

KEEPING CONRAIL ON TRACK

by
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When Conrail was formed, nearly nine years ago, its founding fathers looked a decade ahead and made a bold prediction. The Conrail of 1985, they said, would be "a modern, efficient and profitable railroad."

Few believed that forecast and, given Conrail's parentage -- seven bankrupt and physically bereft Northeastern railroads -- fewer still thought the Consolidated Railroad Corporation would ever become an eagerly-sought commercial property. Yet that is precisely what Conrail is today -- a revitalized, profit-making railroad soon to be returned to the private sector.

The demand for Conrail is no longer in doubt. The issues before us today are when and how the transaction will be completed.

The process of returning the railroad to private ownership began more than three years ago, when Congress passed the Northeast Rail Service Act. That legislation directed the Department of Transportation to prepare and carry out a plan for selling Conrail intact to a responsible buyer. I have been moving steadily and methodically toward that goal. Now, with three firm bids in hand, some are suggesting that I abandon that process in favor of a public stock offering. I oppose that approach for several reasons.

A public offering must be weighed against the three rigorous standards I set months ago to protect the public's financial and transportation interests -- the same standards I used to evaluate the 15 bids the Department of Transportation received

last June. I have consistently stated my intention to favor the offer which leaves Conrail in the strongest financial condition after the sale; best preserves service to Conrail shippers; and gives the taxpayers the best rate of return possible consistent with the foregoing criteria.

Weighed against these criteria, an open stock sale would be markedly less effective than our negotiated sale process in protecting the public interest in nonfinancial aspects of the transaction and in maximizing the return on the taxpayers' investment. That conclusion reflects our careful analysis of the transportation interests involved, and the findings of our investment advisor, Goldman, Sachs and Company.

First, the Federal government has a clear public interest obligation to know who will own this railroad and how they intend to operate it, an obligation that extends for a period of time beyond the date of closing. We owe the public reasonable assurances of the adequacy of the buyer's finances and commitment to rail service in the Northeast.

Under our sale process we know the identity of the buyer, and we can use contractual sale covenants to accomplish this objective in a sale to a single buyer or a group of buyers. The same protections are not available in a public offering. A public offering is nothing more than a bidding contest. Any party can -- regardless of motive -- walk up to the counter and buy a controlling interest in the railroad or mount a takeover bid after the public sale is completed. Even with ownership restrictions on the initial public offering (with a corresponding reduction in the selling price of the shares), there could be no guarantee against a controlling interest in the company being

acquired by a party unacceptable to those who have Conrail's best interests at heart, possibly within a few months after closing. In short, open bidding for Conrail defeats the government's responsibility to ensure that the public interest is protected and that the buyer is financially suited to owning and operating this major railroad.

Second, I believe we have an obligation to negotiate contractual covenants to protect Conrail shippers by governing post-sale operation of Conrail consistent with our public interest criteria. Those covenants should bind Conrail to the railroad business, require the purchaser to maintain a controlling interest for five years, and protect the railroad from being liquidated or stripped of its valuable assets. The buyer must reinvest in the system, and observe dividend limitations to protect Conrail's cash. The purchaser must agree not to defer maintenance, and continue to provide the maximum level of economically sustainable service.

Such covenants can be negotiated, and an enforceable contractual agreement can be reached, with a single buyer or group of buyers. In contrast, Goldman, Sachs advises that agreements of comparable precision and enforceability are not possible in a broad-based public offering, where the ultimate buyer is unknown and there is no sales contract. Trying to secure any of these protections through a public stock sale would significantly impair the marketability of the offering, severely limiting the taxpayers' return.

Third, there is also the issue of timing. In the opinion of Goldman, Sachs, the market's ability to absorb the government's 85 percent interest in Conrail in one offering is highly doubtful. It would likely require several public offerings over a period of years. Given the unpredictable fluctuations in stock prices, a phased public offering

could leave the Federal government a minority shareholder in a publicly held company with no control over management decisions.

