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REPORT BY THE

Comptroller General

OF THE UNITED STATES

Conrail's Reduced Capital Program Could Jeopardize The Northeast Rail Freight System

Because of limited funds, Conrail is planning to reduce its spending on track rehabilitation, additions and improvements to the physical plant, and equipment. GAO believes such cutbacks, which are similar to the strategy which contributed to the collapse of the Northeast rail system, would pose an unacceptable risk to the Federal investment in Conrail.

508955

UNITED STATES GENERAL ACCOUNTING OFFICE

CED-80-56
MARCH 10, 1980

508955

E R R A T A

To the recipients of the Comptroller General's report to the Subcommittee on Transportation and Commerce, House Committee on Interstate and Foreign Commerce, entitled "Conrail's Reduced Capital Program Could Jeopardize the Northeast Rail Freight System" (CED-80-56):

On page v of the digest, under AGENCY COMMENTS, the first sentence should be deleted and the following inserted in its place.

> Conrail disagrees with GAO's conclusion that reduced capital spending creates an unacceptable risk to the Federal investment in Conrail. Conrail believes regulatory reform and operational improvements will enable it to rejuvenate its capital programs before any serious deterioration would occur.

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

B-197328

The Honorable James J. Florio
Chairman, Subcommittee on
Transportation and Commerce
Committee on Interstate and
Foreign Commerce
House of Representatives

HSE02306

Dear Mr. Chairman:

USRA CNG00261

As requested in your August 24, 1979, letter and discussions with your office, we have evaluated the Consolidated Rail Corporation's (Conrail's) strategy of deferring capital programs as proposed in its August 1, 1979, 5-year business plan. Our evaluation centered on whether this capital strategy could hurt Conrail's prospects for long-term profitability and, if so, to determine a level of capital spending that would minimize additional Federal investment. This is our second report in response to your request. The previous report, issued on January 15, 1980, concerned Conrail's plans for eliminating rail lines which the firm believes are unprofitable. On December 20, 1979, we also briefed your office on the method Conrail used to estimate revenues in their August business plan.

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AGC00029

We believe that curtailing track programs and additions and improvements to the physical plant for 1980 and 1981 would pose an unacceptable risk to the Federal investment in Conrail. In August, Conrail believed that deregulation and estimated traffic levels would provide sufficient funds to rejuvenate the capital program beginning in 1982, but this projection was based on assumptions concerning regulatory reform whose realization is not wholly certain. As a result, plant deterioration and a return to poor service could erode many of the benefits already bought by the sizable Federal investment, and savings projected to result from additions and improvement projects will be forfeited.

According to Conrail estimates in late 1979, a larger and more appropriate capital program could be undertaken in 1980 if the decision is made early in the year, but such a program, when coupled with an increase in estimated losses, would deplete the $3.3 billion Federal authorization by the end of 1980. Thus, in 1981 Conrail may need an additional $587 million to continue a more appropriate capital program and to cover greater operating losses.

We obtained comments on a draft of this report from Conrail, the United States Railway Association, and the Department of Transportation. Those comments were considered and included where appropriate in the report.

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

Sincerely yours,

Elmer B. Staats

Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE SUBCOMMITTEE ON TRANSPORTATION AND COMMERCE HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE

CONRAIL'S REDUCED CAPITAL PROGRAM COULD JEOPARDIZE THE NORTHEAST RAIL FREIGHT SYSTEM

D I G E S T

The total Federal commitment to the Consolidated Rail Corporation (Conrail) is \$3.3 billion. Only \$645 million was left at the end of calendar year 1979. In its August 1979 business plan, Conrail proposed reducing its capital spending in 1980 and 1981 from its March business plan levels by about \$379 million to stay within the currently authorized \$3.3 billion. (Capital spending is for track rehabilitation, additions and improvements to the physical plant, and equipment.)

Conrail states that it must take such action since the Congress has not appropriated any additional funding, but the United States Railway Association says that it is Conrail's responsibility to request more funding through the Association and that Conrail has not done so.

GAO believes such cutbacks, which are similar to the strategy which contributed to the collapse of the Northeast rail system in the first place, would pose an unacceptable risk to the Federal investment in Conrail. The resulting deterioration in physical plant and decline in quality of service would erode the benefits bought by the already substantial Federal investment.

In August 1979, Conrail believed that deregulation and estimated traffic levels would provide sufficient funds to rejuvenate the capital program in 1982, but this projection was based on uncertain assumptions concerning regulatory reform (See p. 4.)

TRACK PROGRAMS

Most of the track improvement benefits realized from 1976 through 1979 may be lost because Conrail's limited track program proposal for 1980 and 1981 is at or below the level that allowed the railroad to deteriorate in the first place. Conrail plans to reduce its track program more than other capital programs, which will cause deferred maintenance to increase and the 15-year track rehabilitation program to stretch out.

Conrail's August 1979 plan reduced track expenditures for 1980 and 1981 from the March plan by $300 million, or 41 percent. With the reduced program Conrail may be able to maintain the current condition of its largely rehabilitated main lines, but unrehabilitated track could deteriorate to a point where service quality would decline and derailments would increase. Also, future track rehabilitation costs would increase, efficiencies would be lost, and cost savings from operating on better tracks would be forfeited. (See p. 6.)

Conrail proposed to decrease its track program below appropriate maintenance levels in 1980 and 1981 by 970 miles of rail and 2.8 million ties. To maintain its current track condition through an appropriate program, Conrail needs to replace about 725 miles of rail and 2.8 million ties annually, whereas the August plan is to replace 240 miles of rail and about 1.4 million ties for each of the 2 years. If Conrail is to implement a more appropriate track program in 1980, the decision must be made early in the year so material can be ordered. (See p. 8.)

ADDITIONS AND IMPROVEMENTS PROGRAMS

Planned reductions in Conrail's program to upgrade the physical plant could result in losses in operating efficiency and increases in operating cost. Conrail's August plan reduced spending in 1980 and 1981 by $78.5 million or 27 percent below March plan levels. (See p. 11.)

Conrail proposed a $90 million additions and improvements program for 1980, considerably less than should be invested in a system this size. Conrail estimates that an appropriate level would be about $123 million. (See p. 13.)

The United States Railway Association considers $130 million to be a minimum appropriate level for additions and improvements and estimates it could be as high as $150 million. As with the track program, a more intensive additions and improvements program in 1980 would require a decision early in the year. (See p. 14.)

EQUIPMENT PROGRAMS

Conrail inherited poor equipment from its predecessor bankrupt railroads but has improved the condition of its serviceable freight car and locomotive fleets. The firm now is better able to meet shipper demand.

Changed demand estimates used for the August plan caused Conrail to reduce planned freight car repairs and increase freight car acquisitions. The reduced car repairs are primarily unequipped boxcars and small hopper cars for which Conrail estimates reduced demand.

Planned locomotive acquisitions are to remain the same, as are heavy repairs, while locomotive overhauls and rebuilds are to decrease. Conrail's locomotive strategy is being studied by the Railway Association particularly since Conrail may have an average of 100 surplus locomotives per month in 1980, which it intends to lease to other railroads or put in storage if there is no rental market. (See p. 15.)

ADDITIONAL FUNDING MAY BE NEEDED IN 1981

According to late 1979 Conrail estimates, if there is no Federal regulatory reform, an additional $587 million in Federal funding would be needed in 1981 to finance capital programs at more appropriate levels in 1980 and 1981 and to cover higher projected operating losses. For these 2 years, capital investment in track, and additions and improvements would be increased by $326 million. Conrail estimates it could carry out the higher capital program in 1980 but the currently authorized $3.3 billion in Federal funding would be exhausted by year end. (See p. 2.)

ALTERNATIVES AVAILABLE TO THE CONGRESS

Because the Congress has not appropriated any additional funds, Conrail adopted a deferred capital spending strategy in order to stay within its $3.3 billion authorization. The Congress has several options for responding to the Conrail situation. These options are not mutually exclusive and the optimum response may very well be some combination of two or more of the following: (See p. 22.)

