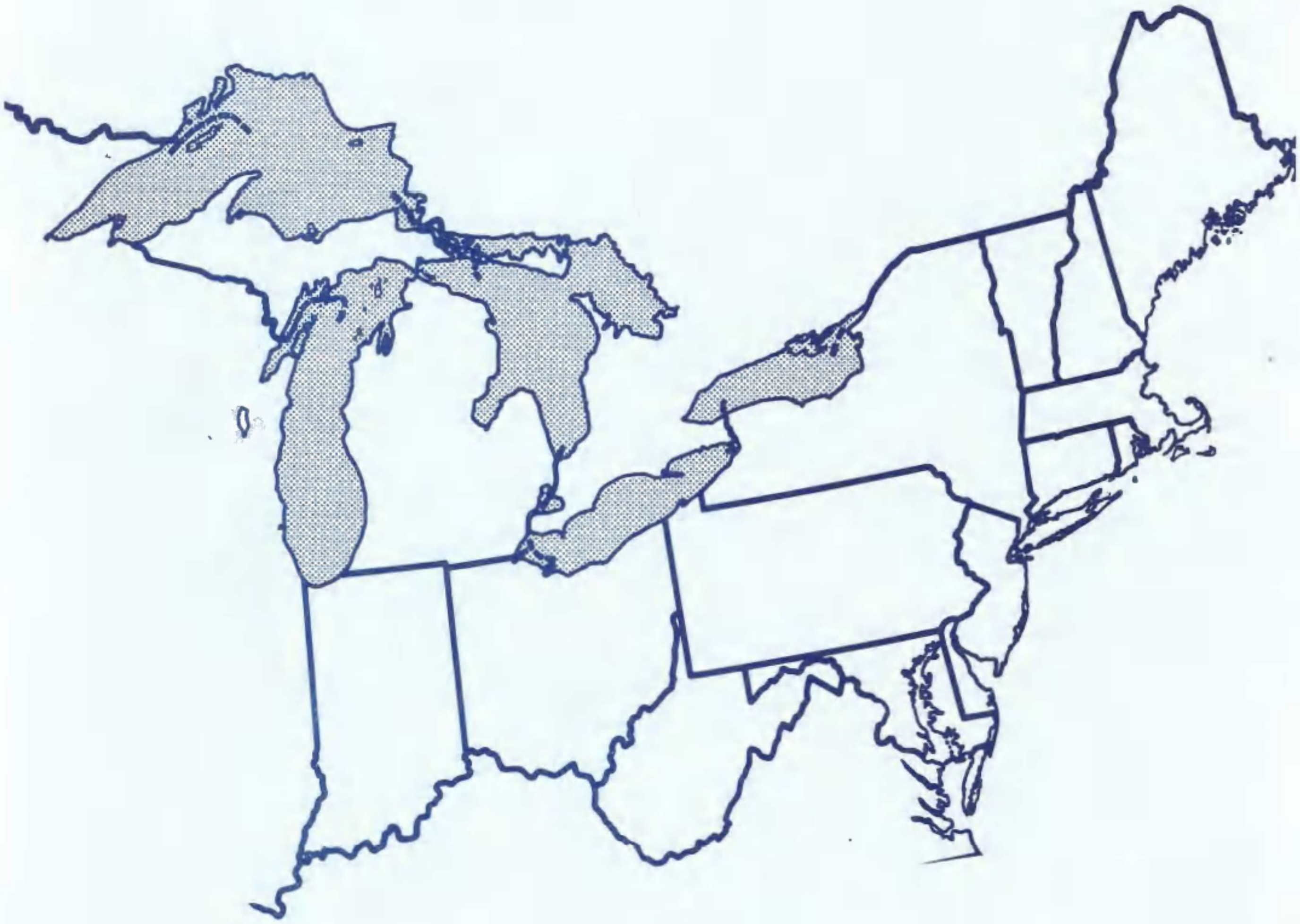
1405

NORTHEASTERN RAILROAD PROBLEM



U.S. DEPARTMENT OF TRANSPORTATION
MARCH 1973

THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

March 26, 1973

Honorable Spiro T. Agnew
President of the Senate
Washington, D.C. 20510

Dear Mr. President:

The enclosed report is submitted in response to Section 2 of Senate Joint Resolution 59-2, enacted February 9, 1973. This resolution directed the Secretary of Transportation to provide within 45 days "a full and comprehensive plan for the preservation of essential rail transportation services in the Northeast section of the Nation...."

In these 45 days it was possible only to concentrate on the key elements of the problem and to outline directions for a solution. The Department expects to submit detailed legislative recommendations in the near future and to provide other additional information for Congressional consideration.

Sincerely,

Claude S. Brinegar

Claude S. Brinegar

Enclosure

THE SECRETARY OF TRANSPORTATION
WASHINGTON, D.C. 20590

March 26, 1973

Honorable Carl B. Albert
Speaker of the House
of Representatives
Washington, D.C. 20515

Dear Mr. Speaker:

The enclosed report is submitted in response to Section 2 of Senate Joint Resolution 59-2, enacted February 9, 1973. This resolution directed the Secretary of Transportation to provide within 45 days "a full and comprehensive plan for the preservation of essential rail transportation services in the Northeast section of the Nation...."

In these 45 days it was possible only to concentrate on the key elements of the problem and to outline directions for a solution. The Department expects to submit detailed legislative recommendations in the near future and to provide other additional information for Congressional consideration.

Sincerely,

Claude S. Brinegar

Enclosure

NORTHEASTERN RAILROAD PROBLEM

A REPORT TO THE CONGRESS

Submitted by
The Secretary of Transportation
in response to S. J. Res. 59-2

DEPARTMENT OF TRANSPORTATION
UNITED STATES OF AMERICA

U.S. DEPARTMENT OF TRANSPORTATION
MARCH 26, 1973

TABLE OF CONTENTS

LIST OF FIGURES AND MAPS

FIGURE

MAPS

INTRODUCTION AND SUMMARY

On February 9, 1973, Congress directed the Secretary of Transportation to provide, within 45 days, a plan to deal with the Northeast area rail problem. This report is submitted in response to that request.

Before presenting our recommendations, a word of caution is in order. Though we have worked hard at it, 45 days is a woefully brief time to deal thoroughly with problems that, in many ways, have been decades in the making. We have done our best to analyze the causes, to examine alternatives, and finally, to outline what appears to us to be a workable plan of action. Obviously, other plans are possible, and with further analysis improvements to this plan might be found. However, we believe that our broad recommendations are sound and that they are in the overall national interest. We urge you to give them close consideration.

Our eight key conclusions are these:

1. The Nation's private enterprise rail system, while suffering under many long-term burdens, is neither dead nor dying. Despite serious problems in the Northeast, many rail companies are doing well and showing signs of further gains. With prompt corrective action the overall system can be restored to its role as an efficient carrier of large quantities of freight, as well as providing rail systems for Amtrak's passenger service.

2. Rail nationalization is unnecessary and would solve little, except perhaps hide some of the short-term Northeast rail problems under the bed of the Federal budget. Experiences elsewhere have made it abundantly clear that nationalization only means increasing subsidies and declining resource efficiency -- something our Nation can ill afford. The largely state-owned rail systems of Japan, Britain, Germany, France, and Italy now report losses that in total exceed $2 billion per year. Nor do we believe that partial or piecemeal nationalization, such as buying only the roadbeds of the bankrupt or ill carriers, is proper. It's awfully hard for the Federal Government to become a "limited partner" in a private enterprise operation, for one thing almost

inevitably leads to another. Likewise, such piecemeal nationalization would weaken -- and perhaps eventually destroy -- the vigor of the private enterprise companies that would be forced to compete with this Federally-backed operation.

3. Without question we face a short-term rail crisis in the Northeast. Six of the rail carriers in this area are in bankruptcy, and the dominant one -- the Penn Central -- is on the verge of Court ordered liquidation in order to prevent further erosion of the creditors' estates. Correcting this short-term problem will require cooperative and public-spirited action by all parties involved -- Congress, the Administration, regulators, labor, creditors, shippers, and the courts. We believe that the problem can -- and indeed must -- be solved within the broad framework of the private sector. We are recommending such a plan of action.

4. If there were a complete and abrupt Penn Central shut-down, the Northeastern area would, in the short-term, feel the impact quite significantly. However, given the ability to make adjustments, other rail carriers and trucks would, in time, willingly step in and pick up most of the slack. The Penn Central, per se, is not essential, though much of the rail service provided over its mainline tracks is.

5. While the Northeast has lost some of its rail freight business in recent years, the overall freight total remains quite large. Certainly it is large enough to support one or more new private sector rail systems that could be developed from the various systems owned by the six bankrupt carriers. It should also be possible -- and it certainly is desirable -- to continue rail competition in high density markets. Our studies suggest that, if permitted to emerge unencumbered from the tangled web that now embraces these carriers, a new entity (or entities) would generate sufficient profits and be able to raise sufficient cash to finance operations and expansions. In a word, quite clearly there is a healthy rail system trying to crawl out of the Northeastern wreck. All of us working together can help it escape.

