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BEFORE THE HOUSE ENERGY AND COMMERCE
SUBCOMMITTEE ON COMMERCE, TRANSPORTATION AND TOURISM

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Mr. Chairman. I appreciate the opportunity to express the Department of Transportation's views on this latest revision of the Allen & Company offer.

Neither Allen & Company nor First Boston are newcomers to the Conrail sale process. My first recollection of First Boston was their attendance at an initial meeting with Alleghany Corporation; Allen & Company had submitted a proposal somewhat similar to the one now before us in early 1984.

Despite a general similarity between its offers, I must begin by telling the Committee that my ability to comment this morning on several aspects of the new Allen & Company proposal is limited by a lack of information. After receiving notice of the new Allen & Company offer, the Department asked its investment advisor, Goldman Sachs & Co., to contact senior officials at Allen & Company, and discuss their offer in detail. That conversation led to a written inquiry seeking information substantially similar to that requested from and provided by the other bidders. In response to that inquiry, Allen & Company has provided Goldman Sachs with copies of H.R. 4429, a specimen Purchase Agreement and its amended S-1 filing with the Securities and Exchange Commission, but has not responded specifically to the questions Goldman Sachs asked.

I will submit a copy of the Goldman Sachs' correspondence for the record, and provide the Committee with the Allen & Company's specific response when it is available. After viewing that response, I may also have some additional substantive comments. However, even without that information, it is evident on the face of H.R. 4429 that the Allen & Company offer fails to meet Secretary Dole's sale criteria as effectively as the offer submitted by the Norfolk Southern Corporation.

It is important to recognize that unlike the Norfolk Southern offer, the price offered by Allen & Company is not guaranteed. If given the right to purchase, Allen & Company's Conrail Acquisition Corp. would conduct a public offering, and pay government whatever the offering raised. The United States government bears 100 percent of the risk of shortfall -- a risk not insignificant, since this would be one of the largest initial public offerings ever attempted in the United States. The Allen & Company offer does nothing that the federal government could not do itself, through its own investment banker. And from the onset of the sale process, the Department of Transportation has made clear to all potential bidders that the United States government would not bear the risk of non-performance in any offer. Because the Norfolk Southern offer is a firm offer from a corporation with the resources to perform, it eliminates that risk.

Second, the Allen & Company (Allen) offer strips Conrail of between $0.25 - $0.5 billion in assets to finance the purchase. Like Morgan Stanley, the Allen offer removes $230 million from Conrail's cash reserves to finance its labor agreement, lowering those reserves to a point just above the minimum needed to insure continued operation of the railroad over the short-term. The Allen offer would also, under certain circumstances, take an additional $0.25 billion from Conrail's reserves to pay the federal government. This $480 million far exceeds what any other bidder proposed to leverage off Conrail's assets. It would appear, on its face, to drop Conrail's reserves below the $500 million needed to assure the Corporation's short-term viability. In contrast to both the Allen and Morgan Stanley bids, Norfolk Southern funds the entirety of the purchase, including its labor settlement, from Norfolk Southern assets.

In addition, the Allen offer requires, as a precondition to closing, that Conrail arrange a $300 million credit line leveraged against the Corporation's assets. How those funds will be used is unclear, but the imposition of an additional $300 million in leverage, coupled with Allen's refusal to accept the covenant designed to prevent payment of dividends with borrowed funds, is a source of serious concern. Overall, the Allen plan could permit up to $780 million in leverage against Conrail's assets, making it leverage leader among the various Conrail bids.

Third, Allen & Company has refused to accept the covenant against asset stripping that Secretary Dole incorporated in the Norfolk Southern agreement. The Allen offer would permit Conrail to borrow to pay dividends -- a practice that proved disastrous to Conrail's predecessor, the Penn Central. It would also permit the Allen investors to drawoff the entirety of Conrail's cash reserves, replacing them with funds borrowed or raised through the issuance of preferred stock. This is an open-door to asset stripping, something expressly precluded by the language of the Norfolk Southern agreement.

Fourth, H.R. 4429 would shield the Allen investors from liability for prior year state tax assessments, a risk all other bidders have been willing to assume.

More important than any of the specifics, however, is what the Allen offer does not do. Like the Morgan Stanley offer -- and unlike Norfolk Southern's -- the Allen offer brings Conrail nothing to compensate for funds leveraged off the corporation, or dividends paid to its investors. That, in our judgment, is fatally at odds with the public interest criteria the Secretary established at the onset of the Conrail sale process.

For nearly three decades, Conrail and its predecessors have suffered from a series of structural weaknesses that have forced the railroads to cannibalize their own assets -- or seek federal subsidies -- to survive. Those weaknesses include:

- A network of north-south routes too short to generate the efficiencies necessary to be price-competitive with other railroads and other modes.

- A service region experiencing a long-term sectorial shift from heavy to light industry, resulting in annual traffic declines averaging 3.6 percent for the past twenty years.

- A traffic base that is highly truck divertible, along with coal reserves smaller than that of any major railroad.

Since the cut-off of federal operating subsidies in 1981, Conrail has had no alternative but to cannibalize its own resources in an effort to break even as a stand alone railroad. That process has inflicted enormous sacrifices on all who depend on the railroad, sacrifices measured in lay-offs, abandonments, subsidies, and liquidations. Over the past year alone, stand alone Conrail has been forced to buttress its cash flows by ....

