preserve the patterns of rail freight service that were established in the late part of the nineteenth century.

The power and the role of the railroad unions were also changing markedly in this period. In 1973, the rail union leaders had been able to virtually dictate the labor protection terms that became embedded in the government's response to the PC bankruptcy. By the late 1970's, they had lost that power. Further, they saw as clearly as anybody that the rail industry was in trouble and that Congress could not be counted on to fix the problem with an indefinite flow of money. This latter point was vividly illustrated by the fate of the Rock Island. The scope of this paper does not allow a full treatment of the long illness and ultimate demise of the Rock Island. The important thing that happened is that the Rock Island was actually liquidated. The railroad stopped running and its property was sold. This was a painful blow to the labor force, because the existing labor protection arrangements applied only to mergers and reorganizations; nobody had contemplated the possibility of a liquidation. Congress did oblige the unions with a last-minute piece of legislation to keep the Rock Island going and provide for labor protection. The Rock Island's creditors challenged this statute in the courts as unconstitutional, and they prevailed. Congress tried again, the creditors won again, and Congress finally voted to have the Federal government, rather than the creditors, make the labor protection payments to workers whose jobs vanished as the Rock Island was finally liquidated.

In these circumstances, the railroad union leadership realized that they would have to act in ways which would strengthen the railroads in the marketplace. They took two actions in particular which bore on Conrail's fortunes. The first had to do with major reform of Federal regulation of the railroads; the second to be discussed later in this chapter, had to do with Conrail's wage bill. Academic economists had been making the case for regulatory reform for some time. The Executive Branch had been sympathetic, but Congress had shown little interest until it incorporated some modest reforms in the 4R Act. As the 1970's

drew to a close, with Conrail bleeding profusely and sick and dying railroads elsewhere, Congress became more receptive.

Virtually all observers attribute the success of railroad regulatory reform to the plight of Conrail. Conrail's management (which, to a degree, had also been USRA'S management) strove hard for this measure. They, and others, told Congress repeatedly and vigorously that, without the freedom to set its rates according to the cost of, and the demand for, its services, Conrail could not hope to stand on its own in the marketplace. The railroad industry as a whole, which had been slow to see the advantage of deregulation, began to push for it. Lastly, and critically, rail labor gave wholehearted support for regulatory reform. The unions saw that, if there were to be enough money left to pay the workers, the railroads could no longer afford to subsidize large numbers of the customers. As a result of this coming together of strong forces, Congress enacted sweeping reforms of Federal regulation of railroads in the form of the Staggers Rail Act of 1980 (named for a Congressman who was one of the principal architects of reform).

A complete account of the changes wrought by the Staggers Act is sufficient material for more than one sizable book, but a few key points should be mentioned here:

The railroads obtained substantial (not total) freedom to adjust rates up or down (on some traffic, the railroads had been restrained from lowering rates, in order to protect their competitors).

The railroads were allowed to enter into contracts with shippers. Heretofore, they had been required to treat all customers alike; now they could negotiate, and keep confidential, individual rate-and-service packages with their major customers.

The procedures for abandonment of unremunerative lines were greatly liberalized.

With the Staggers Act, Congress fulfilled one of the conditions of profitability that had been stipulated by USRA (and by the earlier Penn Central Trustees). Congress also signalled its alarm at Conrail's condition and explicitly questioned whether regulatory reform would be enough to turn Conrail around. Further, Congress signalled its willingness to hurt the interests at risk in order to avoid the permanent dependency of Conrail. The Staggers Act directed USRA, Conrail, and DOT to submit reports to Congress by April 1, 1981, providing a re-study of Conrail's future and alternatives to Conrail. Abandonments of unremunerative lines and improvements in labor efficiency were among the measures that Congress asked be examined in a search for ways to improve efficiency; Congress also made clear that the break-up of Conrail was to be considered. The Staggers Act provided additional capital for Conrail, bringing the total of direct government investment to $3,280,000,000 (the 4R Act had authorized $2.1 billion). As a sign of its changed mood, Congress stipulated that USRA should not hand over any of the new funds unless it were found that Conrail was taking definite action, e.g., surcharges or abandonments, to eliminate losses on unprofitable lines. It is safe to say that, with the Staggers Act, Congress stated that there would not be indefinite Federal funding of Conrail.