6. The streamlining process will lead to a reduction in rail employees and to some community and shipper problems. We recognize that plans concerning adequate job protection or compensation to the affected employees will need to be developed. These plans will require consultation with management and employee representatives, as well as the trustees and creditors of the bankrupt estates. However, until we have a better understanding of the numbers involved

and the extent of the dislocations, it is difficult to address these issues in specific terms. Likewise, special studies will be needed to determine the extent of the problems of communities and shippers, and how best to help them during the period of transition.

7. The emergence of a healthy, streamlined rail system as a new on-going company (or companies) would significantly add to the value of the total estates of the six bankrupt carriers. This added value, plus the proceeds from prompt liquidation of the remaining pieces (including sales to other railroads), should provide a sufficient total to permit the various claimants to work out equitable divisions of the values. Such incentives as special tax provisions and short-term suspensions of certain ICC regulations should encourage the parties to resolve their differences in a reasonable time period. If the incentives to reach agreements are strong enough -- and if the alternatives are sufficiently unpalatable -- reasonable men should reach reasonable agreements. We believe that our plan provides for those incentives -- that it helps to create the machinery and oils the gears. With your help, the private sector can make the machinery move.

8. Looking beyond the immediate problems of the Northeast, it is clear that significant changes are needed in the regulatory framework if rail systems throughout the Nation are to avoid the problems of the Northeast and to become the really effective private sector competitors they are capable of being. Our report contains several specific recommendations for these needed regulatory changes.

* * *

We wish to stress that the time for action is short. The Penn Central reorganization court has set July 2, 1973, as the date to hear proposals either for a workable plan or the trustee's blueprint for liquidation. If no plan is forthcoming, we see liquidation as the Court's only legal recourse. If, however, Congress acts expeditiously along the lines outlined in this report, we believe that the Court will have an alternative to liquidation that is better for all concerned and for the Nation as a whole.

PART I. THE RAILROADS IN PERSPECTIVE

HISTORICAL AND REGULATORY PERSPECTIVE

From a meager start in about 1830, the Nation's rail industry moved ahead rapidly following the Civil War. The decade of greatest expansion in railway trackage was the 1880's. By 1890, nearly two-thirds of our railway mileage was in place. Railway mileage peaked in 1916 when there were 254,000 miles of railway in the United States.

As the industry matured, its overall growth rate slowed drastically and in the Northeast* it has actually declined since 1947. The root of the decline lies in the railroads' changing economic and regulatory environment and the industry's inability to adapt adequately to the changes.

As strong intermodal competition developed, the railroads' intercity freight and passenger markets suffered. Coal's losses to oil, which is transported primarily by pipeline, was another blow to the railroads. Northeastern railroads in particular were hard hit after World War II by the losses to the South and West of industries dependent on heavy freight movements. The diminishing importance of the agricultural, forestry and mining industries in the Northeast, and the shift to a post-industrial service type economy, also hurt. Figure 1 shows various indications of freight traffic trends since 1947.

* The term "Northeast" is used in this report to refer to the area included within the Eastern Railroad District as defined by the ICC.

One of the most important developments affecting the railroads, particularly in the Northeast, was the growth of the intercity trucking and barge industries. Before the advent of large, efficient trucks, the rails had put down thousands of miles of line and were serving virtually every economically important sector of the Northeast. But an extensive network of modern highways built in recent years has tied the big cities together and enabled the motor carriers to capture most of the short haul and medium haul non-bulk commodity traffic from the rails.

At the same time, motor carrier competition, with its constant threat of diverting traffic, has helped to place a ceiling on rail rates. Thus, even though the amount of freight traffic carried by the railroads has expanded as the economy has expanded, the average rail revenue per ton-mile in 1970 was two percent less than in 1958. Although the introduction of piggyback service and tri-level auto cars in the late 1950's allowed the railroads to recover or retain some medium haul traffic, it was not enough to enable them to hold their own against the trucks.

Railroads have also suffered in recent years from government policies which have favored non-rail modes. This has permitted these modes to improve their productivity and quality of service. In addition, many state and local governments have taxed railroads at a higher rate than other industries, and

GROSS NATIONAL PRODUCT AND INTERCITY FREIGHT TRAFFIC
BY SELECTED MODE, 1947-1972 AND RAIL REVENUE TON MILES BY DISTRICT

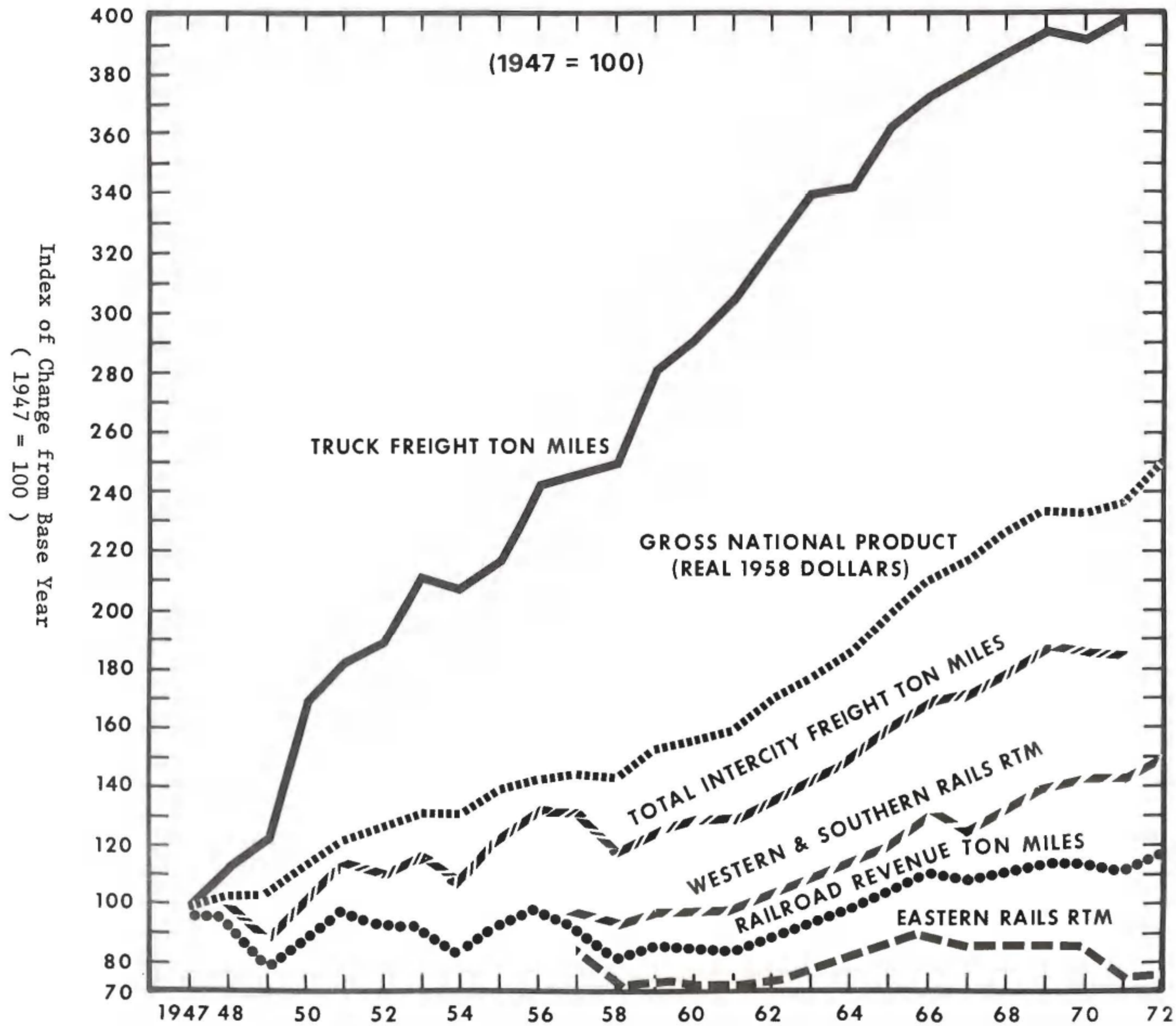


Figure 1

rails currently pay a higher proportion of their gross revenues in taxes than do motor carriers.

Since the railroad industry's costs are largely fixed, its financial performance is more closely tied to the cyclical ups and downs of the economy than other modes whose costs are more controllable. Because profits have not been adequate over these cycles, many railroads have not been able to survive some of the downturns. The industry's history is rife with bankruptcies. As one would expect, the largest number of them resulted from the Great Depression when at one point in the 1930's, 33 percent of all railroad miles were in receivership. At the present time, 13 percent of all railroad mileage operated belongs to bankrupt railroads--essentially all located in the Northeast. However, the two situations are different in that the bankrupt railroads in the 1930's still had some earnings around which they could, and in fact did, reorganize. Today the outlook is less favorable.

