3.104

U.S. Department of Transportation

News:

Office of the Assistant Secretary for Public Affairs
Washington, D.C. 20590

Contact: Mari Maseng
Tel.: (202) 426-4570

REMARKS PREPARED FOR DELIVERY BY
SECRETARY OF TRANSPORTATION ELIZABETH HANFORD DOLE
TO THE TRAFFIC CLUB OF PITTSBURGH
PITTSBURGH, PENNSYLVANIA
MARCH 28, 1985

It is both an honor and a timely opportunity for me to be with you this evening. Your leadership requested that I speak about the sale of Conrail. I welcome the opportunity to do so and to reflect on the events that led to my decision. The Traffic Club of Pittsburgh, the nation's largest and a most prestigious group, is known for its commitment to transportation. And by virtue of your distinguished membership, that's a commitment to transportation all across America.

Those who built Pittsburgh had a vision of this area as the "Gateway to the West," and transportation continues to be a primary interest of the business and community leaders of this city. Nationally, transportation is an $800 billion industry. It accounts for about one quarter of our Gross National Product. It is part of the cost of everything companies produce and every item consumers buy. In short, transportation is essential to our economy, but no one wants to pay more for it than is necessary -- nor should they. We expect carriers to operate as efficiently as possible and shippers to bargain for the best rates. These goals, we have found, are best accomplished in an economic climate of deregulation and private ownership.

In 1980, Congress passed legislation which brought long-needed regulatory reform to our railroads by permitting the relaxation of monolithic government controls over rates and routes. That law, and the greater economic freedoms encouraged by this Administration, were major forces in the dramatic economic turnaround of our rail industry. U.S. railroads have rediscovered the economic benefits of free enterprise. Individual lines may now contract directly and independently with shippers. More than 20,000 rate and service contracts have been signed, where none existed before.

As a result, U.S. railroads are earning the money they need to buy new equipment and better maintain what they have -- in short, to better serve people's needs. Since 1979, major railroads have invested more than $1 billion a year in new track, yards and terminals; and an average of $5 billion annually in maintaining existing facilities. Today, over one-third of the U.S. freight car fleet is under 10 years old and its capacity has increased 15 percent over the last decade.

This revitalization of the rail industry has certainly affected Conrail. Conrail, as you know, came into being as a property of the U.S. government in 1976, after Congress had come to the rescue of seven bankrupt or failing rail companies in the Northeast and Midwest. The taxpayers have spent several billion dollars keeping it in operation, and over the past four years, it has turned a profit, thanks to Stanley Crane and the tools which the Staggers Act and NERSA--the Northeast Rail Service Act--provided. Stanley Crane's management skills and railroad expertise are well known throughout the industry, and the public is indeed indebted to Stanley Crane and his management team for their very important role in making Conrail the success story it is today.

The plan I have submitted to Congress for transferring Conrail to the private sector after almost a decade of federal stewardship was reached after many months of careful deliberation. In fact, when I became Secretary of Transportation in February of 1983, this matter had already preceded me to the Department. We were told that in NERSA--the law of 1981--the Secretary of Transportation was to develop a plan to return Conrail to the private sector, retain an investment banker and move on with it. And Goldman Sachs had already been retained about 10 months before I became Secretary. We moved forward right away to go out and begin to interview and talk with those who had a potential for purchasing Conrail. We looked at the public offering scenario very early--in May of 1983--and the process moved forward.

In reaching my decision, I have kept in mind the sacrifices and security of Conrail's employees, the needs of its shippers and the interest of its majority stockholder: the American taxpayer. We have labored long and hard to reach a recommendation that will best serve not only the region, but the nation.

All feasible options for Conrail's future have been weighed, including the option of not selling it. I relied on the professional advice of our investment banker, Goldman Sachs and we've consulted with the Congressional leadership and many members of Congress, and federal agencies with expertise in relevant areas. We talked with state and local officials from the region, employee representatives, shippers, Conrail management, Conrail board members, and other interested parties. Finally, and most significantly, we have honored all the directives of the statute that governs the sale process, the Northeast Rail Service Act of 1981.