The passage of the Staggers Act coincided with another event important in the history of Conrail: a turnover at the top. The Chairman and Chief Executive Officer of Conrail, who had been President of USRA, left Conrail. A planning-oriented man with little rail experience was replaced by a man with a strong background in railroad operations. For the senior staff inside Conrail, this was an important change. There had been few illusions at the beginning, but they had wanted to try to make a going private-sector concern of Conrail. Many had hoped that they could make progress in bringing some efficiency to the operations of what had been the PC and the other bankrupts. These hopes had been frustrated in the early years, as the senior executive seemed not to be able to come to grips with the railroad's operating problems. Thus, for those trying to run Conrail, 1980 was doubly a year of reversal of fortunes. The political environment had shifted in their favor, and the new top man, L. Stanley Crane, was ready and able to take on the operating problems.

By the time the reports called for by the Staggers Act were submitted, another Presidential election had taken place, the Reagan Administration had succeeded the Carter Administration, and the Republicans had won a majority in the Senate. Both the new Secretary of Transportation, Drew Lewis, and his Federal Railroad Administrator, Robert Blanchette, had been intimately involved in the affairs of the bankrupt railroads. Lewis had been a trustee of the Reading Railroad, and Blanchette had been counsel to, and then one of, the trustees of the Penn Central. Due both to the experience and proclivities of these new men and to the ideological bent of the new Administration, DOT was once more advocating the break-up and sell-off of Conrail.

In its report to Congress, DOT was quite clear that Conrail should be sold off, and the Department's recommendations were focussed on actions which would make the sale feasible by getting Conrail out of the commuter business, releasing a purchasing railroad from Conrail's onerous labor protection provisions, and relieving Conrail of some of its eastern yards and terminals which were considered unsalable.

As things turned out, the new Secretary of Transportation did not stick by this tough position, but he did not have to. Labor was ready to make substantial concessions to Conrail management, and other interests were either ready to give up their privileged treatment or Congress was ready to terminate it. The conditions of profitability could now be met, and DOT was willing to allow Conrail one more try under these conditions, provided that, if Conrail still failed, then the sell-off would have to go forward. In effect, the followers of the myth were forced to give up their claims on Conrail. It had been decisively shown that Conrail could not afford to operate as it had been doing, and Congress was not willing to pay for a prolonged extension of the status quo. After years of limited action on the fundamental issues of the northeast rail problem, events now moved rapidly to a resolution.

The reports called for by the Staggers Act went to Congress on or before April 1, 1981. Within the next few weeks, the Secretary of Transportation, in a public speech, let it be known that he would not insist on the immediate break-up of Conrail. At about the same time,

rail labor leaders let it be known that they were willing to offer Conrail wage concessions to the value of $200 million per year. With the conciliatory gesture from the Administration and labor's concession as part of the background, work could go forward on legislation. The result was the Northeast Rail Service Act of 1981 (known as NERSA) that was swept through Congress in August of 1981 as part of a large piece of budget legislation. As is frequently the case with an Act of Congress, NERSA begins with a set of "findings". They make striking reading against the background of everything that had happened since the bankruptcy of the Penn Central. It is worth quoting in full the first and third paragraphs of these findings:

"(1) the processes set in motion by the Regional Rail Reorganization Act of 1973 have failed to create a self-sustaining railroad system in the Northeast region of the United States and have cost United States taxpayers many billions of dollars over original estimates;

(3) although the Federal Government has provided billions of dollars in assistance for Conrail and its employees, the Federal interest in ensuring the flow of interstate commerce through rail service in the private sector has not been achieved, and the protection of interstate commerce requires Federal intervention to preserve rail service in the private sector;"

This is a strong statement; particularly noteworthy are the last four words of the third paragraph, "in the private sector". These words dramatically change the meaning of what would otherwise be "requires Federal intervention to preserve rail service", words with an all too familiar ring. All in all, the drafters of NERSA wanted to make it as clear as they could that the times were, indeed, a-changing.

In addition to "findings", NERSA also contained a section called "goals". In this section is enshrined the agreement that encompassed the unions' concession of $200 million per year in wages. It specified that the reductions would be for three years, beginning April 1, 1981, and that the amount of the reduction would be adjusted upwards each year to allow for inflation. It further specified that non-union employees (including the highest executives) would forego wage increases and benefits in amounts proportional to those given up by union members.