--Defer any action.

--Pledge additional funds.

--Enact regulatory reforms.

--Seek an alternative solution to rail problems in the Northeast.

MATTERS FOR CONSIDERATION BY THE CONGRESS

If Conrail defers maintenance on its system and regulatory reform permits it to rejuvenate its capital spending programs in 1982, Conrail probably can live within the $3.3 billion already authorized. If Conrail defers maintenance but does not get the regulatory relief it expects, the Government may have to provide more money in 1982 to rejuvenate the capital program. If Conrail continues an appropriate capital program and gets regulatory relief, it may be able to pay for its own capital programs sooner and the Government's investment will be minimized.

If Conrail continues an appropriate capital program but does not get regulatory relief, the Government may have to continue its funding, or seek another solution.

GAO is not recommending that Congress direct Conrail to maintain appropriate capital spending programs and pledge additional support if needed only because it recognizes the need to constrain Federal outlays, and that Congress must choose between this and many other possible uses for Federal assistance.

AGENCY COMMENTS

Conrail and USRA agreed with GAO's findings and conclusions. The Department of Transportation agreed that the Northeast needed a well-constructed and maintained rail system but disagreed with GAO's analysis of the effects of Conrail's proposed 2-year reduction and its proposal that the Congress pledge additional funding, if needed. The Department believed deregulation was preferable to continued funding for Conrail.

GAO believes a satisfactory long-term solution to the rail problem will probably require a combination of congressional actions, including regulatory reform. In the short run, Conrail has enough remaining funding to continue appropriate capital spending in 1980, if told to do so. If regulatory reforms provide the benefits Conrail estimates, its own operations should begin producing funds for appropriate capital programs in 1981 and no further Federal moneys would be needed. If regulatory reforms do not work out as estimated, Federal moneys would be needed in 1982 to rejuvenate capital spending or another rail crisis could result. In either case, GAO believes Federal investment would be higher or benefits already bought would be forfeited. GAO is not recommending any single action but believes Congress should protect its already significant investment and minimize any future needed investment. (See p. 24.)

Contents

ABBREVIATIONS

Conrail	Consolidated Rail Corporation
GAO	General Accounting Office
USRA	United States Railway Association

CHAPTER 1

INTRODUCTION

The Consolidated Rail Corporation (Conrail) began operations on April 1, 1976, with a Federal funding commitment of $2.1 billion. In 1978, the Congress authorized an additional $1.2 billion, bringing the total Federal commitment to $3.3 billion. The original $2.1 billion authorization was fully drawn down in March 1979. Conrail drew down $2.655 billion of the $3.3 billion by the end of calendar year 1979, leaving $645 million for the following years.

On March 15, 1979, Conrail submitted to the United States Railway Association (USRA) a new 5-year business plan for 1979-83, which projected the depletion of the $3.3 billion and a need for an additional $782 million through 1983. These additional Federal funds would be required to fill the gap between cash flow from operations and the large expenditures required for capital programs which would continue the plant rehabilitation begun in 1976. At that time, Conrail also predicted that if substantial regulatory reform was enacted in 1980, the additional Federal funding needs could be reduced from $782 million to $240 million.

Capital expenditures are for service improvements and for efficiency programs which are to reduce operating costs. Such modernization projects are crucial to the long-term efficiency of the railroad and were one of the objectives of the Federal investment in Conrail. These projects include track rehabilitation, 1/ additions and improvements to facilities, and equipment acquisition and overhauls.

On August 1, 1979, Conrail submitted a new business plan to USRA for 1980-84 that revised its March position as to the need for additional Federal investment of $782 million. The August plan was predicated on a changed regulatory environment and a Government investment limited to $3.3 billion. Conrail assumed that it would be able to

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1/Conrail refers to this as discretionary track maintenance, a major rehabilitation effort intended to revitalize Conrail's deteriorated rail network. For financial statement purposes these costs are capitalized, but for Interstate Commerce Commission purposes they are recorded as expenses.

function as though in a free market including extensive pricing freedom and service deregulation allowing abandonment of unprofitable lines.

To operate within the $3.3 billion authorization, Conrail proposed reductions in major capital programs during 1980 and 1981 relative to the March plan. These programs would then be increased in later years since Conrail expected funds to be available from improved cash flow resulting from regulatory reform. Thus, the August plan proposed a short-term reduction in the physical rehabilitation program that Conrail has had underway for more than 3 years. According to Conrail, these cutbacks could be tolerated only if regulatory reform were passed concurrently. Any operating maintenance problems caused by the reductions are assumed to be offset as the programs are rejuvenated in later years.

On November 15, 1979, Conrail released a 1980 budget which significantly changed financial projections made in August. Slower economic growth was forecasted which resulted in lower traffic and revenue projections. Forecasts of losses were increased by 35 percent and Federal drawdown estimates were increased by 23 percent. The August business plan forecasted a net loss of $253 million for 1980 but the November budget increased that estimate by $88 million to $341 million. The November budget cited the need for Federal funds in 1980 as $585 million. This budget brings the total drawdown since April 1, 1976, to $3.24 billion, leaving $60 million for 1981 and beyond.

Conrail based these financial projections on its reducing the capital programs as proposed in the August plan. For an alternate 1980 budget, increasing capital programs to normal levels, Conrail projected Federal funding needs at $668 million. A normal level of program work is intended to maintain the existing condition of the property and avoids deterioration of track, structures, and other facilities. The alternate budget would deplete the $3.3 billion authorization in 1980 and leave a $23 million deficit.

Subsequent to the 1980 budget, Conrail submitted to USRA on December 15, 1979, a revised forecast for the second year (1981) of the August 5-year business plan. The 1981 forecast included two financial projections; a base plan and an alternate plan. The base plan assumes modest regulatory reform and capital programs (track rehabilitation, and additions and improvements programs) would be reduced below normal levels as projected in the August business plan. In contrast, Conrail's alternate plan assumes diminished financial results due to a more restrictive regulatory environment than now exists and increases capital programs to normal and/or more appropriate levels.

For the base plan, Conrail projected a net loss from operations of $26 million in 1981 as compared to a $170 million profit projected in the August plan. The revised projections indicate that Conrail would have a $178 million 1/ cash deficit in 1981 which may require additional Federal funds if it cannot be handled through internal actions. The 1981 alternate plan projects a loss of $128 million, or about a $298 million variance from the $170 million net income anticipated in the August plan. This plan, which increases capital spending to normal levels, anticipates a need for about $564 million in Federal financing for 1981, which would require an additional $587 million authorization for that year.

SCOPE OF REVIEW

This report on Conrail's capital program strategy is based on our review and comparison of the March 15, 1979, (1979-1983) and August 1, 1979, (1980-1984) business plans, budget projections for 1980, and revised forecasts for 1981. We also discussed Conrail's capital programs with Conrail and USRA officials and examined pertinent USRA documents. We discussed matters in this report with Conrail, USRA, and Department of Transportation officials, who agreed that our information is accurate.

1/Conrail estimated a $144 million deficit using an estimated total Federal funds drawn down of $2.621 billion through 1979. Actual drawdown was $2.655 billion which increases the estimated deficit to $178 million in 1981.

CHAPTER 2

DEFERRING CAPITAL PROGRAMS

IS A HIGH-RISK STRATEGY

Conrail's strategy of deferring capital programs presents a high risk to the Federal investment in Conrail. The resulting increase in deferred maintenance and increased costs, due to forfeiture of operational efficiencies, could erode the service benefits already gained by the substantial Federal investment. A fundamental objective of restructuring rail service in the Northeast was to restore adequate service and improve service quality.

A critical assumption in Conrail's August business plan is that complete regulatory reform will provide increased income and improved cash flow to rejuvenate capital programs in later years. The structure of regulatory reform may not be as Conrail assumed, and therefore the funds from operations needed to increase the programs to appropriate levels may not be available.

