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*REPORT OF THE
COMPTROLLER GENERAL
OF THE UNITED STATES*



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**Improved Controls Needed Over
Federal Financial Assistance
To Railroads**

Federal Railroad Administration
Department of Transportation
United States Railway Association

From January 1971 to March 1976, about \$826 million in Federal assistance was provided to railroads primarily in response to crises. The Federal Railroad Administration was responsible for monitoring the financial aspects of four of five assistance programs in operation.

The Railroad Administration's program monitoring did not provide sufficient information to adequately assess how the railroads used total available funds or to insure that internally generated funds were used to the fullest extent possible to continue rail service.

GAO offers recommendations to the Secretary of Transportation and the Chairman of the United States Railway Association for improving administrative controls over future financial assistance programs.



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

B-164497(5)

Chairman, Subcommittee on Federal
Spending Practices, Efficiency, and
Open Government
Committee on Government Operations
United States Senate

Ranking Minority Member, Subcommittee on
Federal Spending Practices, Efficiency, and
Open Government
Committee on Government Operations
United States Senate

This is the second of two reports in response to your letter of December 12, 1975. This report addresses the management of direct Federal financial assistance to private railroads.

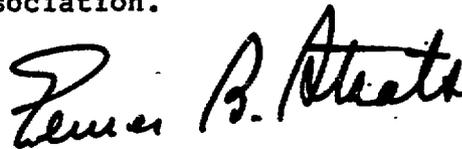
As far as possible, we determined whether Federal assistance to private railroads was spent in accordance with the authorizing legislation; what safeguards are present or may be needed to insure that Federal funds or the railroads' funds which Federal dollars replace are not being diverted to corporate ends not within the realm of the authorizing legislation; and whether procedures used by the Federal agencies responsible for administering railroad assistance funds insure proper control of both past and future appropriations. Where appropriate we made recommendations to the Secretary of Transportation and to the Chairman, United States Railway Association.

We have obtained formal comments on the contents of this report from the Department of Transportation and the United States Railway Association which are included in this report as appendixes. We carefully analyzed the Department's comments and address them in the body of the report.

We are also sending copies of this report to various House and Senate committees concerned with railroad matters;

B-164497(5)

the House and Senate Committees on Appropriations and Government Operations; the Director, Office of Management and Budget; the Secretary of Transportation; and the Chairman, United States Railway Association.

A handwritten signature in cursive script, reading "James B. Street".

Comptroller General
of the United States

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ABBREVIATIONS

| | |
|---------|-----------------------------------|
| ConRail | Consolidated Rail Corporation |
| DCAA | Defense Contract Audit Agency |
| DOT | Department of Transportation |
| FRA | Federal Railroad Administration |
| GAO | General Accounting Office |
| USRA | United States Railway Association |

REPORT OF THE
COMPTROLLER GENERAL

IMPROVED CONTROLS NEEDED OVER
FEDERAL FINANCIAL ASSISTANCE
TO RAILROADS
Federal Railroad Administration
Department of Transportation
United States Railway Association

D I G E S T

Before 1976 direct Federal assistance to the Nation's railroads was essentially in response to specific crises in the midwest and northeast regions. (See p. 1.) The amount of Federal assistance available to railroads dramatically increased as a result of the Railroad Revitalization and Regulatory Reform Act of 1976. (See p. 1.)

From January 1, 1971, to March 31, 1976, more than \$825 million was provided to railroads in loans, loan guarantees, and grants. (See p. 4.) In addition, the Railroad Revitalization and Regulatory Reform Act of 1976 authorized about \$1.6 billion in direct assistance, which will be available industrywide. (See p. 1.)

The Federal Railroad Administration, Department of Transportation and the United States Railway Association are responsible for managing these financial assistance programs. (See p. 2.)

Regarding the use of the railroads' own funds, GAO found that the Railroad Administration did not determine whether the corporations were properly using all their own working-capital resources before approving Federal assistance. A review of the railroads' working-capital accounts by an independent public accounting firm showed situations which may have caused unnecessary use of Federal funds or funds obtained through Federal loan guarantees. (See pp. 24 and 33.) Funds were commingled making it difficult to determine whether specific disbursements were as the legislation intended. (See p. 23.) However, GAO did not find any indications that the railroads were using Federal funds for purposes other than intended by the legislation. (See p. 22.)

The Railroad Administration limited its monitoring of the financial aspects of two

assistance programs totaling about \$587 million to review of information the railroads submitted with no indepth analyses of working-capital accounts or intercorporate transactions which could have affected the railroads' cash position. (See pp. 19, 20, 28 and 33.)

Railroad Administration files did not clearly indicate for the record, the evidence considered and reasoning used in approving or denying applications for some loan guarantees. (See pp. 7 and 16.)

Under one emergency operating assistance program, a railroad was authorized to borrow guaranteed loan funds 18 months in advance of need. (See p. 21.)

To provide adequate administrative controls over future financial assistance programs for railroads GAO recommends the Secretary of Transportation require the Railroad Administration to:

- Develop detailed procedures providing for systematic preaward review and analyses of all applications before implementing the programs. (See p. 16.)
- Document completely preaward review and analyses for all applications, whether approved or denied, to insure that available evidence adequately supports actions taken. (See p. 16.)
- Develop and implement a monitoring system sufficient in scope to insure efficient use of Federal assistance, including ongoing analyses of costs incurred, and regular onsite technical inspections of work done to insure quality, efficiency, and cost effectiveness. Also, for assistance earmarked for working capital, the monitoring system should include indepth analyses of working-capital accounts and review of intercorporate transactions to see that they are prudently conducted. (See pp. 33 and 34.)

GAO also recommends that the Secretary of Transportation require that the Administrator,

Federal Railroad Administration insure complete and timely audit coverage of all future financial assistance programs. (See p. 34.)

In the event the United States Railway Association is given responsibility for financial assistance programs in the future, the chairman of the board of directors should take actions similar to those recommended to the Secretary of Transportation. (See pp. 16 and 34.)

The Department of Transportation stated that GAO's recommendations would be included in the management of future financial assistance programs and that steps are being taken to delegate audit authority to the Railroad Administration. However, the Department believed GAO's findings and conclusions were not accurate or supported by the facts as outlined in the report. (See pp. 17 and 34.)

According to the Federal Railroad Administrator, the statutory goal of the legislation considered in the GAO report was fully met-- essential rail services of the bankrupt railroads were sustained without interruption until a reorganization plan could be developed and implemented. He said considering the urgency of the situation and the critical timing demands that had to be met, the record shows an acceptable balance was maintained between continuing essential services and accomplishing this goal at the lowest possible cost to the taxpayer. (See pp. 34 and 35.)

GAO agrees with the Administrator that the goal of continuing essential rail services was met. However, the Railroad Administration's monitoring system did not provide adequate assurance that program goals were accomplished at the lowest possible cost to the Government. (See p. 35.)

The United States Railway Association stated that if it is given responsibility for additional financial assistance programs in the future, full consideration will be given to GAO's recommendations in carrying out those responsibilities. (See app. II.)

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CHAPTER 1

INTRODUCTION

The Chairman, Subcommittee on Federal Spending Practices, Efficiency, and Open Government, Senate Committee on Government Operations, and its Ranking Minority Member, asked us to review the management of direct Federal financial assistance to private railroads to (1) determine whether Federal assistance expended to date had been spent in accordance with the authorizing legislation, (2) determine what safeguards are present or may be needed to insure that Federal funds or the railroads' funds which Federal dollars displace are not being diverted to corporate ends that do not come within the realm of the authorizing legislation, and (3) evaluate the procedures used by the Federal agencies responsible for administering railroad assistance funds to insure proper control of both past and future appropriations.

FINANCIAL ASSISTANCE PROGRAMS

Before 1976, direct Federal assistance to the Nation's railroads was essentially in response to specific crises in the Midwest and Northeast. Funds primarily in the form of direct loans, loan guarantees, and grants had been authorized under the Emergency Rail Services Act of 1970 (84 Stat. 1975); the Emergency Rail Facilities Restoration Act (86 Stat. 1304); and sections 211, 213 and 215 of the Regional Rail Reorganization Act of 1973 (87 Stat. 985), as amended.

The amount of direct Federal financial assistance available to railroads dramatically increased as a result of the Railroad Revitalization and Regulatory Reform act of 1976 (Public Law 94-210). The act provides financial assistance for railroads throughout the country with the intention of revitalizing the railroad industry rather than merely providing assistance in response to specific crises.

The 1976 act authorized \$6.4 billion in financial assistance to the railroad industry in the form of grants, loan guarantees, and purchases of preferred stock to provide the railroads with capital. About \$1.6 billion of the \$6.4 billion will be available industrywide, with the remainder

available primarily for the Consolidated Rail Corporation (ConRail) 1/ and Northeast corridor improvement.

Federal financial assistance in the form of grants and guaranteed loans has also been available to Amtrak to provide economical and efficient intercity passenger transportation. Our review did not include assistance to Amtrak because many aspects of this assistance were covered in our report entitled, "How Much Federal Subsidy Will Amtrak Need?" (RED-76-97, Apr. 21, 1976.)

The table on page 4 summarizes the direct Federal assistance authorized by the various acts.

MANAGEMENT OF FINANCIAL ASSISTANCE PROGRAMS

The Secretary of Transportation and the United States Railway Association (USRA), a nonprofit corporation created under the Regional Rail Reorganization Act of 1973, are responsible for managing railroad assistance programs. The Secretary was exclusively responsible for managing the programs under the Emergency Rail Services Act of 1970, the Emergency Rail Facilities Restoration Act and section 213 of the Regional Rail Reorganization Act of 1973. The Secretary is also responsible for about \$1.6 billion of the direct assistance authorized by the Railroad Revitalization and Regulatory Reform Act of 1976. USRA, created primarily to prepare and implement the final system plan for reorganizing the bankrupt railroads in the country's midwest and northeast regions was responsible for administering section 211 of the Regional Rail Reorganization Act of 1973. Under the terms of a memorandum of understanding, responsibility for section 215 of this act was shared by USRA and the Secretary with USRA having primary authority.

The Secretary delegated authority to the Administrator, Federal Railroad Administration (FRA) to administer the assistance programs for which he was responsible. The Office of Rail Assistance Programs within FRA is responsible for implementing and monitoring financial assistance programs. The office also does financial and technical evaluations of

1/ConRail was created by the Regional Rail Reorganization Act of 1973, as amended, to acquire and operate the rail properties of seven bankrupt carriers in the country's midwest and northeast regions --Penn Central, Central of New Jersey, Erie Lackawanna, Reading, Lehigh Valley, Ann Arbor, and Lehigh & Hudson River. ConRail began operations on April 1, 1976.

applications submitted for rail service assistance funds and monitors the effectiveness of the Federal assistance programs.

To fulfill its responsibilities under sections 211 and 215, USRA's Office of the Vice President for Financial Planning had primary responsibility for managing the section 211 loan program and the Office of the Vice President for Operations and Facilities Planning had responsibility for the work authorized under section 215.