Unlike other bankrupt industries, bankrupt railroads have not been allowed to reorganize and modernize their operations. Plant and equipment is not dismantled, nor the land and other properties sold, the way other businesses that go through bankruptcy are liquidated. Despite the large number of miles of road in receivership, only an average 0.4 percent of the total road mileage has been abandoned annually since 1916, the peak year. Rail bankruptcies have not been treated as a sign that the industry had fundamental problems (such as over-capacity in a non-growth industry) which needed correction. Nor have they been used as an opportunity to help correct the problems by allowing some of the bankrupt roads, or perhaps major parts of them, to go out of existence. Instead, railroads were deemed too important to the economy to be discarded. It was felt that the companies could be made viable simply by reducing their debt structure or merging them with healthier roads. This patchwork policy has maintained essentially the same railroad network which was in place in 1920, one which was geared to the environment and economy of the late 19th and early 20th century.

The gradual broadening of the Interstate Commerce Act to increase regulatory controls has had a similar restrictive impact on the railroads. The continuing decline of the railroads as an industry, the financial plight of the railroads in the Northeast, and the inflexibility of response to competitive conditions in the marketplace have, in part, been brought about by the regulatory restrictions of the Interstate Commerce Act.

Regulatory practices have adversely affected railroads in many ways. They have permitted, even encouraged, abuses of "value of service" pricing and freight car utilization in ways that have led to a serious misallocation of transportation resources. Probably more important, regulatory practices have produced a rigid pricing structure which, for rails in particular, has prevented them from responding to the needs of a changing market. In addition, outmoded regulations have impeded efficiency within a given mode by restricting competition and by discouraging the abandonment of uneconomic branch lines.

The Administration has pointed out in three successive Economic Reports to the Congress (1970, 1971, 1972) that economic and competitive conditions have changed considerably since regulation began in 1887, and that changes have not been adequately reflected in the regulations governing surface freight transportation. The Department of Transportation believes that regulatory reform is fundamental to any plan to restructure the railroads of the Northeast.

Before closing this brief historical overview, a comparison of experiences in the United States with railroads in other countries needs to be mentioned. The United States is one of the few countries in the world which has not nationalized its rail system. Without exception, nationalized carriers have found themselves increasingly involved in objectives other than providing efficient, low-cost rail service. Various data suggest that foreign rail labor costs and shipping costs are relatively higher than those of U.S. railroads and that overall operating losses are significantly higher. Figure 2 shows published operating losses of nationalized rail systems in five major nations for 1971.

Figure 2

Rail System Losses
($ in Millions)

Nation	1971	Route Miles
Britain	(198)	11,800
France	(128)	22,300
Germany	(725)	18,900
Italy	(669)	9,950
Japan	(884)	12,900

Since the railroads in this country historically have not operated with the same objectives as those of foreign nations, comparisons such as this are of limited value. Nevertheless, the general direction is indicative of a likely outcome of nationalization.

CAUSES OF PRESENT PROBLEMS

The causes of the Nation's rail problems are both external and internal to the industry.

The major external factors are: trends in intermodal competition, especially the relative competitive vigor of the trucking industry; financial vulnerability due to historic low profit rates; shifts in national transportation demand; unbalanced Federal investment policies; and adverse regulatory policies. The main internal factors are capital and operating difficulties, including complications brought about by mergers; inflexibility to change by both management and labor; and lack of technological, marketing, and pricing innovations.

Industry problems vary from region to region and from railroad to railroad. Most of the financially weak railroads are in the Northeast, with this situation existing to a lesser degree in the Midwest. On the other hand, in the West and the South traffic is growing steadily and most systems are reasonably healthy. Particular note should be made of the relative financial strength of such western and southern carriers as Union Pacific, Southern Pacific, Seaboard Coast Line, and Southern Railway. In addition, two eastern carriers--Chesapeake & Ohio/Baltimore & Ohio and the Norfolk & Western--are relatively strong. (Figure 3 gives recent selected financial data for these companies.)

Nevertheless, taken as a whole, the railroad industry is not strong financially, as can be seen in Figure 4, which shows net profits as a percent of equity as compared with other transportation industries and all manufacturing industries. The recent drop to a zero earnings rate overall is, of course, due to the Northeast situation. Yet, even if this group is removed from the totals, we find that the rail industry in total has a rate of return below that needed to attract adequate capital for long-term growth.

SELECTED FINANCIAL DATA
($ in millions)

		UNION PACIFIC	SOUTHERN PACIFIC	NORFOLK & WESTERN	C&O/B&O (Consol.)	SOUTHERN	SEABOARD COAST LINE
REVENUE							
	1971	$ 691.5	1028.7	727.6	1025.0	423.3	530.2
	1972	769.6	1119.9	795.0	1025.0	471.6	563.1
NET ORDINARY INCOME							
	1971	108.2	92.9	77.7	29.7	58.7	41.2
	1972	122.9	93.0	89.8	60.0	59.6	50.7
CASH FLOW FROM OPER. (EST.)*							
	1971	168.7	162.5	139.5	95.8	90.1	71.0
	1972	184.9	164.2	153.0	127.3	93.1	81.6
SHAREHOLDERS EQUITY							
	1971	1416.8	1493.8	1173.4	1060.2	734.7	923.3
	1972	1431.5	1530.5	1146.3	1091.2	763.2	947.1
TOTAL LONG TERM DEBT							
	1971	425.3	794.1	792.3	1035.7	415.0	415.8
	1972	453.8	834.6	763.5	971.8	424.2	396.0
CAPITAL INVESTMENTS**							
	1971	147.2	136.5	81.1	138.9	59.8	85.3
	1972	108.6	171.9	68.0	61.2	62.8	65.1
MILES OPERATED (1971)		9,474	13,525	7,611	11,477***	6,023	9,173

* Equals Ordinary Income plus Depreciation.
** Gross Expenditures for Additions and Betterments.
*** Sum of C&O, B&O, and Western Maryland

Figure 3

Figure 4

RETURN ON EQUITY-REGULATED*
CARRIERS AND ALL MANUFACTURING

YEAR	ALL MANUFACTURING	RAIL	TRUCK	BUS	WATER CARRIER	PIPELINE
1960	9.2	2.6	4.9	11.0	5.7	15.7
1961	8.9	2.2	10.2	11.3	6.1	16.3
1962	9.8	3.3	12.4	11.0	7.7	17.6
1963	10.3	3.7	12.1	12.3	9.5	16.0
1964	11.6	4.0	13.6	12.1	13.4	16.0
1965	13.0	4.6	15.7	18.2	11.9	16.3
1966	13.4	5.0	14.5	15.3	12.5	16.5
1967	11.7	1.8	9.2	11.6	12.2	17.7
1968	12.1	3.1	12.9	14.4	11.0	16.2
1969	11.5	2.6	9.8	15.2	8.9	15.6
1970	9.3	.4	6.7	13.4	10.5	17.1
1971	9.2	.0	16.2	15.8	9.6	16.7