Elsewhere in the statute, the problems of commuter service, unprofitable lines, and labor protection were dealt with. Conrail was specifically relieved of all obligation to carry passengers. Special, expedited abandonment procedures were established for Conrail, which, in effect, allowed it to cease operation on unprofitable lines and dismantle them if no one else stepped forward to take them over.

The labor protection provisions that had been embedded in the 3R Act and considered immutable were drastically changed. Those provisions had been extremely costly and, also, completely useless from Conrail's (or the government's) point of view. Under the 3R Act provisions, Conrail was allowed to shed people made redundant by the reorganizations, albeit at great cost to Conrail and the government, but the employment billets were not eliminated. When a redundant worker was separated and started

to draw his lifetime compensation, the next unemployed man on the seniority roster could step forward and claim the job. For all the hundreds of millions of dollars being spent, no reduction whatever in Conrail's wage bill was being achieved. NERSA specified Conrail's right to eliminate positions and limited the separation payments to incumbents to a maximum of $25,000 per worker.

In addition, Conrail was exempted from all state taxes as long as it was owned by the government. Thus, all the beneficiaries of the myth finally found their subsidy flows cut off. Small shippers and communities lost the rail services that they had been unable or unwilling to pay for. State or local authorities were compelled to take up the burden of operating rail commuter service. Other than $125 million in transitional assistance to these authorities, there was no offsetting increase in Federal aid for local transportation. (An additional $10 million was provided by Congress in 1988, but this can only be regarded as a token sum, in light of the cost of such operations.) There was going to be a real reduction in unneeded workers, and Conrail's wage bill was going to be adjusted downward, reflecting the railroad's ability to pay. State treasuries were to receive no revenues from Conrail as long as it was a Federal dependency.

In NERSA, Congress had done all it could do to turn Conrail into a self-supporting operation. Also in NERSA, Congress provided that the Federal government would sell Conrail back into the private sector, either as a single entity, or, failing that, in pieces. NERSA directed the Secretary of Transportation to engage an investment banking firm to arrange the sale of Conrail's stock, either in a block to a single buyer or in a public offering. The actual provisions of the statute are somewhat involved in this respect, but the thrust of it was that Conrail was to be sold in one piece if it could, indeed, become profitable, or be sold in pieces if that were not the case.

In the upshot, the provisions of NERSA proved to be sufficient to allow Conrail to achieve profitability. Freed from the obligations that flowed from the myth, Conrail was actually able to provide rail service and generate more than enough revenue to cover its costs. In some sense, this was a vindication of the USRA staff's original judgment that Conrail could make money if it could be freed from the burdens that history had placed on it. As Table V-2 shows, however, Conrail has never come anywhere near the levels of revenue or operating profit that USRA forecast. Nonetheless, there were tremendous gains in efficiency and through the elimination of unprofitable traffic. The figures in Table V-3 illustrate these gains. Profitability was achieved, and Conrail was sold as a single entity.

A public offering of Conrail's stock was consummated in the autumn of 1986. There was a wide political consensus behind the privatization of Conrail, but, in an odd concluding episode, there was a bitter struggle between the Secretary of Transportation, then Elizabeth Dole, and a wide range of opponents over the means of privatization. The Secretary wanted to sell Conrail to another railroad, the Norfolk Southern, but, after an intense and protracted conflict, she was compelled to withdraw her proposal and agree to a public offering.

FIGURE V-3

OTHER MEASURES OF CONRAIL PERFORMANCE 1976-1985

	OPERATING RATIO	MILES OF ROAD	FREIGHT TON-MILES (billions)	WORK FORCE	TON-MILES PER MAN (thousand
1976	1 07	NA	NA	86,908	NA
1977	1 11	19,222	92.4	81,843	1,129
1978	1.11	19,013	92.9	78,332	1,186
1979	1.05	19,046	93.1	74,383	1,251
1980	1.05	18,902	83.3	65,691	1,268
1981	0 98	18,420	79.0	57,065	1,385
1982	0.99	17,103	68.0	45,405	1,498
1983	0.91	16,233	70.3	38,497	1,826
1984	0.86	15,468	76.8	37,911	2,026
1985	0.88	14,025	74.1	35,134	2,110

NOTE: Freight ton-miles and ton-miles per man not shown in 1976, because Conrail did not operate for a full year.
Miles of road for 1976 not shown, because number is not strictly comparable with later years.