Direct Federal Financial Assistance
to Railroads by Act and Type of
Assistance
January 1, 1971, to March 31, 1976

| <u>Act</u> | <u>Author- ized</u> | <u>Obli- gated or approved</u> | <u>Ex- perded or exerc- ised</u> | <u>Type of assistance</u> |
|--|-------------------------|--|--|--|
| | ----- (millions) ----- | | | |
| Emergency Rail Service Act of 1970 | \$ 125 | \$106 | \$102.4 | Loan guarantees |
| Emergency Rail Facilities Restoration Act | 48 | 27.4 | 26 | Loans |
| Regional Rail Reorganization Act of 1973, as amended | | | | |
| Section 211 | 275 | 137.2 | 44.6 | Loans |
| Section 213 | 282 | 263.7 | 263.2 | Grants |
| Section 215 | 300 | a/ 291.3 | a/ 285.0 | b/ Agreements |
| Section 216 (note c) | 1,000 | - | - | Purchase of Con-Rail debentures by the United States Railway Association |
| do. | 1,100 | - | - | Purchase of Con-Rail series A preferred stock by the United States Railway Association |
| Railroad Revitalization and Regulatory Reform Act of 1976 (note d) | | | | |
| Section 505 (note e) | 600 | - | - | Purchase by the Federal Railroad Administration of redeemable preference shares and trustee certificates |
| Section 511 (note e) | 1,000 | - | - | Loan guarantees |
| Section 704 | 1,866 | - | - | Grants |
| Total | \$6,596 | \$825.6 | \$721.2 | |

a/Does not include \$7.5 million in interest due to the Federal Financing Bank

b/Assistance provided under section 215 was evidenced by agreements between the railroads in reorganization and United States Railway Association. This assistance was not designated in the legislation as grants or loans, but was identified only as agreements between United States Railway Association and the railroads.

c/Section 216 was created under title VI of the Railroad Revitalization and Regulatory Reform Act of 1976 which amended the Regional Rail Reorganization Act of 1973.

d/Does not include authorizations under title VI, amendments to the Regional Rail Reorganization Act of 1973, which are included under the Regional Rail Reorganization Act of 1973 above. Also, does not include indirect assistance such as rail continuation subsidies.

e/Available industrywide.

CHAPTER 2

REVIEW AND ANALYSIS OF APPLICATIONS

FOR FINANCIAL ASSISTANCE

Direct financial assistance to railroads was to be used in two general areas: (1) to supplement the railroads' working capital to prevent cessation of essential railroad services and (2) for repair, rehabilitation and improvement of track and facilities. The Federal Railroad Administration and the United States Railway Association were responsible for making sure these Federal funds were used for the purposes authorized, and for minimizing and protecting the government's investment. In addition, they were to allocate funds fairly and impartially based on the merits of the individual requests for assistance. One of the means agencies use to be certain these responsibilities are met is to establish formal procedures that are applied consistently.

As discussed in this chapter and chapter 3 FRA did not establish such formal procedures when they were needed. USRA did, at the inception of its assistance programs, establish formal procedures for review and approval of applications, but did not periodically review and revise them as necessary.

EMERGENCY OPERATING ASSISTANCE PROGRAMS

The Emergency Rail Services Act of 1970 and section 213 of the Regional Rail Reorganization Act of 1973 provided working capital to supplement the railroads' cash position. FRA was responsible for administering both programs.

Emergency Rail Services Act of 1970

The Emergency Rail Services Act of 1970 provided that railroads in reorganization under section 77 of the Bankruptcy Act (11 U.S.C. 205), with approval of the reorganization court, could apply to the Secretary of Transportation for loan guarantees. Proceeds from loans guaranteed under this act were required to be used solely for meeting payroll and other expenses necessary to continue essential service. The act required the following findings be made by the Secretary before the loan guarantees could be approved.

1. Cessation of essential transportation services by the railroad would endanger the public welfare.

2. Cessation of those services was imminent.
3. There was no alternative source of funds available.
4. The funds could not be obtained without the Federal guarantee.
5. The railroad could reasonably be expected to become self-sustaining.
6. The probable value of the assets of the railroad, in the event of liquidation, provided reasonable protection to the United States.

The total amount guaranteed at any one time under the act could not exceed \$125 million. As of April 30, 1976, four railroads had submitted applications for assistance under this act--Boston & Maine, Penn Central, Central of New Jersey and Chicago, Rock Island & Pacific. The status of this program as of April 30, 1976, follows.

| <u>Railroad</u> | Amount of guarantee <u>requested</u> | Approved or <u>denied</u> | Amount of guarantee <u>approved</u> | Amount of guarantee <u>exercised</u> |
|--------------------------------------|---|---------------------------------|---|--|
| | (000,000 omitted) | | (000 omitted) | |
| Boston & Maine | \$ 12 | Denied | \$ - | \$ - |
| Penn Central | 110 | Approved | 100,000 | 100,000 |
| Central of New Jersey | 10 | Approved | 6,000 | 2,400 |
| Chicago, Rock Island & Pacific | <u>19</u> | Approved | <u>17,500</u> | <u>-</u> |
| Total | <u>\$151</u> | | <u>\$123,500</u> | <u>\$102,400</u> |

FRA did not have formal procedures for systematically reviewing and approving applications for these loan guarantees to insure that the same evaluation criteria was applied to each application. According to an FRA official, all applications for loan guarantees were reviewed to determine whether there was adequate evidence to support the findings the act required. However, because of the poor condition of FRA's files, we could not determine whether all applications had been reviewed systematically. Analysis and evaluation

of evidence were not sufficiently documented in the files to clearly indicate the evidence considered or the reasoning used in approving the Penn Central, Central of New Jersey, and Rock Island applications and denying the Boston & Maine application.

In a letter dated August 20, 1976, (see app. I), regarding the Penn Central and Central of New Jersey applications the Administrator, FRA, said there is a record of continuous review and analysis by both FRA and the Congress of the urgent need for Federal assistance to continue essential rail services. He said this review and analysis clearly established the need for immediate aid for Penn Central and Central of New Jersey. However, analysis and evaluation of evidence in support of these decisions were not completely documented in FRA's files.

According to an FRA official this analysis and evaluation was not documented because of the urgency of the situation at the time the railroads applied for financial assistance early in 1971. When Penn Central went into reorganization in June 1970, it already had a cash shortfall (obligations were due, but the railroad had no cash with which to pay them). The Central of New Jersey was also facing probable cessation of service.

In the case of both Boston & Maine and Rock Island applications, FRA's files contained both favorable and unfavorable evidence, but no detailed analysis or evaluation to illustrate what factors influenced the final decisions.

Section 213, emergency assistance grants

Section 213 of the Regional Rail Reorganization Act of 1973, as originally enacted, authorized the Secretary of Transportation, pending implementation of the final system plan, to provide \$85 million in emergency assistance grants to the trustees of railroads in reorganization--Penn Central, Central of New Jersey, Erie Lackawanna, Reading, Lehigh Valley, Ann Arbor, and Lehigh & Hudson River--to insure continuation of essential transportation services. The act was amended on February 28, 1975, increasing the authorization to \$282 million.

As of March 31, 1976, \$270 million had been appropriated for this purpose and grants totaling \$264 million had been approved as shown on next page.

| | <u>Grants made</u> | <u>Disburse- ments</u> | Balance available under existing <u>grants</u> |
|-----------------------------|------------------------|----------------------------|--|
| | | | (000 omitted) |
| Penn Central | \$187,718,003 | \$187,718,003 | \$ - |
| Central of New Jersey | 22,320,000 | 22,320,000 | - |
| Lehigh Valley | 8,550,000 | 8,125,000 | 425 |
| Erie Lackawanna | 31,696,956 | 31,696,956 | - |
| Ann Arbor | 4,687,000 | 4,687,000 | - |
| Reading | 7,970,000 | 7,850,000 | 120 |
| Lehigh & Hudson River | <u>796,807</u> | <u>796,807</u> | <u>-</u> |
| Total | <u>\$263,738,766</u> | <u>\$263,193,766</u> | <u>\$545</u> |

Formal procedures for administering the section 213 program were approved by the Administrator, FRA, on March 23, 1976. As of this date, the railroads had already spent a substantial part of the \$270 million appropriated. The stated purpose of the approved procedures was to insure efficient and effective administration of grants under section 213. According to FRA: "Given the long-term nature of the Section 213 program, specific procedures need to be established to administer both the award and monitoring of this grant assistance."

These procedures became effective only 9 days before the section 213 program ended, but according to the FRA Administrator, were consistently followed from the program's inception. Under the approved procedures FRA was responsible for:

- Reviewing the financial information the railroads submitted and making the analyses necessary to recommend the amount of assistance to be provided in the grant.
- Analyzing expenditures to insure that only items consistent with the intent of section 213 were recognized in determining cash deficits.

--Monitoring the cash needs of grant recipients.

The analyses and review the FRA staff made were based on financial data, both current and projected, submitted by the railroad companies. An FRA official told us that, before awarding grants, they held discussions with railroad officials and reviewed the railroads' cash forecasting techniques. However, they did not review the railroads' working-capital accounts.

FRA officials stressed that the railroads' trustees certified the accuracy of the information submitted under this section to both FRA and the reorganization court. FRA relied on the trustees' certification because they were personally liable for any inaccurate or incorrect statements.

MAINTENANCE, REHABILITATION, AND REPAIR PROGRAMS

The Emergency Rail Facilities Restoration Act and sections 211 and 215 of the Regional Rail Reorganization Act of 1973 provided funds for maintenance, rehabilitation and repair of track and facilities. FRA was responsible for administering the Emergency Rail Facilities Restoration Act while USRA was responsible for sections 211 and 215.

Emergency Rail Facilities Restoration Act

In June 1972 widespread devastation occurred along the eastern seaboard from Hurricane Agnes and from resulting severe floods. Among the railroads badly damaged by this natural disaster were three major carriers in reorganization under the Bankruptcy Act--Penn Central, Reading, and Lehigh Valley--and one in the process of entering reorganization--Erie Lackawanna.

At that time these railroads did not qualify for relief under the existing Federal disaster relief programs, and they had limited resources to invest in rehabilitation of facilities damaged by the floods. Responding to this need, the Congress enacted the Emergency Rail Facilities Restoration Act on October 27, 1972, authorizing the Secretary of Transportation to make loans to financially distressed railroads for restoring and replacing railroad facilities, equipment, and services which the Secretary determined to be essential to the public service and which were damaged by Hurricane Agnes.

The maximum amount of loans authorized under this act was \$48 million. This authorization expired June 30, 1975. A summary of the total principal amounts and the drawdowns as of March 31, 1976, are as follows.

| <u>Railroad</u> | <u>Amount of loan</u> | <u>Amount of drawdown</u> | <u>Balance available for drawdown</u> |
|-----------------|-------------------------------|-----------------------------------|---|
| Penn Central | \$17,645,542 | \$16,446,253 | \$1,199,289 |
| Reading | 1,577,735 | 1,405,489 | 172,246 |
| Erie | | | |
| Lackawanna | 3,626,490 | 3,610,678 | 15,812 |
| Lehigh Valley | <u>4,532,835</u> | <u>4,532,835</u> | - |
| Total | <u>\$27,382,602</u> | <u>\$25,995,255</u> | <u>\$1,337,347</u> |

As a part of their applications, the railroads were required to submit documents showing a full description and location of all railroad facilities, equipment, and services which the hurricane damaged or destroyed. The railroads were also required to give full details on facilities or equipment they proposed to restore or upgrade, when work started, when it was finished, and how much of the total work remained to be done.