* *After extraordinary items*

Source: ICC Annual Report and Economic Report of the President

Trends in Intermodal Competition

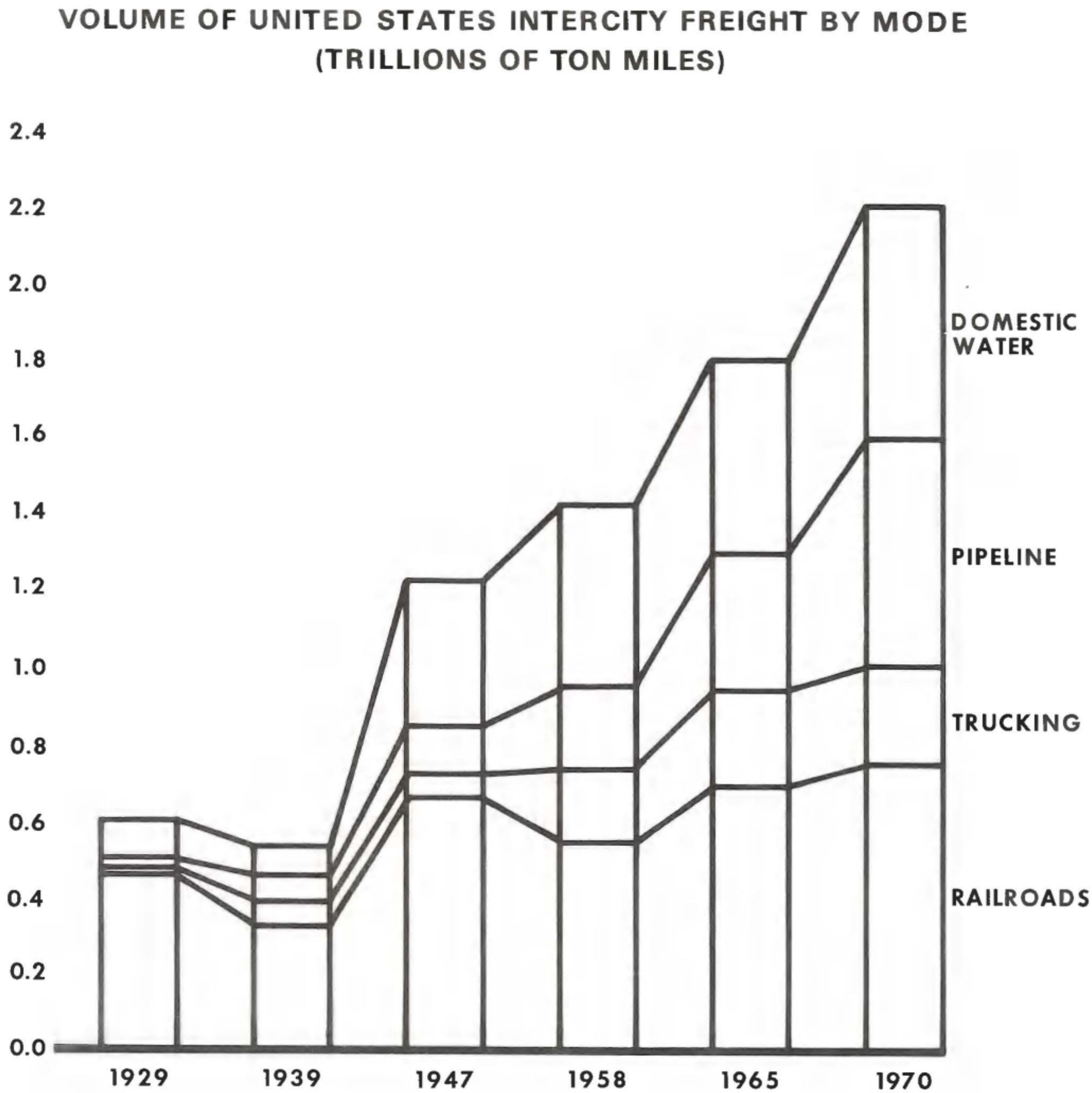
The growth of the intercity trucking industry over the past two decades and the increasing traffic in bulk commodities carried by barges and pipelines have taken their toll on the railroads. For example, the rail share of intercity freight ton-miles dropped from 54 percent in 1947 to 35 percent in 1970. Trucks increased their share from 5 to 16 percent, and pipelines from 10 to 21 percent, as shown below and in Figure 5.

Intercity Surface Freight Ton-Miles by Mode
(Percent of Total)

Year	Rail	Truck	Domestic Water	Pipelines
1947	54	5	31	10
1958	39	13	32	16
1965	39	14	28	19
1970	35	16	28	21

During this same 20-year period, intercity passenger traffic showed an even sharper shift away from rail, with air capturing the bulk of the for-hire intercity passenger market. In 1950, automobiles and buses accounted for 91 percent of the intercity passenger mile total, rail 7 percent, and air 2 percent. In 1970, the percentages for automobiles and buses were 89 percent. 1 percent for rail, and 10 percent for air.

Figure 5


VOLUME OF UNITED STATES INTERCITY FREIGHT BY MODE
(TRILLIONS OF TON MILES)
2.4
2.2
2.0
1.8
1.6
1.4
1.2
1.0
0.8
0.6
0.4
0.2
0.0
1929
1939
1947
1958
1965
1970
DOMESTIC WATER
PIPELINE
TRUCKING
RAILROADS

Financial Vulnerability Due to Historic Low Profit Rates

Railroads and some other regulated industries, which have historically been thought to be low risk, typically have low rates of return. The railroads' financial vulnerability due to low profit rates has resulted in a downward trend that is for some, at least, feeding on itself. Once an industry's profit rate falls near zero, its weaker members find that increasingly they are unable to survive the normal swings in economic activity.

The financial failure (or near failure) of the weaker companies has affected the healthier ones in at least two ways. It has cut into their ability to serve existing business and reduced their prospects for attracting new business. This is because the railroads are a national system and must rely on their interconnections to complete most of their freight business and to generate adequate new traffic.

Shifts in National Transportation Demand

Railroads are extremely vulnerable to both short and long term changes in the national economy. Much of the growth of the American economy in recent years has taken place in the services, finance, trade, and government sectors. By contrast, the bulk commodity sectors such as agriculture, forestry and mining that rails have historically served* have not participated equally in that growth. Thus, despite good growth potential in transportation, the base traffic which could generally only be handled by rail has declined. The remaining markets are highly competitive and much higher risk.

As a result, without the stability of a growing base market, railroads have become especially vulnerable to rising money costs and to rising average labor and material costs.

Unbalanced Federal Policies

Major post-World War II Federal transportation policies have been unbalanced in favor of the competing modes. This may have been inadvertent, but the negative impact upon the railroads has been serious. Federal funds (many of which are backed by user taxes) have helped build the Interstate Highway System, provided for improved inland waterways, built the Saint Lawrence Seaway, and helped finance a national system of airports and airways. As a result, competing modes have been able to operate on smaller amounts of capital and have been better able to survive economic ups and downs in ways that railroads cannot. Further, these investments have allowed other modes to improve their productivity and quality of service.

*The growing export market for agricultural commodities should help improve rail's long-term prospects.

Adverse Regulatory Policies

Federal and state regulatory policies have made it difficult for the railroads to adapt to changing economic and competitive conditions. The Interstate Commerce Act seems especially in need of modification and incorporation of regulatory relief in the following areas.

1. Abandonment

Lengthy procedures often prevent or unnecessarily hinder a railroad's efforts to abandon branch or other lines that can no longer cover even variable costs. Hearings, briefs, rebuttals, and other procedures may delay abandonments for years--all the while forcing the railroad to provide the service at a loss.

2. Rate Making

The present procedures are time consuming, inflexible, discourage innovation, and encourage preservation of the status quo. Also, some of the rates are discriminatory in that they force one class of service to subsidize another (e.g., perishables and freight on light-density lines are subsidized by other freight). Also, some bulk commodities apparently are carried below the carriers' variable cost.

3. Rate Bureau Activities

Certain rate bureau procedures tend to perpetuate historic distortions in rate structures and limit flexibility to adjust rates to cope with competition from other modes.

4. Merger Proceedings

Protracted hearings and court reviews may take so long that expected merger benefits can be dissipated well before the actual merger is permitted.

5. Joint Usage

Regulatory procedures inhibit joint usage and joint control of common trackage, causing inefficient service and expensive operating practices.

Another problem is that some states continue to permit the taxation of railroad assets at higher rates than other commercial assets. This is done by either overassessing rail assets relative to other assets or by imposing higher tax rates.

Capital and Operating Difficulties

The Nation's rail system also has problems in raising money and in operating efficiently.

Capital: Because of poor earnings, poor prospects, high debt ratios, and the reality of several large bankruptcies, railroads face a limited and high-cost capital market. The lack of capital has impeded modernization of plant and equipment and caused right-of-way maintenance to be neglected. It also may have caused an overuse of high-cost, indirect financing through leasing.

Management: Viewed broadly, there is evidence that rail management has been relatively inflexible to change and less innovative than management in other major industries. It is not altogether clear whether this problem is a cause of or a response to the railroad industry's declining fortunes and the restrictive regulatory and unbalanced Federal financing environment in which it operates. It does seem clear, however, that a relaxation of some regulatory restrictions under which rail management must operate would contribute towards a long-term solution of this problem.

Labor: For a number of reasons, rail labor-management relations must be improved. There are situations in which operating procedures have not been modified to meet changing market needs. Since labor costs represent more than one-half of the industry's total expenses, a flexible, long-term relationship is an essential element in assuring the future viability of the industry.

Rail Networks: Most freight shipments require interconnections with one or more other rail companies. Virtually all rail networks and branch lines were in place 50 to 60 years ago. Mergers and abandonments have been difficult and tedious, leaving the Nation's rail system with uneconomic trackage and excessive overhead. In addition, interconnecting terminals are generally outdated, inefficient, and have not been relocated with shifts in demand centers. Service offered by the financially weak adversely affects the delivery capability of the strong. Further complications and inefficiencies come from lack of any coordinated means of programming the nationwide movement of freight cars from one system to another, and from legal restraints on joint control or even cooperation with competing modes, such as intermodal piggyback, rail-truck, and containerized systems to serve branch line areas.

