

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

Examination Of United States Railway Association's Financial Statements, Fiscal Year 1979

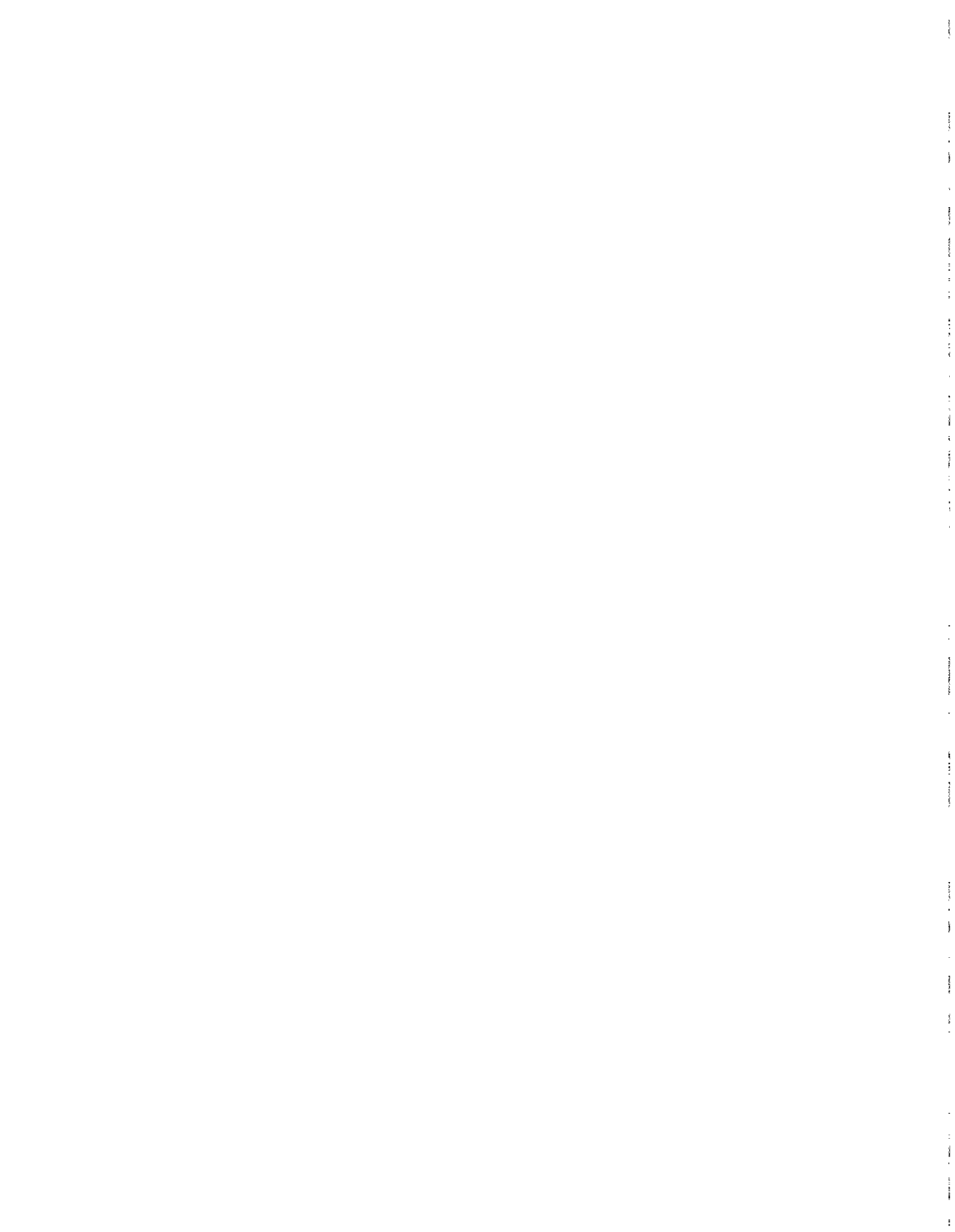
The United States Railway Association monitors and provides financing for Conrail, which operates railroads in the Midwest and Northeast.