USRA has repeatedly expressed concern that the significant deferral of capital programs and the uncertain status of regulatory reform present a high risk. Therefore, for the 1980 budget and the 1981 forecast emanating from the August business plan, USRA requested Conrail to submit alternative budgets and plans reflecting capital programs being continued at more appropriate spending levels.

In response to the request, Conrail submitted alternative plans for 1980 and 1981 projecting an increase of $326 million to the capital additions and improvements and track programs. The following schedule compares the alternative capital programs with the August business plan.

Comparison of Capital Programs Spending Levels

	Alternative plans (note a)			August 1, 1979, business plan			Increase over August plan
	1980	1981	Total	1980	1981	Total	
	(000,000 omitted)						
Additions and improvements programs	$130	$150	$280	$ 90	$121	$211	$ 69
Track rehabilitation programs	323	369	692	200	235	435	257
Total	$453	$519	$972	$290	$356	$646	$326

a/Self-sustaining or appropriate normalized maintenance levels.

The increases in the capital programs represent the additional investment necessary to bring the programs to normal levels. For the alternative plans, Conrail projects that additions and improvements spending would rise to $280 million, $69 million above the August plan. The track rehabilitation increase of $257 million adjusts the track program to normal levels to avoid accumulation of deferred maintenance but does not rehabilitate or upgrade the overall condition of the track.

The changes in the alternative plans lead to quite different estimates for Federal investment. The August plan, assuming complete regulatory reform, projected no additional Federal investment beyond the current authorization of $3.3 billion, which would have been exhausted by 1983. However, the alternative plan projections for 1980, assuming normalized track and additions and improvements spending, would deplete the $3.3 billion authorization by the end of 1980 and leave a $23 million deficit. The alternative plan for 1981, assuming a higher net loss due to more pessimistic economic forecasts and a more restrictive regulatory environment than now exists, as well as continuing normal capital programs, estimates financing requirements for the year at about $564 million. The $564 million, increased by a $23 million deficit from 1980, results in an estimated 1981 Federal financing need of $587 million. The additional $587 million would increase the total Government investment in Conrail to about $3.9 billion.

Conrail's Senior Vice President for Planning, Control, and Information Systems said that Conrail is presently pursuing a strategy of deferred maintenance but that it will review this strategy in March 1980 to determine if additional moneys can be put into the program. He said that in the absence of any other funding authorization, the firm has no choice. Therefore, it is Conrail's position that in the absence of firm Federal quidance indicating the availability of additional funds if needed, Conrail has taken the proper steps of developing plans to live within its means.

On the other hand, USRA's staff pointed out that Conrail in its alternative plans has not made a specific request for additional funding to carry out a higher level of track maintenance, and additions and improvements capital spending programs. USRA staff notes that even at the reduced levels of maintenance, and additions and improvements spending, Conrail stated it would have a shortfall of funds in 1981, but the firm said it would cover the shortfall by managing its resources. The USRA staff further stated that the USRA Board has been considering Conrails' deferred maintenance scenario and will continue to do so.

Capital improvement programs are essential to Conrail's long-term viability. These programs include track rehabilitation, additions and improvements to facilities, and equipment overhauls and acquisition. A synopsis of the facts developed for each of these programs follows.

TRACK REHABILITATION DEFERRALS COULD AFFECT OPERATIONS

Conrail's track system has been only partially rehabilitated and deferring maintenance could harm service and increase derailments. Conrail acquired a deteriorated physical plant from its bankrupt predecessor railroads--the result of their reluctance to make needed investments due to the short supply of funds and the low prospects for return on investment.

After conveyance and with the infusion of substantial Federal moneys, Conrail initiated a program to halt further track deterioration and to improve track quality. This track rehabilitation program was expected to take 15 years to complete and, to date, Conrail has succeeded in largely rehabilitating its most important main lines. This progress was noted in our report "Conrail Faces Continuing Problems" (CED-78-114), dated October 6, 1978. In that report, we stated that Conrail had replaced more rail than originally planned but that it had cost more and that Conrail had problems with productivity, budgeting, and cost controls. In 1979 Conrail shifted some emphasis of its track program from main lines to yards and secondary main lines where deteriorated track was interfering with its service quality.

In its August business plan, Conrail proposed to curtail its track rehabilitation program more than other capital programs in order to stay within the current Federal funding. Conrail planned to reduce its 1980 and 1981 track maintenance expenditures by $300 million, or 41 percent below the levels it planned in March. However, accelerated investment in 1983 above March levels was expected to reduce the 1980-83 cumulative shortfall to $278 million.

The following table compares track maintenance expenditures as proposed by the August and March plans.

Track Maintenance Expenditures

	1980	1981	1982	1983	1980-83	1984
	(000,000 omitted)					
August plan	$200	$235	$369	$472	$1,276	$506
March plan	356	379	399	420	1,554	-
Variance	$(156)	$(144)	$(30)	$ 52	$(278)	-

Conrail's 1980 budget, released in November 1979, reflects the reduced track expenditures for 1980 as presented in the August plan. The reduction in expenditures, if continued in subsequent years, means that Conrail will cut rail replacement by 1,576 miles and tie replacement by 4 million during 1980-83. Paralleling the expenditure pattern, work reductions are most pronounced in 1980 and 1981 when rail replacement will be reduced by 1,272 miles, or 73 percent, and tie replacement will be reduced by 3.6 million, or 56 percent. Rail surfacing will be increased by about 6 percent in an attempt to minimize the operational effects of deferring maintenance.

The following table compares the work program presented in the two plans.

Track Maintenance Program

	1980	1981	1982	1983	1980-83	1984
Rail (miles):						
August plan	240	240	572	876	1,928	876
March plan	876	876	876	876	3,504	-
Variance	(636)	(636)	(304)	0	(1,576)	-
Ties (millions):						
August plan	1.3	1.5	2.8	3.2	8.8	3.2
March plan	3.2	3.2	3.2	3.2	12.8	-
Variance	(1.9)	(1.7)	(0.4)	0	(4.0)	-
Surfacing (miles):						
August plan	8,800	8,600	8,400	8,200	34,000	8,000
March plan	8,300	8,100	7,900	7,700	32,000	-
Variance	500	500	500	500	2,000	-

Comparison of deferred maintenance with a normalized program

A track program of the size proposed in the August plan would defer maintenance throughout the forecast period. The amount of deferral can be approximated by comparing the August plan with Conrail's estimation of a normal level of track maintenance. Normal levels maintain the system at a constant level and are determined by the expected life of rails and ties. The August plan is based on reducing the system by 1,940 route-miles, or about 11 percent, but such a reduction is predicated on the assumption of extensive price and service deregulation occurring in 1981.

The following schedule compares a normal maintenance program with the proposed deferred maintenance program.

Normal Maintenance Versus a Deferred Maintenance Program

	1980	1981	1982	1983	1980-83	1984
Rail (miles):						
August plan	240	240	572	876	1,928	876
Normal	725	725	725	725	2,900	725
Variance	(485)	(485)	(153)	151	(972)	151
Ties (millions):						
August plan	1.3	1.5	2.8	3.2	8.8	3.2
Normal	2.8	2.8	2.8	2.8	11.2	2.8
Variance	(1.5)	(1.3)	0	0.4	(2.4)	0.4
Surfacing (miles):						
August plan	8,800	8,600	8,400	8,200	34,000	8,000
Normal	8,750	8,750	8,750	8,750	35,000	8,750
Variance	50	(150)	(350)	(550)	(1,000)	(750)

As the table shows, deferred maintenance could increase over the period by 972 miles of rail and 2.4 million ties, which means that much of the track improvement realized from 1976 through 1979 may be lost because deferred maintenance from this program will approach preconveyance levels. From conveyance to the end of 1983, the net reduction in deferred maintenance will be 171 miles of rail and 3.6 million ties. In short, the limited programs proposed for the next 2 years are at or below the average level in the 1960s when the system was allowed to deteriorate.