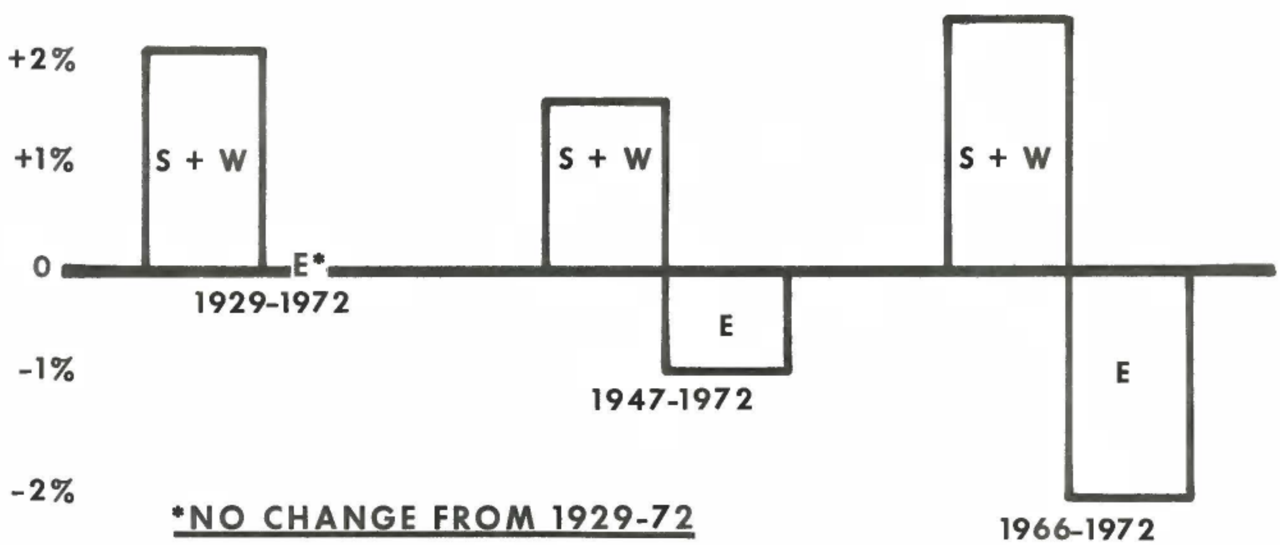
Special Circumstances Affecting Northeastern Railroads

The Northeastern railroads have experienced the problems described above to a significantly greater extent than those in other sections of the Nation.

By any measure, these railroads as a whole are in worse financial shape than those in other areas. Profits are lower, labor costs are higher, investment needs are greater, and utilization of manpower and investment resources is less efficient. As can be seen in Figure 6, the volume of freight ton-miles moved by the Eastern district railroads has declined over the past several years, while that of the Southern and Western railroads has increased. Also, relative capital and employee productivity improvements of the Eastern roads have failed to match those of the Southern and Western roads.

Economic growth in the Northeast has shifted more sharply than in other regions away from bulk commodities and more toward industries and services that require little freight movement. Also, environmental restraints have seriously cut the demand for high-sulfur coal, traditionally a major source of rail revenue in the Northeast.

REVENUE TON MILES – ANNUAL GROWTH RATE
CLASS I RAILROADS
(OVER VARIOUS TIME PERIODS)



E: EASTERN DISTRICT RAILROADS
S + W: SOUTHERN PLUS WESTERN DISTRICT RAILROADS

These railroads, because of the Nation's historical beginnings along the East Coast, are more complex, more outdated, and more in need of rationalization than those in any other section of the country. In addition, the area's greater demands for commuter service intensify public and political pressures for action. Unfortunately, the regulatory framework--especially the Interstate Commerce Act--has made needed changes most difficult to realize. Freight revenues of the Northeastern railroads are inadequate (either because of regulatory restrictions or competition from other modes), and capital for modernization is largely unavailable.

A measure of the extent of the Northeastern railroads' "blind alley" can be seen in Figure 7, which shows that about 50 percent of the Northeastern rail system (measured in miles) is in bankruptcy.

Developments Accelerating Penn Central's Failure

Penn Central is the dominant carrier in an area where rail systems are most in need of change and flexibility, but is among the least able to meet these challenges. In addition, the Penn Central situation has been aggravated by the following factors:

1. The merger between the Pennsylvania and the New York Central was a "last-resort" type response to trends that probably should have been faced years earlier. Numerous other

STATUS OF EASTERN DISTRICT RAILROADS WITH REVENUES AND MILES OF ROAD

Bankrupt Railroads	Revenues (1971) (millions $)	Miles of Road Operated (1971)
Boston & Maine	77	1,497
Central of New Jersey	52	591
Erie Lackawana	269	2,979
Lehigh Valley	45	926
Penn Central	1,775 (38.2%)*	19,864 (36.9%)
Reading	113	1,172
	2,331 (50.1%)	27,029 (50.3%)
Other Eastern District Railroads		
Ann Arbor	11	300
Grand Trunk Western	85	946
Delaware & Hudson	45	718
Maine Central	29	908
Western Maryland	51	862
Pittsburgh and Lake Erie	37	211
Baltimore and Ohio	496	5,543
Chesapeake and Ohio	455	5,048
Norfolk and Western	728	7,619
	1,937 (41.6%)	22,155 (40.1%)
Other Eastern Railroads	(8.3%)	(8.6%)
EASTERN DISTRICT TOTAL	4,650 (100%)	53,785 (100%)
Total U.S.	12,689	210,197

** Percent of Eastern District Totals*

Source: ICC, Transport Statistics, 1971.

regional mergers finally forced these two giants to realize that there were few potential partners left. During the five years of the merger's gestation (1962-1967), excessive management effort was required to keep the merger plan intact and to participate in seemingly endless regulatory and court reviews.

2. Penn Central's management paid a dear price for final approvals, especially in its obligations to try to save the New Haven Railroad, and in labor agreements.

3. Once merged, Penn Central represented both the best and the worst aspects of the Northeastern rail system, but its management did not move ahead to develop the Railroad's potential and make needed changes.

A rough measure of the extent to which Penn Central is burdened with excessive operating costs can be seen in the data in Figure 8, which ranks net ton-miles of freight moved per employee for the Nation's major railroads. Although there are many variables in comparing the number of employees to the ton-miles of freight moved, the overall pattern appears significant.

To bring the Penn Central ratio from its bottom position up to the average of all 11 carriers--between 1,400,000 and 1,500,000 ton-miles per employee--would require either a very sharp jump in freight ton-miles, a sharp reduction in the number of employees, or perhaps some of both.

Figure 8

Ton Mile/Employee Ratio*
(1970)

Carrier	Net Ton-Miles Per Employee (000)
Southern	2,000
Missouri Pacific	1,800
Southern Pacific	1,700
Union Pacific	1,600
Norfolk & Western	1,600
Illinois Central	1,500
Seaboard Coast Line	1,400
Burlington Northern	1,400
C&O/B&O	1,300
Erie-Lackawanna	1,100
Penn Central	900

* Excluding passenger service operating employees.

Rail Passenger Service in the Northeast

For the most part, with the creation of The National Railroad Passenger Corporation (Amtrak) and the gradual take-over of the main commuter rail services by metropolitan transit authorities, the financial burden of unprofitable rail passenger service is no longer a major factor contributing to the financial problems of the Northeastern railroads.

Most intercity rail passenger service in the United States was taken over by the Amtrak in 1971. (Under the Rail Passenger Service Act of 1970, the Department of Transportation sent to Congress on March 15, 1973, its evaluation of intercity rail passenger service operations

Figure 9

SELECTED RAIL INDUSTRY STATISTICS–1970

Value Added by the Rail Industry	**$8.7 billion**
Percent of Transportation Value Added	9.4%
Percent of GNP (= Sum of All Value Added)	.9%
Gross Output of Rail Industry	**$11.9 billion**
Freight–$11.5 billion; Passenger–$440 million	
Percent of Transportation Gross Revenue	6.6%
Rail Employment	**636,000**
Percent of Transportation Employment	7.4%
Percent of Total National Employment	.7%
Employee compensation as percent of Rail Value Added	72%
Employee compensation as percent of Rail Gross Revenue	51%
Estimated Value of Rail Capital Stock, i.e., Plant & Equipment	**$37 billion**
Plant	$21 billion
Equipment	$16 billion
Rough Estimate of Value of Land in Rail Transportation	**$4 billion**

assumed by Amtrak and its recommendations for intercity rail passenger service after July 1, 1973.) The existing Amtrak/railroad agreements require continuation of such service.

States and localities have taken the lead in preserving commuter services in the Northeast and are now moving into direct lease or ownership of plant and equipment. It appears that this type of agreement will in time result in the railroads' receiving proper compensation for maintenance of track and other operational service.

RAIL'S ROLE IN THE ECONOMY

Despite problems such as described in the previous pages, railroads still must be recognized as the Nation's most important intercity freight carrier. And, because of the many interrelationships between transportation and production, it is obvious that rail's importance extends deep into our economic system.

Figures 9 and 10 give some highlights of rail's role in the economy. Of particular significance are the data in Figure 10 which show the several basic industries for which rail hauls 50 percent or more of the ton-miles.

Figure 10

Commodity Movements--Rail
(1970)

	Percent ton-miles by rail
Paper & Products	82
Coal Mining	79
Ordnance	78
Nonferrous Metals	75
Lumber & Products	72
Stone-Clay-Glass Products	66
Furniture	63
Chemicals	63
Motor Vehicles	59
Agriculture	58
Food & Drugs	58
Farm-Construction Machinery	53
Iron & Steel	50

Importance of Bankrupt Railroads to the Northeast

The six major bankrupt Northeastern railroads--the Penn Central, the Erie Lackawanna, the Boston & Maine, the Central of New Jersey, the Lehigh Valley, and the Reading--together represent an important rail network moving about 45 percent of the freight in the Northeast.