As addressed in the Act, this process will assure the return of Conrail to the private sector as a strong, viable railroad. Given that Conrail is profitable, the statute requires a sale of Conrail as an entity through sale of its common stock and further requires us to submit a plan that:

-- ensures continued rail service;
-- promotes competitive bidding for Conrail's stock; and
-- maximizes the return to the taxpayer for the investment that has been made to preserve the railroad.

In honoring these statutory criteria, I am recommending a sale plan that assures long-term rail service to the region, true employment stability for Conrail's work force, and a very high level of confidence that Conrail will never again become a ward of the federal government. We can now give Conrail the opportunity to prosper as a truly private-sector business and as a key part of a stronger company.

Better single-line service to and from points in the South could reduce freight rates and improve service here in Pennsylvania. The potentially faster and more efficient movement of goods over the combined Conrail-Norfolk Southern system offers a good deal to Pittsburgh and to Pennsylvania. Similarly, the potential for cooperation between P&LE and Guilford will provide competitive access to Pittsburgh area markets from the West and Southwest via Chicago and St. Louis.

Our plan will also benefit Conrail's employees. I've had the concerns of labor very much on my mind throughout this process because of the tremendous contributions the employees have made to the turnaround of Conrail. They've given wage concessions and increased productivity, all within the spirit of outstanding cooperation. It's time the employees are able to make plans for the future -- and with Norfolk Southern, they can do just that. The employees will indeed benefit by working for a strong, viable and financially healthy railroad.

We don't expect reductions in force as a result of our plan. The number of employees affected -- a net of about 1200 people -- represent less than one-half of the combined Norfolk Southern-Conrail normal yearly attrition rate.

As you know, the Norfolk Southern bid was subjected to a six-month-long, exhaustive review by the Antitrust Division in the Department of Justice which, I might add applies more stringent standards than does the Interstate Commerce Commission. As a result of that review, the Norfolk Southern has agreed to divestitures of some lines to smaller railroads and other remedies which will ensure that competition is preserved in the Conrail service region. Where there were three competitive railroads before the sale, there will be three afterwards. Where there were two, there will still be two. Further, those divestitures will strengthen competition by allowing the smaller regional carriers access to new markets. Under the conditions, the purchase of Conrail by Norfolk Southern will enhance competition in two important ways:

-- The Norfolk Southern has pledged to open many Conrail gateways and institute joint routes with smaller carriers.

-- Secondly, the divestitures, opening of gateways and granting of trackage rights and reciprocal switching agreements necessary to satisfy the Justice Department's requirements will strengthen the competitive position of smaller railroads in the regions served by Conrail.

The divestitures that Norfolk Southern will make to the Pittsburgh and Lake Erie Railroad will provide new competitive opportunities in Pittsburgh. By strengthening the P&LE's position, the divestitures can save as many as 1000 jobs in the Pittsburgh area. In total, there would be about 1700 miles of track divested to the smaller railroads -- 615 miles to the P&LE alone -- thus creating a pro-competitive effect. As a result, the P&LE will have an opportunity to break out of a situation where it's been basically isolated by Conrail competition.

By giving the P&LE these new "windows to the world" -- leading to auto producing centers and coal consuming areas elsewhere -- we believe the divestitures will lead to a renewed flow of traffic over that system. For instance, the divestitures to the P&LE are designed to address the problem of linking steel plants in Pittsburgh with their sister facilities in the Cleveland, Canton and Youngstown areas and with consuming centers in the upper midwest. Although Norfolk Southern's operations through the

Pittsburgh area are limited, it is clear that had not some of the Norfolk Southern lines been offered to the P&LE, they would ultimately have been abandoned.

Norfolk Southern will pay us a minimum of $1.2 billion in cash at closing. The actual dollar amount will probably be higher, since the final purchase price is keyed to the amount of cash Conrail has on the day of closing. Norfolk Southern will also surrender Conrail's accumulated tax benefits. This surrender of tax benefits -- $2.1 billion in net operating losses and $275 million in investment tax credits -- represents true value to the Treasury and is an important element of the total compensation. Norfolk Southern has also agreed to be bound by a strong set of protective covenants that will safeguard the public interest for five years during the transition to private ownership. And I feel strongly the covenants are a key part of this proposal. The financial strength of this railroad is crucial, and these covenants are designed to go right to the heart of it. All of these elements are part of the consideration we will receive for the government's 85 percent of Conrail's common stock. Those who focus solely on the cash portion of the consideration are overlooking major portions of the value for which we have bargained over these many months.