Because Conrail's future is uncertain, GAO questions whether the Government's investment will be repaid. This circumstance, and the material effect that Conrail securities have on USRA's assets and income, make it impossible for GAO to render an opinion on USRA's fiscal year 1979 financial statements.



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GED-80-107
JULY 31, 1980





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

B-164497(5)

To the President of the Senate and the
Speaker of the House of Representatives

This report presents the results of our audit of the United States Railway Association's financial statements for the fiscal year ended September 30, 1979. Our audit was made pursuant to the Government Corporation Control Act (31 U.S.C. 841).

We are sending copies of this report to the Director, Office of Management and Budget; the Secretary of Transportation; and the Chairman, Board of Directors, United States Railway Association.

A handwritten signature in black ink, reading "Luther B. Stacks".

Comptroller General
of the United States



COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

EXAMINATION OF UNITED STATES
RAILWAY ASSOCIATION'S
FINANCIAL STATEMENTS, FISCAL
YEAR 1979

D I G E S T

The United States Railway Association (USRA), a nonprofit, mixed-ownership Government corporation of the District of Columbia, was created under the Regional Rail Reorganization Act of 1973 to develop and implement a plan to reorganize bankrupt railroads in the Midwest and Northeast. USRA's final system plan for reorganizing the bankrupt railroads into one system was submitted to the Congress July 26, 1975, and the new system--Consolidated Rail Corporation (Conrail)--began operations on April 1, 1976.

USRA

- controls the flow of Government investment and loan funds to Conrail,
- monitors Conrail's performance,
- participates in litigation regarding the allocation of Conrail securities and compensation to the bankrupt railroads whose assets were taken to form Conrail,
- administers railroad loan programs, and
- investigates alternatives to and for Conrail.

GAO does not give an opinion on USRA's financial statements because Conrail's ability to repay the USRA investment in Conrail securities is uncertain.

Conrail has not become a profitable, self-sustaining operation. Both USRA and Conrail believe that Conrail is not likely to succeed without major Government-approved changes to its operating environment or substantial additional Government investment beyond the \$3.3 billion the Congress has

already authorized. What action, if any, the Government might take to enable Conrail to become profitable is not known at this time. Therefore, Conrail's prospects for continuing operations indefinitely are uncertain and, consequently, so is Conrail's ability to repay USRA's investment in its securities.

The book value of USRA's Conrail securities exceeds \$2.7 billion and constitutes more than 80 percent of USRA's assets. More than 95 percent of USRA's income comes from Conrail stock issued to pay interest on USRA's Conrail debentures. In view of the uncertainty regarding Conrail's ability to repay USRA's investment and the size of this investment, GAO cannot give an opinion of USRA's financial statements.

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ABBREVIATIONS

Conrail	Consolidated Rail Corporation
D&H	Delaware & Hudson Railway Company
FRA	Federal Railroad Administration
FSP	final system plan
GAO	General Accounting Office
MKT	Missouri-Kansas-Texas Railroad Company
USRA	United States Railway Association

CHAPTER 1

INTRODUCTION

The United States Railway Association (USRA), a nonprofit, mixed-ownership Government corporation, was created by the Regional Rail Reorganization Act of 1973 (Public Law 93-236). It was incorporated on February 1, 1974, in the District of Columbia under the provisions of the District of Columbia Non-profit Corporation Act (Public Law 87-569). USRA was created to develop and implement a plan to reorganize bankrupt railroads in the Midwest and Northeast region.

The Regional Rail Reorganization Act of 1973 authorized USRA to plan a rail service system that would meet the region's service requirements and to make recommendations for and assist in organizing the bankrupt railroads into an economically viable system. On July 26, 1975, USRA sent the Congress its final system plan (FSP) for reorganizing the bankrupt railroads.

The act also established a profitmaking corporation called the Consolidated Rail Corporation (Conrail) to operate and modernize all or parts of the restructured rail system. Selected rail properties of the bankrupt railroads were conveyed to Conrail on April 1, 1976.

