TESTIMONY OF FEDERAL RAILROAD ADMINISTRATOR JOHN H. RILEY BEFORE THE SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

June 12, 1985

Mr. Chairman. The specifics of the Morgan Stanley offer differ to some degree from the public offering proposals Secretary Dole considered over the past eighteen months. My colleague, Ken Brody of Goldman Sachs will provide the Committee with a detailed review of the specifics of the Morgan Stanley plan, and the Department's concerns about their impact on Conrail's future financial stability.

For my part, I intend to review the offer from a broader public policy perspective. If some of my points seem familiar, it is because the policy implications of this offer -- and in fact, some of its most prominent participants -- are no different from the implications of the old Citicorp offer, and the original management-Morgan Stanley public offering. Secretary Dole weighed these offers, as well as the concept of a direct public offering, against three fundamental criteria:

- The financial strength of the Corporation,

- The impact of the offer on Conrail's ability to serve its shippers and communities, and

- The financial return to the Government.

Under these public interest criteria, the original Citicorp and Morgan Stanley offers failed the test of comparison with the Norfolk Southern plan. Under the same criteria, the latest draft of the Morgan Stanley offer fails for many of the same reasons.

The first criterion is the most critical test, because financial strength is the key to service and job stability. The Norfolk Southern proposal leaves Conrail in a stronger financial position than the Morgan Stanley plan for a number of reasons.

Norfolk Southern does not leverage even one dollar of the purchase price off Conrail's assets, and uses none of Conrail's cash. In contrast, Morgan Stanley reserves the right to use $300 million of Conrail's cash to complete the purchase transaction. There should be no confusion about the impact of this difference.

On the day of closing, the Norfolk Southern offer leaves Conrail with $800 million in cash and no additional debt. On the day of closing, the Morgan Stanley offer leaves Conrail with $500 million in cash, the absolute minimum the Corporation needs to have to retain a safe operating reserve. Norfolk Southern pays a minimum $1.575 billion for the Corporation, including settlement with Conrail's employees, while Morgan Stanley's investors pay $1.2 billion and take the rest out of the Corporation.

Norfolk Southern has agreed to covenants strictly limiting dividends to a fixed percentage of annual income. Morgan Stanley claims to adhere to the same covenants, but if one reads the fine print, you will discover that the first year is defined as an eighteen-month period. That is truly creative financing, and it enables the Morgan Stanley investors to withdraw approximately 50 percent more in dividends during the first year than Norfolk Southern can under the terms of the Memorandum of Intent. Not surprisingly, Morgan Stanley has also crafted significant exceptions to the minimum cash requirements.

The Norfolk Southern will bring Conrail at least $180 million in additional traffic volume each year. More volume means more jobs, and more financial stability for Conrail. The Morgan Stanley offer brings Conrail no additional volume.

The Norfolk Southern offer does not require Conrail to siphon off its cash into dividends to build a public market for Conrail stock. Unlike the Morgan Stanley investors, Norfolk Southern can earn a return on its investment from the improved traffic flows and better routings it acquires in the merger. In other words, it does not have the same need as the Morgan Stanley investors to draw a cash return from Conrail's reserves, year in and year out. In contrast, the Morgan Stanley investors apparently hope to make their money through dividends, and through profits made on quick resale of the Conrail stock. Assuring these profits requires the investors to siphon off Conrail's cash into consistently high dividends to build up the stock's value and marketability. A recent analysis by Kidder, Peabody & Co. -- which is not under retainer to any of the parties in the Conrail sale -- projected that because of Conrail's weak marginal cash flows, dividend requirements similar to the Morgan Stanley plan would leave Conrail with a cash shortfall in the hundreds of millions of dollars by 1988.

The Norfolk Southern/Conrail combination also broadens Conrail's traffic base, making it less recession sensitive by increasing Conrail's access to commodities such as coal and grain. Morgan Stanley does nothing to broaden Conrail's traditionally recession sensitive traffic base, or lessen the impact of economic fluctuations on the carrier and the communities it serves. The impact of this consideration was driven home dramatically in the first ninety days of this year when a few weeks of bad weather, and minor traffic fluctuations, drove Conrail more than $40 million under budget.

The efficiencies of the Norfolk Southern/Conrail merger will enhance Conrail's profitability by lowering its operating costs. The Morgan Stanley purchase does nothing to lower Conrail's costs or improve the efficiency of its operations.

Finally, Norfolk Southern brings Conrail borrowing power, along with the enormous financial resources of the Norfolk Southern system. It provides the best posssible guarantee of long-term job stability, service preservation, and high capital investment levels. In contrast, none of the miscellaneous shareholders in the Morgan Stanley plan have any reason to put their own cash resources into Conrail. They have no long-term stake in the Corporation, and have limited dollar investments at risk. It is much easier for them to write-off a decline in stock value as a capital loss. Does anyone seriously believe that Columbia University, for example, or Morgan Stanley's European investors will place additional cash resources in Conrail in time of need?