Conrail estimates that a normal 1980 track program would cost $323 million, which is $123 million greater than the track program proposed in the August plan. USRA's estimates for a normal track program are slightly less than Conrail's ($310 million in 1980) but the results are basically the same. If Conrail is to implement a larger program in 1980, the decision must be made soon because of the leadtime for ordering material. Conrail stated that a full $323 million program would have required approval by January 31, 1980. If approval is delayed for 1 month, a $316 million track program could be implemented. A 2-month delay in approval could reduce the feasible program to $301 million.

Maintenance deferrals could hurt operations

Because Conrail's track system has been only partially rehabilitated from the condition of the bankrupt predecessor railroads, deferring maintenance could hurt operations. According to Conrail's Chief Engineer for Staff, the track program was selected to receive most of the cutbacks in order to stay within the $3.3 billion because track maintenance deferrals would have only minor impact on service in the short run. Further, an increased surfacing program is expected to soften the impact. USRA's Director of Facilities and Equipment agreed that a short-term reduction may not have a measurable impact on those main lines that have been rehabilitated, but deterioration of unrehabilitated track could worsen because surfacing has little positive effect on lines with bad rail and ties. Thus, the USRA staff believes the reduced level of track maintenance will have a bad effect on train operations, service, and derailments.

Conrail's planned track maintenance reduction will also cause the rail rehabilitation program to stretch beyond the original 15-year plan. If the August plan is carried out, rehabilitation of the entire track system may not be completed until at least 1993.

It is USRA's position that deferring track rehabilitation will increase the overall cost of the program substantially. Increased costs will result from inflated material and labor costs and lost work efficiencies. Work efficiencies could be lower because some experienced maintenance personnel will have to be laid off. Also, according to USRA, by the time the program is reinstated, many of the laid-off employees may have found other jobs and this development, if it occurs, would result in the hiring and training of new workmen. In addition to the problems discussed above, Conrail estimates that delaying rehabilitation could cost over $100 million in lost savings over the period.

Risks associated with the maintenance deferral program

Conrail's Chief Engineer for Staff emphasized that reducing track maintenance beyond 2 years would be unacceptable because it would hamper operations. The strategy's success depends on money becoming available from operations in 1982 to increase track expenditures above normal levels.

USRA's Director of Facilities and Equipment felt that a short-term reduction may not be critical but the real risk was that money would not be available after 1982 for increasing the program. As a result, USRA is concerned that a temporarily reduced program may have to be extended if cash is not available.

In summary, Conrail has made progress in rehabilitating most of its important main lines. A plan to defer maintenance is questionable especially when it is premised on restoring deferrals in later years with improved cash flow thought to be achievable with optimistic regulatory reforms. As noted, USRA is concerned about this strategy and requested Conrail to submit alternative capital plans reflecting appropriate spending levels.

ADDITIONS AND IMPROVEMENTS PROGRAMS HOLD GREAT POTENTIAL, AND DEFERRAL COULD MEAN LOST EFFICIENCIES AND BENEFITS

The additions and improvements program, particularly for yards and terminals, holds great potential for operating improvements and better productivity. A program deferral could mean substantial losses of operating efficiency benefits and significant cost increases.

The additions and improvements program is to replace and improve various railroad facilities, other than track rehabilitation, and is crucial to Conrail's long-term viability. The program includes yards and terminals, communication and signals, safety and environmental programs, service and operating improvements, workshops and machinery, trailer-on-flatcar service facilities, bridges and tunnels, track investment, and miscellaneous. Track investment is that portion of track rehabilitation expenditures which is capitalized because it improves track over its original condition, such as the cost of welding rail.

Our report "Conrail Faces Continuing Problems" (see p. 6) emphasized that yard and terminal rehabilitation and modernization projects were critical and that these programs were falling far short of goals. We concluded that upgrading yards and terminals was important to expediting freight car handling and improving customer service, both crucial to Conrail's long-term viability. During 1978, Conrail attributed its slow-starting yard and terminal program to problems associated with organizing a large capital program and overcoming inertia as well as management's decision to spend more time on analysis to assure moneys were spent wisely. Toward the end of 1978, we felt the program was beginning to show some vitality evidenced by the fact that Conrail nearly met its program expenditure goal for the first time in 1979.

Conrail's August plan reduced expenditures for additions and improvements in 1980 and 1981 by $78.5 million, or 27 percent below levels in the March plan. Increased expenditures in 1982 and 1983 are planned to offset the reductions and increase total expenditures over the 4 years by $8.5 million over the March plan. The following table compares the two spending plans.

Additions and Improvements Expenditures
Compared Between March and August Plans

	1980	1981	1982	1983	1980-83	1984
	--------------(000,000	omitted)--------------				
August plan	$ 90.0	$121.0	$181.0	$200.0	$592.0	$215.0
March plan	141.5	148.0	146.2	147.8	583.5	-
Variance	$(51.5)	$(27.0)	$ 34.8	$ 52.2	$ 8.5	-

Conrail's 1980 budget advanced a $97 million inventory of projects with the expectation that actual expenditures will total $90 million. Total expenditures are the same; however, individual categories of expenditures have been modified. When comparing the inventory of programs with the March plan, the four largest categories of reductions were communications and signaling, 85 percent reduction from $20.9 million to $3.1 million; track investment, 56 percent reduction from $23.3 million to $10.2 million; bridges and tunnels, 47 percent reduction from $12.9 million to $6.9 million; and safety and environmental, 44 percent reduction from $14.9 million to $8.4 million. Yards and terminals, workshops and machinery, and intermodal were reduced by $5.2 million (19 percent), $6 million (30 percent), and $1.8 million (23 percent), respectively. Two categories, service and operating improvements and miscellaneous, were increased.

Conrail also categorizes additions and improvement projects as carryover, mandatory, compelling, and discretionary (new) savings. Carryover is any ongoing project which should be continued based on return on investment analysis, construction process considerations, legal requirements, or corporate commitments. Mandatory projects are those that must be started to fulfill the firm's public responsibility, such as legal requirements or safety. Compelling projects are those that must be carried out to meet the most urgent needs for facility renewal, such as bridges and tunnels. Discretionary projects are designed to reduce costs or penetrate desirable markets. Conrail evaluates and places priorities on proposed projects by using cost-benefit analysis.

In 1980, two-thirds of the $97 million project inventory will go to carryover projects with less than one-sixth allocated to new discretionary savings projects. The breakdown is: carryover--$59.3 million; mandatory--$10.6 million; compelling--$12.7 million; and discretionary (new) savings--$14.4 million.

Comparison of August plan with appropriate spending levels

The August plan is based on a reduced system, and Conrail estimated that an appropriate additions and improvements program for a system this size would be $123 million in 1980. Estimates of appropriate spending levels increase to $181 million in 1983. The planned spending for 1980 and 1981 is $63 million under the appropriate level. Increased spending in 1982 and 1983 is to decrease the shortfall to $24 million. The table below compares the August and appropriate spending levels.

Appropriate Spending Levels for Additions and Improvements Compared with August Plans

	1980	1981	1982	1983	Total
	-------------(000,000 omitted)-----------				
August plan	$ 90	$121	$181	$200	$592
Appropriate	123	151	161	181	616
Variance	$(33)	$(30)	$ 20	$ 19	$(24)

Conrail's Director of Capital Programs said an additions and improvements program of $125 to $130 million for 1980 may be possible. To this end, alternative plans are being developed for a $125 to $130 million budget in case additional funds become available. Current planning would have the additional $40 million investment apportioned as follows: carryover, $10.5 million; compelling, $18 million; discretionary savings, $11.5 million. The increase in carryover funding could speed completion of key projects such as the Elkhart, Indiana yard, and radio acquisitions. Funding compelling projects would cover several safety and environmental projects as well as bridge maintenance that has been deferred. Additional investment in new savings projects would enable Conrail to carry out projects that would improve its fiscal condition substantially starting in 1980.