USRA's responsibilities were greatly altered by the Railroad Revitalization and Regulatory Reform Act of 1976 (Public Law 94-210) and the conveyance of rail properties to Conrail. USRA's role now includes

- purchasing Conrail securities,
- monitoring Conrail operations,
- establishing the value of the railroad transportation properties that created Conrail,
- administering railroad loan programs under sections 211(a) and 211(h) of the 1973 Regional Rail Reorganization Act, and
- investigating alternatives to and for Conrail.

USRA provides funds to Conrail under a financing agreement that establishes formal investment and monitoring. The intent of the financing agreement and the FSP is to make Conrail a profitable enterprise. Under the financing agreement,

USRA provides funds to Conrail in exchange for Conrail securities. USRA has invested \$2.5 billion in Conrail as of September 30, 1979.

The financing agreement does not allow USRA to change Conrail's business plans but only to review them. In other words, this arrangement permits USRA to monitor Conrail's performance and make frequent judgments about its chance for success without becoming involved in the railroad's management.

USRA monitors Conrail's operations by reviewing service quality, equipment reliability, labor productivity, car utilization, track rehabilitation, and operating costs. USRA also analyzes Conrail's cash needs to determine whether its requests for funds are justified and reasonable.

Litigation consumes much of USRA's budget and professional resources. Determining the compensation owed to the bankrupt railroads whose rail assets were taken over by Conrail is the major court case. Other lawsuits concern USRA's designation or failure to designate certain rail properties for conveyance under the Regional Rail Reorganization Act.

In addition to financing Conrail's rehabilitation, USRA administers loans under sections 211(a) and 211(h) of the Regional Rail Reorganization Act. The 211(a) loans have been provided to two railroads--the Delaware & Hudson Railway Company (D&H) and the Missouri-Kansas-Texas Railroad Company (MKT). USRA loaned D&H funds to purchase locomotives, add routes, and operate over Conrail track to provide competition to Conrail. The MKT loans are for track and equipment rehabilitation. The 211(h) loans are for Conrail, which pays rail-related obligations the bankrupt railroads incurred before Conrail's formation.

USRA has an 11-member Board of Directors and is managed by a President and 5 Vice-Presidents responsible for USRA's operating departments. The five operating departments are finance, operations and marketing, law, governmental affairs, and administration. USRA currently has 300 full-time employees.

The 11-member board consists of 3 ex officio Government members and 8 private sector members. The Government members are the Secretaries of the Departments of Transportation and Treasury and the Chairman of the Interstate Commerce Commission. The private sector members are appointed by the President and confirmed by the Senate for 6-year terms.

These board members are nominated by shippers, cities and States, the financial community, labor, and the railroad industry.

CHAPTER 2

CONRAIL SECURITIES REPAYMENT UNCERTAIN

Conrail's prospects for becoming a profitable, self-sustaining operation are uncertain, and therefore it is uncertain whether Conrail will ever be able to repay USRA's investment in its securities. Because of this circumstance and the size of USRA's investment in Conrail, we do not express any opinion on USRA's fiscal year 1979 financial statements.

USRA'S CONRAIL SECURITIES INVESTMENT

USRA receives Conrail debentures and series A preferred stock in return for investing up to \$3.3 billion in funds appropriated by the Congress. USRA also receives series A preferred stock as payment for the 7.5-percent interest on Conrail debentures. As of September 30, 1979, USRA had invested \$2.5 billion in Conrail, and interest on the debentures totaled \$179 million. USRA's Conrail investment totals more than 80 percent of USRA's total assets reported on its fiscal year 1979 statements. USRA's interest income from its Conrail debentures (paid in Conrail series A preferred stock) totals more than 95 percent of USRA's total income reported on its fiscal year 1979 statements. USRA values its Conrail securities at cost, which equals the securities' redemption value. No market value exists for Conrail's securities as they are not traded by the public.

CONRAIL'S FUTURE AS A VIABLE ENTERPRISE IS UNCERTAIN

USRA planners expected that Conrail would become profitable by 1979 and that a \$2.1 billion Government investment would be enough to restore the railroad to physical and financial health. This has not happened. The original \$2.1 billion Government investment limit has been raised to \$3.3 billion, and, instead of a profit, Conrail is reporting a \$178 million loss for 1979.