We might have received a higher cash price for the stock if we had been willing to forego the protective covenants. In fact, I'm certain we would have. Controlling stockholders are not generally accustomed to the sorts of restrictions we have negotiated with Norfolk Southern, but I believe they are essential to the public interest. The covenants will preserve quality service, protect Conrail's shippers, and ensure continued financial strength. The covenants require Norfolk Southern to operate Conrail as a system much as it is today.

Norfolk Southern has agreed to invest hundreds of millions annually in Conrail's physical plant and to refrain from deferring maintenance to any level below Norfolk Southern's own standards, which are the highest in the industry. The covenants require Conrail to refrain from paying dividends on the common stock unless $500 million in cash would remain after those dividends are issued. Norfolk Southern is bound by the covenants to maintain its controlling ownership interest in Conrail for five years. Conrail's expedited abandonment authority will be relinquished, and any lines that are abandoned will be offered to shippers or short line railroads at 75 percent of net liquidation value. All of Conrail's current minority business enterprise and equal employment opportunity programs will be continued. Conrail will maintain its headquarters in Philadelphia and will continue to operate the Altoona shops. All of these covenants are enforceable by federal court injunction. Norfolk Southern has also answered that the Conway Yard in Pittsburgh will continue its important role in system operations.

It is important to note the Conrail-Norfolk Southern agreement does not provide Norfolk Southern with any form of special tax treatment. The tax treatment, in fact, is the same whether Conrail remains in the Federal government, whether it's sold to a private buyer, or whether a public offering is held. In every case, Norfolk Southern has agreed, and in some cases the Department has in fact warranted, that normal tax consequences will apply. The Treasury Department has reviewed the agreement and reaffirmed that fact.

Federal ownership does not in and of itself make Conrail immune to federal tax liability. Conrail files annual returns, and has used its considerable tax benefits to shelter the income it earned over the past four years. If the government simply keeps

Conrail, the full \$3 billion in depreciable Conrail basis will be available to Conrail to shelter its income, as it has been in the past. The major difference is that with the Norfolk Southern sale, \$2.4 billion in investment tax credits and net operating losses will be yielded back to the federal government.

But depriving Conrail of the right to deduct depreciation, as is available to all of its rail and non-rail competitors, would be both unfair and unwise. Such action would place Conrail at a significant competitive disadvantage and deprive it of funds needed to continuously renew its capital assets. The resulting costs would inevitably be passed on to Conrail shippers.

Now there've been some recommendations that the sale be delayed in the hope that we might get a somewhat higher purchase price. In my opinion, and that of our investment advisor as well, a "better" opportunity will never arrive. We solicited offers in good faith, and were rewarded by a wide range of credible offers by serious bidders. The bidders believed we intended to sell a railroad. Conrail's contract employees also have treated the sale process seriously, dealing constructively with each offer presented and making their own offer as well. Since passage of the Northeast Rail Service Act in 1981, Conrail has become profitable at no small cost in time and effort. State and local transit agencies took over commuter rail operations under the Act's directive, Conrail's employees made significant wage concessions, and the states in the region have sacrificed tax revenues from Conrail totaling between \$25 to \$60 million annually. Without Conrail's exemption, Pennsylvania -- for example --would have collected \$10.2 million in state taxes in 1984.

A public offering of Conrail stock also has been suggested. At my request, Goldman Sachs considered a public offering early in our deliberations. Back in May of 1983, to be exact. Goldman Sachs advised me that there were practical difficulties and substantial risks with a public offering. Thus, I used the competitive bid approach, and I conducted extensive negotiations simultaneously with six bidders and then three finalists.