SOURCES· Department of Transportation

FEDERAL EXPENDITURES ON THE NORTHEAST RAIL CRISIS
MILLIONS OF CURRENT DOLLARS

	DIRECT INVESTMENT IN CONRAIL	PAYMENTS TO THE CREDITORS	LABOR PAYMENTS	COST OF USRA	INTERIM OPERATIONS	BRANCH-LINE SUBSIDIES	COMMUTER SERVICE
pre-1976	0.0	0.0	0.0	26.5	495.8	0.0	0.0
1976	309.3	0.0	10.5	21.5	0.0	44.7	0.0
1977	722.0	0.0	59.5	12.9	0.0	69.6	0.0
1978	734.7	0.0	80.0	22.1	0.0	11.2	0.0
1979	708.0	0.0	72.5	28.4	0.0	42.1	0.0
1980	641.0	0.0	27.5	27.9	0.0	27.0	0.0
1981	165.0	2,126.4	129.1	29.0	0.0	9.8	0.0
1982	0.0	644.9	140.0	8.3	0.0	1.8	3.6
1983	0.0	2.0	65.3	3.3	0.0	1.8	121.3
1984	0.0	3.8	22.1	2.4	0.0	0.1	0.0
1985	0.0	0.0	10.1	2.7	0.0	0.0	0.0
1986	0.0	0.0	25.0	2.3	0.0	0.0	0.0
1987	0.0	88.8	1.5	0.6	0.0	0.0	0.0
1988	0.0	0.0	0.0	0.0	0.0	0.0	10.0
TOTALS	3,280.0	2,865.9	643.1	187.9	495.8	208.1	135.0

NOTE: Years are U.S. Federal fiscal years which end on September 30 of the corresponding calendar year.
SOURCE: Department of Transportation

FIGURE V-4

On any financial accounting the government did not recover the money it had put into Conrail. In addition to direct investment, the government had been required to settle in cash with the creditors of the bankrupts. Then there were the costs of labor protection, the costs of the interim operations of the bankrupt carriers before Conrail came into existence, and other costs. Table V-4 shows the breakdown of these costs. The grand total of these costs is $7,816 million. The gross take from the public offering was $1,875 million. When underwriting fees and fees for financial and legal advice are netted out, the government got $1,801 million. As a minor footnote on bureaucratic history, it is worth noting the distribution of USRA's costs over time. Of the total of $187.9 million, only $26.5 million was spent in the planning phase, the rest was spent in watching Conrail in operation.

Nonetheless, nobody doubted the achievement represented by unloading the responsibility the Federal government had carried ever since, for all practical purposes, Congress had responded to the one-day strike on the Penn Central in February of 1973. It took 13 years for the government to take on that unwanted responsibility, decide how to deal with it, and, finally, get rid of it.

CHAPTER VI

REFLECTIONS

When all is said and done, what was achieved in the United States government's response to the bankruptcy of the Penn Central? Viewed in some ways, a great deal was accomplished. At the starting point, there was the Penn Central merger. A large, some one would say bloated, certainly unwieldy, new railroad firm was formed and immediately began to sink in a financial quicksand. It was, in part, the victim of its own inability to function effectively as an operating railroad. It was also the victim of changing economic circumstances in the Northeast which limited its potential for revenue growth. As much as anything, though, it was the victim of the myth which loaded it with burdens it could not carry. According to the myth, any large railroad firm was inherently rich enough to employ more workers than it needed and to provide passenger service to riders who would not pay the cost of that service - and some freight service to shippers who could not, or would not, meet the costs of those services. So strong was the myth that the bankruptcy of the Penn Central caused little furor outside the financial community. It was not until the bankruptcy trustees provoked a strike with their efforts to rationalize the labor force that the body politic could be forced to take notice of the PC's problem. Then it was deeply alarmed, and the United States Congress started to try to do something about the problem.

Congress responded by providing interim operating funds while establishing a structure for seeking a solution and then directing others to plan that solution. Because of its suspicion of the Nixon Administration and of the Department of Transportation, Congress created a new body, the United States Railway Association (USRA), to do that planning. The notion was that USRA was to be an independent and objective planner, Congress' creature, but above the fray. There were, however, sharp limits on what USRA could do.