A September 1979 joint staff report issued by USRA and the Federal Railroad Administration (FRA) stated that Conrail will not become self-sustaining in its current operating environment within the \$3.3 billion Government investment limit. Conrail, the report says, has reached "a crossroads, with its future and the Federal role in that future unresolved."

The report indicates that Conrail is not likely to succeed unless additional Federal funding, which it estimates under one alternative could reach \$1.7 billion, is granted or other Government action is taken to change Conrail's environment. The other Government action mentioned involves (1) reforming the Government-imposed regulations on pricing and on market entry and exit and (2) approving a substantial reduction in Conrail's track by as much as 6,200 miles.

Conrail's own August 1, 1979, business plan and statements by its chairman also indicate that Conrail is not likely to succeed without substantial regulatory reform, track reduction, or major additional Government investment.

No guarantee exists, however, that any of these proposed Government actions will make Conrail self-sustaining. Furthermore, predicting with any certainty what the Government will do is not possible. The Government may even choose to dissolve Conrail and transfer its lines and operations to other railroads. The USRA-FRA staff report mentions this possibility as an alternative to Conrail.

The uncertainties regarding Conrail's future make it uncertain whether the Government's investment in Conrail will be repaid. This circumstance and the material effect that Conrail securities have on USRA's assets and income make it impossible to render an opinion on USRA's fiscal year 1979 financial statements. We therefore disclaim any opinion on these statements. (See ch. 3.)

AGENCY COMMENTS

In commenting on a draft of this report, USRA stated its belief that the report as written could give a misleading impression to the public. USRA stated that for a more balanced presentation of the uncertainties regarding Conrail's ability to repay USRA's investment, the report should include information concerning:

- Conrail's improved financial performance in 1979 when losses totaled \$207 million less than the 1978 losses of \$385 million.
- Senate passage of extensive rail regulatory reform legislation and House consideration of similar legislation. Such legislation would give Conrail an opportunity to further improve its financial performance.
- USRA's legal priority, with respect to all Conrail assets, over holders of series B preferred stock and

common stock, and the book value of these assets, which exceeded Conrail's liabilities (excluding USRA debentures) by \$2.2 billion as of December 31, 1979.

--Conrail's use of more than 90 percent of USRA-invested funds to increase and improve its physical assets.

We considered USRA's suggested additions and came to the following conclusions.

--Although Conrail's financial performance in 1979 improved over 1978, Conrail still lost \$178 million. As we point out on page 5, both USRA and Conrail have stated that Conrail cannot become self-sustaining without considerable additional Government investment or other Government action to change Conrail's environment. Government action in this area is difficult to predict, and no guarantees exist that additional investment or other proposed actions would ultimately make Conrail profitable.

--We do not know how much help current legislative proposals for reforming railroad regulation would give Conrail. Railroads generally view the proposals passed by the Senate as positive steps, but as less than complete reform.

--We believe that substantial uncertainties exist about how much Conrail's assets could be sold for under liquidation. We note that as of December 31, 1979, the book value of Conrail's assets after all liabilities are subtracted is more than \$500 million short of covering USRA's investment in Conrail stock.

CHAPTER 3

SCOPE OF AUDIT AND DISCLAIMER OF OPINION ON USRA'S FINANCIAL STATEMENTS

We examined the statement of USRA's financial condition as of September 30, 1979, and the related statements of revenues, expenses, and losses and changes in financial position for the year then ended. Our examinations were made in accordance with Comptroller General standards for compliance audits and included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As discussed in the USRA financial statements under the Summary of Significant Accounting Policies and footnote 3 to the statements, Conrail securities are valued at cost, which equals their redemption value. Significant uncertainties exist, however, regarding Conrail's ability to repay USRA's investment in its securities. USRA and Conrail have said that regulatory reform and/or additional Government investment substantially beyond that currently authorized by the Congress is necessary to make Conrail self-sustaining. Unfortunately, no assurance exists that these measures will make Conrail self-sustaining. Furthermore, it is not possible to predict with any certainty whether the Government will provide the necessary reforms or additional financial assistance to Conrail. USRA's Conrail securities holdings compose more than 80 percent of USRA's assets and more than 95 percent of USRA's income. The ultimate outcome of this matter cannot presently be determined and could have a substantial effect on USRA's financial position and results of operations. (See ch. 2.)