It is simply undeniable that a Conrail/Norfolk Southern combination is substantially stronger than Conrail standing alone.

The Norfolk Southern/Conrail combination will offer shippers -- and consumers -- lower, more efficient single line rates on virtually every commodity moving between the northern and southern States. Morgan Stanley would leave shippers with the need to pay joint rates and switching fees, along with the loss of time competitiveness in yard operations.

The divestitures associated with the Norfolk Southern offer will break Conrail's monopoly on single line traffic movements between the Northeast and Midwest. Today, there is only one railroad -- Conrail -- that can offer single line service from the Northeast to the major Midwestern gateways at Chicago and St. Louis. After the Norfolk Southern Corporation's acquisition, Guilford Transportation Industries will offer competing single line service to Chicago and St. Louis from a broad range of Eastern and Northeastern markets. This benefits not only Northeastern shippers, but shippers in the upper Midwest and the plain States, who will now enjoy improved east bound options in both the Chicago and St. Louis gateways. A decision to sell to Morgan Stanley would forfeit these advantages, and preserve Conrail's monopoly in the Northeast.

The divestitures will also enhance the competitive viability of the regional carriers in the Conrail region. Conrail's only real competition in the Northeast comes from these regional carriers, and their effectiveness as competitors has been progressively diminished by short-hauls and closed gateways. The divestitures provide these carriers with new connections and extensive reciprocal switching rights in the major markets of the Northeast. Norfolk Southern also will re-enter negotiations to reopen many of the more than 300 gateways closed by Conrail in its 1981 mass gateway closing. These actions increase the competitive capacity of the regional carriers, and will preserve approximately 1,000 jobs on the Pittsburgh & Lake Erie Railroad alone.

Most important, it is undeniable that financial strength is inseparable from service capacity. By leaving Conrail in a stronger position than Morgan Stanley, the Norfolk Southern Corporation's offer better protects Conrail's service capacity.

In overview to the final criterion, financial return to Government, I cannot help but recall the many times over the past four months that CSX, Conrail management, or Morgan Stanley have accused Secretary Dole of "giving Conrail away." It's ironic, isn't it, that when they had to put their own offer in writing, they offered exactly the same price.

In an effort to establish some price superiority, Morgan Stanley now argues that its plan has a $600 million tax advantage over the Norfolk Southern offer. Mr. Chairman, that argument is 100 percent red herring, and I welcome the opportunity to debunk it.

Of the three Morgan Stanley tax arguments, the reddest herring is the contention that job losses associated with the NS offer will cost the Government $245 million in lost railroad retirement taxes. That figure is based entirely on the assumption that there will be ten thousand jobs lost under an NS acquisition that would not be lost in a publicly held Conrail. Morgan Stanley offers no support for that assumption, but for the Members of this Committee, these should be familiar numbers. They are precisely the same numbers CSX predicted in its original testimony before this Committee. Terming this alleged tax saving an "illusory promise," the Pittsburgh Post-Gazette, in its Tuesday, May 21, 1985 editorial, remarked that;

> "... The figure is derived from Morgan Stanley's highly biased comparison of the impact of its takeover with that of Norfolk Southern on railroad retirement and unemployment tax payments. Indeed, this element of the proposal is so completely self-serving that it is difficult not to see the spoiling hand of Norfolk Southern's leading competitor, the CSX railroad system that is a primary investor in the Morgan Stanley plan."

Secretary Dole answered these employment allegations in her testimony before this Committee, and I will not take more of the Committee's time to repeat her response. I will, however, submit an additional written response for the record. But given the way Morgan Stanley is trying to use these numbers, it is important to understand why there would be no reduction in tax revenue even if the CSX threats were well-founded.

CSX argues that an NS/Conrail combination would divert so much traffic from the Baltimore & Ohio Railroad Company (B&O) that 10,000 employees would have to be layed-off. If a diversion of that magnitude did in fact occur, there might be a loss of employment to CSX, but -- given the fact that the number of employees required to serve 100 million tons of freight is a relatively constant number -- there would be a countervailing gain in employment to NS/Conrail. In other words, if it does in fact take 10,000 employees to service the diverted traffic at CSX, and that traffic were shifted to NS/Conrail, NS/Conrail would have to hire 10,000 more employees to service the traffic it had gained. There might be an employment shift between the two companies, but there would be no net decrease in rail employment, and thus no net decrease in the retirement and unemployment taxes paid.

But Mr. Chairman, these numbers are not correct. They fly in the face of logic and of management's own estimates. The number of jobs on a railroad are directly related to the volume it carries. It is undeniable that an NS/Conrail combination will carry at least $180 million in additional volume that a stand alone Conrail will not carry. Moreover, the lower single line rates NS can offer on north-south carriage will divert significant volumes that are now moving on trucks, resulting in a net increase in railroad industry employment. The net employment impact of an NS/Conrail merger is approximately 1200 jobs. In contrast, by management's own estimates, a publicly-held stand alone Conrail will have to eliminate 4,500 jobs over the next four years to meet its profit projections.