Fourth, there is the far more basic question of the taxpayers' interest. How can we justify speculating on the future performance of Conrail or the economy when we can collect payment in full on the day of closing through a negotiated sale to a single buyer? Indeed, our investment advisor's analysis indicates that a public offering, free of the public interest restrictions which I deem essential, would yield net proceeds no greater than the offers now before us.

Fifth, the great concern in Congress when the Northeast Rail Service Act was passed was to assure that Conrail would be retained by a private owner as an entity, and not broken up or carved into pieces. Selling Conrail to a specific buyer achieves that purpose; a public offering would not.

I believe we must also view with great caution any variation of the public offering proposal, such as a "bridge loan" against Conrail's assets to underwrite the entire offer by buying the government's interest now and then later reselling the stock to the public over a period of years. Under a leveraged buy-out of that sort, debt service could destroy Conrail's finances. Any shortfall on anticipated stock yields would create a multi-million dollar financing gap capable of driving Conrail back to the Federal government for financial rescue. Even limiting Conrail stock ownership by a single party to a certain percentage, five percent, for example, would weaken the relative appeal of the public offering. It would undermine both my ability to negotiate effective public interest covenants and to maximize the return on the taxpayers' investment.

There is a well-established financial community consensus that, in any corporate acquisition, potential purchasers will pay a higher per-share price for control of the company than for a minority interest. By forcing the taxpayer to forego this "control premium" when the government sells its Conrail shares, a five percent ownership limit would guarantee that the public cannot maximize its return on Conrail -- in direct contravention of the clear congressional directive in the Northeast Rail Services Act.

There are other problems with a five percent ownership limitation on Conrail stock. Fragmented stock ownership could lead to a divided and conflicting ownership structure, resulting in management gridlock and impairing Conrail's future operation. In contrast, a negotiated sale to a single buyer precludes that possibility. Similarly, while a stockholder holding a controlling interest would be motivated to draw on his own resources to protect Conrail's future and his billion dollar investment, a stockholder with five percent or less would have far less incentive to put additional resources into a troubled carrier.

Any arbitrary limit on stock ownership would also diminish Conrail's ability, relative to competing rail, trucking, and barge companies, to broaden its traffic base by acquiring smaller connecting carriers or intermodal transportation companies in stock-for-stock transactions. This is an important consideration for Conrail, because Northeast railroads have suffered historically from highly recession-sensitive traffic bases. The best solution for a troubled railroad and the shippers who depend on it often lies in a merger with a stronger carrier or nonrail company. A five percent ownership limitation virtually eliminates the merger option, or at best, gives any minority owner a stranglehold on the terms of the merger. That is not in Conrail's or the public's long-term interest.

There is another compelling consideration. In a five percent limitation on a Conrail public stock offering, we would face a virtual duplication of the ownership structure of the old Penn Central. No shareholder owned more than 4.2 percent of that publicly-held company. Such diffuse holdings would virtually rule out the possibility of any owner having a big enough stake in the company to exercise any control or influence over management. That may not sound troublesome today, because we all respect Conrail's present management team. But what about the future?

In selling Conrail, we should consciously avoid duplicating the ownership structure of the Penn Central. I am far more comfortable with a system of reasonable checks and balances, where management is accountable to a carefully selected owner, and the owner is publicly accountable through contractual covenants.

Finally, a public offering could be unfair to Conrail's employees, who have already endured several years of uncertainty about the future of the company. They would face another round of negotiations, with no assurance of job security or protection of benefits. The very active involvement of the Railway Labor Executives' Association in the current negotiations testifies to the desire of many Conrail employees to have the sales process successfully concluded as soon as possible. Cancelling the sale process now would also be a grave disservice to all parties who have made substantial good faith investments of money and management time bidding for the right to purchase Conrail.

In March 1976, just weeks before Conrail began operations, the railroad's future was anything but bright. Yet those who put Conrail in business, at 12:01 a.m. of the first day of April 1976, predicted that within 10 years the railroad would be a

"profitable, well-managed company, providing excellent service to Northeast and Midwest America."

That objective has been achieved. It is now our responsibility to finish the job with the same spirit of commitment to the future, preserving rail service and protecting the public interest.

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