Due to the effects of the matters discussed in the preceding paragraph, we do not express an opinion on USRA's financial position as of September 30, 1979, or the results of its operations and changes in its financial position for the year then ended.

UNITED STATES RAILWAY ASSOCIATIONSTATEMENT OF FINANCIAL CONDITIONAS OF SEPTEMBER 30, 1979

(Thousands of Dollars)

ASSETS

Cash	\$ 96,139
Certificates of Deposit	61
Accounts receivable	285
Interest receivable (Note 1)	105,164
Loans receivable (Note 2)	387,252
Furniture and equipment	481
Investments:	
Conrail 7.5% Debentures, due January 1, 2011	1,000,000
Conrail series A preferred stock (Note 3)	<u>1,653,442</u>
 TOTAL ASSETS	 <u>\$3,242,824</u>

LIABILITIES AND FUND BALANCES

Liabilities:

Accounts payable and accrued liabilities	\$ 3,119
Interest payable	9,313
Loans payable (Note 4)	<u>445,747</u>

TOTAL LIABILITIES \$ 458,179

Fund balances:

Contributed capital (appropriations)	\$2,679,500
Retained earnings	<u>105,145</u>

TOTAL FUND BALANCES \$ 2,784,645TOTAL LIABILITIES AND
FUND BALANCES \$3,242,824

The notes on pp. 12 to 14 are an integral part of this statement.

UNITED STATES RAILWAY ASSOCIATION
STATEMENT OF REVENUES, EXPENSES, AND LOSSES
FOR FISCAL YEAR ENDED SEPTEMBER 30, 1979

(Thousands of Dollars)

REVENUES:

Interest income (Note 5)	\$75,000
Financing and investments income - net (Note 6)	<u>2,806</u>
TOTAL REVENUES	<u>\$77,806</u>

EXPENSES:

Personnel compensation and related benefits	\$ 9,076
Travel and representation	584
Printing and expendable items	981
Rents, utilities and communications	1,619
Contractual services	<u>20,012</u>
TOTAL EXPENSES	<u>\$32,272</u>
EXCESS OF REVENUES OVER EXPENSES	<u>\$45,534</u>

LOSSES:

Loss on settlement of a loan receivable (Note 2)	\$ <u>2,228</u>
NET INCOME	<u>\$43,306</u>

The notes on pp. 12 to 14 are an integral part of this statement.

UNITED STATES RAILWAY ASSOCIATION
STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR FISCAL YEAR ENDED SEPTEMBER 30, 1979

(Thousands of Dollars)

Cash and certificates of deposit on October 1, 1978	\$ <u>131,771</u>
SOURCES OF FUNDS	
From operations:	
Excess of revenues over expenses and losses	\$ 43,306
New appropriations	<u>702,200</u>
	\$ <u>745,506</u>
Increase (decrease) in liabilities:	
Accounts payable and accrued liabilities	2,077
Interest payable	(26,948)
Loans payable	<u>88,950</u>
TOTAL	\$ <u>809,585</u>
USES OF FUNDS	
Purchase of Conrail Series A preferred stock	\$ 708,000
Increase (decrease) in other assets:	
Accounts receivable and advances	(300)
Prepaid expenses	(2)
Interest receivable	32,386
Loans receivable	30,183
Furniture and equipment	(111)
Conrail Series A preferred stock (received as payment of interest)	<u>75,000</u>
TOTAL	\$ <u>845,156</u>
INCREASE (DECREASE) IN FUNDS	
Cash	\$ (35,588)
Certificates of deposit	17
	\$ <u>(35,571)</u>
Cash and certificates of deposit, end of year	\$ <u><u>96,200</u></u>

UNITED STATES RAILWAY ASSOCIATION
SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

SEPTEMBER 30, 1979

Following is a summary of significant accounting policies of the United States Railway Association.