According to FRA officials, FRA did not develop formal procedures for reviewing and approving applications to insure that the same criteria was applied to all applications. FRA, using the information the railroads submitted and other available information determined which lines and equipment were essential to the public service and for which the Federal Government should provide financial assistance for restorations and repairs.

FRA determined the essentiality of lines and equipment on the basis of the following criteria: (1) usage, (2) alternate service, (3) economical and efficient transportation, (4) cost of restoration, (5) Interstate Commerce Commission decisions, and (6) unprecedented demand by the shipping public for freight cars and other railroad equipment.

FRA also made three other findings required by the act.

1. The railroad was in reorganization or was otherwise eligible for financial assistance.
2. All damaged essential facilities and equipment would be restored.

3. There was no other practical means of obtaining funds from either private or Government sources other than a loan under this act.

Before the loan agreements were made, FRA officials surveyed the railroads' track and equipment to verify that damage did in fact exist and to identify the location of that damage. FRA personnel also reviewed each railroad's financial records to determine that the railroads were maintaining records that would facilitate a financial audit of the use of loan proceeds. They did not arrange for audits at that time although a major part of the expenditures for restoration work had already been made.

An FRA official told us that financial audits were not done because FRA did not have audit responsibility or capability--both rested with the Department of Transportation's internal audit group. In addition, he stressed that the important considerations in this situation were timing and need. The railroads needed the money to replenish their working capital because they had already expended their own funds for repairs and restoration. As a result, there was no time to make financial audits.

Section 211, general implementation funds

Section 211 of the Regional Rail Reorganization Act of 1973 originally authorized USRA to make loans to:

- ConRail, Amtrak, and other railroads in the northeast and midwest regions including those in reorganization, to achieve the goals of the act.
- State, local, or regional authorities to help them acquire or modernize railroad lines not in the final system plan.
- Railroads whose lines connected with railroads in reorganization and were in need of financial assistance to prevent possible insolvency.

The total amount authorized for section 211 was \$1.5 billion with no more than \$1 billion to be loaned to ConRail. The act specifically stated that, before approving any loan under this section, USRA was to determine that:

- The loan was necessary to carry out the final system plan or to prevent insolvency.

--The business affairs of the applicant would be conducted in a reasonable and prudent manner.

--The applicant offered security necessary to reasonably protect the interests of the United States.

In addition, the act required that loans made under section 211 be made on terms and conditions which furnished reasonable assurance that the recipients would be able to repay the loans within the time fixed in the agreement and that the goals of the act were reasonably likely to be achieved.

Section 606 of the Railroad Revitalization and Regulatory Reform Act of 1976 amended section 211 and substantially changed USRA's lending authority. Under the amended section 211, USRA was authorized to make loans to:

--ConRail to provide for the purchase of materials, supplies, equipment, and services necessary to permit the orderly and efficient implementation of the final system plan.

--ConRail, Amtrak, and any profitable railroads to which rail properties were conveyed, provided these companies agreed to meet certain existing or anticipated obligations of the railroads in reorganization in the region, as determined by USRA.

The act reduced the authorization for section 211 from \$1.5 billion to \$275 million. Also, USRA was prohibited from issuing obligations or making the proceeds available after the date of enactment except (1) to meet previous commitments or to make loans applied for before January 1, 1976, or (2) to provide preconveyance loans to ConRail for inventory and startup costs and loans for the payment of preconveyance obligations of the railroads in reorganization.

As of March 31, 1976, USRA had acted on six applications for loans under section 211--three from connecting railroads facing possible insolvency and three from ConRail. ConRail's third application was for \$79.2 million to meet preconveyance expenses necessary to facilitate orderly and efficient implementation of the final system plan. The following table summarizes the status of the section 211 program as of March 31, 1976.

| <u>Railroad</u> | <u>Amount requested</u> | <u>Approved or denied</u> | <u>Amount approved</u> | <u>Amount expended</u> |
|--------------------------------|-------------------------|---------------------------|------------------------|------------------------|
| | | | (000 omitted) | |
| ConRail | \$ 90,200,000 | Approved | \$ 90,200 | \$30,742 |
| Missouri-Kansas-Texas | 21,000,000 | Approved | 19,000 | 8,900 |
| Chicago, Rock Island & Pacific | 100,000,000 | Denied | - | - |
| Delaware & Hudson | <u>37,584,006</u> | Approved | <u>28,000</u> | <u>4,995</u> |
| Total | <u>\$248,784,006</u> | | <u>\$137,200</u> | <u>\$44,637</u> |

In September 1974 USRA approved procedures for reviewing and approving applications for section 211 loans. A USRA official told us that these procedures were generally followed.

USRA's review and approval process for section 211 loans involved (1) indepth financial analyses of the data in the applications to determine if the applicants met the eligibility requirements in the act and (2) developing the terms and conditions for each specific loan. The results of these analyses together with recommended action were presented to USRA's board of directors for final determination. Documentation in the project files adequately explained and supported the action taken on every application.

Section 215, maintenance and improvement funds

Section 215 of the Regional Rail Reorganization Act of 1973 as originally enacted, provided \$150 million for the acquisition, maintenance or improvement of railroad facilities and equipment necessary to improve property that would be included in the final system plan. The section 215 program complemented the section 213 program which was to provide the bankrupt railroads with enough cash to continue operations until conveyance.

However, in February 1975, the act was amended to allow the use of section 215 funds for program maintenance on designated rail properties until conveyance to ConRail. The

new section also authorized using section 215 funds to pay equipment obligations of the bankrupts, thereby helping to relieve their cash crisis. The amended section 215 increased the total authorization from \$150 million to \$300 million.

The original section 215 authorized the Secretary, with USRA's approval, to enter into agreements with the railroads in reorganization. However, USRA was responsible for developing and implementing the final system plan for restructuring the bankrupt railroads and, as a result, had a better idea of which lines would be included in the plan than did FRA. On an overall basis, USRA was closer to the operations of the bankrupt carriers. In March 1975 FRA and USRA agreed to informal guidelines for the section 215 program under which USRA was assigned the responsibility of carrying out the broad mandate of the section and FRA the responsibility for oversight and cash flow items. These guidelines were formalized in a June 12, 1975, memorandum of understanding.

In September 1974 USRA formalized internal procedures covering review and analysis of section 215 applications. These procedures were not revised to show the change in responsibility after the memorandum of understanding and were not followed in administering the section 215 program. According to USRA, the essentially "hands on" knowledge USRA had concerning the activities of the bankrupt carriers and the short period of time between startup of the program and conveyance precluded the need for a structured type of process. USRA stressed that the future needs of ConRail were a primary determinant in the allocation of section 215 funds and the magnitude of assistance provided to each railroad was in relationship to their proportionate role in the final system plan. Also, each application for section 215 funds did not require the same degree of review because of wide disparity in terms of size and complexity.

Initially, the railroads were required to submit formal applications for section 215 funds to the Secretary but agreements could not be entered into without USRA's approval. By the end of June 1974, the Secretary had received applications from Central of New Jersey, Lehigh Valley, Penn Central, and Reading railroads for sums totaling about \$344 million.

When the bankrupt's cash situation reached crisis proportions late in 1974, the original applications were put aside and USRA and FRA began a review of the railroads' operating budgets. In effect, these budgets then became the railroads' applications for section 215 funds.

The following table summarizes the funds provided under section 215 as of March 31, 1976, by the four major categories of use.

Assistance Under

Section 215

As of March 31, 1976

| <u>Railroad</u> | <u>Purpose</u> | <u>Obligated</u> | <u>Expended</u> |
|--|--|-------------------------|-----------------------------|
| | | (000 omitted) | |
| Program maintenance: | | | |
| Penn Central | acquisition of materials and performance of maintenance | \$154,300 | \$152,635,046 |
| Erie Lackawanna | do. | 10,000 | 8,671,000 |
| Central of New Jersey | do. | 1,700 | 1,505,889 |
| Lehigh Valley | do. | 6,262 | 5,621,423 |
| Reading | do. | 3,700 | 3,647,458 |
| Total | | <u>175,962</u> | <u>172,080,816</u> |
| Maintenance-of-way machinery: | | | |
| Penn Central | acquisition and storage of equipment | 14,700 | 13,944,973 |
| Erie Lackawanna | do. | 110 | 94,121 |
| Lehigh Valley | do. | 500 | 494,906 |
| Total | | <u>15,310</u> | <u>14,534,000</u> |
| Equipment obligations: | | | |
| Erie Lackawanna | purchase of equipment obligations | 7,800 | 7,794,543 |
| Reading | do. | 1,400 | 1,360,209 |
| Penn Central | do. | 33,800 | 32,259,020 |
| Ann Arbor | do. | 90 | 85,510 |
| Total | | <u>43,090</u> | <u>41,499,282</u> |
| Repairs and rebuilding of equipment and other uses: | | | |
| Penn Central | capital improvement and repair and rebuilding of equipment | 53,490 | 53,424,844 |
| Lehigh Valley | purchase of 12 diesel locomotives | <u>3,440</u> | <u>3,435,096</u> |
| Total | | <u>56,930</u> | <u>56,859,940</u> |
| Total | | <u>\$291,292</u> | <u>\$284,974,038</u> |

CONCLUSIONS

Most of the Federal assistance programs discussed in this chapter were designed to meet crisis needs and, except for the Emergency Rail Services Act of 1970, authority to approve assistance to the railroads has lapsed. USRA did not revise and update its formal procedures for review and approval of requests for section 215 funds. FRA did not develop in a timely manner, formal procedures for reviewing applications or analyzing railroads' financial reporting systems and did not clearly indicate for the record, the evidence considered and reasoning used in its decision for each financial assistance application to help insure that such evidence adequately supports that decision.

Formal procedures are necessary to insure that the criteria used to evaluate applications for assistance are consistently applied to all applications, and that the record clearly indicates the basis for each decision.

RECOMMENDATIONS

To provide uniformity in reviewing applications for financial assistance and greater assurance that the applicants meet the requirements of the program, we recommend that for future financial assistance programs, the Secretary of Transportation require the Administrator, FRA to:

- Develop detailed procedures providing for systematic preaward review and analysis of all applications before implementing the programs.
- Document completely preaward review and analysis for all applications, whether approved or denied, to insure that available evidence adequately supports actions taken.

Also, in the event USRA is given responsibility for additional financial assistance programs in the future, we recommend that the chairman of the board of directors, USRA, take actions similar to those recommended to the Secretary of Transportation.

AGENCY COMMENTS

The Department of Transportation stated that it will continue to follow procedures needed to insure full protection of the public interest in providing Federal financial

assistance to railroads. The Department also said the management of the financial assistance program under the Railroad Revitalization and Regulatory Reform Act of 1976 and any other future programs will include the recommendations made in the report.

The United States Railway Association stated that if it is given responsibility for additional financial assistance programs in the future, full consideration will be given to the recommendations in carrying out those responsibilities.

The comments of the Department and USRA are included as appendixes I and II, respectively. Our analysis of the Department's comments begins on page 34.

CHAPTER 3
MONITORING THE USE
OF FINANCIAL ASSISTANCE

The Federal Railroad Administration had responsibility for monitoring programs under the Emergency Rail Services Act of 1970 and section 213 of the Regional Rail Reorganization Act of 1973 which provided funds to supplement the railroads' working-capital position and the Emergency Rail Facilities Restoration Act which provided funds for rehabilitating rail facilities and equipment. FRA also had responsibility for monitoring the financial position of the railroads receiving funds under section 215 of the Regional Rail Reorganization Act of 1973.