One was time. USRA did not really have management and staff in place until the summer of 1974, and the Preliminary System Plan (PSP) was published on February 26, 1975. This means that no more than six months or so was available for the actual conduct of analysis. This is very little time for such an undertaking. The more severe constraint was the political one. USRA worked in an intensely political environment; Congress was not anxious to destroy the myth. USRA's major official statements, the Preliminary System Plan and the Final System Plan stated, as did the PC trustees in 1972, that the railroad could not operate profitably without fundamental reforms. Nonetheless, those reforms were not addressed, except for the branch-line problem, and that only partially.

Conrail, as launched, embodied an extension of the myth. The lines of the bankrupts had been gathered together and handed over to Conrail, and Conrail was given a sizeable chunk of government capital to get started with. The creditors of the bankrupts were not a problem for Conrail, since the government was going to deal with them. In the fundamentals, however, the Conrail that got started on April 1, 1976, was little better off than the Penn Central that went bankrupt on June 21, 1970. Amtrak had reduced the passenger problem, but Conrail still had to operate commuter service. There were still plenty of unremunerative lines and unremunerative traffic. There was still a vastly oversized labor force and no prospect of it getting any smaller. The prospects for traffic growth were no better than they had been before. Aside from the assumption of much of the passenger burden by Amtrak, the only real difference between the new Conrail and the bankrupt Penn Central was that Conrail had the government for a bank. The myth still lived in that many people hoped that low-priced, or zero-priced, government finance would make the difference.

Could the situation in the spring of 1976 have been otherwise? This sort of historical analysis is extremely difficult, because it contains such a large element of conjecture; it is impossible to know if the outcome of the USRA process could have been any different. Nevertheless, a review such as this one must at least touch on the question. It is clear that Congress did not want to destroy the myth. To do so would have been to inflict pain on the interests that were the myth's beneficiaries. Congress was not ready to do that; certainly, Congress did not appear ready to do that. It was not at all interested when the Secretary of Transportation argued the merits of selling off the properties of the bankrupts and just not having Conrail.

Would Congress' attitude have been any different, if USRA had been more forceful with its caveats? Both the PSP and FSP carry the warnings in the text that the fundamentals must be addressed or profitability cannot be attained. Nonetheless, USRA offered optimistic forecasts when it was quite clear that the fundamentals were not going to be addressed. The Final System Plan told Congress that, with $2.1 billion in government money, Conrail would be able to stand on its own. That was the main message in the FSP. The cautions were the lesser message. Suppose USRA had offered a bleaker forecast, stating that, under the prevailing conditions, Conrail would need indefinite government subsidy. Would it have made a difference? Would Congress have been more prepared to take hard measures, if it had not had USRA's reassuring financial projections before it?

As already noted, there can be no certain answers to these questions. At the time of these events, this writer was a staff member in the Department of Transportation and very certain that USRA had taken the easy way out, missing an opportunity for more profound reform. Looking at the same events in retrospect, this writer is now inclined to a different view: that USRA's leaders were making a correct judgement of the political climate and any attempt to push Congress toward a harsher stance would have been useless. In creating Conrail, Congress was certainly extending the life of the myth. Nonetheless, it can also be

argued that Congress was setting up a necessary experiment. Certainly, the failure of Conrail as it was launched by the 4R Act played a powerful part in finally bringing needed reform, not just for Conrail, but for the whole rail industry. When Conrail failed, Congress was then ready to declare the myth dead, for it was obviously false. Everybody could see that Conrail could not generate the income with which to keep on subsidizing the beneficiaries of the myth. Through 1979, Conrail's rail operations were still consuming over a million dollars a day of government money. Without that palpable fact, clear to all, lying before it, could Congress have moved as decisively as it finally did when it passed the Staggers Act and then the Northeast Rail Service Act? This writer doubts it.