- . Assets, liabilities, revenues and expenses are recognized on an accrual basis of accounting.
- . Loans receivable are stated at face value of the note or loan agreement.
- . Furniture and equipment items costing \$200 or more are capitalized and stated at cost without allowance for depreciation. Depreciation expense is not recognized due to the temporary nature of the Association's existence and the relative immateriality of the depreciation expense amounts involved.
- . Holdings in Conrail Series A preferred stock resulting from purchases are stated at cost (\$100 per share). Shares received in payment of interest due on Conrail debentures are stated at redemption value (\$100 per share).

UNITED STATES RAILWAY ASSOCIATION

NOTES TO FINANCIAL STATEMENTS

SEPTEMBER 30, 1979

1. Interest Receivable

Interest receivable of the Association as of September 30, 1979 consisted of accrued interest on the following:

Conrail 7.5% Debentures	\$ 31,438,356
Section 211(a) loans	5,743,472
Section 211(h) loans	<u>67,982,224</u>
Total	<u>\$105,164,052</u>

Interest on Conrail 7.5 percent debentures is due on April 30th of each year. As provided in the Financing Agreement between USRA and Conrail, interest is payable in Conrail Series A preferred stock if cash is not available. To date all interest payments received from Conrail have been in the form of stock.

Interest on Section 211(a) loans consists of \$1,353,958 accrued but not yet due and \$4,389,514 due from the Delaware & Hudson Railway (D&H) but deferred by the Association's Board of Directors.

Interest on Section 211(h) loans consists of \$11,168,897 accrued but not yet due and \$56,813,327 resulting from the compounding of interest in accordance with notes and financing agreements.

2. Loans Receivable

Loans receivable of the Association as of September 30, 1979 consisted of \$43 million under Section 211(a) and \$344.2 million under Section 211(h) of the 3R Act as follows:

Section 211(a) Loans:

Delaware and Hudson Railway	\$30,000,000
Missouri-Kansas-Texas Railroad	<u>13,000,000</u>
Total	<u>\$43,000,000</u>

Section 211(h) Loans:

Conrail	\$ 76,923,458
Penn Central	236,505,669
Central Railroad of New Jersey	19,687,592
Other estates	<u>11,135,700</u>
Total	<u>\$344,252,419</u>

During fiscal year 1978, USRA's Board of Directors informed Congress that they could no longer make the required legal findings as to the D&H's ability to repay its loans. Congress and the President responded by enacting Public Law 95-611 which liberalized the loan conditions governing the D&H. In November 1979, Congress enacted legislation permitting an increase in the D&H loan authorization from \$30 million to \$34 million.

Performance of the MKT railroad continues to meet or exceed original loan projections. Full repayment of the loan is anticipated by 1982.

Loan advances to Conrail in its capacity as agent for bankrupt estates are subject to repayments under reorganization plans approved for the bankrupt railroads. On October 24, 1978 the Association received two secured notes from the reorganized Penn Central Corporation, valued at \$278.8 million, representing full principal and interest due on Section 211(h) loans. On September 14, 1979 the Association received from the former Central Railroad of New Jersey, under a separate plan of reorganization, \$19,687,591.62 in secured notes. This settlement represented 90 percent of the principal and interest due from the railroad resulting in a loss of \$2.2 million on settlement of the previous loan.

The remaining \$88,059,158 in Section 211(h) loans receivable is unsecured at this date. Of this amount, \$23.6 million was disbursed by Conrail, as directed by Public Law 95-597, to pay health and life insurance premiums for retired employees of the bankrupt estates. The reorganized Penn Central Corporation has challenged in court its legal liability for their share (\$18.3 million) of the payment. Settlement of the remaining \$64.5 million in Section 211(h) loans receivable will be subject to legal settlements of reorganization plans of the bankrupt estates.

3. Investments

The Association's holdings of Conrail Series A preferred stock consist of 16,543,420 shares, stated at \$100 per share. Of this amount 14,740,000 shares were purchased at

\$100 per share. The remaining 1,794,420 shares were received by USRA in payment of interest due on Conrail debentures at the rate of one share for each \$100 of interest due. Market value of the stock is not readily determinable since the stock is not traded on the open market.

Dividends on Conrail Series A preferred stock holdings are non-cumulative. The stock (\$1 par value) is redeemable at \$100 per share. Conditions governing payment of dividends and redemption of the stock are set forth in a Financing Agreement between USRA and Conrail.