The United States Railway Association was responsible for monitoring section 211 of the Regional Rail Reorganization Act of 1973 which provided funds to supplement working capital and for maintaining and rehabilitating facilities and equipment. USRA was also responsible for overseeing the technical aspects of the section 215 program which provided funds for maintaining and rehabilitating facilities and equipment.

We believe that, generally, FRA's monitoring of the programs for which it was responsible was inadequate to insure that total funds available to the railroads were used efficiently and as the legislation intended.

FRA'S MONITORING OF EMERGENCY
OPERATING ASSISTANCE PROGRAMS

FRA's monitoring of emergency financial assistance provided by section 213 of the Regional Rail Reorganization Act of 1973 and the Emergency Rail Services Act of 1970 was based on review of the financial information the railroads periodically submitted under the terms of the grant and loan guarantee agreements. According to FRA, when Penn Central applied for a loan guarantee under the Emergency Rail Services Act, its financial records were in such poor condition they were of little use to FRA necessitating development of a standardized reporting format. For monitoring the section 213 program, FRA and USRA developed a standardized reporting format for use by all seven railroads receiving section 213 grants.

Another monitoring tool available to FRA, although not until very late in the section 213 program, was the review of working-capital accounts and cash flows of the railroads

An reorganization done by Coopers & Lybrand, a certified public accounting firm under contract with ConRail. Under this contract, Coopers & Lybrand reviewed the railroads' cash management practices and analyzed working capital items such as accounts receivable and payable, accrued liabilities, inventories and special escrow accounts to insure these accounts were not manipulated prior to conveyance to benefit the estates of the railroads in reorganization.

FRA had one financial analyst who was responsible for reviewing all the financial data submitted under section 213 and for recommending the amount of financial assistance required to maintain operations. To monitor the railroads' activity, the financial analyst told us he maintained continuous telephone contact with the railroads. However, in our opinion, the information on which FRA's analysis was based was not sufficient to identify all rail and nonrail revenues and expenses which could have affected the railroads' cash deficits and did not allow FRA to determine the reasonableness of intercorporate dealings.

FRA relied heavily on the trustee's certification as to the accuracy and completeness of financial data on which grant amounts were based. (See p. 9.) We found such reliance could be misleading. The latest independent audit report on Central of New Jersey, dated May 30, 1975, contained the following footnote to the financial statement

"Since the Company has been unable to adequately reconcile its cash accounts, it was not practicable to determine the reasonableness of the cash balance. At December 31, 1974, there is an apparent overstatement of cash of approximately \$150,000 in the Company's primary disbursement account represented by an unreconciled difference. The Company has been unable to determine the cause or nature of this difference."

In a letter dated August 20, 1976, (see app. I), the Administrator, FRA, said the \$150,000 amount was a duplicate payment which Central of New Jersey reconciled and recovered in June 1975. The Administrator believed this isolated instance of an unreconciled difference did not undermine the credibility of actual cash data certified by the Central of New Jersey trustees.

Evidence supporting the facts cited by the Administrator showed that this information was obtained by telephone in July 1976--1 month after FRA received a preliminary copy of this report.

We did not find evidence to support that FRA had independently verified the accuracy and completeness of the financial information submitted by Central of New Jersey.

The Administrator also said it was FRA's practice from the beginning of the assistance programs to evaluate the data the railroads submitted and not to rely exclusively on the trustee's certification.

We found that an FRA financial analyst did evaluate the data the railroad submitted but FRA did not independently verify that the data being evaluated was accurate and complete as submitted. Without such verification, the reliability of any evaluation of the data could be suspect.

Audits of operating assistance

FRA also relied on the Department of Transportation internal audit staff's 1/ audits to make sure Federal assistance was used efficiently and as the legislation intended. As of March 31, 1976, the internal audit staff had reviewed the use of Emergency Rail Services Act funds at Penn Central and Central of New Jersey and section 213 funds at two of the seven railroads receiving assistance--Erie Lackawanna and Central of New Jersey.

A November 6, 1974, internal audit report on the Penn Central's use of Emergency Rail Services Act funds stated, in part, that an adequate determination could not be made as to whether funds provided to Penn Central were expended according to the act and the guarantee agreement, and that the funds were used solely for expenses necessary for continuing essential transportation services, or that other revenues of the railroad were used to the fullest extent possible, for operating expenses.

1/Three administrations within the Department have an external audit staff for reviewing grantee records, etc. However, FRA has not been provided with this capability. As a result, when FRA determines it needs audit assistance, it calls upon the Department's internal audit staff. The actual audit assistance can be provided either by the Department, one of the other administration's external audit staffs, or under contract with an outside audit organization.

According to the audit report, the determination could not be made because FRA had not required Penn Central to identify those expenses necessary for essential transportation services or to maintain separate accounting for the disposition of funds obtained through loan guarantees. Also, FRA had not required or received any data which could be used for monitoring the expenditures.

The audit report stated, however, that although guaranteed loan proceeds could not be identified to any specific railroad expenditures, the proceeds could be related to certain expense categories, such as payroll, railroad retirement taxes, and Federal withholding taxes. Total payroll and related expenditures for the periods during which the \$100 million was provided, were in excess of \$117.6 million. In addition, rail-related operating expenditures, other than payroll, during this period were approximately \$227.9 million.

In his reply to the audit report, the Administrator, FRA, stressed the very serious financial situation of the Penn Central at the time the guarantee was made, and the fact that expenditures for payroll and operating expenses far exceeded the loan proceeds as a basis for FRA's judgment that funds were expended according to the act and the terms and conditions of the guarantee agreement. He also stated that:

"It was clear at the time the guarantee was made that the little cash that was available could only have been used for those expenses which were necessary for continued operations * * *. Even if funds had been available for purposes other than rail operations, nontransportation related expenses were constrained by the court."

The internal audit report on Central of New Jersey also disclosed a problem with the railroad's use of guaranteed loan funds.

The report said that under the terms of the guarantee agreement, Central of New Jersey drew down funds on four separate occasions from April 1971 through December 1972. Proceeds from the first three drawdowns, totaling \$1.5 million, were spent within several days after receipt. The final drawdown of \$900,000 was invested in certificates of deposit and Treasury bills on December 31, 1972, and not redeemed until June 21, 1974--18 months later. The interest income earned by Central of New Jersey on these investments during the 18-month period was in excess of \$111,000 while

interest expense from the loan totaled \$89,000 resulting in a \$22,000 net income to the railroad.

In the opinion of the internal auditors, using guaranteed loan proceeds for investment purposes was contrary to the terms of the agreement. The auditors also said that the fact that 18 months lapsed between receipt of the funds and disbursement for authorized purposes indicated that loans were made before the time funds were actually needed and, consequently, was contrary to the intent of the agreement. The audit report recommended that FRA determine whether Central of New Jersey should reimburse FRA for the net income from investing the guaranteed loan proceeds.

In commenting on our report, (see app. I) the Administrator stated that in December 1972 it appeared the railroad needed the \$900,000 to continue essential services. The Administrator cited a State subsidy of \$235,000 per month beginning in February 1973, along with some operating improvements, as the reason for the railroad's delay in using the \$900,000.

Our understanding of this program is that it was designed to meet emergency needs when essential railroad services might be interrupted without the use of Federal financial assistance. The fact that State assistance provided more than a month later supplanted the need for the Federal assistance suggests FRA's monitoring of the situation was not reliable.

The Administrator also said because of limited program staff and tight time constraints, FRA had to rely heavily on post audit coverage to verify that available funds were properly used. According to the Administrator, this audit coverage included GAO's review of section 213 grants. He also stated that the Department's internal audit staff had examined 98 percent of section 213 funds obligated and determined that further audit effort was not warranted.

It is necessary to stress that we reviewed the accounting systems and other financial records of the railroads receiving section 213 funds to determine if FRA's controls over Federal funds were adequate to insure that the funds were used for intended purposes. We also determined that grant funds were used for authorized purposes. However, this review did not constitute a detailed audit of the railroads' accounts and should not be relied upon as verification that railroads' total available funds were properly used. Further, GAO should not be used as a primary factor of administrative control by executive agencies. It is FRA's responsibility to develop a comprehensive monitoring system which provides for complete audit coverage of assistance programs.

Concerning internal audit coverage of the section 213 program, the office of audits in a June 18, 1976, memorandum to FRA, stated that 98 percent of the section 213 funds obligated had

**** * *** either been subjected to audit examination or been determined unauditabile. Most of these amounts were determined unauditabile. (under-scoring added.)

Also, the office of audit concluded that additional auditing of section 213 grants would not accomplish any useful purpose.

Use of emergency assistance grant funds

Based on their review at Central of New Jersey and Erie Lackawanna, the internal auditors concluded that disbursements of section 213 funds at these two railroads were in accordance with the terms and conditions of the grant agreements.

Of the seven railroads receiving section 213 grants, six did not establish separate expense accounts for recording section 213 expenditures and, as a result, Federal funds could not be matched with specific expenditures. The Ann Arbor railroad, however, established a separate system for controlling and accounting for section 213 disbursements, and we traced disbursements of section 213 funds to documents showing that Ann Arbor used Federal funds only for authorized operating expenses.

Because total disbursements by all seven railroads for utility and fuel costs, current interline accounts, ^{1/} and wages and salaries, during the grant periods exceeded the amount of Federal funds contributed under section 213, it may reasonably be assumed that Federal funds were used for the purposes authorized. However, FRA did not determine how the railroads were using funds generated by corporate operations and, therefore, cannot assume that all the terms and conditions of the grant agreements or legislation were met.

^{1/}Interline payments result because many railroads may carry a specific piece of freight from its point of origin to its final destination. The final carrier must collect the revenue for hauling the specific piece of freight and at the end of each month must settle with the other carriers for the amounts due to them for their portion of transporting the freight.

For example, the review of the working-capital accounts and cash flow statements of the railroads in reorganization by Coopers & Lybrand showed that the railroads were using their own funds ^{1/} in ways which may have resulted in unnecessary use of Federal funds.

Because FRA's monitoring did not go beyond a review of the financial information submitted by the railroads, FRA was not aware of these situations until they were revealed by the Coopers & Lybrand review.

We reviewed the recurring reports Penn Central submitted from May 1974 through December 1975 to determine whether financial data submitted therein was adequate to identify

- rail transportation revenues versus expenses;
- nontransportation revenues versus expenses;
- capital improvements in nontransportation entities;
- status of escrowed funds at affiliates, subsidiaries, and real estate operations; and
- notes held by Penn Central (subsidiaries or affiliates).

These reports did not identify all revenues and expenses which could have affected the railroad's cash deficit, and did not allow FRA to determine the reasonableness of inter-corporate dealings.

In replying to our report (see app. I) the Administrator, FRA, stated that if a railroad in reorganization benefited beyond its essential needs from funds received under section 213, that fact can be considered by the Special Court when it decides whether transfers of property to ConRail complied with minimum constitutional requirements of fairness and equity. Also, if the court finds there was an unconstitutional erosion of the railroads' assets, any benefit received under section 213 could serve as an offset to the erosion award.