According to USRA's Director of Facilities and Equipment, Conrail should be spending from $130 million to $150 million a year for additions and improvements. Conrail completed a $144 million program in 1979 and the Director believes that Conrail's project planning and management could successfully implement a program of this size in 1980. Further, he noted that Conrail has successfully completed several large yard projects such as Oak Island, New Jersey, and Allentown, Pennsylvania, but now its question of getting on with other projects which have high returns. USRA had been concerned by the important Elkhart yard, which was scheduled for an important improvement project since conveyance. Conrail started this project in 1979 with increased expenditures planned in 1980 and completion planned for 1981.

The timing of approval is also important to Conrail's ability to implement an increased additions and improvements program. Conrail believes a $130 million program would have required approval by January 31, 1980. A 2-month delay could reduce the feasible program level to between $110 and $120 million in 1980.

Importance of an additions and improvements program

USRA believes that the additions and improvements program, particularly yards and terminals, holds great potential for operating improvements and better productivity--a significant means of reducing Conrail's future need for Federal funding. USRA confirmed its belief by an analysis of the discretionary track and additions and improvements expenditures at the DeWitt yard in East Syracuse, New York.

From this analysis, USRA concluded that high returns on investment can be expected from such modernization projects.

Because of the potential benefits from additions and improvements, deferral of projects caused by reduced expenditures in 1980 and 1981 could result in substantial losses of operating efficiency benefits and significant cost increases. USRA estimated that without additional Federal funding and without deregulation, Conrail would reduce its program by $320 million through 1983 by deferring projects having benefits of $100 million. With deregulation effective January 1, 1980, Conrail would cut its program by $293 million and forfeit $80 million in benefits.

The level of expenditures in the August business plan could cause deferred maintenance to increase to preconveyance levels by 1983 if regulatory reform is not enacted because funds would not be available to increase spending as planned. Conrail's Director of Capital Programs acknowledged that some maintenance would be deferred but stated that the effect was hard to quantify. On the other hand, USRA concluded that Conrail's August plan would result in more deferred maintenance in 1983 than in 1979, with the optimistic assumption of deregulation as of January 1, 1980. With no deregulation, the level of deferred maintenance in the mid-1980's could approach that existing in 1975.

As in the case of the track rehabilitation program, Conrail expects to upgrade its additions and improvements program in 1982 and 1983 through much improved business results made possible by a pricing structure completely free from regulatory restraint. Regulatory reforms may not be enacted as soon as Conrail anticipated and proposed reforms may not allow the complete freedom anticipated by Conrail.

EQUIPMENT REPAIRS AND ACQUISITIONS REFLECT SHIPPER DEMAND

In its August plan, Conrail reduced its equipment maintenance program and increased its acquisition program to reflect changed demand forecasts. Conrail's Mechanical Department Director of Equipment and Budget Control told us that most economically justified repairs are made to locomotives and freight cars to meet profitable shipper demand and acceptable performance levels. After considering annual retirements and utilization, fleet size and car deficiencies are met by the purchase of new locomotives and cars or use of foreign cars.

Conrail's equipment has been upgraded

According to USRA, Conrail has been successful in upgrading the quality of its fleet. Conrail now can better meet shipper demand for locomotives and freight cars, and such measures as locomotive out-of-service ratios, and loads lost because of freight car unavailability are improving. Further, USRA considers Conrail's turnaround in equipment to be one of the firm's successes.

Our report "Conrail Faces Continuing Problems," (see p. 6) identified shortages of serviceable freight cars and locomotives as a major cause of Conrail's problems during its first 21 months of operation. Car and locomotive shortages occurred because Conrail received fewer serviceable cars and locomotives from its predecessor bankrupt railroads than expected and because the equipment was in worse condition than expected. Such shortages contributed to a continuing decline in the quality of customer service, which caused declining traffic and revenues.

Acquisition of freight cars and locomotives financed by private sector funds

Conrail finances its freight cars and locomotives by leasing them from investors; it refers to this leasing method as leveraged leasing. From conveyance to June 30, 1979, Conrail obtained over $550 million in this kind of private financing. In its March plan, Conrail estimated a need for $819 million more in private sector financing over the next 5 years, and that estimate was increased to almost $1.4 billion in the August plan.

The following sections discuss Conrail's planning strategies for its equipment fleet.

Freight car strategy

Conrail reduced its estimate for freight car repairs and increased its freight car acquisitions in its August plan. According to Conrail's Mechanical Department Director of Equipment and Budget Control, the differences are due to changes in demand estimates for certain car types. All needed, economically repairable cars are still to be repaired before new ones are acquired.

Estimates of freight car repairs were reduced by 5,834 cars, or 10 percent, through 1983. The following table compares the March and August plans for freight car repairs, which include both medium and heavy repairs.

Comparison of Freight Car Repairs in March and August Plans

	1980	1981	1982	1983	1980-83	1984
August plan	14,192	11,889	13,915	12,015	52,011	11,639
March plan	15,790	15,145	14,556	12,354	57,845	-
Variance	(1,598)	(3,256)	(641)	(339)	(5,834)	

According to Conrail's Mechanical Department Director of Equipment and Budget Control, Conrail's assumptions about price deregulation resulted in lower estimates of boxcar demand and assumptions about service deregulation resulted in lower estimates of open top hopper demand. In its November budget for 1980, Conrail reduced its demand estimates still further and also decreased its repair estimates. Repairs for 1980 were reduced by 1,514 cars or about 11 percent from the August level of 14,192.

Freight car acquisitions

In its August plan, Conrail increased projected expenditures for acquiring freight cars and trailers from $284 million to $736 million or about 159 percent through 1983. The table below shows the planned increases.

Comparison of Projected Expenditures for Freight Cars and Trailers

	1980	1981	1982	1983	1980-83	1984
	(000,000 omitted)					
August plan	$252	$240	$143	$101	$736	$53
March plan	137	114	19	14	284	-
Variance	$115	$126	$124	$ 87	$452	-

In its 1980 budget, Conrail increased its estimate of the funds needed to make purchases by $6 million to $258 million for that year, but it stated that the equipment acquisition program could be affected by the tight credit conditions existing during the latter part of 1979.

The August plan projected 9,024 more freight car acquisitions and 950 fewer trailer acquisitions through 1983 than Conrail's March plan. These new projections represented about a 188-percent increase for cars and a 19-percent decrease for trailers. The following table shows the variances.

Freight Car Acquisitions
Projected by the Two Plans

	1980	1981	1982	1983	1980-83	1984
August plan	5,459	4,711	2,600	1,050	13,820	200
March plan	3,412	1,384	0	0	4,796	-
Variance	2,047	3,327	2,600	1,050	9,024	

Trailer Acquisitions
Projected by the Two Plans

	1980	1981	1982	1983	1980-83	1984
August plan	1,100	850	700	1,400	4,050	2,000
March plan	500	2,000	1,500	1,000	5,000	-
Variance	600	(1,150)	(800)	400	(950)	-

Conrail's 1980 budget estimated a 3-percent increase in freight car acquisitions to 5,618 instead of the 5,459 estimated by the August plan.

Locomotive strategy

Conrail decreased locomotive overhauls and rebuilds in its August plan but kept acquisitions the same even though traffic forecasts were reduced. USRA noted that Conrail will have surplus locomotives in 1980 and, as a result, Conrail may lease an average of 100 locomotives per month to other railroads or put them in storage if there is no rental market. USRA is uncertain as to whether this surplus locomotive position is beneficial, especially if all rail traffic is down and there may not be a rental market for these surplus units. As of late January 1980, Conrail has been able to lease some locomotives but had to put some idle locomotives in storage.

According to USRA, Conrail has come a long way with its locomotive maintenance program and has improved the condition of its fleet. However, USRA has identified some locomotive maintenance items which were being neglected and Conrail has responded positively to USRA suggestions. Even with the improvement, USRA feels that the number of inservice locomotive failures is still too high.