Their service area includes 19 states and the District of Columbia and stretches from Maine to Missouri (see map of Eastern District Railroads).

Over 75 percent of all rail freight service is now provided by the bankrupt roads in Connecticut, Rhode Island, New Hampshire, Massachusetts, New York, Eastern Pennsylvania, New Jersey, and Delaware. They also dominate rail service in major areas of Ohio, Indiana, Michigan, Maryland, and Western Pennsylvania. Figure 11 summarizes the important characteristics of the six bankrupt railroads.

CHARACTERISTICS OF THE SIX EASTERN BANKRUPT RAILROADS, 1971

	FREIGHT							
	Revenue Ton-Miles (billions)	Revenues (millions)	Passenger Revenues (millions)	Total[a] Railroad Operating Revenues (millions)	Net[b] Railway Operating Income (Loss) (millions)	Net[c] (Ordinary) Income (Loss) (millions)	Miles[d] of Road	Employees (Average Number)
Penn Central	79.09	$1,534	$95	$1,775	($180)	($285)	19,864	88,518
Erie Lackawanna	13.79	240	11	269	9	(1)	2,979	12,811
Reading	3.61	93	9	113	(6)	(12)	1,172	6,271
Boston & Maine	2.61	65	6	77	(2)	(6)	1,497	3,597
Lehigh Valley	2.48	44	0	45	(6)	(8)	926	2,527
Central of New Jersey	1.21	38	4	52	(1)	(6)	591	2,567
TOTAL 6 BANKRUPT ROADS	102.78	$2,014	$125	$2,331	($186)	($318)	27,029	116,291
All Eastern District	225.30	4,131	212	4,650	(32)	(250)	53,785	222,540
U.S. CLASS I RAILROADS	739.40	$11,786	$294	$12,689	$695	$347	210,197	544,369
SIX BANKRUPT RAILROADS AS % OF U.S. TOTAL	13.9%	17.1%	42.5%	18.4%	(26.8%)	(91.6%)	12.9%	21.4%

a/ Includes revenues for freight, passengers, mail, express and incidentals.

b/ This is essentially the profits from operating the railroad before considering how the railroad is financed. It is the remainder of railroad operating revenues after deducting operating expenses, taxes, and rents for equipment and joint facilities, but before adding non-operating income and deducting fixed charges such as interest on debt and rents for leased lines.

c/ Net income (profits) of the company after taking into account income from non-railroad operations, rentals for leased lines, interest and other deductions, but before extraordinary and prior period items.

d/ Represents the aggregate length of roadway operated, but does not include the mileage of yard track or sidings.

Sources, ICC Transport Statistics, 1971 all figures exclude Amtrak.

Figure 11

PART II. THE PROPOSED PLAN

KEY STEPS IN THE PLAN

The Department of Transportation will submit legislation to authorize the implementation of the plan proposed below. The key steps are as follows.

1. Core Rail Service

Using projections of freight and passenger traffic, the Department of Transportation would identify Core Rail Service for the Northeast, based on the concept of long-term economic efficiency in the use of transportation resources. This review would take into account potential intermodal connections and substitutions and would serve as a guide for the long-term restructuring of the existing rail system.

The Core would be identified in terms of areas that should be served and connected by rail service; it would not deal with specific rail networks.

During a 90-day period following enactment of enabling legislation, the Secretary would prepare a report on the Core which would be made available for public comment. The Secretary would then make a final identification of the Core, and his decision would not be subject to judicial review.

2. Formation of New For-Profit Corporation

After Core Rail Service has been identified, a way is needed to ensure that the rail system in the Northeast would, as a minimum, provide such service. Because of the fragmented and competitive nature of many of the present bankrupt estates, we think it unlikely that the estates, working separately, could agree on an acceptable plan to reduce excess facilities and share those facilities which remain. Consequently, we propose that a new, private, for-profit corporation be chartered and charged with the job of selecting certain assets from among the estates on the basis of the Core identified by the Secretary.

a. Termination of Service

Once final Core Rail Service is identified, bankrupt railroads should be permitted to terminate rail service (but not abandon track), within a specific time period and without ICC approval, in those areas not included in the Core. A procedure should also be established whereby states and local communities, other viable railroads, shippers, and others would be afforded the opportunity to provide for the continuation of service not included in the Core by acquiring by purchase or lease the necessary assets of the bankrupt estates and either operating the service themselves or negotiating a contract with the new corporation or operating entities to operate the service.

The bankrupts would, however, have to continue to provide a minimum level of maintenance of those rights-of-way over which service has been discontinued until actual abandonment is achieved.

b. Responsibilities of the New Corporation

The enabling legislation would authorize the establishment of the new corporation, with the Board of Incorporators appointed by the President. The initial purpose of the corporation would be to design one or more rail systems in the Northeast based upon providing Core Rail Service identified by the Secretary.

After appropriate study and analysis, the Board would:

(1) design one or more rail systems based on the Core;

(2) select for such a system(s) certain rail lines, facilities, and equipment presently operated by the bankrupts, and possibly others; and

(3) obtain rights of first refusal and agreements that such properties as selected above are available for purchase.

In designing the system(s) and allocating the elements, the Board would apply as its criteria:

(1) the economic viability of each element of the system(s) and,

(2) the continuation of rail service competition in high density markets to the greatest extent feasible.

Following a review by the Secretary of the Board's specific proposals to assure that they are reasonably consistent with Core Rail Service, the Board would take steps to acquire the facilities and equipment through negotiation with the bankrupt estates and others. Because the "going-concern" value of the acquired assets should exceed their uncertain value under protracted, piecemeal liquidation, we believe that the trustees would find it in their best interests to work out equitable agreements with the Board within specific time limits. If more than one new system has been approved, the Board would establish such additional corporations as are required and assign the properties acquired to the appropriate corporations.

Within a specified time after the Secretary's approval of the Board's proposals, the bankrupts would be able, without ICC approval, to terminate service not included in the Board's final approved proposals or acquired by others, and to abandon such rights-of-way. At this point, additional facilities could be added to the system if those states, localities, or shippers who want them are willing to subsidize fully any deficits involved. Also, depending upon the actions of the Board with regard to operating rail passenger service, possible separate arrangements might have to be made with Amtrak and transit authorities to continue passenger service they consider necessary. Properties of the bankrupt railroads not acquired by a new corporation could then be liquidated by the bankrupt estates.

The actions of the Board of Incorporators and the Secretary's approval would not be reviewable in any court.

c. Valuing the Corporation and Distribution of Assets

The stock of the new corporation(s) would be placed in escrow until it could be allocated equitably to the bankrupt estates. One possibility would be on a pro-rata basis of assets contributed to the corporation. The stock could then be distributed to the bankrupt estates pursuant to the allocation procedure, and each new corporation would become an independent operating entity.

The establishment and operation of the streamlined system(s) would be timed to occur within one year of the date of enactment of enabling legislation.

3. Transition

The period of transition, as the Northeast rail systems are streamlined and returned to a viable place in the private sector, will inevitably cause strains and dislocations. Three areas require particular consideration:

-- The impact on labor;

-- The impact on rail carriers, as they shift from today's over-built structure to the new streamlined structure; and

-- The impact on those state and local communities and shippers who will be required to deal with changing types and costs of freight service.

Proper and equitable handling of the various problems will require further analysis and planning. In this report we can only suggest some tentative approaches.

a. Labor

The six bankrupt railroads in the Northeast employed approximately 116,000 persons in 1971. (Figure 12 shows the breakdown of this total by railroad and by general classification of employee.)

Specific plans must be developed, in consultation with management and employee representatives, as well as with the trustees and creditors of the bankrupt estates, to provide adequate job protection or compensation to affected employees. Such plans can, of course, only be developed following an understanding of the numbers involved and the extent of dislocations.

RAILROAD EMPLOYMENT BY CLASSIFICATION*

(Year 1971)

OCCUPATIONAL GROUP	PENN CENTRAL	READING	CENTRAL NEW JERSEY	LEHIGH VALLEY	BOSTON & MAINE	ERIE LACKAWANNA	TOTAL
Executives, Officials, etc.	1,634	143	82	63	76	294	2,292
Professional, Clerical, etc.	17,327	1,542	593	575	799	2,501	23,337
Maintenance of Way	10,382	756	331	433	540	1,682	14,124
Maintenance of Equipment	21,295	1,474	534	469	715	2,689	27,176
Transportation (Other than T&E)	6,825	421	232	139	265	1,083	8,965
Transportation (Yard)	1,644	115	68	53	61	182	2,123
Transportation (Train & Engine)	29,411	1,820	724	795	1,141	4,380	38,271
TOTAL	88,518	6,271	2,564	2,527	3,597	12,811	116,290

* *As Reported to Interstate Commerce Commission*

Figure 12

Those employees of the bankrupts who are hired by a new entity would be guaranteed appropriate job protection in their agreements with the new corporation. Some of the employees of the bankrupts may also be hired by non-bankrupt railroads that acquire parts of the bankrupts' systems, or by other rail freight and passenger systems. Those employees would also be guaranteed appropriate employment and labor protection rights.