^{1/}Details of the situations Coopers & Lybrand revealed are not included in this report to avoid the possibility of prejudicing the position of either the Federal Government or the creditors of the bankrupt railroads in any current or future legal proceedings connected with conveyance of the bankrupt rail properties to ConRail.

We agree it is possible that any benefit received under section 213 could serve as an offset to an erosion award. However, we view the reliance on the Special Court proceedings as a secondary control. These proceedings will probably last for a number of years, they will require a substantial investment of Federal funds, and there is no guarantee that the Government will be successful in defending its position.

FRA should have taken steps to institute controls to insure that any benefits beyond essential needs for funds under section 213 could be identified so that action could be taken in a timely manner.

Defaults Under the Emergency Rail Services Act of 1970

On January 15, 1976, Penn Central defaulted on \$50 million in principal of a \$100 million loan guarantee received under the Emergency Rail Services Act of 1970. As of that time, Penn Central had made interest payments on the entire \$100 million guaranteed loan on time. Also, on April 20, 1976, the Central of New Jersey defaulted on principal and interest due on a \$2.4 million loan guarantee under the act. At that time, the Secretary of Transportation became liable, under the terms and conditions of the agreement, for principal and interest amounting to about \$2.48 million.

According to an FRA official, FRA was aware of the impending defaults well in advance of their occurrence. For example, in October 1975, FRA questioned Penn Central on its ability to repay the \$50 million which was to come due January 15, 1976. FRA's legal staff prepared a memorandum outlining the alternatives available to Penn Central.

FRA petitioned the reorganization court to order Penn Central trustees to pay the \$50 million. The court, however, found that, to order the trustees to pay the \$50 million would seriously jeopardize their ability to carry out their responsibilities. The reorganization court did order the trustees to escrow \$50 million in unattached funds. According to an agency official, FRA will have first claim against these funds.

MONITORING OF REPAIR AND REHABILITATION PROGRAMS BY FRA AND USRA

Four loan agreements were executed under the Emergency Rail Facilities Restoration Act in August 1973. Each agreement required the railroad receiving a loan to submit a program for restoring or replacing essential facilities and equipment to FRA within 15 days after the agreement was executed.

FRA could reimburse the railroads for restorations completed with the railroads' own funds before executing the loan agreement. To obtain reimbursement, the railroads were required by FRA regulations to submit verified statements of restoration work completed at the time of loan approval. Also FRA could advance the railroads an amount equal to their estimated expenditures for a specified period on the basis of verified statements similar to those submitted to obtain reimbursements after costs were incurred. FRA officials told us they did inspect some of the work for which the railroads requested reimbursements, but did not inspect work done after loan approval.

Only Penn Central and Lehigh Valley received advance funds. Lehigh Valley received funds well in advance of need on several occasions. While Penn Central received only one advance, the funds were not fully used until almost 2 years after receipt. According to FRA, the railroads requested loan advances as needed. A financial analyst in FRA reviewed the requests for reasonableness and mathematical accuracy but there were no attempts to verify the accuracy of the data used as the basis for the statements which were submitted.

Loan agreements did not require railroads receiving Emergency Rail Facilities Restoration Act funds to provide special accounts for loan proceeds. As a result, loan funds were commingled with other railroad revenues, thus losing their Federal identity and eliminating a direct audit trail.

As part of FRA's monitoring effort, the Department's internal auditors reviewed the use of loan proceeds provided under the act to Penn Central and Erie Lackawanna for restoring and replacing facilities and equipment Hurricane Agnes damaged in June 1972. At Penn Central, the auditors stated they were not able to determine whether funds had been used according to the provisions of the act and the terms and conditions FRA established because there were no records to indicate the condition of Penn Central tracks or equipment before Hurricane Agnes or immediately after.

The internal auditors were able to verify expenditures made for repairs and restoration of railroad property except for certain shop labor, materials, and overhead, amounting to \$355,264. However, during their physical inspections of damaged areas, the auditors found that Penn Central's maintenance and inspection records of the storm damage were unreliable for assessing the extent of damages and the repairs and restoration work done.

The auditors recommended that for future programs involving financial assistance affecting railroad

maintenance or capital improvements, FRA clearly assign responsibility for on site technical surveillance of the work to be done under the program. They also called for FRA to issue procedures for monitoring future loan programs to insure that the funds provided would be used for the intended purpose.

Responding to the auditor's conclusions and recommendations, FRA maintained that the condition of the Penn Central's track and equipment before Hurricane Agnes had no relevance to the administration of the loan program. FRA felt that the only concern of the Emergency Rail Facilities Restoration Act was to provide the financial assistance necessary to restore essential railroad operations. It also contended that there was no need for technical evaluations of the level of the storm damage. In addition, FRA stated that the quality of the restoration work was not under the auditor's jurisdiction and an audit determination in this area was not necessary since the act did not establish a quality level of restoration.

We believe that although the act did not specify a quality level for restoration, FRA, had an implied responsibility to insure the railroads did as much repair and restoration as possible with the Federal funds.

In June 1973, just before executing the loan agreement in August 1973, FRA determined that the Erie Lackawanna prepared and maintained adequate documentation to support flood damage expenditures. However, less than 2 years later, internal auditors were unable to verify costs amounting to \$3.3 million reported by Erie Lackawanna for repairs to tracks and facilities and for repairs to cars before June 30, 1973, because of the condition of the records. The auditors also found that the railroad's reported costs of materials for repairs to cars subsequent to June 30, 1973, was overstated by about \$30,000.

The auditors recommended that FRA require Erie Lackawanna to establish appropriate records to support actual costs incurred. They also recommended that FRA recover the difference between the amount loaned to the railroad and the actual cost to do the work the loan agreement covered.

In response, FRA stated that there apparently was source material in the railroad's possession which, given the necessary time and resources, could have been restructured to permit a satisfactory audit examination.

We agree that the railroad had cost records and given enough time it might have been able to support the costs. Apparently the Erie Lackawanna's accounting deteriorated

during the period between loan approval and the audit. More timely audits may have avoided the situation eventually encountered.

We also reviewed the Reading and Lehigh Valley railroads' use of Emergency Rail Facilities Restoration Act funds. Although the Reading's accounting records identified storm damage expenditures, Federal loan funds were provided on a reimbursable basis and the reimbursements equaled the amount of storm damage expenditures FRA approved.

The Lehigh Valley disbursements for facility restorations were traceable through specific work orders for labor and material which were directly identified to track segments Hurricane Agnes damaged.

Section 215 maintenance and improvement funds

Primary responsibility for monitoring the technical aspects of the section 215 program under the Regional Rail Reorganization Act of 1973 belonged to the program manager USRA and FRA designated under the terms of the June 12, 1975, memorandum of understanding. FRA maintained responsibility for monitoring the financial position of the railroads receiving section 215 funds.

To aid in monitoring the financial and technical aspects of the section 215 program maintenance work, FRA provided funds so that (1) USRA could contract with an engineering consultant and (2) Department internal auditors could contract for a program auditor. USRA employed the services of STV, Incorporated, an engineering consulting firm, and the internal auditors at USRA's request hired the Defense Contract Audit Agency (DCAA) as program auditor.

DCAA's monitoring activities included independent cost analyses and audits of costs the railroads incurred for eligible section 215 projects. A USRA official told us both FRA and USRA were aware that requirements of section 215 funds were affected by the application of section 213 funds and vice versa. USRA officials also told us they believed a comprehensive ongoing review similar to the Coopers & Lybrand work was necessary to insure not only that section 215 funds, but also section 213 funds, were being used effectively. However, FRA's monitoring of the financial aspects of both the sections 213 and 215 programs was essentially limited to review of financial information the railroad submitted without an indepth review and analysis of the railroads' working-capital accounts such as receivables, payables, accrued liabilities, inventories, and special escrow accounts or intercorporate transactions, to

insure that internally generated revenues were being used to the fullest extent possible to continue railroad operations.

DCAA audited costs about 60 days after the end of the month in which costs were incurred. When a railroad requested drawdowns on loans under section 215, DCAA evaluated the requests and recommended either the amount requested or an amount they determined to be adequate. DCAA based its recommendations on the railroads' estimated expenditures on section 215 projects and the balance of any section 215 funds previously applied. The program manager generally accepted DCAA's recommendation and authorized a drawdown in the amount recommended.

In general, the railroads deposited section 215 money into special bank accounts. The railroads' records showed drawdowns from these accounts, to reimburse the trustees for eligible costs and expenses of the section 215 program. Fund balances in the several accounts were invested for short periods of time and interest earned on these short-term investments was credited to the section 215 accounts.

Our review at Erie Lackawanna showed the possibility that the railroad received assistance from both USRA and another source for the same maintenance work.

In July 1967 the State of New Jersey entered into an agreement with the Erie Lackawanna to subsidize the railroad for costs which would not have been incurred if the railroad had not agreed to operate and maintain suburban commuter service. These avoidable costs included portions of the railroad's maintenance-of-way expenditures. Under section 215, USRA funded approximately 36 projects on the commuter lines subsidized by the State. Through January 1976, Erie Lackawanna had requested from USRA \$1.1 million in section 215 funds for maintenance-of-way work on these projects.

We attempted to define the amount of possible duplicate payments for State subsidies and USRA projects. Erie Lackawanna officials told us they did not have a breakdown of maintenance-of-way subsidies received from New Jersey which could be related to USRA projects. They explained that in 1975 total avoidable costs for maintenance-of-way under the agreement with the State were estimated to be \$2.2 million. However, this included many costs which could not be

applied to authorized USRA projects. Erie Lackawanna officials said their records would not accommodate a comparison of costs incurred on USRA work with New Jersey subsidies related to the same work, but they estimated the possible duplicate payments between the two programs to be \$853,000. However, without records for making this comparison it is possible that the overlap could be as high as \$1.1 million--the amount charged against the section 215 projects.

Erie Lackawanna officials told us that if the railroad had not received both section 215 funds and State subsidies, their critical cash position would have required them to request more section 213 emergency assistance grants.

USRA officials, however, said they were not aware of the overlap, and if they had known, they would not have approved maintenance on the commuter line projects.

USRA inspected work done under the locomotive and freight car repair and rebuilding programs. Inspections of the freight car repair and rebuilding program were performed by four inspectors. Inspection of the locomotive repair program was done by one full-time inspector supplemented on a part-time basis by USRA staff. All of the inspectors reported to a Superintendent-Section 215 Shop Programs, a USRA employee.

This inspection program included preinspection of all freight cars and locomotives for acceptance into the repair and rebuilding programs before starting repairs. The equipment was inspected at various stages of repair and a final inspection was made when repairs were complete.

STV, Incorporated was hired to monitor the technical aspects of the section 215 program. STV was responsible for inspecting completed projects involving repair and rehabilitation of track and other fixed facilities and reporting the results to USRA, including recommending acceptance or rejection of the work.

While STV was used primarily in a quality control capacity determining the adequacy of the program maintenance work done by the railroads, USRA had originally established a statement of work for the engineering contractor whereby it would provide three types of technical support-- (1) planning, (2) standards development, and (3) oversight.

According to FRA officials, the original proposal USRA prepared would have cost over \$1 million and because of budgetary constraints only the oversight phase was funded

at a cost of \$200,000. Since FRA funds were used to pay the monitoring contracts, they decided how broad the engineering contractor's scope would be. In a June 12, 1975, memorandum to USRA, FRA stated that the only support effort it should have been buying was after-the-fact inspection and certification of work done, not services which would insure the timely and economical use of Federal dollars. FRA stated that the technical support contract was to insure that work for which Federal funds were paid was, in fact, accomplished.