In its August plan, Conrail deleted all of the $90.9 million allotted to 283 locomotive rebuilds through 1983. According to Conrail's Mechanical Department Director of Equipment and Budget Control, all 283 locomotives are of two older classes which in March seemed marginally beneficial to rebuild. But with reduced traffic levels forecasted in the August plan, these 283 locomotives will be retired and new units will take their place. Conrail hopes to reduce locomotive maintenance costs and increase reliability by having a fleet with a higher percentage of newer units. USRA's Director of Facilities and Equipment said this strategy is being studied in light of Conrail's financial conditions and because last year the benefits of rebuilding looked attractive.

Conrail estimates its reduced locomotive repair program will cost $244 million through 1983. These costs break down into $199 million for overhauls and $45 million for heavy repairs. The following table shows that the number of overhauls was reduced by 170, or about 11 percent, but the number of heavy repairs remains constant. Conrail's Mechanical Department Director of Equipment and Budget Control said the fewer overhauls were due to fewer repair candidates as a result of a smaller fleet and the improved condition of Conrail's locomotives. Lower traffic forecasts will require a smaller fleet size to meet acceptable levels, which will permit increased retirements of marginal locomotives. The 1980 budget confirmed the numbers of overhauls and heavy repairs for that year.

Comparison of Numbers of Locomotives to be Overhauled and Repaired

	1980	1981	1982	1983	1980-83	1984
Overhauls:						
August plan	381	306	335	364	1,386	506
March plan	381	375	400	400	1,556	-
Variance	0	(69)	(65)	(36)	(170)	-
Heavy repairs:						
Both plans	250	250	250	250	1,000	250

Between March and August, Conrail did not change its decision to acquire 536 new locomotives through 1983; however, costs were estimated to be $29.6 million, or about 8 percent, greater. The table below shows the cost variances.

Cost Variances for Locomotive Acquisitions between March and August

	1980	1981	1982	1983	1980-83	1984
	(000,000 omitted)					
August plan	$88.7	$98.0	$110.7	$119.8	$417.2	$234.0
March plan	80.7	90.2	104.9	111.8	387.6	-
Variances	$ 8.0	$ 7.8	$ 5.8	$ 8.0	$ 29.6	-

The 1980 budget again escalated the cost of the first year's purchase of locomotives by $1.3 million to $90 million. This cost is for the same number of locomotives.

In summary, Conrail has upgraded the equipment situation inherited from its predecessor bankrupt railroads and now is better able to meet shipper demand. Conrail changed its equipment repair and acquisition estimates to reflect changes in estimated demand.

CHAPTER 3

CONCLUSIONS AND RECOMMENDATIONS

Conrail's plans for significantly reducing its capital programs in 1980 and 1981 to stay within the current $3.3 billion Federal funding creates an unacceptable risk. Capital investments at this reduced level could result in plant deterioration and a return to declining service quality, thereby eroding the benefits gained from the already significant Federal investment. Conrail assumed that regulatory reform would enable it to make pricing and plant rationalization changes that would produce revenues it could use to rejuvenate its capital programs. But regulatory reform may not allow the complete freedom anticipated by Conrail. Further, current Conrail estimates for reduced traffic and net income for 1980 and 1981 cause us to doubt whether Conrail can generate sufficient revenue to support increased investment programs in 1982.

Conrail's August 1979 business plan reduced the track rehabilitation program previously proposed for 1980 and 1981 by $300 million, or 41 percent. This reduction could result in an increased rate of deterioration in unrehabilitated lines, a decline in service quality, and an increase in derailments. Additionally, rehabilitation program costs would increase, efficiencies would be lost, and cost savings would be forfeited. Conrail has succeeded in rehabilitating its most important main lines, but deferred maintenance could increase by about 970 miles of rail and 2.8 million ties during 1980 and 1981 if planned cuts are implemented. Conrail estimates that about 725 miles of rail and 2.8 million ties must be replaced annually in order to maintain the system and not defer maintenance, and estimates that such an appropriate program for 1980 and 1981 would cost $692 million, $257 million more than the August plan level of $435 million.

The additions and improvements program, which rehabilitates and modernizes the railroad's physical plant and is crucial to Conrail's viability, is to be reduced in 1980 and 1981 by $78.5 million, or 27 percent. Additions and improvements projects hold great potential for operating improvements and better productivity and are one of the most significant methods for reducing Conrail's future need for Federal funding. The deferral of projects proposed in the August plan could result in substantial losses of operating efficiencies and significant cost increases. Also, deferred maintenance could increase to preconveyance levels by the mid-1980's if substantial regulatory reforms are not enacted. USRA estimates that an appropriate additions and improvements program would cost between $130 and $150 million annually as compared with the proposed 1980 investment of $90 million and the 1981 investment of $121 million.

Conrail has successfully upgraded the deteriorated freight car and locomotive situation inherited from the bankrupt railroads and now is better able to meet shipper demand for equipment. In its August plan, Conrail reduced its freight car maintenance program and increased its car acquisitions. The reductions mainly involved unequipped boxcars and small hopper cars for which reduced demand is expected. Changed demand estimates also caused Conrail to decrease planned locomotive overhauls and rebuilds, while leaving planned acquisitions and heavy repairs the same. USRA believes that Conrail may have an average of 100 surplus locomotives per month in 1980 which it may lease to other railroads or put into storage.

To project the result of a more appropriate track maintenance and additions and improvements program for 1980 and 1981, Conrail developed alternate plans increasing the capital spending levels over the August business plan for these years by $326 million to $972 million. Implementation of a more appropriate capital program in 1980 would deplete the $3.3 billion authorization and leave an estimated $23 million deficit. Continuance of a more appropriate capital program in 1981 could require an additional $587 million in Federal funding, including the $23 million 1980 deficit and a $564 million 1981 deficit.

If Conrail is to implement a larger program in 1980, the decision must be made soon. According to Conrail, a $453 million capital program for 1980 would have required approval by January 31, 1980. A 2-month delay could reduce the feasible program level to about $420 million.

ALTERNATIVES AVAILABLE TO THE CONGRESS

Unless the Congress indicates that it will provide additional funding if needed, Conrail will reduce its capital spending to stay within its $3.3 billion authorization. Conrail has decided to reduce short-term capital spending to stay within its $3.3 billion authorization rather than request additional Federal funding through USRA. The Congress has several alternative courses of action available for responding to Conrail's strategy.

Defer any action

By deferring action, the Congress would allow Conrail to reduce capital spending below self-sustaining levels in the hope that regulatory reform would provide enough cash benefits in later years to rejuvenate the programs. This alternative would minimize the Federal investment in Conrail in the short run but would introduce the risk that essential facilities and services could deteriorate. This risk could become unacceptable if regulatory reform is not enacted or if reforms do not provide the cash benefits now estimated by Conrail. If Conrail cannot enhance its financial position, capital program deferrals may have to be extended beyond 1981, necessitating Government action to preclude further deterioration. Rehabilitating the physical plant 2 years from now will likely be costlier than maintaining the lines at an appropriate level.

Pledge additional funding

The Congress can pledge additional funding if needed and direct Conrail to continue its capital spending at appropriate levels. Such action would protect the Government's substantial investment of $3.3 billion by avoiding the risks associated with deferring maintenance. Funds remaining from the $3.3 billion authorization could support an appropriate capital spending program during 1980, but such expenditures would exhaust available Federal funds during that year and leave an estimated $23 million deficit. If Conrail continues this level of rehabilitation effort during 1981 and financial results are as Conrail predicts, an additional $587 million in Federal support may be required during this year. Of course, such a pledge would not be binding on a future Congress unless the funding is actually appropriated.

Enact regulatory reforms

The Congress can enact substantial regulatory reform of the rail industry, which according to Conrail, would reduce or eliminate the shortfall in funds it needs for capital spending. Conrail estimates that relaxed price and service regulation would allow it to generate enough cash from operations to fund capital programs at appropriate levels. Current forecasts indicate that substantial regulatory reform is the key to minimizing Federal rail subsidies in the long run, but the outcome of regulatory reform is uncertain. If regulatory reform does not provide the relief Conrail says it needs to achieve self-sustainability, the Congress may decide to continue subsidies for the public good or consider other changes in Federal policy with respect to the Northeast rail freight system. But consideration of these significant rail issues takes time, and deserves careful deliberation by the Congress, and the issue remains whether deferring rehabilitation is in the best interests of the Northeast freight system, pending congressional action on regulatory reform.