With respect to the labor protection rights of other employees, some form of appropriate compensation will have to be found. It is recognized that labor may seek a share of the estates. The cash required for any payments from the estates could come from receipts from early liquidation of assets or from advanced borrowing against the liquidation.* If additional cash were needed to finance such compensation, a loan secured by the stock in the new corporation would be a further possibility. If the various regulatory and other changes outlined in this plan are forthcoming, we believe that this stock would constitute ample security for such a loan.

---

* Such lump sum payments may be eligible for tax treatment that recognizes the special nature of the payments.

b. Rail Carriers

Until new operating entities take over rail service from the bankrupt railroads in the Northeast, most existing service would be continued by the bankrupt railroads. Based on current experience, these operations will produce a continuing cash loss for these railroads.

We believe that the courts and creditors would permit these cash losses provided that they can reasonably expect a future higher liquidation value.

A key issue is the constitutional right of the creditors to prevent the continued erosion of the estates' assets. Certainly, if there were no end in sight, cessation of operations and prompt liquidation would be the proper course of action. However, with evidence that this plan would be implemented, it seems reasonable to expect the courts to permit further limited losses during the transition period.

Another area of consideration is the need for startup financing for the new corporation or other entities which will operate the restructured system. Financing will be required for initial working capital, deferred maintenance, and capital for equipment, facilities, and possibly some new connecting track. An analysis of these requirements, viewed in the context of the viable system which will emerge, leads us to believe that the private capital market will meet these needs. It would appear, however, to be proper to allow the new corporation to be able to use the tax losses of the bankrupt railroads. This action would help generate extra cash during the critical early years and would provide an incentive for immediate efficiency.

c. Communities and Shippers

Once the Core and additional service areas that are to be retained have been identified, the problem of communities and shippers who are affected by abandonments can be better understood. These groups, together with governmental agencies, can then determine the appropriate action to deal with these problems.

An important objective will be to provide the affected communities and shippers sufficient lead time to make plans for obtaining alternate means of transportation or new markets. Even with the substantial abandonment of light density branch lines, we would expect rail service to continue to be available close to most of these areas. In addition, shippers would have access to trucking service and rail terminals. Also, states and local communities will be given the opportunity to ensure the continuation of rail service if they find it necessary and are willing to subsidize the deficits fully.

While the Senate Joint Resolution asked that alternatives be considered for those areas which might not have future rail service, it is not possible to make specific recommendations until the Core is identified and the Board of Incorporators takes action.

4. Regulatory Revisions

In addition to the near-term problem of the Northeast railroads, we must also address the problem of outmoded and excessively restrictive regulatory procedures which affect the entire industry. Railroads are no longer the monopoly they were when most of the regulations were developed, and appropriate changes are long overdue.

The proposed changes, which will shortly be submitted in detailed legislative proposals, are as follows:

a. Liberalized rail abandonment procedures

Existing regulatory procedure tends to discourage rail abandonments. Abandonment cases often entail protracted hearings and too often offer a railroad only the prospect of expense and delay. In addition, the standards for the adjudication of these cases lead to uncertainty and prevent the early settlement of issues. As a result, despite the availability to shippers of highway, and, in some cases, water and pipeline networks, light density lines continue to operate long after they should have been abandoned.

It is necessary to make changes to the abandonment process in order to speed up the cases and provide appropriate standards for their resolution. To accomplish this it is proposed that the ICC be required to permit the abandonment of a service where it can be shown that continued operation would not provide sufficient revenues to cover the long run variable costs of operating the line. The proposed new procedure would provide for rapid investigation by the Commission and quick disposition of any contested abandonment.

b. Making ratemaking more flexible

The current regulatory pricing system severely limits the scope of an individual carrier's freedom to innovate in pricing his service and often produces rates which do not meet the costs of the service.

The economic consequences on the railroads have been serious. In addition to losses incurred from underpricing some services, some overpriced rail service has resulted from "across the board" percentage increases. This rigidity in the rate structure is discouraging experimentation with service innovations and delays their introduction due to the time and cost of litigation.

We recommend regulatory changes to permit individual rail carriers to increase or decrease their rates and to improve the range of service offered without undue ICC delay.

To eliminate rates below variable cost and to provide for flexibility in the ratemaking process, two basic revisions are proposed:

(1) that rail carriers be required to raise all below-cost rates to the variable cost level; and

(2) that where any new rate is a reduction from the current rate it shall go into effect as long as the new rate is above variable cost.

To allow railroads additional flexibility in introducing new rates and new service, it will also be proposed that the ICC be required to rule promptly on such proposals. Should the Commission fail to act promptly, the rates or service would go into effect.

c. Eliminate subsidization of government service at the expense of others

Federal, state and local governments are currently permitted to negotiate rates with carriers. These rates may be below rates which non-government shippers are required to pay and unfairly require other shippers to subsidize government shipments. To correct this situation, it is proposed that Federal, state and local governments be required to pay the same rates as other shippers.

d. Restrict certain practices of rate bureaus

Concerted action by carriers subject to the Interstate Commerce Act is now exempt from prosecution under antitrust legislation. Under the carrier agreements permitted by the ICC, the rate bureaus or carrier associations make decisions for the carriers on the rates each shall charge, whether these rates are single line or whether they are joint rates involving two or more carriers.

Rates set in the context of agreements between carriers tend to ignore individual carrier's cost and are based on average costs of all carriers who are parties to the rate. Such rate agreements maintain the historic distortion in the rate structure, channel traffic away from its direct routing, and restrict ratemaking flexibility in intermodal competition.

It is proposed that antitrust immunity no longer be extended to rail carrier agreements for rates applicable to the traffic of a single rail carrier, nor to any agreement which allows a rail carrier to participate in discussions or to vote on joint or through rates unless the carrier participates in the joint movement. Rail rate associations would be required to allow individual members independent action and would not be permitted to protest or seek the suspension of rates. They would be required to dispose of any joint rate proposals filed within 120 days and to publish their votes.

e. Provide procedures to expedite merger decisions and the acquisition and joint use of common facilities, and to facilitate intermodal ownership

Excessive duplication of facilities is a major problem of the rail industry. Efforts to reduce excess capacity

TIMETABLE

NORTHEASTERN RAIL PROBLEM

Key Steps	By	Time From Congressional Action
Legislative action to permit Board of Incorporators to act as described	Congress	Immediate
Identification of Core Rail Service	Secretary of Transportation	90-120 days
Action of Board of Incorporators/Court Approvals of Asset Transfers	Board/Trustees/Labor/Creditors/Courts	360 days
Regulatory Reforms	Congress	0-180 days
New Entities Take-over Rail Operations	New Corporation(s)	360 days

by mergers are often long delayed by protracted ICC hearings (in one case at least ten years). Joint usage of facilities, another possible solution to the problem of excess capacity, has been used only moderately. Such arrangements should be encouraged.

Current law also raises artificial barriers to intermodal ownership which limit arrangements to provide greater efficiency in transportation operations.

It is proposed that a 12-month time limit be imposed upon ICC deliberations on applications for mergers and other consolidations, after which cases would be transferred directly to the Federal courts.

It is also proposed that the ICC be required to grant any application for the joint use of facilities which the petitioner can demonstrate to be in the public interest. New applications of common carriers to engage in intermodal operations will be similarly encouraged by both simplifying procedures and the removal of other restrictions on intermodal operations.

f. <u>Permit easy entry of motor and water carriers to fill gaps created by liberalized rail abandonments</u>

Means must be provided to ensure that shippers have an effective and efficient transportation alternative when low-density rail service is abandoned. Current standards require a finding of an immediate and urgent need for new services before ICC approval can be obtained. This standard could be too restrictive if liberalized rail abandonment procedures are adopted. It is proposed that the ICC be required, upon application by a motor or water carrier or by a railroad seeking to operate truck or barge service, to authorize immediate and permanent service in markets abandoned by rail carrier service.

g. <u>Amend Section 77 of the Bankruptcy Act to give courts adequate authority to act promptly and rationally to solve railroad bankruptcies</u>

Statutory provisions dealing with bankrupt railroads are out of date. Geared to the problems of the Depression, they are designed primarily to deal with a railroad suffering from too great a debt structure. But as the current Penn Central situation demonstrates, they are generally inadequate to deal with a debtor railroad which is unable to generate sufficient earnings to stop losses, or to provide an adequate basis for a plan of reorganization in the time frame demanded by the constitutional rights of its creditors.