In commenting on this report, (see app. I.) the Administrator, FRA, said the contract was limited to oversight because the planning and standards development functions for the section 215 program had already been completed by the railroads and it was necessary to start work as promptly and expeditiously as possible.

Section 211, general implementation funds

As of March 31, 1976, no detailed system had been formalized for monitoring the section 211 program under the Regional Rail Reorganization Act of 1973. According to a USRA official, the unofficial monitoring system in operation had three stages. First, USRA maintained ongoing contact with railroad officials by phone, written correspondence, and meetings. Second, USRA officials also made periodic inspection trips to review the progress of work being financed with section 211 loan funds. Third, USRA made continuous in-depth reviews and analyses of financial information the railroads submitted to insure that the covenants included in the loan agreements were not being violated.

Section 211 loans were approved for both working capital and repair and rehabilitation projects. A summary as of March 31, 1976, of the approved uses of loan funds follows.

| <u>Railroad</u> | <u>Use of funds</u> | <u>Amount</u> (millions) |
|-----------------------|--|-----------------------------|
| Missouri-Kansas-Texas | Rebuild 110 miles of main line | \$ 4.2 |
| | Rehabilitation of rolling stock and locomotives | 1.7 |
| | Purchase and installation of rail and related accessories | 10.1 |
| | Working capital | 3.0 |
| ConRail | Preconveyance administrative and operating expenses | 11.0 |
| | Purchase maintenance-of-way equipment | 6.0 |
| | Purchase of materials Inventory | 16.3 23.5 |
| | Contingency to cover contract cancellation charges if conveyance did not occur | 33.4 |
| Delaware & Hudson | Rail line acquisitions | .4 |
| | Purchase locomotives | 7.5 |
| | Debt refinancing | <u>20.1</u> |
| Total | | <u>\$137.2</u> |

During our review at each of the railroads we found documentation to show that the funds were expended for the purposes specified in the loan agreements.

CONCLUSIONS

Financial assistance programs which provide funds for working capital, such as the Emergency Rail Services Act of 1970 and section 213 of the Regional Rail Reorganization Act of 1973, do not lend themselves to the type of monitoring where expenditures can be readily identified to specific projects. Effective monitoring of working-capital programs requires, in addition to review of financial information the railroads submit, analyses of working-capital accounts and cash flows and review of intercorporate transactions which could affect the railroads' cash position. Such review and analyses would provide better assurance that the railroads are using all available resources to continue or improve railroad operations.

In cases where total expenditures for authorized purposes exceeded Federal financial assistance, it may reasonably be assumed that the assistance was used for authorized purposes; however, it does not necessarily follow that the railroads' own funds generated by corporate operations were used as the legislation and the terms and conditions of the grant agreements intended. We believe the statements the railroads submitted and the analyses FRA made did not provide sufficient information necessary to adequately assess how the railroads used total available funds or to insure that reasonable and prudent business judgment was being exercised in determining the amount of cash to be used for nonrail expenditures. The uses of corporate funds disclosed by the Coopers & Lybrand review illustrate the need for such information.

We believe FRA's heavy reliance on the certification of trustees or other corporate officials as evidence of the accuracy and completeness of the financial information the railroads submitted, without an independent verification of the railroads' financial position, including intercorporate transactions, is an undesirable alternative to firsthand knowledge obtained from indepth financial review and analysis.

Because FRA did not have audit capability, they relied on the Department's internal audit staff to review the railroads' use of Federal financial assistance. As of March 31, 1976, FRA had requested audits at one of the two railroads receiving Emergency Rail Services Act assistance and three of the four railroads receiving Emergency Rail Facilities Restoration Act assistance. As a part of a continuous monitoring effort, we believe FRA should have taken action to have financial audits made at each railroad receiving assistance at the end of the programs or when most of the Federal costs had been incurred.

RECOMMENDATIONS

Authority to provide direct financial assistance to railroads, other than ConRail, under the Emergency Rail Facilities Restoration Act and the Regional Rail Reorganization Act of 1973 has expired. While FRA still has authority to guarantee loans under the Emergency Rail Services Act of 1970, actual activity is minimal.

Therefore, for future railroad financial assistance programs, we recommend that the Secretary of Transportation require the Administrator, FRA, to develop and implement a monitoring system sufficient in scope to insure that the railroads use Federal assistance for the purpose intended. This system should at least provide for

--ongoing analyses of costs incurred for federally assisted programs and

--regular, onsite technical inspections of work done to insure quality, efficiency and cost effectiveness.

For assistance earmarked for working capital, the monitoring system should also include review and analysis of working-capital accounts and cash flows and review of intercorporate transactions to see that they are reasonably and prudently conducted.

Considering the amount of financial assistance authorized under the Railroad Revitalization and Regulatory Reform Act of 1976 and FRA's increased responsibility for the assistance programs, we recommend that the Secretary of Transportation require the Administrator, FRA to insure complete and timely audit coverage of all future financial assistance program.

Also, in the event USRA is given responsibility for financial assistance programs in the future, we recommend that the chairman of the board of directors, USRA, take actions similar to those recommended to the Secretary of Transportation.

AGENCY COMMENTS AND
OUR EVALUATION

The Department of Transportation stated that management of future financial assistance programs will include the recommendations made in the report and that steps are being taken to delegate audit authority to FRA. The Department also said, in programs of assistance earmarked for working capital, analyses of working capital accounts and review of intercorporate transactions will be based on considerations of the urgency of assistance needs, apparent legality of intercorporate transactions, and the cost of such analyses and review in relation to anticipated benefits.

Concerning our major findings and conclusions, the Department believed they were not accurate or supported by the facts outlined in the report. According to the Department, the statutory goal of the legislation considered in this report was fully met--essential rail services of the bankrupt railroads were sustained without interruption until a reorganization plan for the continued operation of their rail facilities could be developed and implemented. The Department felt that, considering the urgency of the situation and the critical timing demands

that had to be met, the record shows an acceptable balance was maintained between continuing the essential services in the public interest and the accomplishment of this goal at the lowest possible cost to the taxpayer.

We agree that the statutory goal of continuing essential rail services was met. However, FRA's monitoring system did not provide adequate assurance that program goals were accomplished at the lowest possible cost to the taxpayer. As discussed in chapter 3, FRA did not arrange for financial audits of assistance recipients in a timely manner; it did not determine that the railroads were properly using their own working-capital resources before approving financial assistance; it did not independently verify the accuracy and completeness of financial information on which grant awards were based and it did not establish a quality level for restoration work performed under one assistance program or consistently inspect the work done to insure quality, and least cost to the Government.

The Department also stated that a critical consideration is the key role of the Federal District Courts in supervising the reorganization proceedings of the railroads receiving assistance and the Department's direct and active involvement in the proceedings before these Courts concerning the bankrupts' cash needs and their use of Federal assistance. The Administrator said the complementary nature of the judicial procedures, the Department's independent evaluations of the railroads' needs, and the post audit coverage of railroad records supporting such needs provided an effective means of safeguarding proper use of the railroads' total funds.

In our opinion, FRA's involvement in the judicial procedures relating to the bankrupt railroads was not sufficient to insure that Federal assistance was used only when needed. We observed that a review by an independent public accounting firm revealed court-approved escrows of corporation funds that might otherwise have been used as working capital by a railroad. FRA was not aware of most of these escrows prior to the review. Also, as we pointed out earlier in the report, FRA's independent evaluations of railroads' needs were based on unverified information provided by the railroads. The Department's internal audit staff stated that most of the expenditures under section 213 were not auditable. (See p. 23.)

After carefully considering the additional information provided by the Department and the facts on which our findings are based, we believe our conclusions are justified. The Department's comments to our report are included as

appendix I. We considered these comments and they are discussed at various places in the report. (See pp. 7, 19, 20, 22, and 24.)

The United States Railway Association (see app. II.) stated that if it is given responsibility for additional financial assistance programs in the future, full consideration will be given to the recommendations in carrying out those responsibilities.

CHAPTER 4

FUTURE FEDERAL ASSISTANCE

The Railroad Revitalization and Regulatory Reform Act of 1976, was enacted February 5, 1976. Included are a variety of programs that will provide substantial financial assistance for railroads. Implementing these assistance programs depends, in part, on the completion of certain specific studies the act requires.

The act authorizes \$6.4 billion in financial assistance to the railroad industry. Some of the major assistance provisions of the act include the authorization of \$2.1 billion for the United States Railway Association to purchase ConRail debentures and preferred stock and \$1.87 billion to improve the Northeast Corridor. The act also establishes two programs which can provide up to \$1.6 billion in direct Federal assistance to railroads. The Federal Railroad Administration under delegation of authority from the Secretary of Transportation, is responsible for administering both programs.

The Secretary can purchase up to \$600 million in equity in railroads through the Railroad Rehabilitation Fund authorized by the act. These funds are to be used for facilities maintenance, rehabilitation, improvements, acquisition of equipment or rail lines, and other uses which the Secretary may approve.

The Secretary can also approve up to \$1 billion in guaranteed loans to railroads. Proceeds of guaranteed loans will be used to acquire or rehabilitate and improve railroad facilities or equipment. Up to \$200 million may be used to electrify ConRail's high-density main line routes.

Paramount to implementing these two assistance programs is the completion of two major studies the act requires. By February 5, 1977, the Secretary of Transportation will be required to finalize standards for classification of main and branch lines and designations of rail lines according to those standards. These final standards and designations will be based on the railroads' analyses of their rail systems which were submitted according to a standardized FRA format and the input from public hearings on preliminary standards and designations, which the Secretary must formalize.

A study of capital needs is also required by the new act. This study will be in three phases and will include studies of (1) deferred maintenance (2) delayed capital

improvements, and (3) projected capital needs from 1976 through 1985. FRA has established standardized reporting formats for the first two phases and an FRA official told us they had not established guidelines for the third phase.

The intention of the final standards and designations study is to develop an interstate main line network and thereby indirectly establish priorities for rehabilitation projects. The capital needs study along with the final standards and designations will enable FRA to determine the amount and type of funding which will be needed for both assistance programs.

CONCLUSIONS

The future financial assistance programs authorized under the Railroad Revitalization and Regulatory Reform Act of 1976 give FRA tremendous responsibility in terms of the actual amounts of assistance authorized and the wide variety of uses to which the assistance can be applied. If these assistance programs are managed well, the Nation's rail system may realize great benefits. We believe that proper management of these and any future programs, however, will require the type of improved controls discussed in chapters 2 and 3.

Specifically, FRA's preaward analysis needs to be thorough enough to indicate what should be done and what will be required in terms of money and materials to complete the work. Monitoring procedures must also be sufficient in scope to insure efficient and effective use of Federal assistance and must include standardized reporting formats. Also, for assistance earmarked for working capital, the information required for both preaward analysis and monitoring purposes must be in sufficient depth and detail to show the flow of the railroads' total funds and incorporate transactions, which could affect the overall financial position of the railroad and the Government's investment.

AGENCY COMMENTS

The Department of Transportation (see app. I) stated that the management of the financial assistance programs under the Railroad Revitalization and Regulatory Reform Act of 1976 will include the recommendations made in this report.