Seek another solution to the Northeast rail problem

The Congress can seek another solution to the rail crisis in the Northeast. USRA has outlined several possible alternatives to Conrail as it presently exists. These options range from a "continue current operations" to a "controlled transfer" of Conrail lines to other railroads. USRA said that Conrail's ability to achieve operating efficiencies, make modifications to its physical plant, and implement regulatory reform would determine which option was the most promising. USRA warned that the status quo would require an additional $1.4 billion in Federal support.

There are, of course, many combinations of these choices. A satisfactory solution will most likely take considerable congressional deliberation and time and could easily involve aspects of all these alternatives.

MATTERS FOR CONSIDERATION BY THE CONGRESS

If Conrail defers maintenance on its system and regulatory reform permits it to rejuvenate its capital spending programs in 1982, Conrail probably can live within the $3.3 billion already authorized. If Conrail defers maintenance but does not get the regulatory relief it expects, the Government may have to provide more money in 1982 to rejuvenate the capital program. If Conrail continues an appropriate capital program and gets regulatory relief, it may be able to pay for its own capital programs sooner and the Government's investment will be minimized. If Conrail continues an appropriate capital program but does not get regulatory relief, the Government may have to continue its funding, or seek another solution.

AGENCY COMMENTS AND OUR EVALUATION

Conrail's Senior Vice President for Planning, Control, and Information Systems, and USRA's Vice President for Operations and Marketing, reviewed a draft of this report and told us they agreed with our findings and conclusions that a short-term reduction in Conrail's capital programs is risky because, if continued it could result in a return to declining rail service in the Northeast. They felt the risk would increase if it becomes apparent that price and service regulatory reforms may not provide all of the fiscal benefits estimated by Conrail in August 1979.

The Department of Transportation said it agreed with our conclusion that any long-term solution to rail service in the Northeast will require a well constructed and well maintained rail system. However, the Department disagreed with our conclusion that a 2-year reduction in capital spending would create an unacceptable risk to the Federal investment and Conrail's future profitability. The Department pointed out that the concept of an appropriate capital program is dependent on the size and type of fixed plant Conrail needs and that under proposed deregulation, Conrail's plant will most likely be smaller than that indicated in our report. The Department stated that our recommendation that the Congress continue to support appropriate maintenance levels risks leading Conrail into long-term dependency on Federal funds and that we do not fairly depict the hard choice facing the Congress. The Department believes the choice is between continued public support for Conrail and thus indirect subsidization of noncompensatory traffic or deregulation, allowing Conrail to fund its own capital needs based on a physical plant appropriate to compensatory traffic levels. The Department preferred deregulation as the correct alternative.

The Department pointed out that Conrail and USRA agree that reducing maintenance programs for 2 years will not cause serious problems if catch up funds are available at the end of that period. We agree that a short-term reduction in capital programs may not be critical but believe a depressed level of capital spending beyond 2 years could risk a return to an inadequate rail freight system in the Northeast. Enough Federal funds remain for Conrail to continue appropriate capital programs in 1980 to maintain the system and prevent deterioration. If regulatory reforms are enacted and provide the benefits estimated by Conrail, then internal Conrail funds would begin to become available in 1981 to continue appropriate capital spending without additional Federal investment. Thus, additional cost to the taxpayers would be minimized and deterioration would not be risked. Conversely, if regulatory reform does not occur or does not provide the benefits estimated by Conrail, additional public moneys would be needed to rejuvenate the capital programs in 1982 to avoid another crisis similar to the one that Conrail was created to correct. We believe the public cost would be higher to correct problems allowed to accumulate during the next 2 years than it would be to support appropriate capital spending currently.

We agree with the Department's comments that the appropriate amount of capital spending for Conrail would vary with the quantity and weight of the traffic carried. Other variables such as the weather are also important. We also agree that regulatory reform may change traffic levels and patterns which would also affect the appropriate capital spending levels. The fact is, however, Conrail is still rehabilitating some of its main lines although work is also being done on secondary main lines and yards. Even low-density lines must be maintained to satisfy safety requirements until Conrail is relieved of its operating responsibility, and if the low-density lines are abandoned by Conrail, their operation could be assumed by other carriers or public bodies-in either case, they must meet minimum acceptable standards of maintenance.

The Department thinks we are wrong to advise the Congress to authorize or encourage Conrail to spend additional funds for rehabilitation that may, in part, prove unnecessary, and suggested we change our recommendation. We have stated a satisfactory solution to the rail problem may involve several actions, including regulatory reform, and take a considerable amount of time. In the draft report the Department of Transportation reviewed, we stated that we thought the public's investment would be best protected and future investment minimized if the Congress directed Conrail to continue a minimum acceptable level of capital spending and pledged additional funding, if needed. We have stepped back from flatly recommending that the Congress pledge additional assistance because we recognize the need to constrain Federal outlays, and that the Congress must choose between this and many other possible uses for Federal assistance.

Lastly, the Department felt we did not make clear that Conrail does not advocate additional Federal investment in 1981 even without deregulation, and the 1981 additional investment need of $587 million under alternate plans includes moneys needed for other funding requirements not associated with capital spending. The funding need we cited of $587 million under Conrail's alternative plan is not Conrail's preferred option and includes money for purposes other than appropriate capital spending. We also cite other figures (see pp. 5, 7, 9, 12, and 13) in our report representing various other possible levels of capital spending, but are using the $587 million to represent the most that would be necessary in 1981 if the Congress takes no action to alter the status quo.

The preponderance of our work relating to the railroad industry suggests that substantial regulatory reforms are needed, and we agree with the Department that an attempt to shift decisions about railroad service in the Northeast from Government to the marketplace through regulatory reform is a good idea. There are many ways to achieve the reforms, ranging from abolition of the Interstate Commerce Commission to leaving its authority unchanged and simply directing it to unshackle the industry administratively. We are not endorsing one approach over another, but would encourage resolution of the matter as soon as practicable because of the importance of the regulatory environment to the industry.

The Department's complete comments are included as appendix I.

OFFICE OF THE SECRETARY OF TRANSPORTATION

WASHINGTON, D.C. 20590

February 20, 1980

ASSISTANT SECRETARY
FOR ADMINISTRATION

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

Dear Mr. Eschwege:

We have enclosed two copies of the Department of Transportation's (DOT) reply to the General Accounting Office (GAO) draft report, "Conrail's Reduced Capital Program Could Diminish Its Prospects For Long-Term Viability."

Conrail's August 1979 business plan reduced capital spending in 1980 and 1981 for track programs and additions and improvements to the physical plant. The General Accounting Office believes this strategy would pose an unacceptable risk to the Federal investment and Conrail's prospects for profitability. GAO recommends that the Congress direct Conrail to continue its capital improvement program at a normalized level by indicating its willingness to provide additional funding if needed.

The Department does not believe that Congress should be advised to encourage Conrail to spend additional funds for a rehabilitation effort that may prove unnecessary. Simply continuing to provide a "normalized" track rehabilitation program severely oversimplifies the complex and unsettled issue of the size and type of fixed plant Conrail needs for its future traffic base, especially under proposed rail deregulation. These points and others are discussed in detail in the enclosed reply.

If we can assist you further, please let us know.

Sincerely,

for Edward W. Scott, Jr.