- eliminating 2,800 jobs,

- liquidating $90 million in railroad property,

- seeking and receiving more than $11 million in federal labor protection subsidies, and

- posting 570 miles of line for potential abandonment.

Conrail's own projections suggest that this process will continue into the future, and Conrail management has talked openly of the need to shrink the stand alone railroad another 4,000 to 5,000 miles.

The tragedy is that even these enormous sacrifices have not brought Conrail financial stability. We have all seen reports of Conrail's impressive net income -- $442 million in 1985, and another $20 million in January and February of 1986. Those are accurate figures, but it is important to recognize net income for what it is.

Net income is not a bottom line figure. It measures Conrail's income but not its net cash position after the railroad makes the enormous capital investments necessary to keep its facilities in sound operating condition. In recent years, those investments have exceeded $500 million annually; that figure will grow to more than $600 million a year over the last half of this decade. When one looks at cash flow figures -- Conrail's actual bottom line, after taking account of capital investment -- the picture changes dramatically.

For example, Conrail claims a "net income" of $20 million for the first two months of 1986. That seems impressive, but after capital investments are accounted for, Conrail's cash reserves have actually dropped by $29 million over the same period. To say the same thing another way, -- despite impressive net income figures -- Conrail's cash reserves have been dropping $0.5 million a day since January 1. Were it not for the layoffs, property sales and abandonments, state tax exemption, and federal labor protection subsidies, Conrail's annual operating losses would reach the hundreds of millions of dollars.

To sell Conrail in a way that fails to address its structural weaknesses condemns the railroad to continue this cycle indefinitely. And as Secretary Dole has so persuasively argued, Conrail simply cannot shrink itself into prosperity. As CSX Corporation Chairman and Chief Executive Officer Hays Watkins once observed,

> "... The sale of Conrail to a non-railroad entity fails to shore up Conrail's inherent vulnerability."
>
> "... Conrail would remain a regional carrier without committed reserves to abide the cyclical adversity which has beset every railroad that has ever operated in its territory."
>
> Hays Watkins
> Letter to Secretary Elizabeth H. Dole
> November 16, 1984

> "Conrail's traffic base is eroding. Its ton-miles probably will be lower three or five years from now than they are today, just as they are lower today than they were five years ago. There is no escaping this fundamental conclusion."
>
> "... The business cycle will produce a recession at some point, and the market will only support two carriers. Because of Conrail's particular vulnerability to truck diversion, its lack of significant coal reserves, and the lack of a strong parent, an independent Conrail will be the carrier to fail ..."
>
> Hays Watkins
> Letter to Secretary Elizabeth H. Dole
> June 13, 1984

Conrail needs a buyer that will bring it strength and stability -- not take strength away. Norfolk Southern fits that criteria better than any other bidder.

The compelling advantage of the Norfolk Southern offer lies in the fact that it is the only offer capable of addressing Conrail's structural problems. It brings Conrail better routes, new markets, and a substantial increase in shipping volume. The merger extends Conrail's north-south routes so they can again be competitive with trucks and other carriers. It brings Conrail financial strength, and a better chance of surviving future economic downturns without cutting service and sacrificing jobs. By any measure, a Norfolk Southern/Conrail combination is far stronger financially than Conrail standing alone.

Because it alters Conrail's structure, the Norfolk Southern purchase also provides consumer advantages no other bidder can duplicate:

- A Norfolk Southern purchase, with the divestitures to Guilford Transportation Industries, Inc., will break Conrail's monopoly on single line service from Chicago and St. Louis to the northeast, opening new competitive opportunities for midwest farmers and shippers.

- It will reopen many of the more than 100 gateways and joint routes that Conrail closed to competitive traffic three years ago.

- The Norfolk Southern agreement lowers reciprocal switching charges by amounts ranging from $46 to more than $100 per car across Conrail's midwest service region, increasing shipper access to competitive options.

- By providing less costly single line service to shippers from the Canadian border to the Gulf of Mexico, the Norfolk Southern proposal could actually lower rates for shippers and consumers in the south and northeast.

It is essential to remember that Norfolk Southern has placed more of its own dollars on the table than any other bidder. Others have sought to enhance their bids by stripping Conrail of its cash or burdening it with debt, but that approach is in neither the railroad's nor the public's long-term interest.

But perhaps the most persuasive difference between the competing offers lies in the nature of the acquisitions themselves. Norfolk Southern wants to buy a railroad, to integrate that railroad into its transportation system for the long-term. The other bidders want to buy stock, and particularly in the case of the Morgan Stanley investors, stock they believe they can resell at a profit in the short-term. Norfolk Southern is best able to assume the risk of Conrail's uncertain future, and only through a Norfolk Southern purchase can we address the structural problems that have inflicted so much loss on northeastern railroads, shippers, and employees over the last three decades.

Many of the factors that make the Allen & Company and Morgan Stanley proposals attractive to short-term investors are the very factors that would endanger the railroad's financial stability over the short and long run. In contrast, the Norfolk Southern Corporation is a buyer for all seasons. By every measure -- service enhancement, financial strength, employment stability, and managerial skill -- the Norfolk Southern Corporation's offer brings more to Conrail and those who depend on it than any other option.