In January, some members of Conrail management submitted a proposal based on a public offering. Again, I asked Goldman Sachs to review it. Measured against the criteria I had established, Goldman Sachs advised me that the Conrail management proposal is less advantageous than the Norfolk Southern bid in a number of respects. And let me review those quickly.

First, the management plan takes a minimum of \$300 million in cash out of the company, regardless of its cash position. Second, the management plan forces the company to issue \$600 million in preferred stock bearing cumulative dividend obligations. In fact, this would be the largest preferred stock issue in American history. In contrast, Norfolk Southern's proposal involves neither preferred stock nor fixed dividend requirements.

Third, the management plan clearly violates the dividend covenants that Norfolk Southern has accepted. Based upon Conrail management's own projections for the 1985-88 period, the dividend covenants would allow a total of only \$60 million per year in dividends on common stock. The management plan requires combined common and preferred dividends of at least \$126 million per year, and it would require increased borrowing by Conrail over the next four years of \$422 million.

Fourth, there is no firm commitment by Morgan Stanley or anyone else to underwrite the management public offering plan. I have only been given estimates, opinions, and predictions. If the market is unable to absorb $500 million in common stock and $600 million in preferred stock in one offering, then either the government or Conrail would have to absorb the shortfall. Since there only has been one initial public offering of over $300 million by an industrial company in American history, the risk is very large. Yet that one offering by the Ford Motor Company in 1956 had many advantages a Conrail offering would not have.

Fifth, despite optimistic estimates made by some that we can get much more for Conrail through a public offering, the management plan only proposes to raise $1.1 billion at best. Again, the balance is to be paid out of Conrail's treasury.

Take a moment to look at this issue from my perspective. I must determine what is best for the employees, best for the shippers and -- overall -- what is best for the public. I have one goal and one goal alone and that is to serve the public interest. In the one instance, I have a bird in hand. I've got $1.2 billion, cash on the barrelhead paid to the government on the day of closing. And any cash over $800 million in Conrail on the day of closing goes to the government. I have the surrender of net operating losses of $2.1 billion and investment tax credits of $275 million. That's real value to the Treasury. And I have a lot of tough covenants designed to ensure the financial strength of this railroad. On the other hand I have an opinion. "We are of the opinion," Morgan Stanley wrote to me, "that the public offering is feasible." What would you do if you were in my position, if you had a bird in the hand -- a strong deal -- as opposed to an "opinion." And an opinion that involves uncharted waters. An opinion that would result in the largest component of preferred stock ever offered in the history of the United States and an industrial common stock offering only surpassed in size by Ford Motor Company in 1956. And what do you do about the covenants in a public offering?

Another important point to recognize is that Conrail's freight traffic over the past 20 years has been declining -- from about 380 million tons carried by its predecessors in 1964 to 190 million tons last year. And by Conrail's own projections, profits will decline in 1986 and 1987.

Now, you want a strong railroad -- if you don't want lines abandoned and service diminishing and you don't want downgrading of the lines -- that means the railroad has to be financially healthy. We want to maximize the return to the government, but that is only after we ensure the financial strength of the railroad.

Because the Conrail management plan takes so much cash out of the company and requires huge additional borrowings, it would soon leave the company with less than half of the cash necessary at a minimum to cushion it against adverse developments, such as a strike. Conrail would go from cash-rich to cash-poor.

I have made what I truly believe is the best recommendation for a strong Conrail in the future. Now it is Congress' turn to act.

Four years ago, Congress directed us to take the government out of the freight railroad business. I have made the utmost effort to find the best possible buyer for this railroad. I have negotiated a strong, bona fide financial package with due regard for the competitive implications of the transaction. I would suggest to you that if you were in my position you would have taken the very same course and made the same decision you would have made had you been in my position.

Change is crucial if we are to meet the challenges of moving goods more efficiently and effectively. "If you want to make enemies," Woodrow Wilson used to say, "change something." I prefer to think we are making progress -- listening as well as leading, considering the views of all those affected before we challenge old courses or chart new ones.

Let me just say how much I appreciate your listening to me tonight and giving me the opportunity to talk about Conrail so that I could really lay my case before you.

Thank you very much for inviting me.

# # # #