CHAPTER 5

SCOPE OF REVIEW

Our review was conducted at the Washington, D.C., Headquarters of the Department of Transportation and at the United States Railway Association. We examined pertinent records, documents, and reports and held discussions with responsible agency officials regarding the management of direct Federal financial assistance provided to the railroads under the Emergency Rail Services Act of 1970; the Emergency Rail Facilities Restoration Act; and the Regional Rail Reorganization Act of 1973, as amended.

We reviewed the accounting systems and other financial records at each of the corporate headquarters of the railroads receiving financial assistance to determine if controls over the Federal funds were adequate to insure that the funds were used for the intended purposes. We also used the Department's internal audit reports, where appropriate, to supplement our review and avoid duplication of effort.

We held discussions with representatives of the certified public accounting firm which reviewed the working capital accounts of the railroads and reviewed their working papers and periodic reports required under their contract.

We also held discussions with representatives of the contractors hired to monitor the section 215 program.

We obtained comments on matters discussed in this report from the Department of Transportation and the United States Railway Association. Their views were considered in its preparation.

APPENDIX I

APPENDIX I



OFFICE OF THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

ASSISTANT SECRETARY
FOR ADMINISTRATION

August 20, 1976

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

Dear Mr. Eschwege:

This is in response to your letter of June 28, 1976, requesting the Department of Transportation's comments on the General Accounting Office's draft report entitled, "Improved Controls Needed Over Federal Financial Assistance Provided to Railroads." We have reviewed the report in detail and prepared a Department of Transportation reply.

Two copies of the reply are enclosed herein.

Sincerely,

William P. Davis
for William S. Heffelfinger

Enclosures

DEPARTMENT OF TRANSPORTATION REPLYTOGAO DRAFT REPORT OF JUNE 28, 1976ONIMPROVED CONTROLS NEEDED OVER FEDERAL FINANCIAL
ASSISTANCE PROVIDED TO RAILROADSSUMMARY OF GAO FINDINGS AND RECOMMENDATIONSFindings

Procedures for review and analysis of applications were inadequate to insure appropriate determinations of eligibility and financial need.

Provisions for monitoring the various financial assistance programs were not sufficient to adequately assess whether the recipients' total funds, both Federal and corporate, were being used to achieve program purposes economically.

Recommendations

Develop formal, detailed procedures for systematic pre-award review and analysis of applications; completely document evaluations; comprehensively monitor program costs incurred and work performed; maintain in-depth analyses of working capital accounts and intercorporate transactions in working capital assistance programs.

Take steps necessary to insure complete and timely audit coverage of future financial assistance programs.

SUMMARY OF DEPARTMENT OF TRANSPORTATION POSITION

The Department does not believe the principal findings in the report are accurate nor supported by the available facts, as outlined in the report.

The statutory goal of the legislation considered in the report was fully met: essential rail services of the bankrupt railroads were sustained without

interruption until a reorganization plan for the continued operation of their rail facilities could be developed and implemented. Considering the exigencies involved and the critical timing demands that had to be met, the record shows an acceptable balance was maintained between continuing the essential services in the public interest and the accomplishment of this goal at the lowest possible cost to the taxpayer.

There is no specific assertion in the report that there was, in fact, an unnecessary drain on Federal funds. Nor is there any indication of willful misapplication of funds or other deliberate failure to comply with the legislation and assistance agreements. The record shows that the Department made continuous, positive efforts to insure that assistance awards were consistent with actual cash needs.

A critical consideration not recognized in the report is the key role of the Federal District Courts in supervising the reorganization proceedings of the railroads receiving assistance and the Department's direct and active involvement in the proceedings before these Courts in regard to the bankrupts' cash needs and their use of Federal funds. The complementary nature of the judicial procedures, the Department's independent evaluations of the railroads' needs, and the post audit coverage of railroad records supporting such needs provided an effective means of safeguarding proper use of the railroads' total funds.

The Department will continue to follow procedures needed to insure full protection of the public interest in providing Federal financial assistance to railroads. Management of the financial assistance program under the Railroad Revitalization and Regulatory Reform Act of 1976 and any other future program will include the recommendations made in the report. In programs of assistance earmarked for working capital, analysis of working capital accounts and review of intercorporate transactions will be based on considerations of the urgency of assistance needs, apparent legality of intercorporate transactions, and the cost of such analysis and review in relation to anticipated benefits.

Steps are being taken to delegate to the Federal Railroad Administrator audit authority with respect to FRA programs, which up until now has been reserved to the Office of the Secretary. We expect this transfer to be completed shortly.

POSITION STATEMENT

The Department wishes to submit the following more detailed statement with respect to the conclusions and observations set forth in the subject report.

General Observations

As we interpret it, the report draws two principal conclusions:

1. that procedures for review and analysis of applications were inadequate to insure appropriate determinations of eligibility and financial need, and
2. that the provisions for monitoring the various financial assistance programs were not sufficient to adequately assess whether the recipients' total funds, both Federal and corporate, were being used to achieve program purposes economically.

We do not believe either conclusion is accurate nor supported by the available facts, as outlined in the report. Before addressing the conclusions, however, certain fundamental points need to be emphasized.

1. The emergency nature of the assistance programs, involving as they did bankrupt railroads in acute financial difficulty, made the programs unique. The goal of both section 3 of the Emergency Rail Services Act of 1970 ("ERSA") and section 213 of the Regional Rail Reorganization Act of 1973, as amended ("Rail Act"), was the uninterrupted provision by the bankrupt railroads of essential transportation services in the public interest. This goal was achieved. Considering the exigencies under which the financial assistance was furnished and the critical timing demands that had to be met, the record shows an acceptable balance was maintained between the continuation of essential rail services and the accomplishment of this goal at the lowest possible cost to the taxpayer.
2. Significantly, there is no specific assertion in the report, that there was, in fact, an unnecessary drain on Federal funds. Nor was there disclosed in the examination of the records any indication of willful misapplication of the assistance funds or other deliberate failure on the part of the

Trustees of the bankrupt railroads to comply with the provisions of the legislation and the assistance agreements. We believe effective safeguards were in place to insure that the assistance furnished was consistent with actual cash needs.

3. Each of the financial assistance programs was administered in the context of railroad reorganization proceedings under section 77 of the Bankruptcy Act. The report fails to recognize the impact of the reorganization process on the administration of Federal assistance programs.

Each railroad trustee was subject to the supervision of the Federal District Court which exercised jurisdiction over all of the railroad's assets and exercised broad supervisory powers over the trustee's actions. Thus, applications for financial assistance, the amount of assistance to be requested, and the terms and conditions under which assistance would be provided were all subject to prior approval by the Courts.

The Department of Transportation was a party to each reorganization proceeding and participated vigorously when we felt it was necessary. In those instances where we did not agree with a Court's supervisory decision, we were able to, and did, comprehensively document in the public record of the reorganization proceeding our evaluation of the assistance requirements and our ability to serve those needs. A partial listing of such Court proceedings is shown in Attachment A. [See GAO note 1, p. 52.]

The Courts also exercised a critical role in preventing misapplication of the railroads' own funds. In a railroad reorganization proceeding, the Court has a dual responsibility to protect the interests of the creditors of the railroad and to protect the public interest. *New Haven Inclusion Cases*, 399 U.S. 392, 491-92 (1970). Pending independent audit verification at such time as might be feasible, we considered it reasonable to proceed on the basis that the Courts' jurisdiction would serve to insure that the application of the railroads' funds was consistent with all statutory requirements.

4. With respect to section 213 of the Rail Act, in particular, if a railroad in reorganization has

benefitted beyond its essential needs from funds it received under that section, that fact can be considered by the Special Court when it decides, pursuant to section 303(c) of the Rail Act, whether the transfers of rail property comply with the minimum constitutional requirements of fairness and equity. In addition, if the Special Court determines that there was unconstitutional erosion of a railroad estate which must be compensated, any benefit received under the Rail Act could serve as an offset to the erosion award.

5. Notwithstanding paragraph 3 above, it was our consistent practice from the outset of the emergency assistance programs, to independently evaluate the data presented by the Trustees in support of working cash needs. Under no circumstances were the Trustees' certifications of cash needs as derived from such data relied on exclusively. In the section 213 program, for example, substantial differences often existed between the amount of assistance requested by the Trustees and the actual assistance that was provided, as shown in Attachment B. - Evaluations in the record of specific [See GAO note 1, p. 53.] requests for such assistance clearly demonstrate that continuous, positive efforts were made to tie assistance awards to actual cash requirements on a timely basis, irrespective of the amount of the certification.

As was stressed to the General Accounting Office representatives, we did not depend on Trustees' certifications per se. With the limited program staff that was available and the very tight time constraints within which the assistance decisions normally had to be made, it was necessary as a practical matter to rely heavily on post audit coverage of the railroads' records to verify that available funds were properly used. Audits of the railroads' records for each of the assistance programs covered in this report have now been completed. This includes the General Accounting Office review of the use of section 213 funds at each of the seven railroads receiving assistance as specified in the report. The OST Office of Audits overview of section 213 funds by audit examination or other means covered 98 percent of funds obligated. It was concluded by this Office that further audit effort on this program was not warranted.

Comments on Principal Conclusions

The conclusions in the report with respect to the review and analysis of applications are generally directed to the development of formal procedures and the documentation of pre-award reviews and analyses of applications.

In implementing the Acts discussed in the report, the application procedures were tailored to fit the circumstances and timing considerations associated with each Act. We believe these procedures incorporated the controls needed to insure compliance with the intent of the legislation and full protection of the public interest in the providing of Federal funds. There were only a very limited number of eligible applicants to be considered under each Act.

Specifically, with respect to ERSA, there is a record of continuous review and analysis by the Administration and the Congress (H. Rept. 91-1770 dated December 16, 1970) from the date of the bankruptcy of the Penn Central Transportation Company ("Penn Central") to the enactment of ERSA, of the urgent need for Federal assistance to insure the preservation of essential rail services on the lines of Penn Central and other bankrupt railroads. We believe this review and analysis clearly established the need for immediate aid for Penn Central, and subsequently for the Central Railroad Company of New Jersey ("CNJ"). In March 1971 Secretary Volpe testified before the House Committee on Interstate and Foreign Commerce on the granting of assistance to Penn Central, and in July 1971, submitted to the President and the Congress the initial report on such aid, as required by the Act. A similar initial report on the CNJ was submitted by Secretary Volpe, and thereafter, the Secretary's activities under the Act and the financial condition of the Penn Central and CNJ were fully and regularly documented in annual reports to the President and the Congress as required by ERSA. In each case, findings were documented as required by the Act, as were those for the Rock Island made on April 20, 1976.

In regard to the Emergency Rail Facilities Restoration Act ("Agnes Act"), the pre-award review and analysis procedures that were followed and the required findings are fully documented in the report submitted to the President and the Congress on October 26, 1973, pursuant to the requirements of this Act. Formal procedures for the Rail Act were developed as the report indicates. However, the record confirms that these procedures were consistently followed in their entirety from the inception of the section 213 program.

Concerning the second principal conclusion in the audit report, the essential issue is whether sufficient safeguards were in place to assure that the recipients' total funds, both Federal and corporate, were applied to achieve program purposes at the least possible cost to the Government. We believe our monitoring activities, together with our direct and active involvement in the reorganization proceedings of each recipient provided reasonable assurance that the recipients' total funds were so applied.