Morgan Stanley then makes the argument that the Federal government would lose an additional $350 million because an NS/Conrail combination could use Conrail's investment tax credits and depreciation benefits more quickly than Conrail standing alone. Before pointing out the flaws in this argument from a technical tax perspective, I cannot resist observing that this argument on its face concedes that Conrail is likely to be more profitable and more financially secure as part of the NS system that it would be standing alone. And that's a strong argument in its own right for the NS plan. But on a strictly revenue basis, there are at least two problems with this analysis.

First, note that NS acquires no investment tax credits (ITC's) in the Conrail purchase. Under Section 4 of the Memorandum of Intent, NS forfeits 100 percent of Conrail's ITC's on the day of closing. That includes not only the credits acquired with Federal dollars, but the credits acquired with Conrail's own dollars after the Federal subsidies ceased. The ITC's Morgan Stanley refers to are generated by new investments made in Conrail after the date of closing. They derive from the investment of NS dollars, and any other owner, in a private sale or public offering, will generate the same level of ITC's with the same investment. Moreover, NS could generate the same ITC stream by simply investing the same dollars in some part of its system, or in an outside investment other than Conrail.

Second and more important, Morgan Stanley fails to point out that a stand alone, publicly-held Conrail can and in fact has produced a similiar "time advantage" through leveraged leasing transactions. Under current law, a company that cannot make immediate use of its tax benefits can pass the benefits onto a wealthier taxpayer through sale and leaseback arrangements, or similar transactions. Conrail management has already utilized this technique to the extent of nearly $1 billion over the past five years. In fact, the entirety of Conrail's 1981 profits came from leasing transactions. And if you read the fine print, the Morgan Stanley proposal assumes that the publicly-held Conrail will indulge a minimum of $125 million per year in tax leasing.

These leasing transactions give stand alone Conrail a similar ability to force immediate recognition of tax benefits generated with by respect to a substantial portion of Conrail's investment. Using figures supplied by Coopers & Lybrand -- Conrail's own accountants -- Goldman Sachs estimates that the net present value difference between the NS offer and a stand alone Conrail, even using Morgan Stanley's conservative leasing numbers, totals only $30.77 million dollars. That assumes, incidentally, that current law prevails on the date of closing. There appears to be a significant chance that fundamental tax reform will in fact become law this year. And if the current Treasury tax proposal becomes law, Goldman Sachs estimates that the Treasury would collect approximately $8 million more in taxes from an NS/Conrail combination than it would collect from Conrail standing alone.

These are the net present value differences between the two proposals under the three issues Morgan Stanley raises. But there is another issue, one that Morgan Stanley does not raise. It stems from an apparently innocuous provision concerning Conrail's earnings and profits account that Morgan Stanley has inserted in its proposal.

Conrail presently has a nearly $1 billion dollar deficit in its earnings and profits (E&P) account. A negative E&P account would have the practical impact of sheltering hundreds of millions of dollars in dividends paid by Conrail to individual shareholders from Federal income taxation. Morgan Stanley offers to yield back the negative account, and in fact has asked Congress to legislate a $500 million surplus in the account.

But on close inspection this isn't the generous sacrifice it might seem to be on its face. Morgan Stanley shareholders are not individuals. They are either tax exempt institutions, or corporate purchasers who cannot benefit from a negative E&P account to any substantial degree because they already qualify for the 85 percent corporate dividend exclusion. In other words, the Morgan Stanley investors -- given their makeup -- are surrendering nothing, since they draw little or no benefit from the existence of a negative E&P account.

Conversely, however, they can draw an enormous tax shelter from its elimination and the establishment of a $500 million positive balance. Why? Because distributions paid under a negative E&P account are considered return on capital, and thus lower the investors' basis in its stock. The lower the basis, the more Morgan Stanley investors would have to pay in capital gains taxes when they resell their stock shortly after closing. By eliminating the negative E&P balance, and replacing it with a positive one, Morgan Stanley effectively shelters its non-tax-exempt investors from an enormous capital gains exposure by precluding any reduction in basis from the payment of the $120 to $200 million in annual projected dividends.

This simple procedure will enable the Morgan Stanley investors to shelter up to $500 million in cash distributions from both capital gains and normal income taxation. This is particularly significant in a plan where the investors envision turning over all or a substantial portion of their investment as quickly as possible.

The bottom line to this tax analysis is fairly simple. With the exception of the E&P account issue, there is, in truth, very little difference among the tax consequences of the various Conrail purchase formats. The net return to Government is virtually identical. There is nothing in this third criteria to outweigh the enormous financial strength and service advantages NS brings to the transaction.

Mr. Chairman, this concludes my formal statement. I will be happy to answer any questions you and the Members of this Committee may have.