The same questions that have been raised about USRA can also be raised about the management of Conrail in the first four years after the 4R Act (to a considerable degree, they were the same people: the first chairman of Conrail had been president of USRA). They may be criticized for continuing to operate as if their main mission was to bend with the political climate, not try to change it. They kept running out of money and coming to Congress for more. They did little to improve Conrail's operations. On the other hand, the leaders of Conrail at that time were also leaders, and, by all accounts, effective ones, in the fight for railroad regulatory reform. A strong case can be made that they had to maximize their strength for the battle for deregulation and so were very wise to avoid acquiring any more enemies than they had to. In order to get reform, they had to fight only one battle at a time.

It seems equally important to acknowledge that, as the nature of the challenge faced by Conrail changed from a focus on public policy to a focus on operating effectiveness and credibility, the shift in management to Stanley Crane's leadership was of critical importance. There are very few observers of the Conrail saga who do not credit him with a major share of the credit for the eventual favorable outcome. In fact, the roles played by Crane, by Judge Fullam (the original bankruptcy judge), by Transportation Secretaries Drew Lewis and William Coleman, by Deputy Transportation Secretary John Barnum and Federal Railroad Administrator Robert Blanchette underline a fact which should never be ignored: personal leadership and personalities are important. Had these men not been in place, at the critical times when they emerged, the outcome might well have been different and less favorable.

Another question that cannot be avoided is whether Conrail can, in fact, continue to survive as a profitable firm, or whether it should still be broken up and sold to the two stronger railroads that operate in the southern part of the Northeast and in the Southeast, the CSX and the Norfolk Southern (these firms are successors, via mergers, of the Chessie System and the Norfolk and Western that were referred to earlier). Many objective observers question whether Conrail can survive for the long run. Certainly (see Table V-2), USRA's traffic projections for Conrail were grossly overoptimistic. Conrail has little of the coal or grain traffic that stronger railroads can count on as a revenue source for which they do not have to compete with trucks. Much of what Conrail carries are manufactured goods or intermediate materials for manufacturing processes, traffic for which trucks are strong competitors.

The question of whether Conrail should be left to stand alone is now largely one for the market and Conrail's management. In any event, it cannot be settled in this paper. It is more useful to turn back to the question posed in the first sentence of this chapter: what was achieved? The answer can well be stated in what was avoided. The bankruptcy of the Penn Central and the other northeastern railroads brought on a crisis whose resolution was by no means certain. For a long time, the United States had enjoyed a system under which the railroads supported themselves while employing excess labor and providing several classes of their customers with subsidized service. When it became clear that the railroads, at least the northeastern ones, could no longer afford to do this, there were two choices:

> terminate the flow of unearned benefits and leave the railroads in the private sector; or
>
> maintain the flow of benefits and allow the railroads to become quasi-permanent wards of the state.

The United States ultimately took the former choice and avoided the latter choice. That is what was achieved in the long struggle with the northeastern railroad problem. It was a major achievement, and it was not an inevitable outcome. Outright nationalization of the railroads was never a live question in the main political debate, but it was certainly being talked about on the edges. USRA felt compelled to give the option of Federal ownership of the railroad rights-of-way at least cursory examination. The greater danger was that de facto nationalization in the form of an indefinite financial dependency would have been allowed to occur. At the time of the 4R Act and in the next few years it certainly looked as if it might occur. That it did not, was a major achievement.

It was also an achievement that was a long time in coming. It took thirteen years and five or so billion dollars (netting out the proceeds of the sale of Conrail) for the government to turn the PC and the other bankrupts into a railroad firm that could stand on its own. In retrospect, it is doubtful that it could have been done much faster or much cheaper. Almost by definition, economic reform means that pain must be inflicted on those that have benefitted from an inefficient way of doing things. The more valuable the reform, the stronger the interest groups that oppose it. This tends to be as true in societies with non-market economies as in the market-oriented democracies, a point which is being emphasized by the Soviet Union's experience with perestroika.

Certainly, one lesson from the Conrail experience that can be applied outside the United States and, particularly, in developing countries, is that meaningful reform of economic institutions is a slow and difficult process, even in a comparatively wealthy and stable society. This does not mean that aimed at the elimination of economic inefficiencies should not be sought. On the contrary, it must be striven for with vigor, but also with patience and a strategic sense of timing and opportunity. It also means, however, that reforms of this sort must not be undertaken

lightly. There must be adequate time for all analyses to be completed, reviewed, and for affected parties to adjust. There must also be available sufficient resources, both financial and human skills. Finally, there remains the need for patience, and, most important, political will.

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