Enclosures

DEPARTMENT OF TRANSPORTATION REPLY
TO
GAO DRAFT OF A PROPOSED REPORT
ON
CONRAIL'S REDUCED CAPITAL PROGRAM
COULD DIMINISH ITS PROSPECTS
FOR LONG-TERM VIABILITY

SUMMARY OF GAO FINDINGS AND RECOMMENDATIONS

In order to limit the Government's investment in Conrail to the currently authorized $3.3 billion, Conrail has decided to reduce capital spending in 1980 and 1981 for track programs and additions and improvements to the physical plant. GAO believes this strategy would pose an unacceptable risk to the Federal investment in Conrail and to Conrail's prospects for profitability. Therefore, GAO recommends that the Congress direct Conrail to continue its capital improvements program and pledge additional funding if needed because any long-term solution to rail service in the Northeast will require a well constructed and maintained rail system.

SUMMARY OF DEPARTMENT OF TRANSPORTATION POSITION

The Department of Transportation (DOT) agrees with the GAO conclusion that any long-term solution to rail service in the Northeast will require a well-constructed and a well-maintained rail system. However, the DOT does not agree with the GAO conclusion that a reduced level of capital spending in 1980 and 1981 for track maintenance and additions and improvements (A&I) to the physical plant precludes a viable future for Northeast rail freight transportation. The DOT believes that simply continuing to provide a "normalized" track rehabilitation program severely oversimplifies the complex and unsettled issue of the size and type of fixed plant Conrail needs for its future traffic base, especially under proposed rail deregulation. Conrail and the Federal Railroad Administration (FRA) staff concluded that a two-year reduction in the current levels of rehabilitation and maintenance, while these other issues are being resolved, will not adversely impact the long-term future of Conrail provided that the necessary funds are available at the end of that period to catch up with any necessary maintenance. The United States Railway Association (USRA) also indicated that such a reduction may not be critical, and that the real risk was that money would not be available after 1982 for increasing the program. The GAO approach risks leading Conrail into a long-term, if not permanent, dependency on Federal funds, the very outcome the GAO report purports to prevent.

The DOT does not feel that the GAO report fairly depicts for the Congress the long-term financing cost to the general public for continuing the current rehabilitation levels. This GAO report should note the hard choice facing the Congress on the Conrail issue, i.e., on-the-one-hand, continued subsidization of noncompensatory Conrail traffic by other profitable Conrail traffic and the Federal Government (which risks making Conrail a permanent ward of the Federal Government) and, on the other, Conrail's own funding of a physical plant appropriate to a deregulated environment with funds generated by a profitable traffic base. The DOT prefers the latter course.

POSITION STATEMENT

Track rehabilitation and A&I programs must be viewed with respect to Conrail's near-term and long-term needs. The current so-called normalized levels of rehabilitation and maintenance, outlined in the GAO report, are derived primarily from the projected tonnage levels and the anticipated plant size assumed in the Final System Plan prior to the start-up of Conrail on April 1, 1976. However, the substantial decrease in Conrail's actual versus planned traffic base, and the 1979 joint USRA/FRA staff report which indicates that the size of the present Conrail system may need to be reduced by at least 4,600 route-miles (25 percent), suggest that existing track rehabilitation and normalized maintenance program levels are too high and should be reduced.

For example, a comparison of the USRA tonnage forecast for "Unified Conrail" (the current Conrail system) in the September 1975 Final System Plan Supplemental Report (FSPSR) (Table 6, page 117) with the actual Conrail tonnages in the following table indicates that actual tonnage is an average of about 22 percent less than the adjusted FSPSR forecast tonnage:

Year	Forecast Tonnage* (millions of tons)	Forecast Tonnage Adjusted for Estimate of Double Counting (millions of tons)	Actual Tonnage (millions of tons)	Percent Difference (Adjusted Forecast vs. Actual)
1977	377.4	340	267	-21
1978	361.4	325	263	-19
1979	369.5	333	265	-20
1980	399.2	359	254-261 (projected)	-29 to -27

*Forecast tonnage contains some double counting because of joint movements by two or more predecessor carriers to Conrail and is overestimated by roughly 10 percent.

The USRA projected track rehabilitation and maintenance requirements for the Conrail system, in order to handle the FSPSR projected tonnage, are also given in the FSPSR (Table 4, page 116). A comparison of these estimates with the actual work accomplished is shown below:

	Rail Laid (miles)		Ties Installed (millions)	
Year	Projected	Actual	Projected	Actual
1976	727	727	4.1	4.0
1977	739	1,011	4.6	4.4
1978	934	1,057	4.2	4.5
1979	1,154	1,054	4.2	3.6
Total	3,554	3,849	17.1	16.5

The FSPSR states that Conrail's maintenance requirements, whether accelerated to eliminate deferred conditions or maintained at normal levels to prevent further deterioration, are related most directly to the size of the plant and the use it receives. The DOT recognizes the fact that the extent of one-time rehabilitation for a specific track is dependent on the existing condition and operating speed on the track with respect to the desired track operating speed. However, once the desired class of track is determined and attained, the normalized track maintenance levels required to maintain the track at that class are significantly affected by variations in traffic volume (i.e., gross tons per track-mile), axle loadings, car lengths, operating requirements, and the environmental and physical characteristics of the railroad.

T. K. Dyer's March 31, 1978, report on United States Class I Railroads Fixed Plant Requirements, p. 59, indicates that a 22 percent decrease in annual gross ton/mile will result in about a 15 percent to 17 percent decrease in annual track maintenance cost per main track-mile. Conrail's declining traffic base, and the USRA/FRA analysis concerning the reduction of the plant size by 4,600 route-miles (6,100 track-miles), which according to USRA could reduce the annual rail and tie requirements by 60 miles and 300,000 respectively, suggest that the current estimate of the present annual maintenance requirements of about 700 miles of rail and 2.7 million ties is too high. In addition, the continuation of these maintenance levels could result in unnecessary expenditures of Conrail's limited Federal assistance.

In addition, future Congressional action on the Administration's deregulation initiatives could significantly influence the volume of traffic on a specific track, and hence, future decisions as to whether or not the particular track should be upgraded or downgraded. For example, if Conrail were given the flexibility to price noncompensatory traffic to profitable levels, lines that are currently carrying high volumes of marginally noncompensatory traffic and, consequently, could be candidates for rehabilitation, might in the near future be downgraded if rates were increased and the noncompensatory traffic were diverted to other carriers or transportation modes.

In any case, a detailed line-by-line review of traffic volumes, axle loadings, physical and operating conditions, and future disposition of each line should be conducted before continuing with the heavy maintenance-of-way and A&I program levels of the past four years. Particular attention should be given to multiple track-routes, in order to determine specific normalized maintenance program needs based on current traffic trends, possible future plant rationalization, and the current physical and FRA class status of each line. Consequently, with respect to present and future rail service needs, it appears inappropriate to continue the present levels of rehabilitation at this time, even if adequate funding were available.

In addition, it must be pointed out that the Conrail "Alternative Plan," as discussed on page 5 of the GAO report, was never intended to be Conrail's preferred option if rail deregulation was not legislated. The "Alternative Plan" represented a hypothetical analysis of the required Federal financing under status-quo assumptions. Thus, the $553 million for 1981 financing does not reflect Conrail's recommended financing level absent deregulation. Furthermore, in the cover summary, GAO should reflect the funding required to carry out a so-called normalized track rehabilitation program instead of the $553 million that includes assumed funding requirements in areas beyond the purview of this GAO report.

As stated in the GAO report, both Conrail and USRA believe that the level of the rehabilitation and A&I programs could be reduced over the next two years without any serious adverse impact to Conrail's physical plant, provided that the necessary funds are available at the end of that period to catch up with any necessary maintenance. Given the present uncertainties as to the level of required maintenance-of-way and A&I program activity, the DOT does not believe that Congress should be advised to either authorize or encourage Conrail to spend additional funds for a rehabilitation effort that may, in part, prove unnecessary and that Conrail believes can be postponed for at least two years. The DOT recommends that the GAO report reflect the fact that Conrail's past levels of normalized maintenance and rehabilitation may no longer be necessary, and that the GAO recommend that Conrail be allowed to pursue programs that Conrail's management considers necessary given Conrail's currently available funds and the prospects for rail deregulation.

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