To provide for reshaping a debtor railroad's organization, the proposed amendments would require trustees, with court approval, to abandon uneconomical lines, and, if necessary, to raise rail rates to cover variable costs. Mergers and consolidations with another railroad would be effected without ICC approval, while providing for the job protection or compensation of affected employees.

h. <u>Eliminate discriminatory state and local taxation of rail assets</u>

Discriminatory taxation by many state and local governments contributes to the financial problems of the railroads. These jurisdictions should be prohibited from continuing discriminatory practices in assessing railroad property and establishing tax rates for such property.

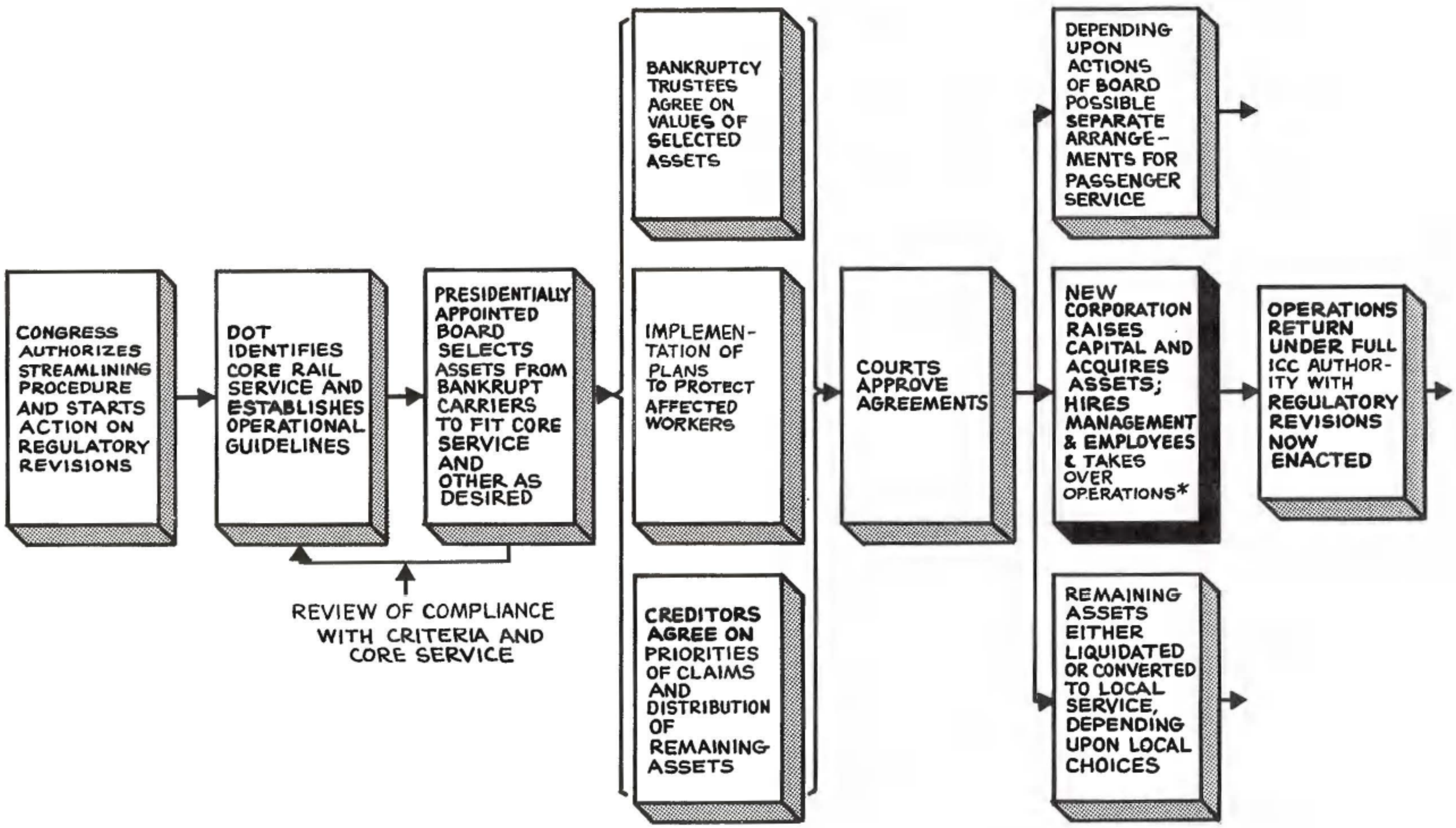
i. <u>Eliminate delays in state approval of intrastate rates that coordinate with changes in interstate rates</u>

Action should be taken to alleviate the problem of time lags between Federal and state action to change rail rates. Due to the substantial amount of intrastate traffic, these time lags deprive rail carriers of a significant amount of needed revenue.

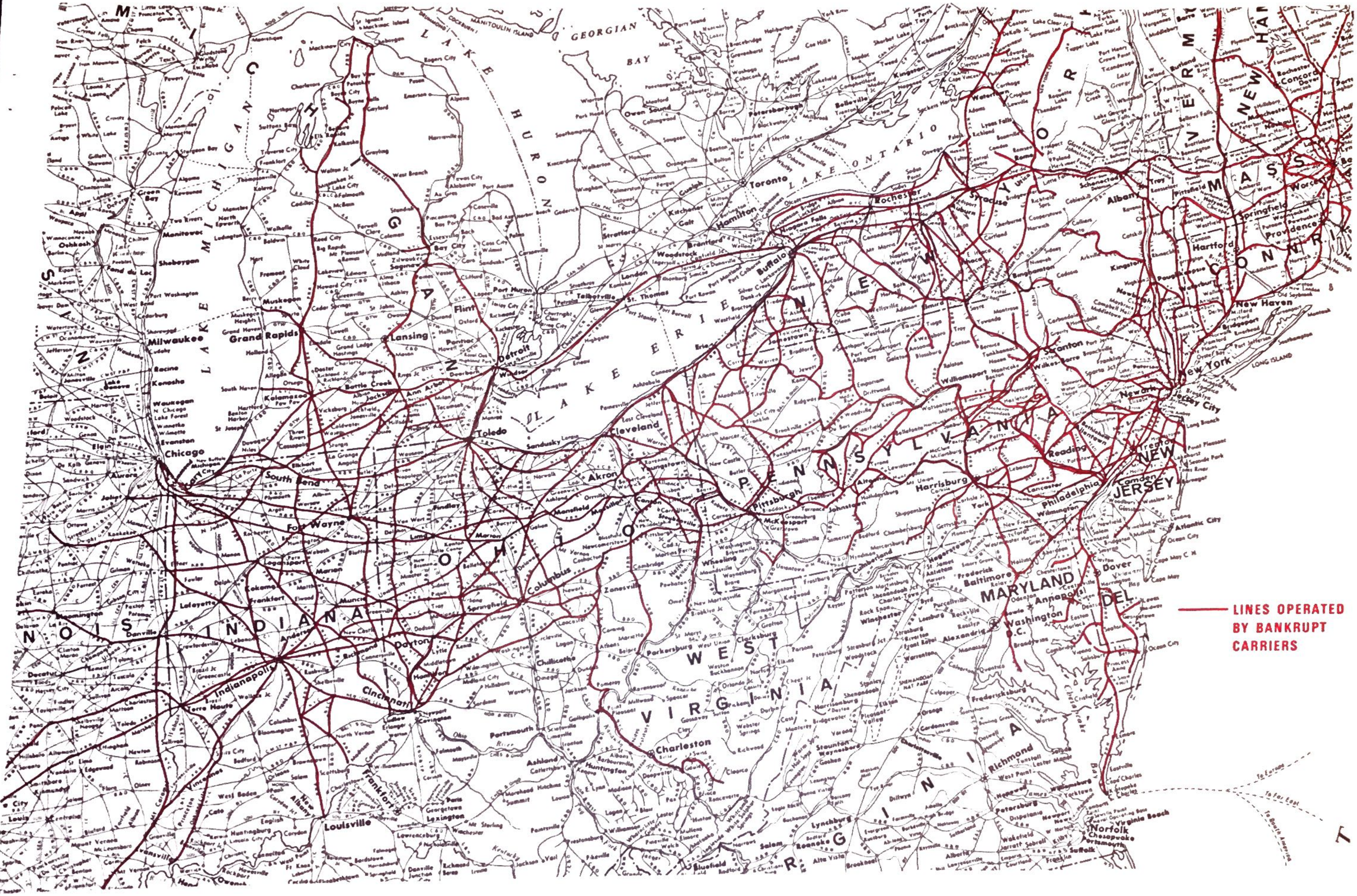
* * *

The Administration has in the past expressed its support for broad regulatory reforms in transportation. The recommendations in this report deal with a part of the problem; additional recommendations to deal with other modes will be forthcoming in the near future.

ILLUSTRATION OF PROCEDURE TO STREAMLINE NORTHEASTERN AREA RAIL SERVICE



* THIS COULD BE ONE OR MORE CORPORATIONS AND/OR IT COULD BE INCLUDED AS PART OF EXISTING CORPORATIONS


LINES OPERATED
BY BANKRUPT
CARRIERS