We fully recognized, and so raised the issue in our memorandum of September 10, 1975, on the review of Penn Central's cash management system, and again in our memorandum of May 4, 1976, requesting section 213 audit coverage of the recipient railroad records, that with both Federal funds and regular operating revenues being used by the railroads to provide essential services, the critical consideration was whether the total cash resources of the railroads receiving assistance were being applied the maximum extent possible to sustain such essential services. From an audit standpoint, however, we were advised that such comprehensive audits of the recipient railroads' records would not be practical. Such audits would have to cover transactions involving billions of dollars and would require extensive audit resources and funds significantly in excess of those available.

As the audit report points out, in December 1975 the certified public accounting firm of Coopers and Lybrand was engaged by the Federal Railroad Administration ("FRA") in conjunction with the United States Railway Association ("USRA") to examine the working capital accounts and inter-corporate transactions of the railroads in reorganization. The results of the Coopers and Lybrand audit are being studied by our legal staff for possible use in future Court proceedings as explained in Mr. R.L. McCaffrey's letter to Mr. H.J. Wessinger dated June 28, 1976.

In assessing whether the railroads' total available funds were applied in accordance with the authorizing legislation, particular reference is warranted with respect to the monitoring that was maintained over section 213 funding. We consistently took the position that we would not eliminate any cash deficiency resulting from payments by the RRRRA railroads of deferred interline settlements, other pre-RRRA debts, or escrowing of operating funds. In the case of Penn Central, as an example, it was necessary to resolve through Court action a dispute with respect to the extent to which some \$42 million in funds sequestered by the

Trustees on their own initiative in certain special accounts would be used to meet operating expenses. The Court dissolved in part the special accounts. The balance--\$10 million--was always considered to be available to meet operating expenses when we made our evaluations of the amount of assistance Penn Central needed.

Similarly, we consistently withheld \$1.4 million in assistance to the Trustees of the Erie Lackawanna Railway Company ("EL") for ineligible payments made on their own initiative to EL subsidiaries. Also there were numerous instances in which our monitoring prevented ineligible payments by other Trustees--particularly the CNJ Trustee.

The net result is that we were able to sustain essential services and meet the bankrupt carriers' legitimate needs without requiring appropriation of the full \$282.0 million authorized funding. Additionally, despite substantial pressures caused by a month's delay in the conveyance of rail properties, we were able in the process to preserve \$6.3 million in appropriated funds.

Comments on Selected Points

To complete our comments, there are a number of particular references in the draft report to which we wish to respond. Specifically -

\$900,000 Drawdown of Trustee Certificates - CNJ

The report makes an observation with respect to a \$900,000 drawdown of ERSA guaranteed Trustee certificates by the Trustee of the CNJ as being in advance of needs. While the report does not question the determination that was made by the Department in this regard, a complete understanding will be facilitated if the report reflects the underlying conditions and circumstances immediately surrounding the drawdown, as summarized below.

The drawdown of the \$900,000 stemmed from a series of events in the last several months of 1972 threatening a cessation of essential services on the CNJ. This series of events culminated in a ruling by the Reorganization Court in December 1972 that such services should continue to be provided by the CNJ. This ruling relied in part on an understanding with the Department that we would not deny the drawdown of \$900,000 as approved by the Court.

From the Department's standpoint, the main responsibility during the series of events in 1972 and in the December Court proceeding was to assure the continuation of essential services in the public interest. It appeared reasonable in the light of the in-depth financial record before the Court that the \$900,000 was needed, and that with the \$900,000 drawdown the CNJ would be in a position to continue the services at least through 1973. Further, there was no other basis for denying the drawdown approved by the Court, as the report points out. Accordingly, the Court was advised that the Department would interpose no objection to the drawdown.

Subsequently, in January 1973, there was a resolution of a related State passenger subsidy issue, which increased the subsidy to the CNJ by \$235,000 per month--commencing in February 1973. This increase, which was not anticipated in the December Court proceedings, together with other improvements in operations, substantially assisted the Trustee in stabilizing the railroads' cash position during 1973, thus resulting in the delayed use of the drawdown proceeds. Since these were the proceeds of a guaranteed loan, there was no direct outlay of government funds at that time.

Complete details with respect to the foregoing developments were included in the ERSA annual reports submitted to the President and the Congress in January 1973 and July 1973.

\$150,000 Cash Balance Reconciliation - CNJ

The report refers to an independent audit qualification concerning an unreconciled difference of \$150,000 in the CNJ's primary disbursement account at December 31, 1974, as reflecting unfavorably on the credibility of data certified by the Trustee.

The \$150,000 amount is an isolated error that resulted from a changeover to a new computer program in October 1974. It represented a duplicate payment in that amount by the CNJ to the Seaboard Coast Line Railroad, which was reconciled by the CNJ and recovered in July 1975.

We do not believe this isolated instance of an unreconciled difference undermines the credibility of actual cash data certified by the CNJ Trustee. In any event, we wish to emphasize that the reliance in providing grant assistance

APPENDIX I

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was not on the certification by the Trustee, but rather on our own independent evaluation and post audit review as we previously indicated. In the interests of accuracy, we believe it is particularly important that the report reflect this clarification.

[See GAO note 2, p. 53.]

[See GAO note 2, p. 53.]

Application of ERSA Proceeds

The report states with respect to the application of Penn Central ERSA proceeds, that "total payroll and related expenditures for the period during which the \$100 million was provided, were in excess of \$117.6 million. In addition, rail-related operating expenditures, other than payroll, during this period were approximately \$227.9 million." These figures appear to be based on outlays for portions of the months during which the drawdowns were made--which we believe understates the point.

Based on the cash flow reports prepared by the railroads, the full cash outlays per month for the drawdown months (first four months of 1971 and August 1972) are as follows (in millions):

| | <u>Range of Outlays</u> <u>Per Month</u> |
|---|---|
| Total cash outlays | \$199 - \$237 |
| Payrolls and related expenses | 76 - 96 |
| Interline settlements, utilities and services, fuel oil, materials and supplies | 58 - 99 |

We believe the full month figures provide a more realistic assessment of drawdowns in relation to need. As may be seen, \$100 million does not cover one month's needs.

Audit Responsibility

The audit report refers to the lack of audit capability in FRA and points to the need for arrangements to provide FRA with adequate services when needed and where needed to enable complete audit coverage of financial assistance programs. Steps are being taken to delegate to the Federal Railroad Administrator audit authority with respect to FRA programs, which up until now has been reserved to the Office of the Secretary. We expect this transfer to be completed shortly.

Conclusion

The record shows that the primary objective of the emergency legislation considered in the report was fully met, i.e., the essential rail services of the bankrupt carriers were maintained on an uninterrupted basis until a reorganization plan for the continued operation of their rail facilities could be developed and implemented. In carrying out the intent of this legislation, the Department has endeavored to provide for the continued provision of the essential rail services while keeping the cost to the Government at a minimum. We believe this objective also has been met, there being no specific finding in the report that the use of funds by the railroads was contrary to the intent and purposes of the legislation.

We believe that our working in close harmony with judicial procedures, coupled with our own independent evaluations of railroads' needs and reliance on post audit coverage of

railroad records supporting such needs represented an effective means of safeguarding proper use of the railroads' total funds. Because of the size and scope of the undertaking, and timing considerations, a sustained, full-scale analysis of working capital accounts and intercorporate transactions along the lines discussed in the report would not have been practical.

The Department will continue to follow procedures needed to insure full protection of the public interest in providing Federal financial assistance to railroads. Management of the financial assistance program under the Railroad Revitalization and Regulatory Reform Act of 1976 and any other future program will include the recommendations made in the report. In programs of assistance earmarked for working capital, analysis of working capital accounts and review of intercorporate transactions will be based on considerations of the urgency of assistance needs, apparent legality of intercorporate transactions, and the cost of such analysis and review in relation to anticipated benefits.

We appreciate this opportunity to submit our comments on the conclusions and observations set forth in the draft report and trust the General Accounting Office will give favorable consideration to incorporating our views in the final report.


ASAPH H. HALL
Administrator

GAO note 1: The attachments were considered on our evaluation and because of their length have been deleted from this final report.

GAO note 2: Deleted comments refer to material in the draft report which has been revised or deleted from this final report.

APPENDIX II

APPENDIX II

United States Railway Association

2100 Second Street, S.W.
Washington, D.C. 20595
(202) 426-1991

Arthur D. Lewis
Chairman of the Board

August 26, 1976

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

Dear Mr. Eschwege:

This letter is in response to your request of June 28, 1976, for the Association's formal comments on the draft report entitled "Improved Controls Needed Over Federal Financial Assistance Provided to Railroads, Federal Railroad Administration, Department of Transportation, United States Railway Association.

We appreciate the opportunity afforded us to review a preliminary draft of your report prior to its circulation in final draft form, and the Association has no further suggestions concerning the present draft. Should USRA be given responsibility for additional financial assistance programs in the future, full consideration will be given to the recommendations contained in the draft report in carrying out those responsibilities.

Sincerely,

Arthur D. Lewis

PRINCIPAL OFFICIALS
RESPONSIBLE FOR ADMINISTERING
ACTIVITIES DISCUSSED IN THIS REPORT

Tenure of office
From To

DEPARTMENT OF TRANSPORTATION

SECRETARY OF TRANSPORTATION:

| | | |
|-------------------------|-----------|-----------|
| William T. Coleman | Mar. 1975 | Present |
| John W. Barnum (acting) | Feb. 1975 | Mar. 1975 |
| Claude S. Brinegar | Feb. 1973 | Feb. 1975 |
| John A. Volpe | Jan. 1969 | Feb. 1973 |
| Alan S. Boyd | Jan. 1967 | Jan. 1969 |

ADMINISTRATOR, FEDERAL RAILROAD

ADMINISTRATION:

| | | |
|------------------------|-----------|-----------|
| Asaph H. Hall | Aug. 1975 | Present |
| Asaph H. Hall (acting) | Nov. 1974 | Aug. 1975 |
| John W. Ingram | Oct. 1971 | Nov. 1974 |
| Carl V. Lyon (acting) | July 1970 | Oct. 1971 |
| Reginald N. Whitman | Feb. 1969 | July 1970 |
| A. Scheffer Lang | May 1967 | Feb. 1969 |

UNITED STATES RAILWAY ASSOCIATION

CHAIRMAN, BOARD OF DIRECTORS:

| | | |
|-----------------|-----------|---------|
| Arthur D. Lewis | July 1974 | Present |
|-----------------|-----------|---------|

PRESIDENT AND CHIEF OPERATING
OFFICER:

| | | |
|------------------|-----------|-----------|
| Vacant | Mar. 1976 | Present |
| James A. Hagen | July 1975 | May 1976 |
| Edward G. Jordan | Mar. 1974 | July 1975 |

VICE PRESIDENT, FINANCIAL

—PLANNING:

| | | |
|----------------|-----------|-----------|
| Russell Murphy | Apr. 1976 | Present |
| John J. Terry | Aug. 1974 | Apr. 1976 |

VICE PRESIDENT, OPERATIONS
AND FACILITIES PLANNING:

| | | |
|------------------------|-----------|-----------|
| Charles Hoppe | Oct. 1975 | Present |
| Charles Hoppe (acting) | July 1975 | Oct. 1975 |
| James A. Hagen | Mar. 1974 | July 1975 |