4. Loans Payable

Loans payable by the Association as of September 30, 1979 consisted of amounts owed to the Federal Financing Bank as follows:

Section 211(a) advances

Principal advances	\$ 42,626,000
Advances to pay interest	<u>2,414,511</u>
Total	<u>\$ 45,040,511</u>

Section 211(h) advances

Principal Advances	\$344,239,701
Advances to pay interest	<u>56,467,112</u>
Total	<u>\$400,706,813</u>

Interest rates on borrowing currently exceed by as much as 5 percent the rates fixed by bankruptcy courts on amounts owed to the Association by the Penn Central Railroad and the Central Railroad of New Jersey.

5. Interest Income

The Association received 750,000 shares of Conrail preferred stock as payment of \$75 million in interest due on Conrail 7.5 percent debentures.

6. Financing Income - Net

Net financing income of \$2.8 million consisted of financing (interest) and investment income of \$36.1 million less financing (interest) expense of \$33.3 million.

Additional Notes:

Unfunded Leave and Severence Pay

The Association has a severence plan for employees entering duty prior to January 1, 1978. Under the plan employees accrued 2 days severence pay for each full month of service up to a maximum of 60 days. In addition, all employees accrued leave at the rate of 2 days per month with a maximum carryover of 60 days on a calendar year basis. As of September 30, 1979, the Association's unfunded liability for unused severence and leave totaled \$1,069,288.

Contingent Liability

The Association has issued Certificates of Value for conveyed assets transferred from bankrupt railroads to Conrail. These certificates, representing the contingent liability of the Federal Government, are deposited with the Special Court and equal the 31,740,373 of Series B preferred stock shares issued by Conrail. They guarantee the net liquidation value with certain adjustments of the assets conveyed to Conrail and are redeemable in cash by the Association on or before December 31, 1987.

The Federal Government's liability in connection with the Certificates of Value will be decided by the Special Court. This court was established by the Regional Rail Reorganization Act of 1973 to determine the Federal Government's liability for rail assets conveyed by bankrupt railroads to Conrail. The transferors originally submitted claims totaling approximately \$16 billion, but testimony filed during the past 13 months indicates that current claims total about \$5 billion.

United States Railway Association

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

Donald C. Cole
President and Chief Executive Officer

May 8, 1980

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

Dear Mr. Eschwege:

The United States Railway Association appreciates the opportunity to comment on your proposed report entitled "Examination of the United States Railway Association's Financial Statements."

The Association believes that, as written, the report, by selecting certain information and omitting other information, could give a misleading impression to the public.

The General Accounting Office report does not render an opinion on USRA's financial statements because of uncertainty regarding the ability of Conrail to repay the USRA investment of \$2.5 billion in Conrail securities. For a balanced presentation of this problem, the GAO report should include information concerning:

- (1) Conrail's improved financial performance in 1979 when losses totalled \$207 million less than the 1978 losses of \$385 million;
- (2) The fact that 90% of USRA-invested funds have been used by Conrail to increase and improve the Corporation's physical assets;
- (3) The fact that the Association has preference with respect to all Conrail assets over Series B Preferred Stock and Common Stock holders, and

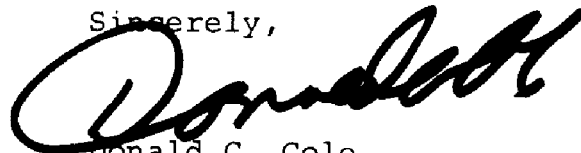
Mr. Henry Eschwege
May 8, 1980
Page Two

the book value of these assets exceeded the Corporation's liabilities (excluding USRA Debentures) by \$2.2 billion as of December 31, 1979; and,

- (4) The fact that the Senate has passed extensive rail regulatory reform legislation and the House has such legislation under active consideration. Such legislation would give Conrail an opportunity to further improve its financial performance.

I am hopeful that these comments will bring about modification in the proposed report. Should a determination be made that the report should not be modified, it is requested that the comments of the Association be incorporated in GAO's report.

Sincerely,



Donald C. Cole
President

(343743)

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